



Integer Wealth Advisors Group, LLC

Advise, Guide and Protect

Fourth Quarter 2017 Market Commentary

We start every market commentary by highlighting an observation from our previous commentary. Here is what we said last quarter regarding the markets:

Now, back to the question of where we are in the economic cycle? Growing GDP beats low GDP, lower interest rates keep credit affordable and low unemployment suggests people are employed and incomes are rising due to demands for skilled labor. We think the markets have room to move higher for the balance of the year, and should tax reform become a reality, well into 2018.

Tax reform did become reality just before Christmas as President Trump sign the bill into law, just in time for many corporations to declare some nice bonuses for workers. AT&T had announced if the tax bill was signed before Christmas, every worker would get a \$1,000 bonus. Trump delivered, and 200,000 checks were cut to AT&T employees. Not a bad Christmas gift for sure.

While there were still a lot of questions about the new changes, there was little doubt that the changes could have positive impacts for the economy. Market analysts were scrambling to revise their 2018 earnings forecasts due to the tax changes. Many were suggesting a revision of 8-10% higher in EPS earnings for the coming year. Despite these rosy forecasts, the markets finished down from the high hit on December 28th (24,836), but primarily due to repositioning of portfolios, or investors booking losses that would benefit them in their high tax year of 2017.

Looking back over the quarter, with the Dow starting off at 22,405, the economic news was positive. Jobless claims remained low, The Fed Beige Book reported moderate growth in all regions of the country, housing starts were at their highest since October 2007, Black Friday shopping was up 16% over 2016, GDP was about 3%, and the Chicago PMI scored its best number, 63.9, in 20 years. What was not to like? The only fly-in-the-ointment that we can see is the distractions going on with the White House and their political adversaries.

Investors usually do not care who occupies Washington, D.C. We've said that many times. Aside from 2009, even President Obama had good stock market years. The difference today is the rollback of excessive regulation, the tax cuts and a more pro-business White House. The result is just a bit more turbo-charged than we saw in the previous Administration, and that is good so long as investor enthusiasm is matched by economic results. So far, so good.



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Fourth Quarter 2017 Highlights

DOMESTIC EQUITY STATISTICS

Index	4th Quarter 2017
S&P Small Cap	3.57%
S&P Technology Sector	8.65%
Dow Jones Average	10.33%
S&P 500 Index	6.12%

(Period Ending 12/31/2017. Source: S&P Dow Jones Price Weighted Indices)

<u>Company</u>	<u>Percentage Weight</u>	<u>4th Quarter 2017</u>
S&P 500		6.12 %
Energy	6.1%	5.27%
Materials	3.0%	6.40%
Industrials	10.3%	5.53%
Consumer Discretionary	12.2%	9.46%
Consumer Staples	8.2%	5.76%
Health Care	13.8%	1.06%
Financials	14.8%	8.12%
Technology	23.8%	8.65%
Telecommunications	2.1%	2.28%
Utilities	2.9%	-0.59%
Real Estate	2.9%	2.33%

Source: Standard and Poor's (www.spindices.com), price returns.



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Style Return Box for the Fourth Quarter 2017

	VALUE	CORE	GROWTH
LARGE	5.68%	6.12%	6.38%
MID	4.84%	5.83%	6.75%
SMALL	3.57%	3.57%	3.58%

Source: Standard and Poor's (www.spindices.com), total returns.

DOMESTIC EQUITIES

It was a bullish quarter for domestic equities. A quick review of the style box above provides a focused picture of where investors were putting money. And before we move on to the obvious, that growth dominated value (in the mid and large space) and large caps dominated the others, the returns in the small cap boxes are not typos. We had to check those twice because we thought they were! Across the style continuum in the small cap space, there was nothing to stand-out via performance amongst the three. Small caps stocks were not the darlings of investors in 2017. Even their full year returns left these indexes far behind the mid and big cap brethren. But then again, that is why we diversify our holdings and why small caps just might have the upper hand in the new year.

Speculation is that the new tax code will benefit smaller companies more than their international conglomerates. It makes sense, for these companies are more U.S. focuses and probably do not have the wherewithal to move funds around the globe like multinationals; or to hire a phalanx of accountants and lawyers to counsel them on such movements. Rather, these companies will benefit not only from the tax breaks coming in 2018, but from the global expansion that they help feed by supplying the big multinationals.

For 2018 we continue to favor U.S. domestic equities over international when doling out a strategic allocation and weighting. We have been domestic bulls for years, and not from a xenophobic perspective but rather that the international markets had more exogenous risks associated with them than the U.S. Risks such as more localized terrorism, socialist policies that continue to heap high taxes and regulations on businesses, and the fraying of the European Union membership (notable Great Britain's "Brexit"). With the new administration and the more pro-business friendly environment, coupled with a world-matching tax code, we believe, as do many others, that U.S. companies will have a better year all together.



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If one thinks about the tax changes for large multi-nationals (lower taxes, easier repatriation of overseas cash), the price/earnings multiples of many of these companies have to be adjusted higher for 2018. It's simple logic when a very large burden, namely taxes, is lifted from the cost of doing business, the bottom line should improve (assuming idiots are not running most companies). More available cash means more investment, better wages (especially in a tight labor market where employees now become more valuable) and, yes, stock buybacks.

INTERNATIONAL

The international market found a bid in 2017 and cranked some impressive returns. Large international growth mutual funds dominated their value-oriented peers which is consistent with the growth-over-value domination we have seen domestically. And after 10 years of being behind the U.S. domestic equity market, every dog deserves a day in the sun. And 2017 was their day. With the global synchronized growth of all economies, international and emerging markets should continue to do well, but we still believe the U.S. markets are the dominant weight of choice.

From our notes in the preceding section it is obvious that we are favoring the domestic U.S. markets over the international markets. The logic simply seems clear to us, and should be for investors around the world. Capital flows to where it is well treated, and beginning in 2018 it is going to be treated very nicely in the United States. This is not to say an investor should abandon the international market.

As we said, the international markets have had a tough go over the past 10 years as they have struggled to match the performance of U.S. stocks. The added burden on those companies keeping up got harder with the clock turning over to 2018. The lighter tax burden will be a huge competitive edge to U.S. corporations.

So, why invest in the international space at all? Our favorite word: diversification. International investments are not held in any of the major indexes of the United States. Gaining exposure to emerging markets and international companies can only come through owning purely international positions. And we don't know when the economic cycle will necessarily turn, but we do feel that the wind is in the sails of US based companies. Finally, the valuation of the international stock market is below that of the United States market which makes it compelling to own.

According to Ed Yardeni Research, the forward P/E of the EAFE countries is 16.7 and the emerging markets countries are 13.1. This compares to 18.8 for the United States, which is not a crazy valuation, but on a relative basis, higher than that of the international space.



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FIXED INCOME

Ah, the one subject that is the most boring, most controversial and least appreciated. It is hard to figure out where to start, but let's start at flashing signals in the fixed income world and work our way backwards.

One of the key measures we like to watch in the bond market is the spread between the 2-year Treasuries and the 10-year Treasuries. Known simply as “2’s minus 10’s”, the spread between them is widely seen as a gauge for potential recession in the economy. During economic cycles, such as we are in now, the spread starts out wide, meaning yields for shorter end securities are lower than longer dated securities. This suggests that short-term borrowing can be done at a relatively inexpensive level.



When bank assets (longer-duration loans) generate less income than bank liabilities (short-term deposits), the incentive to make new loans dries up along with the money supply. The severity of the recession depends on the intensity of the asset bubbles in existence prior to the inversion. An inverted yield curve, which has correctly predicted the last seven recessions going back to the late 1960's. The last two times the yield curve inverted was in the years 2000 and 2006 before each of the last recessions.

But could this time be different, or could the spread begin to widen out? Back in 2000 there were bubbles, big time and the inversion was the correct response. In 2006? Yes, once again there were bubbles in real estate that flowed over into collateralized debt market; and the fueling of leverage trading on Wall Street. Today, however, we are finally at the end of a 10-year period in which the Fed has kept interest rates unusually low via the Fed Funds Rate. In 2018 the Fed has indicated its desire to raise rates three times.



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We welcome that news for a couple of reasons. First, it reconfirms that the economic activity is real, and the Fed wants to make sure there are no massive bubbles forming. Second, it's about time that they started raising them to give retirees some yield on their cash. Third, even with three interest rate hikes, the real inflation adjusted yields are still low. Finally, it's positive for the banks as the spread between what they borrow and what they lend widens out. We need a healthy banking system.

So why not keep raising rates indefinitely? Raising rates is a balancing act that the Fed must walk constantly. As we have seen in the past, raising or lowering too quickly can have negative effects on the economy. Right now, raising rates that get us back to a normal, nominal level, that pushes the 10-year rate closer to 3% would not be a disaster. If rates move higher? To say 4%, or more, then there is incentive for investors to shift from stocks to bonds, and do so in a herd mentality.

Why, then, should an investor have any bond positions in their portfolio? Because when the market is impacted by a "black swan" event, or a good, generic pullback occurs, or a recession does hit, having bonds that cushion the downside will be welcomed by investors.

IN SUMMARY

2017 finished with a stellar market return, yet investors are nervous. The S&P 500 was up 19% while the Dow was up 25%. Meanwhile back in 2013, the S&P 500 was up nearly 33%. Back then we were only four years removed from the 2008 financial crisis. Today we are approaching nine years removed and it still impacts how investors react to investing in the markets. Granted, there are a lot of investors who got smoked in 2000-2002 (especially 2002), and then again in 2008-09. "Fool me once, shame on you; fool me twice shame on me" seems to be the investment philosophy of choice after nearly two decades of difficult market conditions.

The most dangerous words in our business are "this time it is different". To be sure, it feels a bit like the 1995-1999 market period when we experienced a double-digit return for five years straight. We remember those years as neophyte investment advisors. The Wall Street Journal was running the "Darts versus the Pros", where the Editors would invite money managers to do their best against three random stocks hit by the darts on the stock pages (back then there were stock pages in the WSJ). The internet was in its infancy launched by the release of Netscape Navigator in late 1994. Having a website was good enough for 20 points to the value of your stock. It was all about driving eyeballs to your website.

What do we see a "different" this time? Three things that were not present in the 1990's:



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1. The new tax code. Those changes are substantial; transformative to business and impactful to millions of wallets. There were no substantive tax changes to speak of in the late 1990's. Today we have one of the biggest tax reductions that we've seen in a lifetime (depending upon who you listen to!).
2. The internet today is a useful productivity and business tool. In the mid-1990's there were companies that were simply driving "eyeballs" to a website with no real business behind it. Today, the web, the rise of mobile phones and the productivity it brings is a real, tangible benefit for companies.
3. Finally, there is Bitcoin and the rise of crypto-currencies. The fear here is that somehow this will be the next speculative bubble like the nascent internet stocks were in the day. And we tend to concur on the speculative part of the equation regarding the value of a Bitcoin. But the underlying technology of Bitcoin, the blockchain technology, is the next transformative technology impacting the web and business in general. More and more companies are becoming involved with the technology, and the Chicago Board of Options Exchange now has listed options on Bitcoin, just like for any other commodity.

The scary part of all of this is the speed at which technology is changing. It is changing faster than any one person can learn it all. And when something like a Bitcoin, blockchain, or the changes to tax code occur, and an investor cannot discern their impact, anxiety and doubt move in to fill the knowledge void. For you as our clients, we at least have the tax angle covered! As for Bitcoin? Suggest you stay away from investing in any of the crypto-currencies. And blockchain? Well there are some great TED talks you can listen to that should put your mind at ease about that technology.

Based on the changes in the tax code, the continuing drive of the business of the internet and transformative technologies on the horizon, 2018 looks to be another decent year for the markets. We always hedge the bet with diversification, and each investor should always be assessing where they are on the risk-to-reward spectrum. Our advice is to set a target return that you are comfortable with and manage to that target. Other investors may earn more, some less, but at the end of the day, your ratio of "eat well/sleep well" that matters.

Integer Wealth Advisors Group, LLC

Atlanta Office:
3440 Blue Springs Road, Suite 403
Kennesaw, GA., 30144
(o) 770.974.2787

Philadelphia Office:
790 Penllyn Blue Bell Pike, Suite 304
Blue Bell, PA., 19422
(o) 215.643.6490