LEWIS WEALTH MANAGEMENT

Quarterly Newsletter

4th Quarter 2017

January 23, 2018

Market Data as of December 31, 2017

		2017
U.S. Equities	Russell 3000 ETF	20.95%
International Equities	MSCI EAFE ETF	24.94%
Emerging Markets Equities	MSCI Emg Mkts ETF	36.42%
U.S. Bond Market	Barc Agg ETF	3.59%
U.S. Bond Short Duration	Barc U.S. 1-3 Year ETF	1.27%
Hedging Strategies	HFRX Global Hedge	5.99%
Commodities	S&P GSCI Comm ETF	4.48%
Real Estate	DJ U.S. Real Estate ETF	9.37%

Executive Summary

Equity markets around the world had a fantastic year. We are currently enjoying the second-longest bull market since World War II.

The Fed has helped foster this market by keeping interest rates low, which has caused investors to sell bonds and continue buying stocks.

But the Fed and other central banks have reversed course, and we should take notice.

Stock valuations have become elevated. The price/earnings ratio for the S&P 500 is at 26.8, about 50% higher than its historical average. Inflationary pressures are gaining momentum, and we are at full employment.

No one knows how much longer these markets can continue to rise. We should be prepared for changing market conditions, and be very clear about our strategies and tactics. We should caution against viewing the markets solely through a political lens.

It's time to make sure you have a sound asset allocation and that it is correctly balanced.

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What a Year!

Equity markets around the world had a very, very good year. U.S. stocks were up 20%. International stocks were up 25%. Emerging market stocks were up 36%.

We are currently enjoying the second-longest bull market since World War II. The Federal Reserve has been hoping and fighting for this outcome for a long time. ***The Fed has played a significant role in this current market, but that role has recently changed, and we should take notice.***

Since the Great Recession of 2008–2009, the Fed has driven down short-term interest rates lower and lower. In fact, the 10-year Treasury yield is still lingering at about 2.5%. Because current expectations of inflation are at about the same level, the long-term expected real rate of return on government bonds is zero.

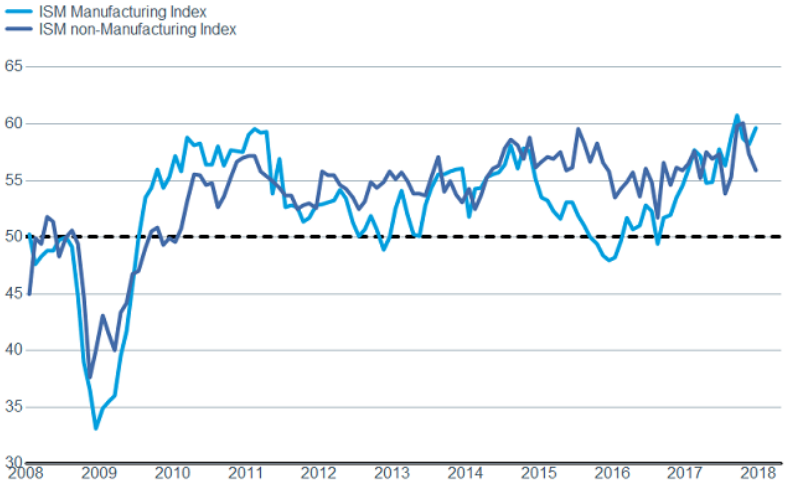
Consequently, over the past 9 years, investors have been selling bonds and buying stocks with the hope of higher returns. This has fueled historic returns in the stock market. ***The S&P 500 has gained***

more than 200% in the 7 years from 2009 to the month before the 2016 election. The total increase is now about 300%.[1]

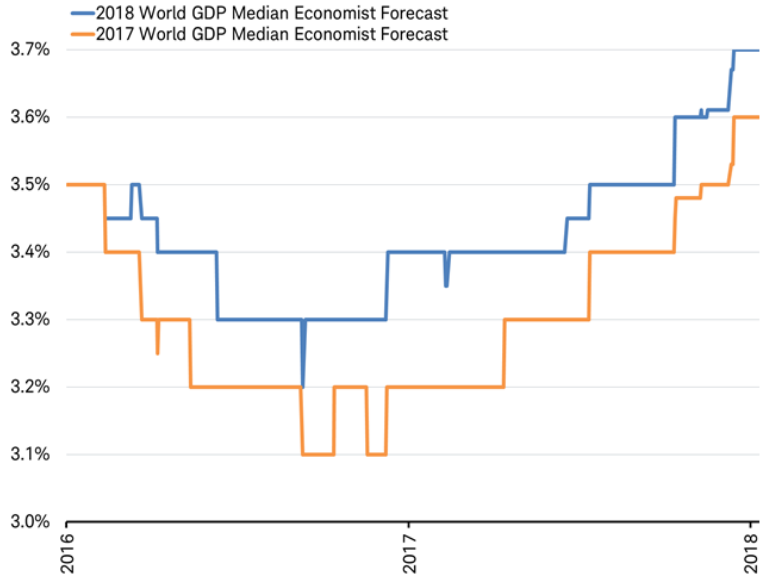
But the Fed has reversed its course. It raised short-term interest rates several times last year, and more increases are planned for this year. Why?

Stock valuations have become elevated. The price/earnings ratio for the S&P 500 is at 26.8, about 50% higher than its historical average. Inflationary pressures are gaining momentum, and we are at full employment.

Business confidence remains high.

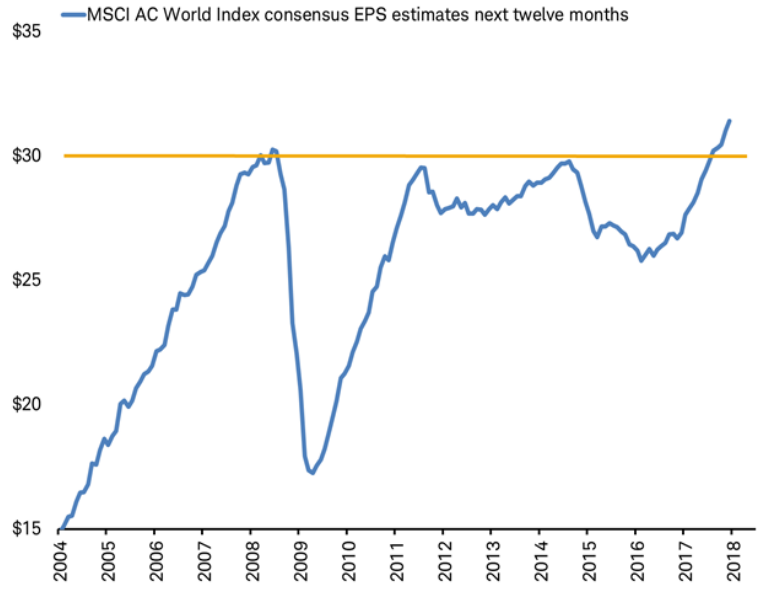


Economists continue to revise their GDP forecast up for 2018.



[1] Feldstein, Martin. Stocks Are Headed for a Fall, *The Wall Street Journal*, January 16, 2018 (Mr. Feldstein is a professor at Harvard University and was the chairman of the Council of Economic Advisors under President Reagan).

Global earnings per share outlook has exceeded $30.



How Long Can This Last?

No one knows for sure, and don't trust anyone who says they do. But we can draw several commonsense conclusions from what is going on.

No one has abolished the business cycle. ***There will be a correction eventually.*** We just don't know when. At this point, I believe we are much closer to a market top than we are to a market bottom, but that is not always clear.

Central banks are no longer trying to stimulate the economy – they are trying to restrain it. The Federal Reserve is tightening the money supply by raising short-term interest rates several times this year. Central banks around the world are pulling back on further economic stimulus. This should slow down economic growth over time.

Expectations of continued earnings growth are high, which means that even good earnings may disappoint high market expectations.

Volatility has been at historic lows. ***Behavioral finance experts warn that even a small amount of downside volatility may surprise some investors who have grown to expect placid markets.*** Some investors have forgotten (or did not experience) the painful periods of volatility in 2008–2009.

We may be experiencing a "melt up" this year. A melt up is a dramatic and unexpected improvement in the investment performance of an asset class driven partly by a stampede of investors who don't want to miss out on its rise, rather than by fundamental improvements in the economy. These investors create upward momentum in stock prices. Recently, have you noticed the market setting new records when there is little or no positive news to support the rise?

Are You Feeling Fearful, Greedy, or Both?

My favorite Warren Buffett quote is that you should be fearful when others are greedy and greedy when others are fearful. This is great advice, of course. But what if some people are fearful and greedy at the same time?

If you are feeling fearful, you are not alone. I hear from investors who see how far the markets have come and how long this bull market has endured. They are concerned about the potential for policy error in Washington. They are concerned about overexuberant investor behavior.

If you are feeling greedy, you are also not alone. These investors feel that the "animal spirits" of the market have finally been released. They are excited about the recent tax reform law, and how that may boost corporate profits even further. They believe the new direction in Washington is refreshing.

Some of us are feeling fearful and greedy at the same time. There is no denying that we had a good year and that the economy is humming along. We are currently enjoying outsized investment returns, but we also have concerns and reservations about the future.

Politics Corrupts Our Investment Judgment

Complicating matters is our polarized political climate. In my view, politics corrupts our investing judgment. If you lean to the left, you are much more likely to be pessimistic about the markets this year. If you lean to the right, you are more likely to be optimistic. Just remember that politics and investment markets move independently. Yes, they are interdependent to a degree, but not as much as many investors want to believe. ***Too many investors look at the capital markets through a political lens.*** That's a mistake.

Recommendations

Be objective. Look at reliable measures of performance, like corporate earnings, when making judgments about the markets. Don't let your political passions corrupt your investment decisions.

Be logical, not emotional. The pain of losses on the downside and the regret of missing out on the upside are mathematically identical and should be treated the same. But they are not. Most people feel the pain of losses much more acutely than the regret of missed opportunities. This means they are much more likely to panic during a down market. This is a common weakness to understand, appreciate, and guard against.

Be prepared for all market conditions by using a sound asset allocation. Use a diversified portfolio of stock investments to take advantage of market upside. Use conservative asset classes, like bonds, to help support the portfolio if the markets take a dive. How much of each asset class to deploy will depend on a number of individual factors, like your risk tolerance and your goals and objectives.

If you are already using a sound asset allocation, now is the time to rebalance!

Be reasonable when it comes to your expectations. Great investors know that good long-term returns require consistent and disciplined exposure to the capital markets over time. Market timing does not work. Because of this fact, great investors understand they will lose money from time to time, and there is no way to consistently avoid these losses without also missing out on the upside, which historically has been greater in the long run.

Great investors also know that if we are disciplined and have a sound investment philosophy, our chances of making money over the long term are very, very good, even if we have periodic setbacks.

If you have questions or concerns about your situation, please give us a call at (855) 353-3800.

Thank you,
Austin Lewis