ECONOMIC REVIEW

Steve Scranton, CFA
Chief Investment Officer & Economist

2017 was a year that began with a strange combination of high levels of optimism *and* uncertainty. Individuals and businesses were very optimistic that changes would occur that should benefit them but at the same time very uncertain as to what an all Republican Congress and Administration would mean for the economy. What we discovered was that, despite the high level of drama and noise emanating from Washington, D.C., the economy continued to grow in the same range that it has for the vast majority of this economic cycle. Although 4th quarter Gross Domestic Product (GDP) data is not yet available, most forecasters believe that 4th GDP growth came in around 2.5%. That would put full year GDP growth close to 2.5%. Average GDP growth since the recovery began through the 3rd quarter of this year has been 2.2%. 2.5% growth would be a nice improvement over the 1.5% rate in 2016. The biggest difference for 2017, compared to most of this recovery, was the sustained level of optimism throughout the year. Both individual and business confidence/optimism indices remain at levels last seen before the 2008-2009 Financial Crisis.

2017 economic growth started on a weak note with 1st quarter GDP registering a 1.2% annualized growth rate. This is very similar to what we have seen during this business cycle, and some economists believe that there may be an inherent seasonal adjustment data problem at play. Similar to other years, GDP growth rebounded to a 3.1% annualized rate in the 2nd quarter. As we moved to the 3rd quarter, the data was influenced by the natural disasters that occurred at the end of August and the subsequent rebuilding efforts that started in September. Third-quarter GDP growth grew at 3.2%. Digging beneath the headlines, what became apparent was that consumer spending slowed, potentially due to the impact of the natural disasters as people were without power and transportation. The contribution to GDP growth from personal spending dropped by an annualized .75% compared to the 2nd quarter. Business spending on inventories, net exports and government spending picked up the slack and kept GDP growth at virtually the same level as the 2nd quarter.

One of the encouraging changes that occurred in the 4th quarter was the trend of economic news coming in better than expected compared to forecasts. At the end of the 1st quarter, four out of the six major economic categories were coming in better than expected. In the 2nd quarter, the trend shifted as four out of the six categories came in worse than expected. That trend held in the 3rd quarter as four out of the six categories again came in worse than expected. Perhaps forecasters become more cautious after two consecutive quarters of economic data coming in worse than expected but, whatever the reason, all six categories came in better than expected in the 4th quarter.

The economy clearly has momentum even though it may not appear so with the 2.5% forecast for 4th quarter GDP. The last two quarters of the year were clearly distorted by the noise from the natural disasters. Looking at the underlying data we see that jobs growth remained solid during the year, government spending was increasing, and businesses were benefiting from a weaker dollar and the first steps toward reduced regulatory burden. Housing continued to show the "two steps forward, one step back" pattern, but it consistently improved throughout 2017.

As 2017 came to a close, Congress and the President enacted the biggest tax cut since the Reagan era tax cuts. As we go to press, businesses, individuals, analysts and the media are all busy trying to assess what the true impact of the tax reform bill will be for the economy. With mid-term elections occurring in November, we can probably be confident that the noise and drama from Washington, D.C., will not abate, but we also know that consumers and businesses remain confident heading into 2018.

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ALTERNATIVE STRATEGIES

Rick Cloutier, CFA
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Investors, expecting tax reform, were rewarded in the 4th quarter, and equity markets continued to rally. The 2017 Tax Cut and Jobs Act was initiated by the desire to bring US corporate tax rates in line with foreign developed markets and it should do just that. However, investors should temper their enthusiasm because any positive effects to corporate profits should be modest.

For the year, risk assets continued their stellar performance. The S&P 500 has now completed its ninth consecutive year of gains and, since 1926, that has only happened once — during the 1990s. Large caps outperformed small caps, and international stocks outperformed domestic stocks. Growth trounced value, but even value investors can't complain, having received a double-digit return.

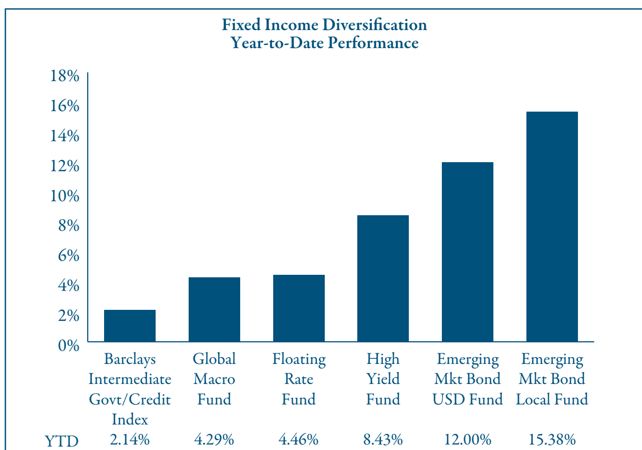
Emerging market stocks and bonds easily beat their less volatile counterparts.

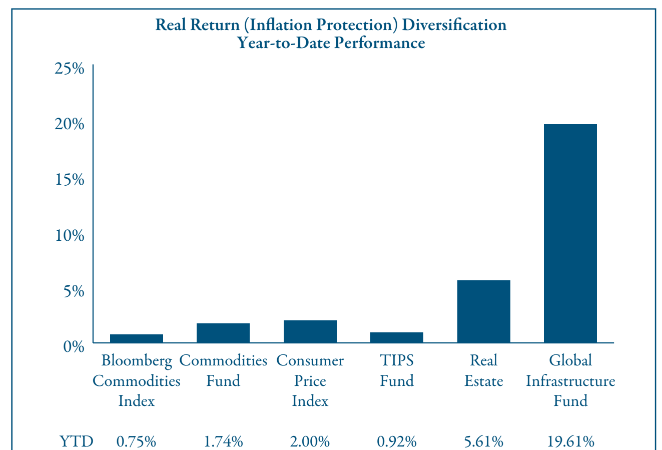
Oil prices remained at or near $50/barrel for a good part of the year, but continued production cuts from OPEC, coupled with an unexpected fall in US production, led to a late year rally and pushed prices for WTI Oil close to $60/barrel. For the year, oil was up around 12%, but during the last half of the year the gain was closer to 50%.

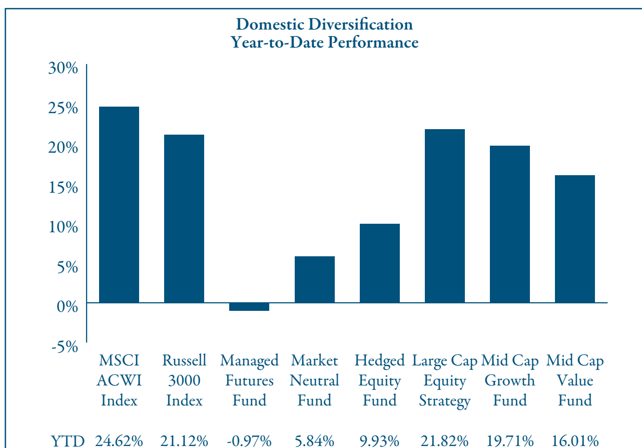
The Fed did as expected and raised interest rates a ¼ point in December. The market is expecting another two to three hikes next year as well. Through the year, the yield curve flattened, with short-term rates rising faster than long-term rates. The 2-year Treasury increased about 70 basis points, closing with a yield just below 2%, while the 30-year Treasury gained about 30 basis points to close yielding just about 3%. High yield closed the year returning over 7%.

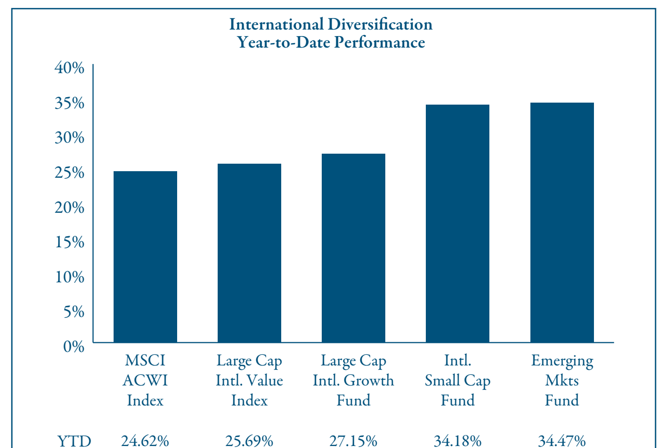
Our risk management strategies, as often is the case, provided returns that fell in between the returns provided by stocks and bonds. Managed futures continued to lag the group while hedged equity led.

The current market environment — low interest rates, benign inflation, solid S&P earnings growth and synchronized global growth — is clearly bullish for equities. And equity prices, well above their historic averages, reflect this. As always, we remain fully invested but pay particular attention to risk management.









DOMESTIC EQUITIES

Gayle Sprute
Senior Portfolio Manager

What a year for the stock market! Performance was strong, which is noteworthy given that this bull market is almost nine years old. The best-performing index, the Nasdaq Composite, rose 29.7%, followed closely by the Dow Jones Industrial's gain of 28.1%. Last year's "star" was this year's laggard. The Russell 2000 gained a less impressive 14.6%.

The market's climb was fueled in part by hopefulness about progress for the Trump administration's "pro-growth" agenda. Sentiment was also aided by confirmation that corporate America emerged from the "earnings recession." Easy comparisons versus the prior year set the stage for earnings growth of 15.3% and 12.4% in the 1st and 2nd quarters, respectively. Although earnings growth slowed to 8.4% in the 3rd quarter, investors remained steadfast. Some topics rattled psychology during the year: 1) geo-political events, especially North Korea's ballistic missile launches; 2) periodic outbursts of political drama in Washington, D.C.; and 3) concern about a possible "valuation bubble" in the technology sector. While investors sometimes paused to ponder these topics, the effect was limited. The market did not experience a single pullback or correction during 2017 (a pullback is a 5%+ decline and a correction is a 10%+ decline). At the sector level, Technology was the overwhelming leader, with an impressive gain of 38.8%, followed by Basic Materials' gain of 23.8%. Only two sectors were in the red: Telecommunications, down 1.2% and Energy, down 1.0%.

Looking into 2018, it seems like there is little to "rock the boat." Complacency is high and volatility remains extremely low versus historic levels. The economy and corporate America are expected to benefit from tax law changes. In fact, some strategists are forecasting that 2018 earnings for the S&P 500 companies could benefit by 5%-7%. But, a key consideration is how the tax law changes will affect corporate America's spending decisions. Some expect companies to spend tax savings on higher wages and capital expenditures. Others think that management will continue to deploy cash via dividend increases and share buybacks. What companies decide to do — and how it affects earnings growth — will be important to watch in 2018.

FIXED INCOME

Brian Brill, CFA
Senior Portfolio Manager

As we look back at 2017, the most notable observation was the flattening of the US Treasury yield curve and the continued spread compression in the riskier aspects of the fixed income market.

Entering 2017, the US Central Bank (Fed) was predicting a total of three 25-basis-point increases in the Fed Funds rate along with the hope that it could begin reducing its huge balance sheet. The market on the other hand was doubtful, and worried that this approach would ultimately lead to a policy mistake and thus choke off the recovery as evidenced by the muted inflationary data.

As the Fed began to fulfill its forecasts, the early political disappointments suffered by the Trump administration and tensions with North Korea fueled economic worries and policy mistake concerns.

At the same time, other major central banks flirted with changes to their very easy monetary policies as their economies showed signs of strength. This flirtation remained mostly just that as the European Central Bank (ECB) and the Bank of Japan (BOJ) continued to purchase assets.

Expectations began to change in September as the effects of Hurricanes Harvey and Irma stoked investors' hopes for increased economic output stemming from the rebuild of the devastation. Additionally, the belief that a tax cut/reform would happen this year began to take shape.

With tax cuts being signed into law and the Fed being very pragmatic with monetary policy, short maturity yields increased, while long-term maturities, still affected by policy error concerns and muted inflation, decreased.

These factors were also the reason investors favored the more risky sectors of the fixed income market as the hunt for yield continued. This is very evident in the corporate bond space. With good earnings and very accommodative foreign central bank policies, foreigners increased their purchases of US investment grade debt. As 2017 closed, corporate bond spreads to Treasury securities were at their tightest levels of the year.

We enter 2018 with the Fed again forecasting another three rate increases while its balance sheet continues to shrink. The ECB's asset purchases will probably end late in the year and the BOJ's purchases continue full steam ahead.

Washington Trust Bank
WEALTH MANAGEMENT & ADVISORY SERVICES

INTERNATIONAL REVIEW

Thomas Nesbitt, CFA
Senior Portfolio Manager

The year ended with a positive tone as foreign economic growth continued into the 4th quarter. Emerging markets countries outpaced developed countries in Year over Year (YoY) GDP growth, with India up 6.3%, China up 6.8% and Turkey up a strong 11%. Conversely, Japan's GDP growth was 2.1% and the Euro Area (EA) was up 2.6%. Inflation crept up in developed economies over the course of the year as well, but remained below central bank targets of around 2%. Foreign economies have been a driver in economic growth over the past year despite some political speed bumps along the way.

One of those bumps has been the ongoing Brexit negotiations. The two-year countdown began following the letter UK Prime Minister Theresa May sent to the European Council in March formally triggering Article 50. Since this time, there have been numerous negotiations and discussions to agree upon terms, which have yet to be finalized.

Central banks around the globe continued their accommodative monetary policies, but many are beginning to explore ways to reduce those stimulus packages. The European Central Bank and the Bank of England left rates unchanged at their latest meetings but are talking about how to tighten monetary policy. Only the Bank of Japan remains fully in the easy money camp.

The US dollar weakened further in the 4th quarter, ending the year down 10.4%. The weaker dollar has benefited foreign market returns.

Overall it was a strong year for foreign equity and fixed income markets.

	Latest 12 Months
MSCI EAFE Index	25.0%
MSCI Emerging Markets Index	37.3%
JPM GBI EM Global Diversified Bond Index	15.2%

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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HIGHLIGHT

ECONOMIC OUTLOOK

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Chief Investment Officer & Economist

The US economy enters 2018 with momentum that should keep the economy growing and avoid recession for the year. Even before considering the 2017 Tax Cut & Jobs Act (i.e. tax reform bill) there are forces that will provide a positive push to economic growth.

- **Global Growth:** Economic growth is improving globally and the US will benefit via higher export sales.
- **Housing:** Rebuilding from the natural disasters of 2017 (two hurricanes and two major wildfires) should provide an additional boost to housing construction in 2018.
- **Government Spending**: Defense spending is set to increase in the new budget and geopolitical pressures are unlikely to reduce that need.
- **Infrastructure:** Natural gas and oil pipelines construction should continue and rebuilding of infrastructure damaged during the natural disasters will provide a boost to economic growth.

Economic forecast without consideration for tax reform bill: The economy should be able to maintain economic growth in the 1.5%-2.5% range. The question is how individuals and businesses will respond to the tax reform bill.

- **Will consumers spend the improvement in their paychecks?** Polls continue to show that most Americans expect their taxes to increase rather than decrease. They will probably have to see the actual results in the paychecks before they change their mind.
- **Will the consumer use the increased income to pay down debt?** The most recent Federal Reserve Bank of New York report showed that consumer debt is at a record high of almost $13 trillion.
- **Will businesses invest their tax savings in new plant and equipment to boost productivity?** The average age of plant and equipment in the US is the oldest on record.
- **Will businesses use their tax savings to buy back shares and pay out higher dividends?** Neither of these strategies boosts GDP growth except through a trickle-down effect.
- **Will businesses use their tax savings to pay down the debt they have issued?** With the reduced tax for repatriation, US companies may use that repatriated cash to pay off the debt.

Economic forecast with the tax reform bill: If consumers and businesses spend their tax savings, then 2018 economic growth could grow between 3-4%.

What is the biggest wild card that could boost economic growth more than expected?

- The Bush tax cut of 2003 resulted in the economy growing 1.2% faster than the Congressional Budget Office (CBO) projected. If that impact was repeated with this tax cut, economic growth could be more than 1% higher than forecast.

What is the biggest wild card that could damage economic growth more than expected?

- Monetary policy is the biggest wild card risk. If the Federal Reserve overreacts to faster economic growth or rising inflation, it could commit an economic drag that overwhelms the benefits of the tax reform bill. It is also important to understand that the global central banks are scheduled to reduce the amount of stimulus in the global economy by almost $1 trillion in 2018 via Quantitative Tightening. Since this has never been done before, nobody (including the global central banks) truly know what the impact to interest rates will be.

Conclusion: 2018 holds the potential to see the economy hit a 3% or higher growth rate. The critical areas we will have to watch are how businesses and individuals respond to the tax reform bill and ultimately, how the Federal Reserve reacts.

Market Overview

Cumulative Periods *as of 31 December 2017*

	Year-to-Date	1 Year	Annualized 3 Years	Annualized 5 Years	Annualized 10 Years
Russell 3000 Index	**21.13**	**21.13**	**11.12**	**15.58**	**8.60**
S&P 500 Index	21.83	21.83	11.41	15.79	8.50
Russell Mid Cap Index	18.52	18.52	9.58	14.96	9.11
Russell 2000 Index	14.65	14.65	9.96	14.12	8.71
FTSE NAREIT All Equity REITs Index	**8.67**	**8.67**	**6.67**	**9.84**	**7.77**
Bloomberg Commodity Index	**1.70**	**1.70**	**-5.03**	**-8.45**	**-6.83**
MSCI ACWI All World Index	**23.97**	**23.97**	**9.30**	**10.80**	**4.65**
MSCI EAFE Index	**25.03**	**25.03**	**7.80**	**7.90**	**1.94**
MSCI EAFE Small Cap Index	33.01	33.01	14.20	12.85	5.77
MSCI EM Index	37.28	37.28	9.10	4.35	1.68
Barclays Govt/Credit 1-5 Yr. Index	**1.27**	**1.27**	**1.27**	**1.10**	**2.46**
Barclays US Treasury TIPS Index	0.80	0.80	1.25	0.12	2.04
BOAML US High Yield Master II Index	7.48	7.48	6.39	5.80	7.89
JPM GBI Global Diversified Index	15.21	15.21	2.53	-1.55	3.56
Barclays Municipal 1 Yr. Index	**0.92**	**0.92**	**0.61**	**0.64**	**1.48**
Barclays Municipal 3 Yr. Index	**1.56**	**1.56**	**0.94**	**1.07**	**2.36**
USTREAS Stat US T-Bill 90 Day Index	**0.82**	**0.86**	**0.40**	**0.26**	**0.34**