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OUTLOOK 2018

Presented by the Investment Policy Committee
of Clearwater Capital Partners, LLC

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Introduction

Our many clients and friends are familiar with the time and care we devote each January to setting forth a baseline set of economic assumptions and observations for the coming year. Our goal is to develop an intelligent wealth management framework that will inform and guide our investment strategies.

Each year we remind our readers that our purpose in creating this report is not to time market movements or even to establish trading parameters. Our perspectives remain long-term and our conviction for owning quality financial assets throughout market cycles remains intact. We do, however, believe it is beneficial to develop expectations and understandings of the near-term environment. Having a general thesis for the coming year will help us judge and respond to the inevitable ups and downs that will come our way.

In preparation for writing this report, we have studied market commentary and analysis from a wide range of economists and research sources. In this report we set out to objectively frame the important questions surrounding the global economy, while offering our thoughts and insight on these critical issues.

As we remind our readers each year, the observations offered in this report represent our best efforts at sorting out the available data. In doing so, we must always contend with conflicting information and a wide range of plausible interpretations. Certain variables are unpredictable in nature, while others can become unexpectedly volatile. Our economy and the capital markets are driven by the simultaneous impact of many variables and uncertainties. Accordingly, we rely heavily on historical perspectives as we set forth our direction for the coming year.

Our ***Outlook 2018*** report is fashioned to impartially identify the principal trends and issues shaping the global economy. Working from this foundation, we present our interpretations and clearly summarize the various expectations we have for the year, with emphasis placed on the directional merits of our forecasts and observations.

We welcome the hard work that brings us to our own conclusions and opinions. This discipline promotes a better understanding of the primary forces affecting the financial system, while enhancing our ability to keep critical decisions close to our clients. We remind our readers that this report is not intended to time market movements or to establish active trading schemes.

As has been our practice, we will continue to monitor all developments along the way and will keep our readers current through monthly letters and the more extensive mid-year update. We thank you for your continued confidence in our abilities to add meaningful value to you and your family.

Looking Back at 2017 - Reflections on an Inflection Point

The current period of economic expansion began in 2009, following the Great Recession of 2007 – 2008 (the worst economic downturn since the Great Depression). For the most part, the recovery has been extraordinarily uneven and frustratingly slow – the most lackluster recovery in the modern post-war era.

Over the past nine years consumers and businesses around the world have been hesitant as economic activity appeared to follow a “start / stop” pattern every few months. Making things worse, just as certain regions around the world experienced building momentum, others stalled. Then, the tables would turn with the better performing regions slowing unexpectedly - as others made progress.

Calendar year 2017 will be remembered as the year when things began to come together for the global economy. It was our view that conditions really began to change in the spring of 2016 when we noticed the "start / stop" pattern starting to recede. We also saw the early signs of a synchronized upswing in global economic growth wherein countries and regions started to progress at the same time.

It was these observations, along with the prospects for more business friendly policies coming from Washington DC following the November 2016 election, which provided the very foundation for our constructive view of the global economy at the start of 2017. In our ***Outlook 2017*** report we wrote:

> ***"The pace of economic growth will likely accelerate from the disappointing pace of the past seven years. Our expectation is for the U.S. economy to expand at a rate of 3.0% this year; rising to 4% in 2018. Pro-growth policy initiatives initiated by newly elected President Trump and a Republican controlled congress should drive a significant paradigm shift for the U.S. economy."***

While it remains to be seen if growth continues to accelerate, our constructive forecast for 2017 proved to be correct. What we found astonishing was the bearish and negative perspectives that dominated Wall Street just a year ago. Nobel prize winning economist, Paul Krugman, predicted the stock market, which initially sold off on the unexpected Donald Trump election victory, would "never" recover from the blow. He said that Trump would plunge the country into a terrible recession.

On January 3, 2017 CNBC published an article entitled: "Despite Trump Euphoria, Wall Street's 2017 Forecast is the Most Bearish Annual Outlook in 12 Years". The article observed that the Wall Street consensus forecast for the S&P 500 coming into the New Year called for little more than a 5% return in 2017. This prediction would take the index to approximately 2,362 and represented the smallest anticipated gain since the +2.8% forecast heading into 2005 (Source - Bespoke).

Goldman Sachs analyst, David Kostin, said in a research note to clients, "S&P 500 will rally to 2400 in Q1 2017 alongside enthusiasm over corporate tax cuts, but budget constraints will limit the magnitude of tax reform and fiscal spending and the index will fade to 2300 by year-end."

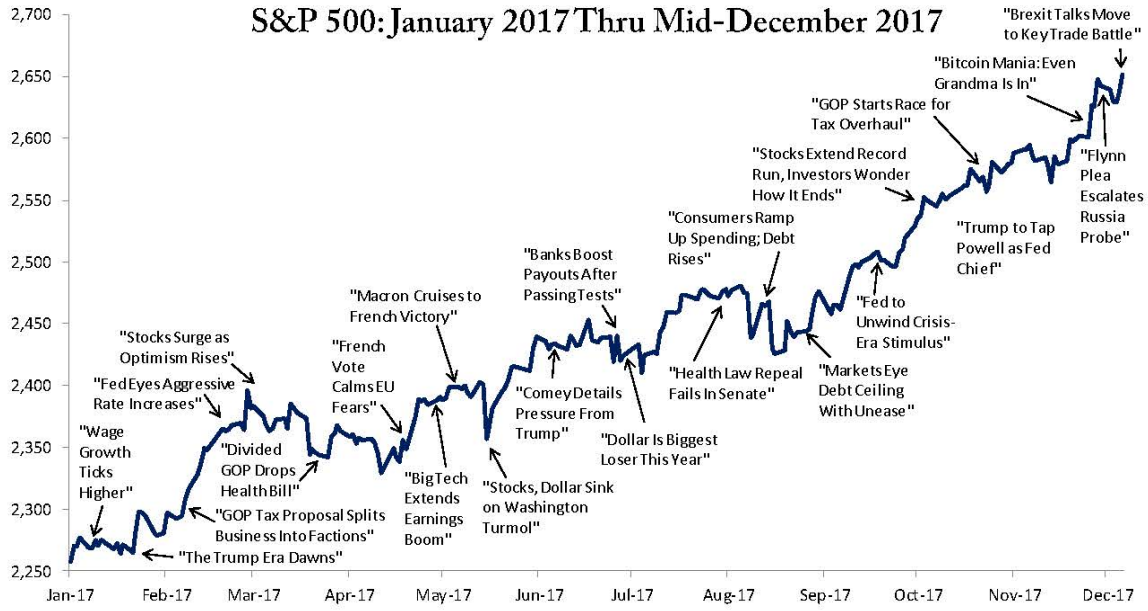
These doom and gloom perspectives were not new. In 2012, Time magazine published an article titled "Why Stocks are Dead" which documented the dire forecast of money manager Bill Gross. Savita Subramanian, head of U.S. equity strategy at Bank of America – Merrill Lynch, predicted in late 2016 that the U.S. will "hit a recession sometime in the 2nd half of 2017." And famed market analyst Marc Faber predicted on August 8, 2016 that the S&P 500 was "set to crash by 50%".

We struggled to reconcile our economic analysis, and the upbeat forecasts we had formulated, with these decidedly calamitous predictions. None-the-less, we published our ***Outlook 2017*** report and pursued portfolio strategies that reflected our constructive views. It was only later that it occurred to us how many otherwise intelligent players allowed emotions to cloud their thinking. Rather than maintaining a disciplined view of hard data and facts, they appear to have been swayed by feelings and fears.

Throughout the year two distinct narratives competed for the hearts and minds of investors. The first narrative followed the negative perspective above and continuously warned of **the many things that could go wrong**. Understandably, geopolitical worries have been a big part of this narrative, and to be clear war with North Korea is a legitimate concern. Other anxieties focused on trade wars, misguided monetary policy, the deportation of 11 million people, and most recently the possible firing of Special

Counsel Mueller plunging the country into a full blown constitutional crisis. The political divide became particularly worrisome with both sides claiming that the other had become totally unhinged. This narrative was often speculative; almost always sensational in nature, and was without doubt discouraging. Fortunately, this narrative has also thus far proved to be wrong.

The other narrative had to do with **a global economy that was gaining traction** and developing self-reinforcing qualities that produced something of a virtuous cycle. Jobs were being created and people were going back to work. Homes were being built, cars purchased, and factories were ramping up production. Measurable and sustainable improvements in one area triggered gains in other areas. This narrative was based on economic statistics and facts. It was also positive, which did not align well with those voices promoting fear. But as we have observed many times, it is important to keep one's politics separate from one's finances. We also believe it is important to place facts over feelings.



Source - Bespoke

Current events around the world were a significant driver of news flow and sentiment in 2017. Geopolitics in Europe, the Middle East, Asia, and even within North America with the renegotiation of NAFTA all served to create nervousness and caution.

For our part, we did our best to look past the emotion. Our experience has taught us to focus on the data, while keeping emotions (and politics) in check. This discipline has served us well over the years. Even as negative headlines involving investigations, collusion, impeachment, and constitutional crisis dominated the news cycle, we remained focused on the empirical evidence of the economy. Our response was to highlight economic bright spots, which included The Leading Economic Indicators (LEI), a strong labor market, decent housing statistics, and surging activity in manufacturing as measured by the ISM Manufacturing Index. **Despite the many apprehensions that played out for most of 2017, we concluded that worries over relentlessly negative headlines were overblown**.

Accordingly, we stuck to our convictions and strategies – even as the national arguments raged on. All along we observed that well-constructed strategies should only change when the facts change. In our

Mid-Year Update we stated: ***"We are maintaining a positive outlook of the future because that is where we believe the facts lead us. The President's detractors would have us believe that this is an administration in chaos. The President's supporters would have us believe that this is an administration firing on all cylinders. As is usually the case, we believe the truth lies somewhere in between."***

It was in our ***Mid-Year Update*** that **we raised our 2017 year-end target for the S&P 500 to 2,660**. Amid the uncertainty at the time, the economy and the markets were doing quite well. Our view was that ***"the implementation of pro-growth fiscal policies such as tax reform, infrastructure spending, and deregulation remain likely."*** On two of these three factors we were spot-on, and the S&P 500 finished 2017 at 2,673 – just 13 points away from our target.

The S&P 500 Index advanced in every month of the year in 2017 (the first time on record it gained ground in all 12 months of a year). The last month with a negative total return for the S&P 500 was October 2016 with a -1.82% return. **Since the election of Donald Trump, the S&P 500 has not had a down month**.

While 2017 has been the first perfect year in terms of monthly total return gains, there have been three prior periods where the S&P was up for 12 or more straight months. Once those streaks of monthly gains came to an end, the S&P 500 was higher over the following six months every time and higher one year later two out of three times.

Information Technology led all other sectors in 2017 with the popular "FAANG" group of stocks (Facebook, Apple, Amazon, Netflix, and Alphabet's Google) soaring an average of 48% for the year. Financials also performed well as the Federal Reserve raised interest rates three times in 2017 and the Trump administration's deregulatory agenda lifted sentiment for the sector. Energy was the worst performing sector despite the recovery of oil prices to their highest levels since 2015.

Notably, small cap value stocks underperformed during the year with the Russell 2000® Value Index gaining less than 6%. In contrast, the NASDAQ 100 Index, which includes the largest technology stocks, gained 31.5%. The performance differential is the largest since 2009 and underscores investor's current preference for growth-oriented strategies over value.

We now have every S&P 500 Industry Group trading above its 200 Day Moving Average (DMA), something that rarely happens. In the ten other periods since 1990 that it has occurred, the S&P 500 was higher three, six, and twelve months later every time. If you bet that this time will be the exception, the odds are against you (Source - Bespoke).

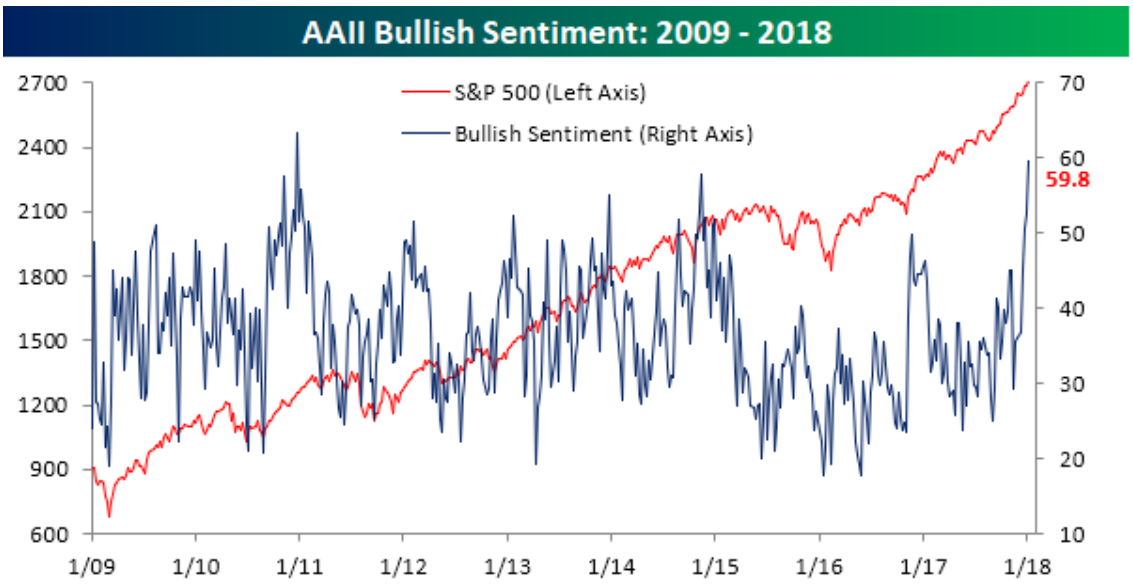
Interest rates remained low in 2017 with the yield on the 10-year U.S. Treasury Note (which ended 2016 at 2.45%) ended the year at 2.40%. Similarly, the yield on the 30-year U.S. Treasury Bond (which ended 2016 at 3.06%) finished 2017 with a yield of 2.74%.

These downward trends in long-term rates, coupled with the rise in short-term interest rates, led to a flattening of the "yield curve." An inverted yield curve often indicates expectations for an economic downturn. In this case, we believe the curve has only flattened and will not likely invert.

Despite three interest rate hikes, the U.S. dollar actually weakened in 2017. Entering the year, some economists voiced concerns that the continued rise in the dollar could suppress economic growth. Instead, improving conditions overseas buoyed the value of foreign currencies which more than offset the dollar's strength.

Americans now have greater confidence in their circumstances than at any time in the past 17 years. The number of Americans who say they'll be better off financially in 2018 has climbed to 82.5 %, up from 72 % who were bullish over 2017, according to a survey by Lend EDU, an online financial marketplace.

Not surprisingly, investors are taking notice. According to the weekly sentiment survey from the American Association of Individual Investors (AAII), bullish sentiment increased to 59.8% at the beginning of 2018. Not only was this the third straight week where bullish sentiment has been above 50%, but it's also the second highest reading in bullish sentiment of the bull market. The only week that saw a higher reading was back in December 2010 when it reached 63.3%. After stubbornly resisting the rally for several years now, individual investors are starting to believe.



Source - American Association of Individual Investors (AAII), Bespoke

In many ways, 2017 proved to be an inflection point for the global economy. Importantly, most of the positive developments that have emerged over the past year are largely still in place. In fact, some of these economic trends are actually strengthening as we turn to 2018 and we see no signs that the economy is peaking. Key indicators like Auto Sales, Housing Starts, and the ratio of Leading to Coincident Indicators are all at or near their cycle highs.

Optimism in the manufacturing sector soared in December with the ISM index hitting 59.7, behind just September for the highest reading of the year and the fastest pace of expansion going back to 2011. Sixteen of eighteen industries reported growth, while survey respondents noted a pickup in increased customer activity in both the U.S. and abroad. For the full year, the ISM manufacturing index averaged the highest readings for a calendar year going all the way back to 2004 (see chart on next page).

Comments from the panel reflect expanding business conditions, with new orders and production leading gains, employment expanding at a slower rate, order backlogs expanding at a faster rate, and export orders and imports continuing to grow in December. Supplier deliveries continued to slow (improving) at a faster rate, and inventories continued to contract at a slower rate during the period. Price increases continued at a faster rate.

Should the current level of economic activity deliver 3%+ of GDP growth in the fourth quarter, it would mark the third consecutive quarter of such strength. The U.S. has not had a streak such as this since 2004.

Source - TradeEconomics

Our constructive forecasts for 2017 were in part dependent on a new administration's ability to deliver on campaign promises. Donald J. Trump has been President of The United States for almost a year and he has been criticized for a failure to get much done, along with the Republicans in Congress. However, an honest assessment reveals that a great deal has been accomplished. In less than a year he has signed 96 laws with 16 of those 96 laws repealing rules and regulations (that we believe in part were hindering stronger economic growth).

The regulatory path has clearly shifted and, against just about everyone's expectations, tax reform was signed into law making U.S. companies much more competitive. **We believe the economic uptick from tax reform and further deregulation will be the big story in 2018**.

A Review of *Outlook 2017*

As is our tradition, we pause to offer a straightforward assessment of our previous year's expectations and perspectives. Typically, we expect to find "mixed results" when reflecting on our expectations from a year ago. While the outcomes related to some of our specific targets were mixed, the themes and context of our 2017 report were highly accurate.

Here is a recap of our major forecasts from the original ***Outlook 2017*** (Executive Summary Pages 6 - 7) and a summary of how things actually played out:

- ✓ ***Outlook 2017* Forecast: The pace of economic growth will likely accelerate from the disappointing pace of the past seven years. Our expectation is for the U.S. economy to expand at a rate of 3.0% this year; rising to 4.0% in 2018. Pro-growth policy initiatives initiated by newly elected President Trump and a Republican controlled congress should drive a significant paradigm shift for the U.S. economy.**

  On our first, and most important, forecast from ***Outlook 2017*** we hit the mark. After eight years of substandard economic activity, the pace of growth for the U.S. economy has accelerated. The second and third quarters of 2017 both came in above 3% and with the recent surge in retail sales,

we are confident the fourth quarter number will also top 3%. It has been twelve years since our economy has had three consecutive quarters of 3% plus growth.

- ✓ ***Outlook 2017* Forecast: Given the various positive factors outlined in this report, our forecast for corporate earnings on the S&P 500 comes to $129 - $133 per share. This forecast is highly dependent on the pace of regulatory reform, as well as the final details of corporate tax reform.**

Regulatory reform was meaningful in 2017, however corporate tax reform was signed into law only in December and will not take effect until 2018. We now believe that final fourth quarter earnings growth will approximate 10%. Accordingly, as Q4 numbers are reported in January of 2018, we are confident that final 2017 S&P 500 earnings will come in at about $132.

- ✓ ***Outlook 2017* Forecast: Our full year target for the S&P 500 Index is 2,535. This represents a gain in the index of about 12.25% for the calendar year. Our target for the Dow Jones Industrial Average is 22,800 in 2017. To meet this objective, investor sentiment must remain strong and market multiples must modestly expand to a little over 19 times earnings. Each of these conditions are achievable assuming President Trump is able to maintain his early momentum and is successful in securing legislative support of his various reform initiatives. If his agenda is delayed or materially redirected, we would expect much more modest progress for U.S. equity markets.**

On October 10th the DJIA reached our original target of 22,800. In our ***Mid-Year Update***, we revised the original target to 23,500. On November 2nd the DJIA reached our revised target. On October 3rd the S&P 500 index reached our original target of 2,535. In our ***Mid-Year Update*** we revised the original target to 2,660. **On December 4th the S&P 500 reached our revised target. The index would finish the year at 2,673, only 13 points (less the one half of one percent) away from our revised target**. Investor optimism was strong in 2017 and the S&P 500 price earnings multiple expanded above 19, as we had forecasted.

- ✓ ***Outlook 2017* Forecast: We expect the U.S. dollar to rise by approximately 5% this year and the strong dollar cycle could continue for at least another 12–18 months. The pace of the dollar's rise will likely be a bit slower than recent years and there is the potential for temporary setbacks along the way as markets struggle to process the often conflicting impact of trade and fiscal policies.**

Despite a relatively modest rise in U.S. interest rates and the successful passage of tax reform, the rally in the U.S. dollar that began in late 2016 stalled out and the currency declined in 2017. With this forecast, we were completely wrong. The Wall Street Journal Dollar Index, which measures the U.S. currency against the currencies of 16 other countries, closed 2017 at $85.98, down from its 2016 year-end mark of $93.26 — a decrease of almost 9%. This marks the first annual decline in the value of the dollar in five years. Stagnant inflation and positive economic strengthening in other parts of the world weighed on the U.S. currency.

- ✓ ***Outlook 2017* Forecast: We expect the rate of consumer inflation will heat up in the coming year as the economy accelerates. There remains a massive amount of excess liquidity in the system and inflation is likely to pick up along with the velocity of money. For 2017, we expect the Consumer Price Index (CPI) to increase to between 2.5% and 3.0%.**

The rate of inflation finished 2017 exactly where it began. According to the Bureau of Labor Statistics, over the last 12 months U.S. CPI rose 2.1%. This remains a bit of an economic mystery for

2017, as investors try to determine why inflation has not increased along with economic growth. When analyzing month over month for 2017, we found that the pace of inflation did increase towards the latter part of the year, attributed in part to Hurricane Harvey and Irma.

- ✓ ***Outlook 2017* Forecast: We project that the Federal Reserve will raise rates three or four times in 2017. Accordingly, we see the fed funds rate between 1.50% and 1.75% by year end. We also see the 10-year Treasury yield going up to between 3.0% and 3.5% in 2017. Should economic activity stall due to political delays of President Trump's pro-growth initiatives, we would expect the Fed to raise rates only one or two times over the course of the year.**

The Federal Reserve raised interest rates a total of three times in 2017 as Janet Yellen wound down her term. As of year-end the fed funds rate sat right at 1.50%. The 10 year rate did not increase quite as much as anticipated, hitting just 2.4% at year-end, before trading above 2.5% in January.

- ✓ ***Outlook 2017* Forecast: President Trump has pledged to give U.S. companies a tax break to encourage them to repatriate significant levels of cash held oversees. If successful, this would provide something of a windfall to American corporations that already hold trillions of dollars in cash. Accordingly, we expect a surge in share buybacks and increasing dividends payments in 2017.**

The net dividend increases for U.S. stocks were up 56% in 2017, rising to $37.1 billion (source S&P Dow Jones Indices) with S&P 500 companies paying a record $419.8 billion in dividends to shareholders. It was the eighth consecutive year of higher payments and we believe 2018 will be another record year. According to S&P Dow Jones Indices, companies in the S&P 500 repurchased about $129.2 billion of their own stock in the third quarter of 2017 (the most recent period for which it has such data). This level of buybacks represents growth of 15.2% from the third quarter of 2016. Corporate tax reform was not fulfilled until December of 2017 and the resulting cash windfall we had forecasted will now occur in 2018. U.S. companies are already holding record levels of cash and we continue to expect higher share buybacks and dividends going forward.

- ✓ ***Outlook 2017* Forecast: We believe the labor markets will continue to tighten in 2017 with continuing healthy job growth. Accordingly, the unemployment rate will keep falling to about 4.4% by the end of the year; compared to 4.7% at the end of 2016. Unless the labor participation rate rises significantly over the coming years, job growth averaging 150,000 – 180,000 per month will not be sustainable and will lead to labor pressures that will trigger higher inflation.**

Job growth in 2017 increased faster than most had anticipated. At year end, the U.S. unemployment rate was measured at 4.1% according to the Bureau of Labor Statistics. An element which caught the eye of many Americans was the minority unemployment rate. In December, African American and Hispanic unemployment rates hit all-time lows.

- ✓ ***Outlook 2017* Forecast: Equities in the Eurozone and Japan began a cycle of outperformance relative to U.S. equities in the second quarter of 2016. We project that this outperformance by both Europe and Japan will persist in 2017 (in local currencies). In both instances, we continue to recommend that exposures be implemented on a currency hedged basis.**

Even with the strong returns for U.S. equities in 2017, both Eurozone and Japanese equities did in fact outperform. Japan returned about 21% and the Eurozone returned about 25%.

Looking back, 2017 was another notable year for our ***Outlook*** report. Many of the above observations, made last year at this time, proved to be extraordinarily accurate; especially our original and revised targets for the S&P 500. **Throughout the year we saw opportunity where others saw risk. While our original expectations were decidedly optimistic, we chose to raise these targets by mid-year**. When most of Wall Street had a modest expectation of just 2,425 for the S&P 500 at year-end, we published our target of 2,660. We were very pleased to see the index finish the year at 2,673.

Of our forecasts that missed the mark, most were directionally correct with some forecasts happening sooner than we expected, and others occurring later. **We are very pleased that this framework for decision making over the past year held up so well given the various challenges that came our way**.

Beyond the specific forecasts reviewed above, there was an important context to our ***Outlook 2017*** report. In January 2017, when the report was being researched and written, president-elect Donald Trump had not yet taken office.

As we studied the economic environment at that time, we arrived at three important conclusions. First, the global economy was gaining self-reinforcing momentum. Second, President Trump's pro-growth agenda represented a significant paradigm shift. And third, political dissonance would be a serious challenge to maintaining a disciplined and unemotional investment strategy.

We were correctly forecasting economic activity would accelerate to 3.0% and better government policy would be a key element of this progress. The following are direct quotes from ***Outlook 2017***:

> ***"The message of our Outlook 2017 report is that we finally have legitimate reason to believe that the U.S. economy could finally gather some steam. We expect the pace of growth could exceed 3% this year, led by faster growth in home building, a return to more normal growth in inventories, and, most importantly, more business investment. This momentum would have the potential to build into 2018 with growth rates reaching 4%, or more.***
>
> ***Our thesis continues to observe that the incoming administration has unambiguously signaled its intent to address many of the policy issues that have held the economy back. Should a seismic shift in government policy produce some degree of mean reversion in the coming years, we would expect we are entering an era of accelerating economic activity and higher prosperity.***
>
> ***Meaningful corporate tax reform, a large fiscal stimulus package, and a transformation of regulatory burdens could provide a boost to economic activity that translates into a pickup in earnings. With no obvious signs of excess or imbalances, the U.S. expansion (now well into its seventh year) continues to show that age is just a number.***
>
> ***Over the past couple of years, there has been too much pessimism about the global economy, however this perception appears to be turning around in dramatic fashion."***

We offered this insight just as Donald Trump was about to be sworn into office. **It is interesting to see how the markets have reacted to the pro-growth policies we anticipated a year ago**.

The "significant paradigm shift" we described in ***Outlook 2017*** is playing out as we had hoped and will continue to drive markets forward in 2018.

Outlook 2018 – Executive Summary

Our positive view of global economic growth in 2018 translates into what we believe will be the strongest and most broad based corporate earnings cycle in the last seven years. Better government policies regarding corporate taxes and regulation will serve as an important tailwind that should help propel the global bull market forward in 2018, and likely 2019.

What follows is a quick summary of our major observations and expectations for the coming year.

- ✓ **The Tax Cuts and Jobs Act represents a substantial positive development for the U.S. economy. The pace of economic growth and higher corporate profits will exceed current expectations and serve to drive equity prices, the rate of inflation, and interest rates all higher in 2018.**

- ✓ **The pace of economic growth will continue to accelerate from the 2.5% - 3.0% pace of 2017. We believe the combination of a more competitive tax code, the repatriation of foreign profits, higher consumption and capital spending will add between 0.25% - 0.75% in economic growth. Our expectation is for the U.S. economy to expand at a rate of 3.0% early in the year; rising to 4% later in the year as the positive impact of tax reform more fully develops.**

- ✓ **Given the various positive factors outlined in this report, our forecast for corporate earnings on the S&P 500 comes to $149 - $154 per share. Within this range, our target number is $151. This number includes the year's originally expected year-over-year growth, the tax savings from the new tax plan, and the anticipated incremental growth related to the new tax plan.**

- ✓ **We believe that the potential exists for U.S. equities to gain 12% to 16% in the coming year. This suggests levels above 3,000 for the S&P 500 and 27,500 for the Dow Jones Industrial Average. Clearwater Capital's official target for the S&P 500 for the end of 2018 is 3,115.**

- ✓ **We expect the rate of inflation will increase to a level of 2.5% in 2018 as measured by the Consumer Price Index (CPI). Over the past three months the CPI is up at a 2.6% annual rate, signaling that inflation is accelerating further above the Fed's 2% target.**

- ✓ **We expect the Fed will raise interest rates three or four times in 2018. Given the strength of the labor market, with unemployment at the lowest level in more than a decade and headed lower, a fourth hike is looking increasingly likely. We also expect the 10-year Treasury yield will rise to a range of 2.75% to 3.25% in 2018.**

- ✓ **Equities in the Eurozone, Japan, and emerging markets continued a cycle of outperformance relative to U.S. equities in 2017. We project that this outperformance will persist in 2018 and believe these regions should be over-weighted in portfolio strategies.**

- ✓ **The period of exceptionally low volatility will likely come to an end in 2018 with the return of the occasional market correction. Because of the extended time since the last 3% correction, the return of volatility will be particularly difficult for certain investors who might be tempted to sell every drawdown.**

- ✓ **We are forecasting another record year for corporate dividends and share buybacks.**

Tax Reform – A Really BIG Deal

Since 1993 the top federal tax rate on U.S. corporations has been 35%, one of the highest in the world. This led many U.S. companies to expand overseas. For years both sides of the political aisle were aware that this was hurting the U.S., yet nothing was ever done.

On Friday, December 22, 2017, President Trump signed the 2017 Tax Cuts and Jobs Act into law. This new legislation represents the most comprehensive tax reform in more than 30 years. Although the depth of detail of this new law may be intimidating, on balance, we believe the new tax code will have a significant impact on the economy in 2018.

Now the corporate tax rate is 21% and businesses will be allowed full expensing of business investment for tax purposes. These two changes alone will significantly shift how companies invest and operate in the U.S., leading to more demand for labor, faster wage growth, and an uptick in economic activity overall.

Rising capital investment will increase productivity, and help push wages higher. That virtuous cycle will gather steam this year. Already a growing number of U.S. corporations have issued bonuses to employees and some are raising wages. On Thursday, January 11th, Walmart became the latest of dozens of companies to announce one-time bonuses related to the new tax law. Notably, the company also said it would raise its minimum wage to $11 an hour. The list of companies making such moves now includes: American Airlines, AT&T, Bank of America, Comcast, Fiat Chrysler, Fifth Third Bancorp, JetBlue, and Southwest Airlines.

The Tax Cuts and Jobs Act is estimated to produce tax savings of $1.5 trillion. It is a complex, 1,000-page law intended to spur economic activity through a reduction in both individual and corporate tax rates, and simplify the tax code by eliminating or trimming a variety of deductions and exemptions.

At a high-level overview:

- ✓ The Joint Committee on Taxation suggests the estimated total cost over 10 years will be just over $1 trillion, with the offset of $500 billion in added revenue from an estimated economic growth impact of +0.7% per year over the next 10 years.
- ✓ The estimated net tax cut for individuals totals approximately $1.15 trillion, or about 77% of the package, a greater focus on individual tax cuts than the original House bill.
- ✓ The estimated net tax cuts for U.S. corporations total around $330 billion, or 23% of the overall package.

The tax bill increases the progressivity of the U.S. tax code. That means fewer people at the bottom will pay income taxes, and people at the top will see their share of taxes paid increase. Tax reform has also repealed Obamacare's individual mandate. Repealing the mandate would not force anyone to give up their coverage or forego their current tax credits, it would just make the Obamacare insurance optional.

Contrary to claims of critics, lower- and middle-income families will receive the greatest benefits of the new tax law. They would also be beneficiaries of business tax reforms that would generate higher wages and more job opportunities across America, as we have already been seeing.

A summary of the major changes for individual tax payers is presented below, "Current Law" in the graphic below represents 2017 policies:

		Current Law	Final Bill
INDIVIDUAL	Top individual tax rate	39.6%	37% (until 2025)
	Married filing jointly tax brackets and rates	10%: $0; 15%: $18,650; 25%: $75,900; 28%: 153K; 33%: $233K; 35%: 417K; 39.6%: $471K	10%: $0; 12%: $19,051; 22%: $77,401; 24%: 165K; 32%: $315K; 35%: 400K; 37%: $600K
	Estate tax exemption	$5.5MM/person	$11MM/person
	State and local tax (SALT)	Deductible	Mostly eliminates; caps property tax/income up to $10,000
	Mortgage interest deduction	Deductible up to $1MM mortgage + $100,000 home equity	Deductible up to $750,000 of new mortgages; no home equity
	Student loan interest deduction	Deductible	No change
	Personal exemption	$4,150/person	Eliminates
	Standard deduction	$6,500 single; $13,000 married	$12,000 single; $24,000 married
	Individual alternative minimum tax (AMT)	Includes a $86,200 exemption + $164,000 phase-out	Increases exemption to $109,000 + phase-out to $1MM
	Child tax credit	$1,000/child	$2,000/child; refundable up to $1,400
	Obamacare individual mandate	Penalty of $695 or 2.5% income for no health insurance	Repeals
	Requires first in, first out (FIFO) upon sale	Flexibility to optimize tax harvesting	No change (i.e., no FIFO requirement)
	Municipal interest tax exemption	Muni interest exempt from federal taxes	No change
	Municipal private activity bonds	Tax-exempt bonds for specific public/private projects	No change
	Advanced refunding bonds	Allowable	Eliminates
	Capital gains	Long term: 0/15/20% (income dependent); short term: taxed as ordinary income	No change

Source: Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO, LPL Research

In 2018, the net tax cut for individuals is set to exceed $100 billion, and as the effects of the alternative minimum tax (AMT) changes settle out in 2019, the consumer windfall could eclipse $200 billion, or approximately 1.0% of gross domestic product (GDP).

Most middle-class taxpayers would land in the 12 percent bracket; upper-middle-class households go from the 25 percent bracket to 22 percent, or from 33 percent to 24 percent, or from 39.6 percent to 35 percent. Families will also be able to benefit from a slightly expanded child tax credit. According to an analysis from the Tax Policy Center, the bill would reduce taxes for Americans in all income groups in 2018 — increasing after-tax income by an average of 2.2 percent.

Unfortunately, the new tax bill does very little to actually simplify the tax code. Despite early efforts from the House, which passed a version of the tax bill that condensed the current seven tax brackets to four and cut many of the deductions — like those for teachers' supplies and high medical expenses — the final draft of the tax bill does no such thing. We do not expect that any taxpayer will ever see the postcard-size tax return that was once promised.

We believe the greatest benefit stemming from tax reform will be seen on the corporate side. The tax bill will position U.S. corporations to potentially boost investment from a combination of lower taxes,

repatriated profits, and immediate expensing, further supporting economic growth. The repatriation of foreign profits alone will bring over $1 trillion in overseas cash back to the U.S. and will be used for business investment, higher dividend payments, or share repurchases. Importantly, the many benefits of the new tax bill will provide fiscal support for the economy as monetary support is withdrawn.

A summary of the major changes for corporate taxpayers is presented below:

CORPORATE	Corporate tax rate	35%	21% (permanent)
	Corporate tax rate starts	Not applicable	2018
	Top pass-through rate	39.6%	20% deduction for certain income until 2025 (with caveats)
	Corporate AMT	20% tax to broadly defined alternative income	Repeals
	Expensing	50% expensing through 2020	100% expensing through 2023
	Interest expense deductibility	No limit	Limits to 30% EBITDA until 2021; 30% EBIT thereafter
	Net operating losses	Allows carry backs 2 years; carry forwards up to 20 years	Eliminates carry backs; indefinite carry forwards (with caveats)
	Taxation of foreign income	Worldwide (though only taxable when repatriated)	Territorial; 100% exemption
	Deemed one-time repatriation tax	Not applicable	15.5%; 8% illiquid
	Carried interest	1-year holding period (minimum)	3-year holding period (minimum)
	Minimum taxes from income	Not applicable	10% tax on high-return income; increase to 12.5% in 2025

Source: Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO, LPL Research

As shown above, the new tax law has important implications for major corporations, small businesses, and individual taxpayers, and is designed to shift the trajectory for economic growth, the federal budget, monetary policy, and perhaps most critically for investors—corporate earnings.

Accordingly, **we are projecting that the tax reform package will add somewhere between 6% and 10% in 2018 S&P 500 earnings**.

The reduction of the corporate tax rate from 35% to 21%, combined with businesses' ability to fully expense their capital expenditures for the next five years, will have a major effect on growth.

The goal was to make the tax code more competitive with countries like Canada, which has a 15 percent corporate tax rate, or Ireland, which has a 12.5 percent rate. Corporations will no longer have to pay corporate taxes on money they claim to have earned abroad — a move that was encouraging companies to keep income in foreign tax havens. Corporate income brought back to The United States during repatriation will be taxed between 8 and 15.5 percent, instead of the current 35 percent.

The idea is that the lower tax rate will push corporations to invest more in the United States, raise wages, increase jobs, and unleash unprecedented economic growth. It is reasonable to expect this will lead to job creation, higher wages, and ultimately higher demand for a wide range of goods and services over the next several years. This will create a positive feedback loop and the uptick in economic growth will further advance already strong corporate earnings. Our view is that these positives are currently being underestimated and not yet fully priced into the markets.

Strategist's S&P 500 Targets

Coming into 2018, Wall Street strategists had an average year-end price target of 2,854 for the S&P 500. Based on the S&P's closing level for 2017, the average 2018 target translates into a gain of 6.7%.

This is better than the 4.9% gain originally predicted for 2017 a year ago, however it still appears to represent a relatively modest expectation given the many positives in play. There are only three firms who believe the equity market will gain more than 10% in 2018.

Given the strong start for equity markets in this year, some analysts have already began to revise their target numbers higher. The table to the right shows the original forecasts as they stood coming into 2018.

2018 Wall Street S&P 500 Targets

S&P 500 as of 12/31/2017: 2,673.61

Firm	Target	% Change
Canaccord	3,100	15.9%
Evercore ISI	3,000	12.2%
Oppenheimer	3,000	12.2%
Bank of Montreal	2,950	10.3%
UBS	2,900	8.5%
Credit Suisse	2,875	7.5%
Jefferies	2,855	6.8%
Duetsche Bank	2,850	6.6%
Goldman Sachs	2,850	6.6%
Bank of America	2,800	4.7%
Citigroup	2,800	4.7%
Wells Fargo	2,784	4.1%
Morgan Stanley	2,750	2.9%
Scotiabank	2,750	2.9%
Stifel Nicolaus	2,750	2.9%
HSBC	2,650	-0.9%
AVERAGE	**2,854**	**6.7%**

Source - The Bespoke Report 2018

The second table below this text shows the average S&P 500 year-end price target of Wall Street strategists going back to the year 2000. For each year, we list the average year-end price target and what that would have represented in terms of the year's forecasted percentage gain.

Historical Strategist S&P 500 Price Targets

Year	Prior Year's End	Average Target	Predicted Gain %	Actual Year End	Actual Gain %
2000	1,469	1,525	3.8%	1,320	-10.1%
2001	1,320	1,593	20.7%	1,148	-13.0%
2002	1,148	1,291	12.5%	880	-23.3%
2003	880	1,004	14.1%	1,112	26.4%
2004	1,112	1,169	5.1%	1,212	9.0%
2005	1,212	1,246	2.8%	1,248	3.0%
2006	1,248	1,348	8.0%	1,418	13.6%
2007	1,418	1,550	9.3%	1,468	3.5%
2008	1,468	1,632	11.2%	903	-38.5%
2009	903	1,078	19.4%	1,115	23.5%
2010	1,115	1,225	9.9%	1,258	12.8%
2011	1,258	1,371	9.0%	1,258	0.0%
2012	1,258	1,344	6.8%	1,426	13.4%
2013	1,426	1,534	7.6%	1,848	29.6%
2014	1,848	1,955	5.8%	2,059	11.4%
2015	2,059	2,233	8.5%	2,044	-0.7%
2016	2,044	2,216	8.4%	2,239	9.5%
2017	2,239	2,362	5.5%	2,673	19.4%
2018	2,673	2,854	6.7%	?	?
		AVERAGE	**9.3%**		**5.0%**

Source - The Bespoke Report 2018, Standard & Poor's

Where the S&P 500 actually ended each year is then presented in the fifth column in terms of price level. The sixth column lists the actual percentage change for the S&P 500 for each year.

The average expected gain in 2017 was only +5.5% which fell well short of the +19.4% actually realized for the year.

It is also interesting to note that the average forecasted gain for 2018 (+6.7%) is well below the average gain forecasted going back to 2000. Despite the many positive developments, strategists would seem to be less optimistic for 2018 on average.

Since the bull market began, Wall Street strategists have under-shot the actual gain in seven of the nine years. This reflects our observation that there has been too much pessimism and caution during this current bull market. We believe that this continues to be the case for 2018.

Our expectations for equites in 2018 are at the higher end of the range based on our expectation that continuing benefits from deregulation and the favorable impact coming from the 2017 Tax Cuts and Jobs Act will propel corporate earnings to new record levels.

We see economic growth rising above 3% with the possibility we may see a 4% growth quarter in 2018. This, along with the savings from lower tax rates, pushes our S&P 500 earnings target to between $149 and $154 per share. Accordingly, we believe that the potential exists for U.S. equities to gain 12% to 16% in the coming year. This suggests levels above 3,000 for the S&P 500 and 27,500 for the Dow Jones Industrial Average. **Clearwater Capital's official target for the S&P 500 for the end of 2018 is 3,115**. We arrive at this number using a number of $151 in S&P 500 earnings and a multiple of 20.6x.

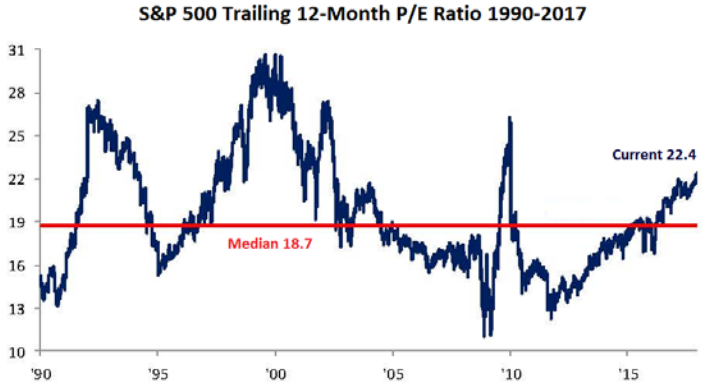
Given our earnings forecast, these index levels would be accompanied by a price/earnings multiple of 20 or higher. After first hitting 22 in the middle of 2016, the S&P 500's trailing P/E ratio moved sideways to lower right through July of 2017 where it stabilized and drifted higher. In the closing weeks of the year, though, multiples shot higher as the prospects for tax reform began to increase. From late October through the middle of December, for example, the S&P 500's trailing P/E increased by a full point from 21.5 up to 22.5.

Valuations

With the strong move in equity prices in 2017 and early in 2018, the S&P 500 now trades with a price/earnings multiple over 23.0x on a trailing 12-month basis. Using our forecast of $152.00 in S&P 500 earnings in 2018 the forward price/earnings multiple stood at 17.6x at the end of 2017.

While high valuation ratios tend to predict lower future price growth, it is important to recognize that the measurement of the relationship between P/E ratios and subsequent real equity price growth changes over time. When Alan Greenspan gave his famous "irrational exuberance" speech in 1996, the P/E ratio for the S&P 500 stood at 27.6x. Analyzing data since 1996, the relationship between the P/E ratio and real equity price growth appears to be becoming weaker as variation in real earnings growth increases (Source: FRBSF Economic Letter 1-08-2018).

Valuation metrics are typically presented in the context of 80+ years of historical data. Whereas this analysis is useful, we would argue that the investment landscape has substantively changed over time and is quite different now than it was 50 years ago. One example would be how companies are now much less capital intensive. Thus, we feel added weight should be put on the periods that are more recent.



As shown in the chart to the left from Bespoke, the S&P 500's P/E ratio is about 3.7 points above its historical median going back to 1990. Relative to recent history, the market is still not cheap, but valuations are not wildly out of line, and today's market is nowhere near as expensive as it was in the late 1990s. In fact, since 1990, the S&P 500 has traded at a higher multiple than its current level more than 25% of the time.

While valuations are quite rich right now, they alone won't likely be the catalyst for a market decline. The key to understanding valuations is found in the direction of future earnings. If corporate profits develop as we expect in 2018, one could argue that valuations here are compelling. The low level of long-term interest rates relative to historical levels also supports a higher level of the P/E ratio, as lower interest rates imply a lower discounting of future corporate earnings and thus higher equity prices.

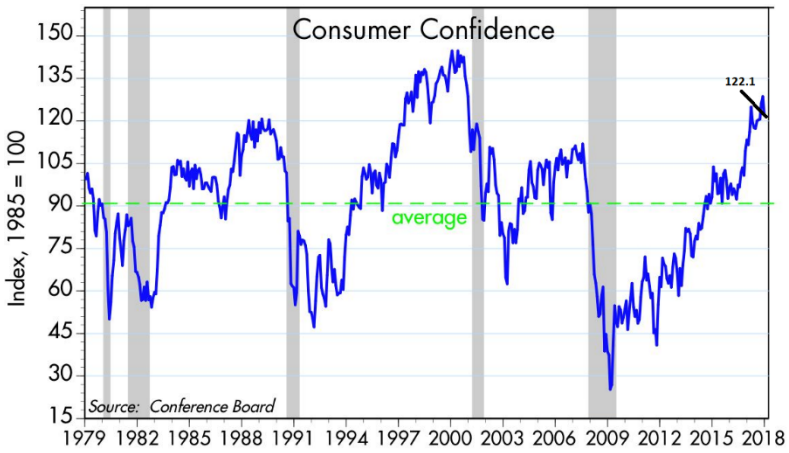
Optimism, Confidence and Leading Indicators

Small business confidence surged the day after the 2016 election and remained remarkably strong for all of 2017, making last year the strongest in the 45-year history of the NFIB Index of Small Business Optimism.

One reason for increased business optimism is undoubtedly the huge reduction in regulatory burdens that the Trump administration has managed to achieve in one short year. Under Trump's leadership, there has been a one-third reduction in the number of pages in last year's Federal Register compared to Obama's last year, and the number of rules in the 2017 Federal Register was the lowest since records were first kept in the mid-1970s.

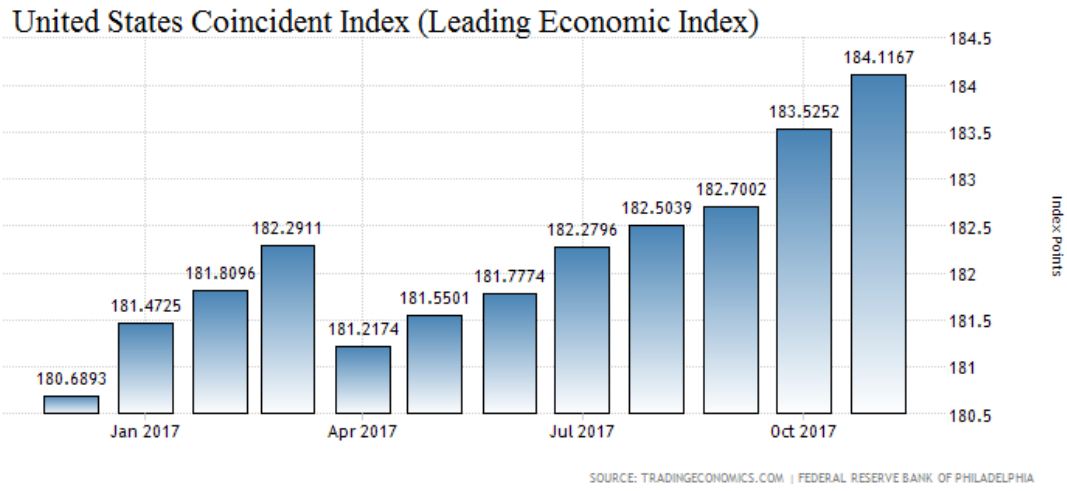
And that low figure of course includes all the rules that Trump issued to get rid of other rules, so the reality is even better than the numbers suggest (Source: Scott Grannis).

According to the Conference Board's index Consumer confidence hit 122.1 in December, slightly below November's 128.6, the 17-year high.



The U.S. job market is very strong with unemployment at 4.1%, the lowest level since 2000. Unfilled job openings are abundant also. The U.S. economy has gained jobs for 86 consecutive months, the longest streak in history, according to Labor Department figures going back to 1939. Balanced growth in the global economy also supported U.S. hiring in 2017.

Consumers are planning big-ticket purchases in the next six months. The share of Americans likely to buy refrigerators and washing machines (9.2%) reached its highest point since at least 1978, according to the Conference Board's December survey. Over 60% of Americans surveyed by the Conference Board in December said they intend to take a vacation in the next six months, a sign of optimism. That level is just below October's figure of 63.5%, which was the highest since at least 1978.

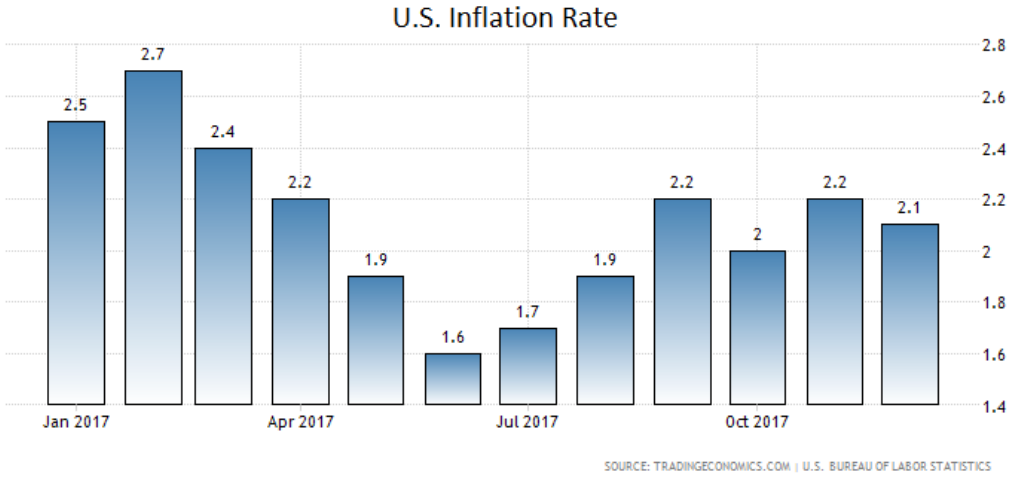


The Leading Economic Index in the United States averaged 121.76 Index Points from 1979 until 2017, reaching an all-time high of 184.12 Index Points in November of 2017 and a record low of 70.21 Index Points in January of 1979.

Inflation

Inflation is a monetary phenomenon which results from an excess of money relative to the demand for it. Today we see declining money demand as the prices of risk assets surge. People are becoming less and less risk averse, and the demand for cash and cash equivalents (like savings accounts) is declining in favor of increased demand for equities and other risky assets. With more confidence comes less desire for safety and a greater desire to take on risk.

At the same time, the current supply of money remains abundant (e.g., $2 trillion of excess bank reserves) and interest rates remain very low. It's likely that because of this we are seeing the early signs of rising inflation in the form of higher prices for commodities, and a decline in the value of the dollar.



Consumer prices in the United States increased 2.1 % year-on-year in December of 2017, easing from a 2.2 % rise in November. Figures came below market expectations of 2.2 % amid a slowdown in gasoline and fuel prices. Still, core inflation edged up to 1.8 % and the monthly rate increased to 0.3 %, the highest in eleven months amid rising cost of rents, healthcare and autos. Inflation rates in the United States averaged 3.27 % from 1914 until 2017, reaching an all-time high of 23.70 % in June of 1920 and a record low of -15.80 % in June of 1921.

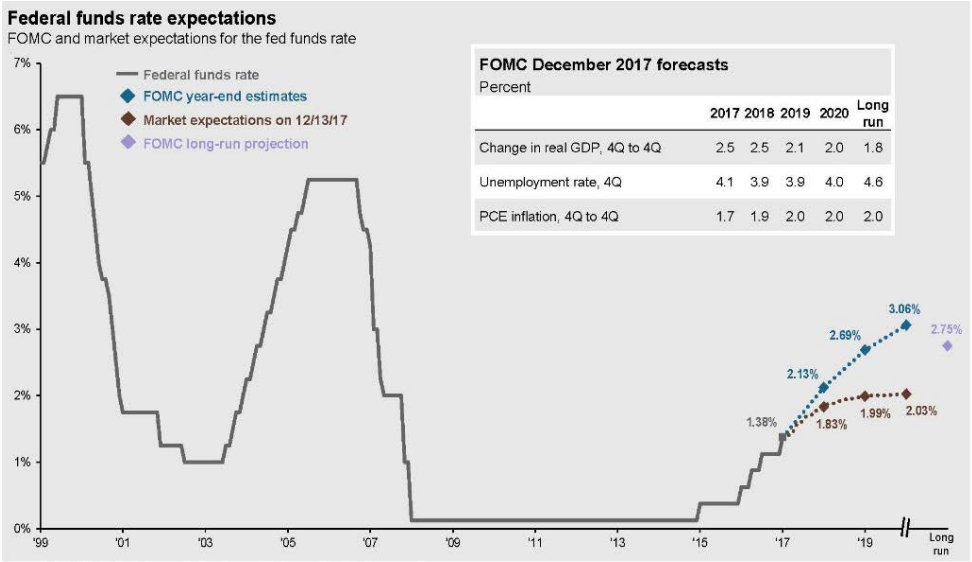
We expect the rate of inflation will increase to a level of 2.5% in 2018 as measured by the Consumer Price Index (CPI). If we experience another year of above trend economic growth in 2018, and if the Fed does not move to aggressively reduce money supply (in the form of excess reserves), then rising inflation could become a worrisome issue. This could lead to interest rates rising more than is currently expected which could begin to choke off growth.

Interest Rates

U.S. interest rates have fallen to record lows over the past three decades. Many factors have contributed to this phenomenon, including the deflationary pressures that have emerged from an increasingly global economy. Going forward, it would appear that these trends have shifted, with economic activity and inflation beginning to move higher around the globe. Higher wage growth as a result of a tight labor market will provide the Fed with the rationale for further rate hikes.

In December of 2017, the Fed raised its benchmark federal funds rate by 25 basis points to a range of 1.25% to 1.50%. The Fed explained that this move was predicated on better-than-expected growth for the U.S. economy and strong job growth. Chicago Fed member Charles Evans and Minneapolis Fed member Neel Kashkari voted against the December rate increase partly because inflation remains short of the Fed's 2% target. The Fed now expects to raise interest rates three times in 2018.

We expect three, possibly four, rate hikes in 2018 with the 10-year Treasury yield rising to a range of 2.75% to 3.25%. Recent inflation data puts the Fed on track to hike rates in March and June. Depending on how quickly economic activity picks up in 2018 we would expect a third hike and quite possibly a fourth hike late in the year.



FOMC December 2017 forecasts
Percent

	2017	2018	2019	2020	Long run
Change in real GDP, 4Q to 4Q	2.5	2.5	2.1	2.0	1.8
Unemployment rate, 4Q	4.1	3.9	3.9	4.0	4.6
PCE inflation, 4Q to 4Q	1.7	1.9	2.0	2.0	2.0

Source: FactSet, Federal Reserve, Bloomberg, J.P. Morgan Asset Management

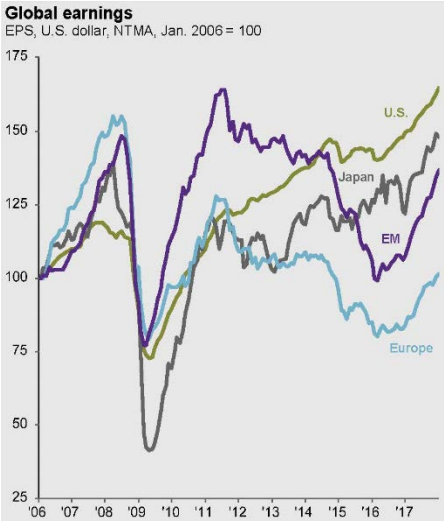
Global investors may continue to find relative value in the benchmark 10-year Treasury, supporting demand and putting some downward pressure on rates. Any move near a 3.0% yield for the 10-year Treasury will likely attract global interest and potentially limit the risk of a move above our target range.

Fixed income Investors face several challenges, including a Fed that is no longer backstopping Treasury auctions, higher issuance of federal debt to support deficit spending, and the inflationary risk associated with stronger economic growth. Long-term inflation expectations are moving higher and the Fed will need to respond accordingly. Wage growth should prove the key determinant for policymakers in 2018. It should be noted, however, that current wage growth is only up about 2.5% year-over-year and well below the 4.0% pace that has historically caused the Fed to raise rates aggressively.

The Fed's official mandate is to effect monetary policy that produces full employment and low inflation. In 2018 we suspect the Fed will also track "unofficial" factors such as financial market volatility and the mid-term elections, which could give policymakers reason to pause. This said, we continue to believe the Fed's path for balance sheet reduction of approximately $300 billion in the coming year will remain unchanged.

We have been expecting interest rates to move higher for much of the past several years. Accordingly, we have maintained neutral-to-short duration bond strategies in our portfolios.

International Equities

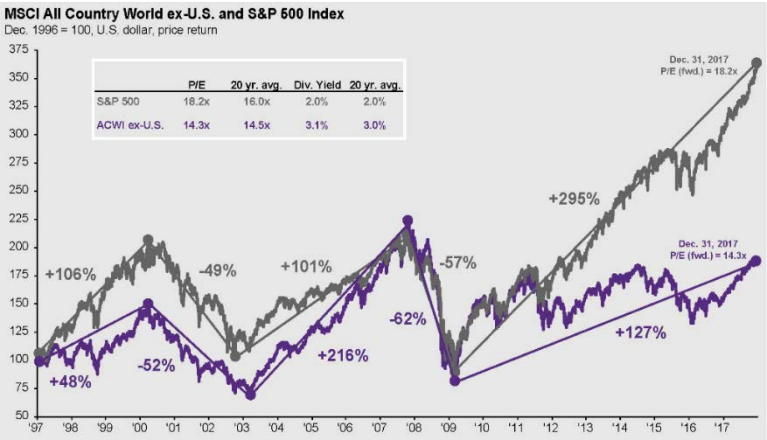


International equities outperformed the S&P 500 by a wide margin in 2017. We believe the trend of international stocks outperformance has plenty of room to run before becoming extended and we remain focused on opportunities within the Eurozone and in Japan. Based on relative performance data going back to the start of 2000, these periods of out/under performance typically last many years rather than months.

From an economic fundamentals perspective, we believe that the U.S. has led the globe over the past nine years and that other developed nations are on average about two years behind where the U.S. is today. As is presented in the chart to the left, Japan, Europe, and the emerging markets have all struggled with varying degrees of downturns since the U.S. recovery began in 2009. Valuations, as shown in the chart below, are quite attractive when compared to U.S. equities.

The Eurozone surprised to the upside in 2017. The worst-case scenarios related to divisive populist political movements were averted, while the economy continued to deliver relatively robust GDP growth. Unemployment and core inflation remain low, suggesting significant room for future growth. While growth had been largely dependent on the stronger core economies in the early years of the recovery, all member states are now in expansion. According to research published by Riverfront Investment Group, despite a powerful 25% advance during 2017, developed international equities remain about 30% below their long-term trend and represent one of the few equity asset classes offering a substantial discount to average valuations. Historical periods that began with this level of undervaluation produced returns of nearly 15% per annum over the next 5 years. Over the past 60 years, U.S. and developed international stocks have established a consistent pattern of 5 to 7 years of outperformance by one being followed by 5 to 7 years of outperformance by the other.

With the election of Prime Minister Shinzo Abe in 2012, Japan has steadily pursued the structural changes necessary to reinvigorate the economy and markets. Currently, Japan is the only major equity market not trading at a premium to its own 10-year history. Returns for Japanese companies are increasing due to corporate governance reforms and stronger global growth.



Emerging market (EM) equities led the bull market run for global stocks in 2017 and the underlying fundamentals for EM equities are improving after five years of declining profitability and weak earnings growth. Emerging market companies have cleaned up balance sheets, initiated critical structural reforms,

and, according to Blackrock, EM free-cash flow for non-financial companies exceeds that of developed markets for the first time since 2007. MSCI EM valuations are at their highest since 2010, but 24% below developed markets — not expensive, on a relative basis.

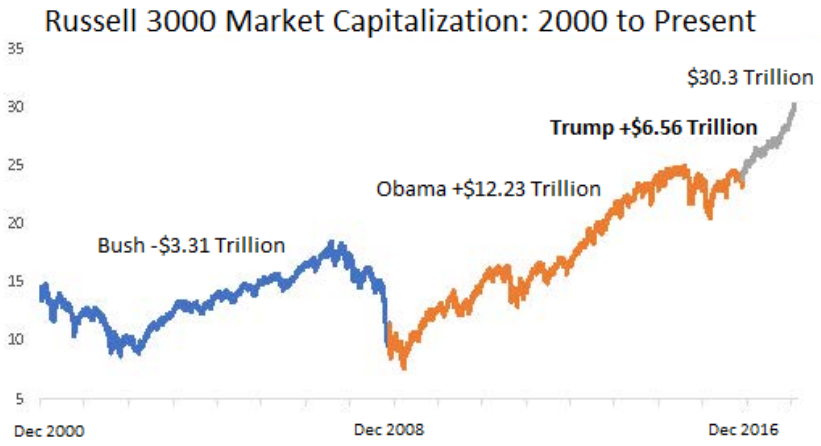
BOOM - 2018 is Here

Equities started 2018 with a bang as investors focus on the many positives associated with the recently passed tax reform package and hopes for further corporate deregulation. The S&P 500 is already up more than 4% year-to-date through just 9 trading days. That's the best start to a year since 2003 when the index gained 5.89% out of the gate.

The starts to 2003 and 2018 are of similar magnitude, but the environment couldn't be more different. In 2003, the S&P 500 was close to the very end of the nasty Dot Com bust bear market when it bounced to start the year, only to collapse 12% over the next month on fears over the Iraq war, then tested and held its bear market lows in early March. This year S&P 500 is rallying as it starts its 9th year of the bull market.

Since 1928, there have been only 18 prior years when the S&P 500 gained more than 3% through the first 9 trading days of the year. While the history for those 18 years show the average returns over the next month were mostly flat, the returns over the next six months and the rest of the year were quite good with an average gain in the next six months of 6.49% and an additional 8.10% for the rest of the year (Source Bespoke).

The U.S equity markets now have one of its longest streaks without a 5% drawdown since 1930. According to Goldman Sachs, should the markets continue to climb through Thursday, January 18th, this current run will take its place as the longest such streak ever. The S&P 500 already has the longest-ever stretch without a 3% decline (a drop that would be considered relatively common). The last 3% pullback occurred on November 7, 2016. This low volatility was a defining characteristic of the U.S. equity market in 2017. According to the WSJ Market Data Group, the daily percentage change for the Dow Jones Industrial Average was lower in 2017 than in any year since 1964. The average observed one-month volatility in the S&P 500 was lower in 2017 than in any year since 1970. Not surprisingly, bullish sentiment now stands at a seven year high.

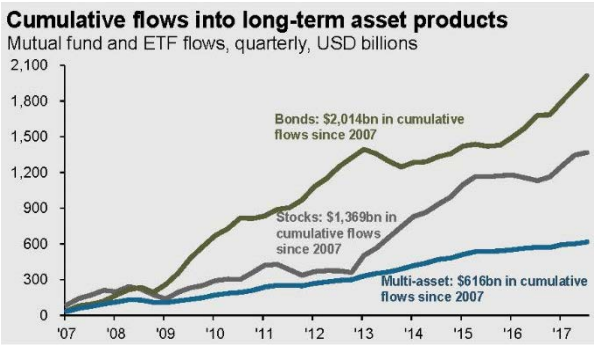


The amount of wealth creation that has occurred in the stock market since President Trump took office has been astonishing. The total market cap of the Russell 3000 (98.5% of total US stock market cap) topped the $30 trillion mark for the first time ever. The chart below shows the path of the Russell 3000's market cap going back to December 2000 and shows how wealth, as measured by the Russell 3000, fluctuated under President Bush, President Obama, and now President Trump (Source Bespoke).

The Great Rotation Revisited

The anticipated shift to a rising interest rate environment has many important implications for investors. We believe we have seen the low in bond yields and prefer shorter-duration fixed income and unconstrained income strategies in a rising rate environment. Historically, companies that have sustainable free cash flow and the ability to raise their dividend payouts over time (dividend growers) are among the most resilient in a rising rate environment.

Fixed income as an asset class has been the beneficiary of fund flow over the past ten years. Bonds have been favored over stocks in this time period with $2.0 trillion cumulative investment compared to just $1.3 trillion flowing into equities. See chart below.



We have referenced this phenomenon several times in recent years and have observed that once interest rates began rising investors would increasingly rotate out of bonds into stocks. This shift in fund flow has become known as "The Great Rotation" because of the material impact it could have on equity prices. Great or not, even a modest "rotation" out of bonds into equities can have a significant impact on prices.

While we do not foresee a collapse in the fixed-income markets, investors will increasingly recognize in 2018 that bonds are currently quite expensive. If interest payments are to bonds prices what earnings are to stock prices, it could be said that the 10-year Treasury bond currently has a price earnings ratio of 40X. For stocks, the S&P 500 currently has a price earnings ratio of about 23X.

A New Stock Market Super Cycle?

Loyal readers of our ***Outlook*** series are familiar with the attention we have given to the Super Cycle concept. We revisit the details again this year as the pattern does appear to be forming.

Markets regularly go through long phases; bullish, bearish and sideways. The 20th century saw three secular bull markets. The first lasted nine years from 1921 to 1929. After World War II, the next bull market lasted about 20 years, more or less from 1946 to 1966. The most recent bull market began in 1982, with the Dow starting at about 1,000, and ending in 2000 at 11,750; generating an impressive gain of more than 1,000 percent.

Long secular bull markets occur for a specific reason: waves of industrial, technological and economic progress make their way into employees' wages, consumers' pockets and corporate profits. Improving standards of living are also reflected in the psychology of an era. Not surprisingly, as markets do well investors become willing to pay more for a dollar of earnings, and the cycle progresses. Multiple expansion, in the form of rising price-to-earnings ratios, eventually influence returns more than rising profits. In 2018, however, we see rising profits as the primary driver of equity markets.

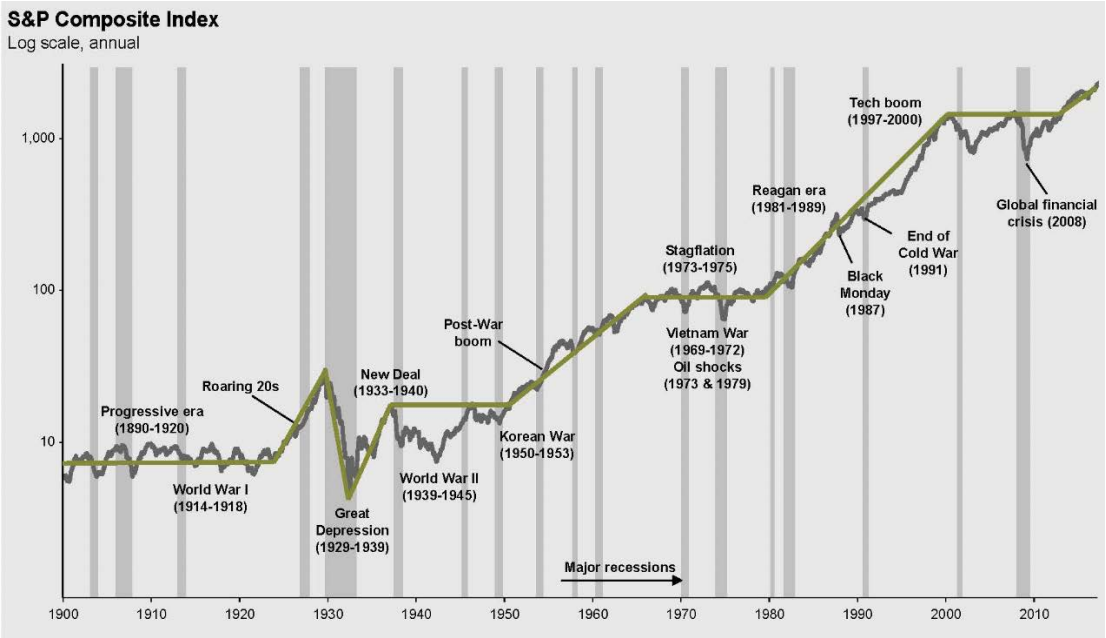
Since 1871, secular bear markets for the S&P 500 (prolonged periods of below-average returns) have on average lasted about 14.5 years and had a nominal total return of 1 % and a real return of a negative

2.3 %. The market's price earnings multiple compressed by an average of nine points, from 20.5 at the start to 11.3 at the end.

The average secular bull market lasted 21.2 years and produced a total return of 17.2 % in nominal terms and 15.9 % in real terms. The market's price earnings multiple more or less doubled, from 10.1 at the start to 20.5 at the end.

By these measures, **the period from 2000 through 2012 represented a secular bear market**. Over this 13 year time span, equity prices as measured by the S&P 500 returned less than 1 %. In 2013, markets broke out, implying the start of a new bull market. The S&P 500's price earnings multiple has averaged 16 during the past three years, in the middle of the range during secular bull markets.

The chart below shows the S&P Composite Index, on a logarithmic scale, since 1900. The log scale helps illustrate long-term index patterns, namely the distinct periods of range bound and trend bound markets. Secular market cycles are typically defined by large movements in the major stock averages often by as much as 40% or more where the cycle lasts at least 5 to 20 years. Cyclical market cycles are typically understood as short-term in nature and rarely last more than a year.



Source JP Morgan, FactSet, NEBER, Robert Shiller – Data as of December 31, 2017

Are we in the early stages of a new secular bull cycle? We will only know the answer to this question well in the future as secular market cycles are terribly clear in hindsight and exceedingly difficult to discern in real time. For now, we believe this logarithmic presentation of stock price movement over long periods of time would indicate that secular bull markets do indeed follow prolong periods of below average returns such as observed in the sideways price movement from which we have recently emerged.

One could argue that the bulk of the cycle looks to be ahead, rather than behind us. While the S&P 500 rose approximately 11% in 2016 and 19% in 2017, the current bull market looks strong. Investors are increasingly bullish and global economic strength appears to be building.

Conclusion

Significant components for a stronger economy are now in place. Tax incentives are correctly aligned to encourage more business investment; regulatory burdens are being reduced, business confidence is high, and the Fed is not a threat for the foreseeable future. Swap and credit spreads are low, as is implied volatility, and that tells us that liquidity is plentiful and systemic risk is low.

Economies around the globe are also doing better and economic progress has become increasingly synchronized. **We believe the global economy enters 2018 at its strongest point in more than a decade**.

Our base case is that global growth will accelerate in 2018. Most importantly, **we expect a significant boost in corporate earnings coming from lower tax rates and the additional economic activity we believe will be the logical consequence of less regulation and increased business investment**. Sustained above-trend economic growth has helped companies deliver strong earnings growth and strong equity returns for over a year now; and both should persist in 2018.

One observation can be made about the election of Donald Trump as the nation's 45th president. The electorate simply wanted to shake things up in Washington. The "establishment" represented by status quo bureaucracies, high tax rates, institutions, and regulations had the economy mired in the slowest recovery on record and people wanted change. **Whether one agrees with the political developments of this past year or not, the U.S. has not witnessed economic policy changes like this in a very long time**. We labeled the election of President Trump a "significant paradigm shift" for our economy and we remain confident the policy changes will continue.

With the anticipation of accelerating economic growth, we must recognize that two important factors are shifting as we contemplate the investment environment for 2018. These factors are inflation and monetary policy. **Inflation is likely to rise moderately in the coming year and the Fed will be forced to effect further tightening activity. The key question here will be how fast either of these factors develop**.

While we have a constructive view on the economy and risk assets in 2018, we are aware that this positive view is now consensus. **We would prefer that we were the contrarians in the mix as this new consensus view sets the stage for possible disappointment if things don't meet expectations**.

The S&P 500 has now been up on a total return basis for nine straight years, tying the all-time record for consecutive up years from 1991—1999. **Even with our positive outlook, we understand that there will be at least be some trouble along the way. Markets typically climb a wall of worry, but there doesn't seem to be much worry as we move into 2018**.

The major theme of this ***Outlook 2018*** report is that meaningful tax reform and a continuing transformation of regulatory burdens will likely provide a significant boost to economic activity and earnings in 2018. With no obvious signs of excess or imbalances, we believe **the U.S. expansion has a long way to go**.

Over the years, we have worked hard at developing and maintaining an independent perspective relative to the world economy and the capital markets. We focus our attention on the fundamentals and try to screen out noise and emotions. **Last year our disciplines led us to take a bold stance on how 2017 would play out, and we stuck to our convictions. With so many of the same positive factors in place, and getting better, we believe our constructive view for 2018 represents the right call**.

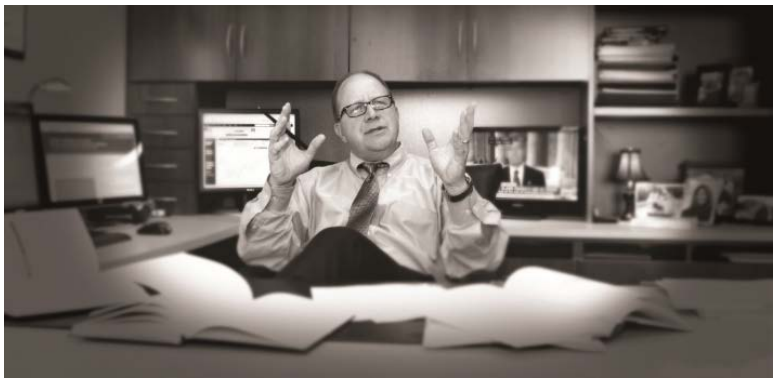
Thank You

Proper wealth management demands a sound framework for decision making. As new information becomes available, our thesis will most certainly be adjusted throughout the year. Please know we will work tirelessly to maintain relevant perspectives. **There is no substitute for hard work, insight, planning, and action in pursuit of unambiguous goals. By establishing a working thesis for the economy and markets, we have confidence that we will be better equipped to respond to the various twists and turns coming our way**.

We take nothing for granted, and we strive to construct judgments that are supported by data and logic. Given the diligence with which we approach this challenge, we have genuine confidence the conclusions presented in this year's ***Outlook 2018*** report will again prove valuable.

Thank you for taking the time to review our perspectives and forecasts. We look forward to a prosperous 2018 and are deeply grateful for the many relationships of trust and commitment we share with our clients.

John E. Chapman
Chief Executive Officer
Chief Investment Strategist
January 2018



About John Chapman

John Chapman is the Chief Executive Officer of Clearwater Capital Partners, LLC and serves as the firm's Managing Partner. With thirty five years of Wall Street experience, John directs all wealth management and advisory services for the firm, is the firm's Chief Investment Strategist, and chairman of the firm's Investment Policy Committee.

John has a Bachelor of Science degree in Finance from the University of Illinois, Urbana-Champaign. He is a graduate of the Certified Investment Management Analyst program, sponsored by IMCA, in association with the Wharton School at the University of Pennsylvania. In 1998, he became a graduate of the Securities Industry Institute and the Securities Industry Association's Branch Management Leadership Institute at Wharton. He also completed Executive Leadership and Strategy programs at the University of Chicago's Graduate School of Business.

In 2008, John earned the Accredited Investment Fiduciary® designation through the Center for Fiduciary Studies, in association with the University of Pittsburgh Joseph M. Katz Graduate School of Business. In 2012, John completed the Retirement Management program at Boston University's Center for Professional Education and in 2013, received a certificate in Advanced Investment Strategy from IMCA.

He is a member of Advocate Sherman Hospital's Board of Directors, where he chairs the Development Council and serves on the Finance Committee. He is also a board member of the Advocate Charitable Foundation. John is a former president of the Westminster Christian School's Encore Society and is currently the Executive Director of the Clearwater Capital Partners Charitable Foundation.

About Clearwater Capital Partners, LLC

Clearwater Capital Partners, LLC is an independent Registered Investment Advisor registered with the Securities and Exchange Commission (SEC). The firm was founded in 2006, by John Chapman, as a locally owned, privately held independent advisor. The firm provides comprehensive wealth management services to successful individuals and families through its Private Client Practice. The firm's Institutional Advisory Group offers a suite of professional services to businesses, non-profit organizations, foundations, and ERISA governed retirement plans.

Our services are designed to help simplify the increasing demands and complexities related to making sound financial decisions. As an independent advisory firm, we embrace the fiduciary responsibilities we have for our clients and are at liberty to deliver solutions we believe best reflect their unique needs. Our professional services are provided in accordance with our core beliefs and always with the utmost discretion and confidentiality.

Wealth management is a process; one that takes place over long spans of time, and one that is best served through dedicated expertise, meticulous evaluations, and disciplined judgment. Our process adheres to these precepts and seeks to create an intelligent framework for consistent and rational decision making.

Our process sets forth a course of deliberate action reflecting each client's most critical objectives. Our methods are designed to prioritize critical goals and to achieve congruity between action and values.

Wealth management firms vary widely in their philosophies and in the services they offer. Clearwater Capital is dedicated to a well-organized process that places the client at the center of our business model. We are uniquely qualified in the disciplines of wealth management, and our clients have entrusted us with the care of their most cherished ambitions. In return, we endeavor to meet this privilege with diligence and accountability.

IMPORTANT DISCLOSURES

The opinions presented are those of Clearwater Capital Partners, LLC and John Chapman, Chief Executive Officer and Chief Investment Strategist, as of January 2018 and may change, without notice, as subsequent economic and market conditions vary.

This material is presented as opinion and commentary. It is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. It is strictly intended for educational purposes only.

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International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments.

The two main risks related to fixed-income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments.

Index performance is referenced for illustrative purposes only. You cannot invest directly in an index. The Dow Jones Industrial Average is owned by S&P Global, the S&P 500 is a registered trademark of The McGraw-Hill Companies, and The Russell 3,000 Index is maintained by FTSE Russell. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

Nothing contained herein is offered as tax advice. Please consult qualified professionals with any tax planning needs or tax questions you may have.

Investment Advice offered through Clearwater Capital Partners, LLC a registered Investment Advisor. Please consult with a qualified investment professional before investing.

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