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INVESTMENT MANAGEMENT

Contravisory Capital Markets Overview

Q1 2018

U.S. Equities

As anticipated, the equity markets cruised into year-end without much fanfare. December produced another positive month capping a great year for equities. Paradoxically, the world around us seemed fraught with volatility and anger while the financial markets were calmly rewarding those who could set aside their emotions and stay invested.

Looking back, 2018 robust performance may be shocking to many investors given the uncertainty at the beginning of the year, a result of the unanticipated Trump election. His administration seemed ill prepared to take over the White House and a steady stream of provocative tweets by the President had the whole world fixated on "The Donald" throughout the year. He loves attention! Tweets and missteps aside, it's undeniable that the course of history has been disrupted. The political establishment has been upturned and an overly aggressive, even repressive, tax and regulatory climate is being rolled back. Your perspective on whether these things are good or bad depends on where you stand politically; however, within the private sector there is a sense of relief and a hope that the economy can now reach its full potential. And that's what the markets are responding to. It's a good reminder that "big government" crowds out the private sector and misallocates resources.

While Trump garners much of the world's attention, voters across the globe are rebelling against the status quo in what has been a tsunami of change. To name a few, Brexit is still being processed, the French have elected a reformer, and Germany's Chancellor Angela Merkel who once had absolute power now has to reach out to form her government. And in Japan, Abe's reforms appear to be gaining traction. While politicians are deadlocked, voters are cleaning house one election at a time. It may be extremely uncomfortable but, isn't that the way it should be? We've commented several times that governments must enact true structural reform and we are now seeing it play out globally and the markets are responding accordingly.

The markets are always looking ahead and after taking a quick timeout over the holiday period, the markets continued their record setting ways thus far in 2018 as the venerable Dow Jones Industrial Average closed above 25,000 for the first time in history. As mentioned in previous letters, there are several reasons for this optimism – the combination of strong global growth, low interest rates, tame inflation, full employment, tax reform, and steady corporate earnings have all contributed to what can best be described as a goldilocks investment environment.

While we still believe we are in the midst of a longer-term secular bull market, nothing is guaranteed and no bull market is perfect. In fact, when you dig below the surface, there are divergences that are of concern. One important example that we pay close attention to is the divergence between growth companies vs value companies. The Russell 1000 growth index was up 30% while the Russell 1000 Value index was up 13% in 2017. That's the largest delta since 2009. From a valuation perspective, some measures have the growth vs. value premium at its most extreme since 2000. That will be adjusted. It's just a question of when and whether it will be orderly or disruptive.

It's no secret that mega-cap growth companies have contributed disproportionately to benchmark returns. While the temptation is there to chase the performance of these fully-valued growth stocks, prudence

dictates otherwise. Given the constructive fundamental backdrop we would expect a more orderly "changing of the guard" and a continuation of this bull market.

Sector Comments:

- After underperforming throughout 2016 and most of 2017, the *Consumer Discretionary* sector is upgraded from negative to *neutral*. This sector steadily improved throughout the 4th quarter as the economy surged thanks in large part to full employment and tax reform. Like the consumer discretionary sector, the *Consumer Staples* sector also enjoyed a strong finish to the year. The improvement is notable but not enough to warrant an upgrade.

- *Energy* stocks also enjoyed a nice finish to the year, culminating in an upgrade from negative to *neutral*. The Energy sector has demonstrated some "head-fakes" in the past, so let's be patient here before committing capital.

- The *Financial* sector continues to thrive, boosted by the impressive strength of the large cap segment. Our *buy* interest is mostly within large cap *banks* and *diversified financial services*.

- The *Health Care* sector limps to the finish line in 2017, but the sector remains *positive*. The correction has led to a plethora of *buy* opportunities across most industry groups.

- The *Industrials* sector finishes 2017 with a bang. This powerful sector remains firmly entrenched in an uptrend. An improving global economy, tax reform and a strengthening U.S. economy are providing a lot of lift to this economically sensitive sector. Stay *overweight*.

- The *Information Technology* sector rests again in December. We'll see how things play out in 2018 but at this point we don't see any evidence that a leadership change is imminent.

- The up-trending *Materials* sector squirts higher in December. There has been some unevenness in this sector particularly in the metals groups. If the economy continues to improve as expected this sector should continue to perform well.

- The *Telecom Services* continues to rally from a deeply oversold condition. While the sector is still in a downtrend, it is noteworthy that VZ was upgraded this month. Let's wait and see how things develop from here.

- The *Utilities* sector is crushed in December and is *downgraded* from positive to *negative*. The prospect of higher rates put the brakes on what was already a faltering sector. *Hold* for now.

International Equities

After surging throughout most of the year, international stocks limped to the finish line in 2018. The underperformance of international stocks relative to their domestic counterparts was not too surprising considering domestic stocks surged at year-end and some consolidation seemed in order across international markets. Nevertheless, the early uptrend for international is still very much intact and a resurgent global economy will likely keep international equities in play throughout 2018.

International Recommendations Matrix

Overweight Developed	Underweight Developed	Overweight Emerging	Underweight Emerging
Japan	Australia	China	*Taiwan
Austria	Belgium	Peru	*India
Italy	Canada	South Korea	Brazil
Denmark	Finland	Thailand	Russia
France	Hong Kong		Indonesia
Germany	Switzerland		Turkey
Ireland	*Spain		
	Sweden		

*New upgrade/downgrade

Fixed Income

The fate of interest rates is in the forefront of all investors' minds. It's been a 30+ year bull market for fixed income amidst the ideal backdrop of declining, and ultimately, historically low interest rates. This has been the ultimate goldilocks environment for fixed income and with the economy hitting its stride and the Fed signaling more rate hikes are likely in order; investors are concerned that 2018 could be the end.

Count us in the concerned camp too as the regime change in Washington has marked the end of artificially low interest rates and a return to normalcy for rate policy, putting fixed income markets at risk. Interest rate sensitive segments of the equity markets are under pressure in recent months, casting a bearish signal for fixed income. The best example of this is within utilities stocks.

Utilities stocks, the most interest-rate sensitive sector in the market, have eroded significantly over the past several months. These high yielding stocks perform best in declining interest rate environments, and vice versa. On the next page, we share our chart on the Utilities Sector SPDR and highlight the recent relative (and absolute) weakness. This weakness is signaling rates are likely to rise and is an important indicator we consider when arriving at our *negative outlook on fixed income*.

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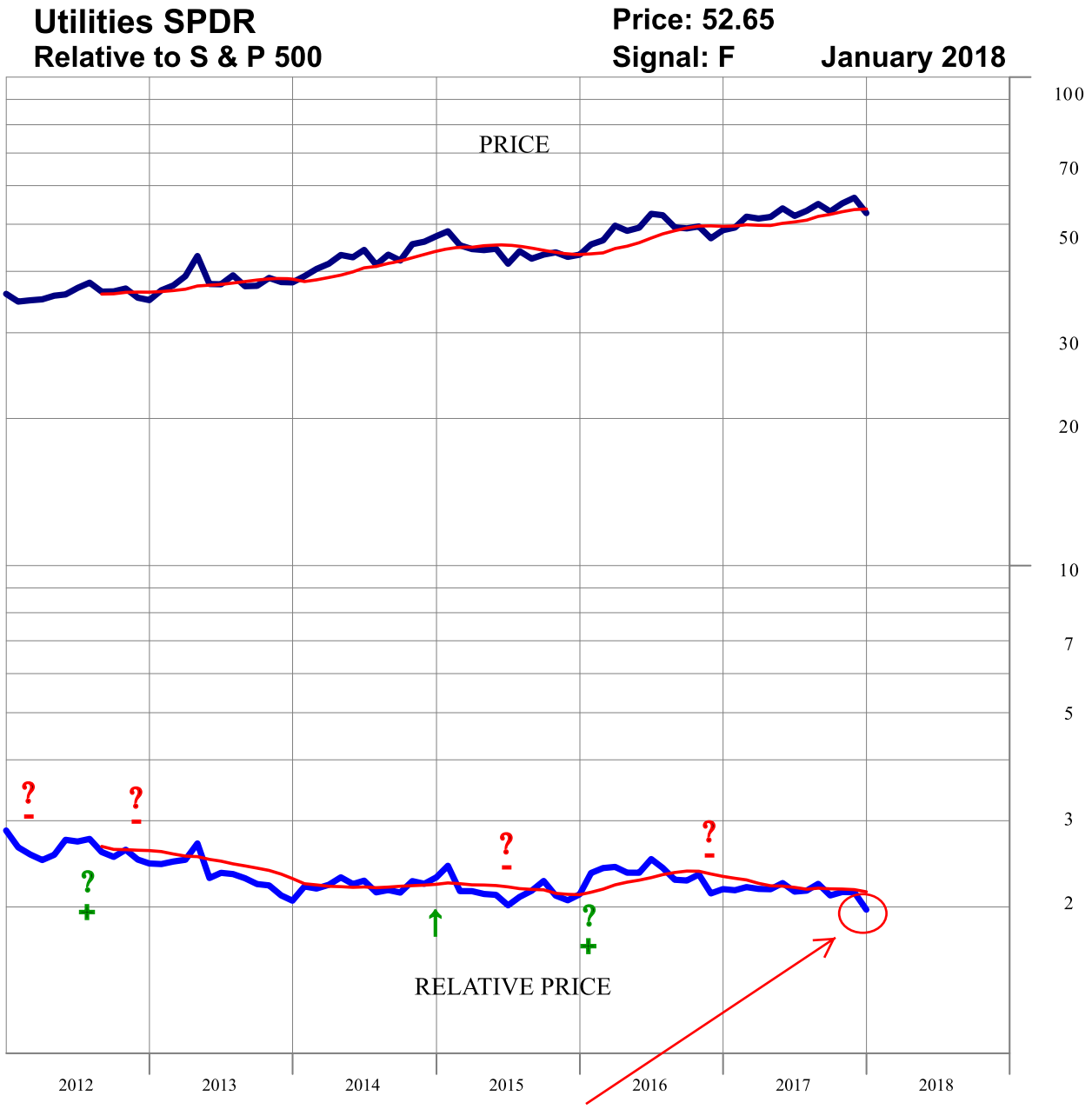

Dramatic relative price weakness in interest rate sensitive utilities stocks are signaling higher rates and a major headwind for fixed income markets.

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