



ZACKS MARKET OUTLOOK AND STRATEGY COMMENTARY

Q4 2017

IN THIS ISSUE:

Mitch's Outlook

Strategy Commentary

January 27, 2018

The bulls ruled in 2017. Total return for the S&P 500 Index in the fourth quarter was a brisk +6.6% bringing 2017's total return up to +21.8%. Perhaps the most remarkable feature of equity investing in 2017 was the sheer lack of volatility – the S&P 500 broke a 66-year record for number of days (551) without a 5% drawdown.

As of this writing, the market has continued its upward ascent with little trace of downside volatility. Since February 2016, the S&P 500 has generated an annualized return of 20% against a volatility (VIX) of just 6 compared to an average annual return of 11% against a volatility of 15. Enjoy it while it lasts, but expect volatility to return in 2018.

The high-level view is that U.S. and global economic growth should continue in 2018 with corporate earnings experiencing another full calendar year of positive growth. This macro view supports higher stock prices too, but with valuations already somewhat stretched I would expect gains to be materially lower than 2017. Still, the base case is that stocks should remain the most attractive asset class relative to bonds or cash.

In the U.S., there are broad economic themes we believe will play-out in 2018:

- Positive corporate earnings growth, but lower than in 2017
- Rising inflation pressures with global central banks tilting toward tightening financial conditions
- Corporate profit margins squeezed by rising resource and labor costs
- Positive flow-through to consumer spending from personal tax cuts and wage growth
- Global GDP growth in the 3% to 3.5% range, U.S. GDP growth at 2% to 3%, and China GDP growth at 5.75% to 6.75%; all solidly positive
- Regulatory pressures growing on the biggest players in the Technology sector

Economic indicators have been posting positive surprises at their highest rate in over 5 years. Additionally, the U.S. economy is operating at close to full capacity, which means that tighter resource and labor markets are likely to put increasing pressure on costs. One could argue that the risk of rising costs only matter if they translate to compressed profit margins, higher inflation and, ultimately, a faster-than-anticipated pace of financial tightening from the Federal Reserve. Time will tell, but I see all of these dynamics as distinct risks to the current outlook.

We see inflation picking up in 2018, but the risk of the Fed over-tightening seems low (for now). While inflation figures at the wholesale levels (Producer Price Index) recently touched 2.4%, the highest level since early 2012, we have not seen it flow down to the consumer level, as measured by CPI. Core CPI in December came out at a year-over-year rate of 1.7%. For the Fed to seriously take inflation into account, CPI has to rise at a rate higher than 2% per year – and it hasn't done so in 5+ years. Wages are a modest concern because, while increasing, they are doing so from a very depressed starting point.



Mitch Zacks

Senior Portfolio Manager

Mitch's Outlook

After a flurry of activity, Congress passed the tax reform bill in late 2017. The biggest beneficiaries will be corporations, whose top tax rate drops from 35% to 21%. For individuals, while the standard deduction amount almost doubles, the limitation on state and local tax deductions could hurt investors in areas where either tax rates or property taxes are high.

Three Risks to the Forecast

There are certainly more risks to an optimistic outlook for the economy and stocks, but here I'll focus on just these three...

Risk #1: Tightening Financial Conditions

The Federal Reserve raised interest rates in December, as expected, and appears on target to continue more of the same in 2018. But, the Fed's dilemma in 2018 has more to do with the pace of tightening. Inflation could be the most important economic indicator of 2018, as it sets the pace for tightening monetary conditions here in the U.S. Overseas, effective this month, the European Central Bank is set to halve its bond buying as it scales back its quantitative easing program. Using the Fed's "taper" as a historical example, markets can become volatile as the so-called "punchbowl" of liquidity is gradually removed.

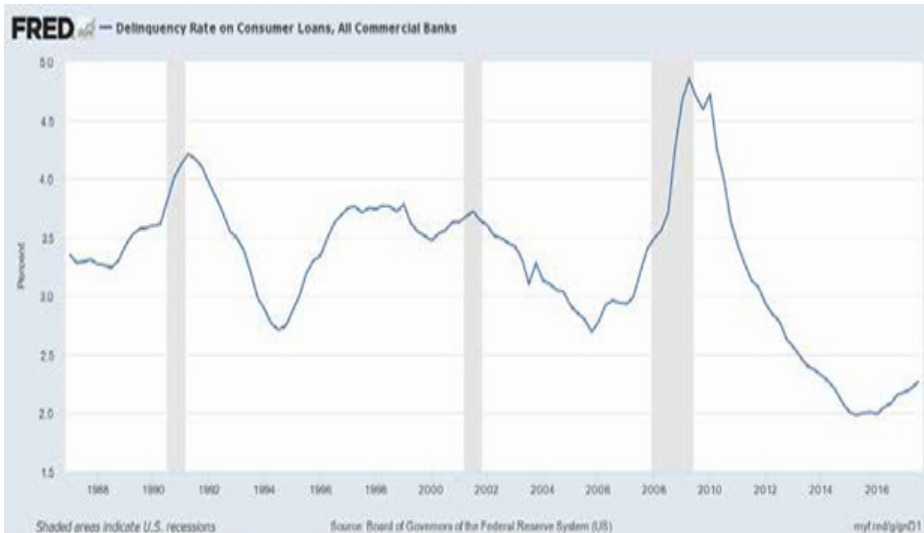
Risk #2: NAFTA and Trade

This is an event that could have an impact as early as the first half of the year. Uncertainty surrounding the future of the free trade agreement is palpable – will the agreement be torn up, fundamentally reworked, or more or less stay the same? The most acute risk, in our view, is that costs rise and margins get squeezed as some corporations are forced to move production back to the U.S. as a result of tariffs, which is arguably the wrong reason to do so. Canada and Mexico are our second and third biggest trading partners, respectively, so any tension in the new agreement is likely to hurt all parties involved. The Trump Administration has already made some small waves with the slapping of tariffs on washing machines and solar panels, and market participants are wondering how far the toughness on trade will go.

Risk #3: Reversal of the Credit Cycle

Delinquency rates on consumer loans, auto loans, C&I loans (mainly energy related), and others have been quietly rising since 2015 as credit growth slows. Rising delinquencies in these areas have historically preceded recessions (grey bars in chart) and, to make matters more troubling, U.S. bank credit growth appears to have peaked around the same time delinquencies bottomed in 2015.

Delinquency Rates on Consumer Loans (All Commercial Banks)



Source: Board of Governors of the Federal Reserve System (US)

Should delinquencies continue to increase as the Federal Reserve tightens monetary policy, it could discourage banks even further.

We are also watching corporate debt structure as leverage sits at a 13-year high. In 2007, consumers were wildly overstretched. Today, it may be the corporate sector that is over indebted, having long relied on debt to fuel sizable stock repurchases. If the credit cycle continues to show signs of potential unwinding, it could be something for which to pay close attention.

Bottom Line for Investors

In 2017, stocks flourished in an environment of synchronized global growth, anchored interest rates, and low inflation. And for the first time in history, the S&P 500 experienced a positive total return during every month of the year. While we expect more global synchronized growth in 2018, there could be some challenges in the inflation and interest rate arena as the U.S. economy operates at capacity and cost pressures rise. Even so, we expect four more quarters of positive earnings growth which should support higher stock prices on balance for 2018.

As mentioned earlier, however, the low volatility environment has been welcomed but unusual, particularly this late in the cycle. Investors would be wise, in my view, to remain optimistic throughout 2018 but also to expect a much bumpier ride than we experienced in 2016 or 2017.

All the best,

Mitch Zacks

Dividend Strategy

Strategy Description: The Zacks Dividend Strategy seeks tax efficient total returns from both capital appreciation and dividend payments. We focus on companies with attractive valuations, strong dividends and low risk characteristics.

Since inception, the Zacks Dividend Strategy ranks in the top 2% out of 823 managers in the Morningstar Large Cap Value Universe. Economic growth around the world remained strong and commodity prices strengthened during the quarter. Corporate profits and employment growth in the U.S. also came in strong. Additionally, Congress passed a comprehensive tax reform law that was seen by the markets as having potential to boost corporate earnings and the U.S. economy further. Though inflation was weak, taking into account the strengthening economy and near full employment, the Federal Reserve still raised interest rates as expected.

This confluence of positive economic data, investor sentiment, and the tax bill supported positive market momentum. Investors appeared to increase their exposure to perceived winners from tax reform while decreasing exposure to perceived losers. In the 'large value' space, Financials, Energy, Materials, and Technology outperformed over the quarter. Utilities, Industrials, and Health Care underperformed. Our overweight to Technology and underweight to Utilities helped relative performance, while our overweight to Health Care hampered performance.

If favorable fiscal policies are implemented in the future and inflation remains largely in check, this should allow the Federal Reserve to maintain their measured approach to raising interest rates and placate market participants. In turn, this should support U.S. and global economic growth momentum, ultimately leading to further gains in equities markets. We believe that the strategy should continue to produce attractive returns in this environment.

Finally, due to the tax-advantaged nature of dividend payments, as well as a more attractive yield of +2.91% in Q4 2017 compared to the 10-Year US Treasury yield of +2.40%, we believe the strategy remains well-suited for investors seeking moderate growth and income.

DISCLOSURE Past performance is no guarantee of future results.

Results for the Strategy reflect the reinvestment of dividends and other earnings. The results portrayed is the performance history of a composite of all discretionary accounts with no material investment restrictions, which are not restrained by investment style, type of security, industry/sector, location, size or market cap; it invests primarily in U.S. common stocks.

Prospective clients and clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the Strategy during the period. Clients of the firm may receive different performance than the composite. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), and client- mandated investment restrictions. Wholesale, retail and institutional clients of the firm may have differing performance due to timing of trades.

Investments in the Strategy are not deposits of any bank, are not guaranteed by any bank, are not insured by FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested. Net of fees performance is based on the maximum fee of 1.75% for a \$500,000 account. Lower fees may apply to larger accounts; higher fees may apply to smaller accounts. Separately managed account minimums apply. Inherent in any investment is the potential for loss. Standard management fees are available on request and are described in Part 2A of Form ADV.

The sample portfolio holdings provided represents the top 10 largest equity positions in the Strategy as of 12/31/2017 based on the aggregate dollar value for a representative account. The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the Strategy, and the reader should not assume that investments in the securities identified and discussed were or will be profitable. All information is provided for informational purposes only and should not be deemed as a recommendation to buy the securities mentioned.

Morningstar Rank:

The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile as of 12/31/17. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.

Indexes Presented:

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. An investor cannot invest directly in this Index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 2000 Index is a well-known, unmanaged index of the prices of 2000 small-cap company common stocks, selected by Russell. The Russell 2000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell Mid Cap Index is a well-known, unmanaged index of the prices of approximately 800 mid-cap company common stocks, selected by Russell. The Russell Mid Cap Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Value Index is a well-known, unmanaged index of the price of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 3000 Index is a well-known, unmanaged index of the prices of 3000 broad U.S. equity company common stocks, selected by Russell. The Russell 3000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The MSCI EAFE is an index from Morgan Stanley Capital International. The MSCI EAFE is a well-known, unmanaged index representing developed nation countries around the world. The MSCI EAFE Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Zacks Investment Management may utilize mutual funds in some client portfolios. Zacks Investment Management is the advisor to these funds and will receive compensation from the funds and their shareholders for advisory services. Additional information is available upon request.



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