Verdence Capital Advisors

Weekly Investment Strategy Update

Weekly Economic Recap – *Good but Not Great Jobs*

- The December ISM Manufacturing Index rose (59.7) to the second best level since February 2011. The new order component, a harbinger for future growth rose to the highest level (69.4) since 2004 while prices paid, which can be an inflation measure, remained near the highest level since 2011.
- The ISM Non Manufacturing Index, a gauge on the service sector, moderated in December (55.9) after reaching the highest level since 2005 in November. However, every segment of the Index was in expansion territory led by inventory sentiment, prices paid and export orders.
- Vehicle sales rose at a 17.76 million annual pace in December. This is well above the historical average of 14.6 million and a good harbinger on the health of the consumer. A consumer would not likely take on a big ticket item (e.g. car loan) unless they felt confident about their job/wage prospects.
- The U.S. economy added 148K nonfarm payroll jobs in December and the unemployment rate remained at 4.1%. While still a solid number, at 148K it was lower than the rolling 12 month average (172K) and wage growth was moderate (0.3% MoM). This may take pressure off the Fed to be aggressive with rate hikes in 2018.

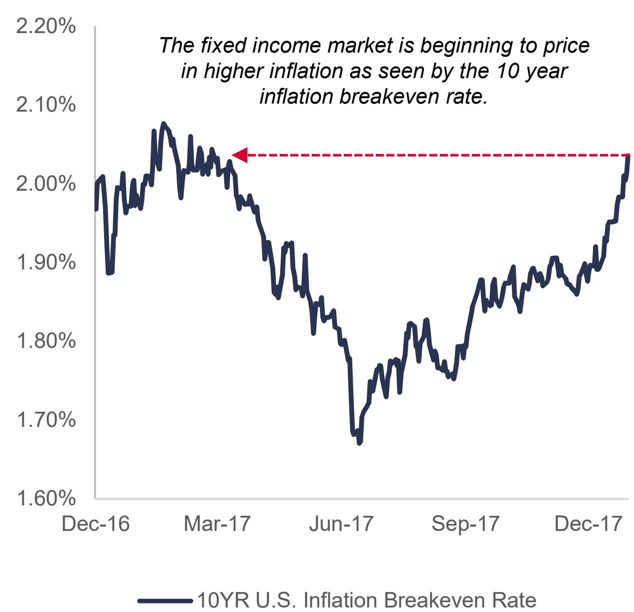
Weekly Market Recap – *Strong Start to a New Year*

- **Fixed Income:** Strong economic data and equities hitting fresh record highs challenged fixed income. The Barclays Aggregate Index posted its second worst week in the past eight weeks. Treasuries led the weakness after the 10YR Treasury bond fell 0.5%. However, pricing pressures in select manufacturing Indices pushed inflation expectations (10YR inflation breakeven rate) to the highest level since March 2017 (2.03%). As a result, TIPS (-0.1%) fell less than Treasuries. EM and high yield bonds rallied alongside solid risk appetite in equities.
- **Equities:** Optimism about the upcoming earnings season and solid economic data helped global equities kick off 2018 on a positive note. Within the U.S., the Dow surpassed 25,000 for the first time on record, the S&P 500 had its best first week of a new year in five years and even the Russell 2000 Small Cap Index participated in the rally by hitting a new record high. Eight of the 11 S&P 500 sectors ended the week in positive territory. The interest rate sensitive sectors (e.g. real estate, telecom and utilities) were the only sectors to decline.
- **Commodities/FX:** The Bloomberg Commodity Index fell for the first time in four weeks despite a weaker dollar. Solid gains in crude oil and gold were overshadowed by the drop in copper after stockpiles rose to the highest level since November.

Low Wage Growth Takes Pressure off Fed

Footnotes: Data as of December 2017.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Market Based Inflation Expectations Rising



Footnotes: Data as of January 5, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Weekly Strategy View – *A Closer Look at Inflation*

Last week, inflation advocates were disappointed by the lackluster gains in average hourly earnings. Average hourly earnings rose 2.5% (YoY) in December and have not been able to consistently rise to levels that you would historically see with unemployment at 4.1%. While wages are a significant harbinger for future inflation, there are other indicators that are worth monitoring. Some of these data points suggest that investors and consumers should be prepared for higher inflation in 2018.

- **Manufacturing prices suggest higher inflation**: The December ISM Manufacturing Index showed that prices paid by manufacturers remained near the highest level since 2011. In fact, the prices paid component has been above 65 (a level above 50 suggests expansion) for nine out of the past 13 months. However, this has not filtered into inflation data. Using history as a guide, prior to the Great Recession, if the prices paid component of the ISM Manufacturing Index has been above 65, core PCE has grown 4.4% (YoY), on average. *Currently core PCE has averaged 1.6% (YoY) in the past 13 months while ISM prices paid has been above 65.
- **Rising housing prices should filter into rents**: One of the major components of the CPI Index is housing, specifically owners' equivalent rent. With home prices expected to rise as inventories are at a record low and household formations are rising, this should filter into the CPI Index in 2018.
- **Will healthcare prices rise in 2018?** Healthcare costs are a major component of the Fed's preferred inflation gauge (PCE Core) and have been growing at a tepid pace in recent years. In fact, healthcare costs in the PCE Index have grown by less than 2% over the past six years, well below the historical average annual growth of 4%. Uncertainty over the changes to Obamacare (or complete dismantle) and the aging population could put pressure on healthcare costs in the future.
- **Self fulfilling prophecy:** Inflation can also be driven higher by consumer expectations. If consumers think that prices will be higher in the future, they may pull spending forward. Increased spending can be followed by companies raising prices. Currently, one year forward looking inflation expectations in the University of Michigan Consumer Sentiment Survey show that consumers think prices will rise 2.7% over the next 12 months. This is near the highest level in 20 months.

This week we receive several inflation reports (import/export prices, producer and consumer prices) that should strengthen the view that the disinflation environment may be behind us. As a result, we expect yields to continue to move higher in the near term. In addition, 4Q17 earnings season kicks off with many major financial companies reporting earnings. Some of the things to watch include views on the new tax plan, the economic environment, rising input costs and future growth plans.

Asset Class Performance

U.S. Equities

	Current	1WK	1MO	3MO	1YR	YTD
Dow Jones Industrial Average	25,296	2.4%	4.7%	11.7%	30.2%	2.4%
S&P 500	2,743	2.6%	4.5%	8.0%	23.3%	2.6%
Russell 1000 Growth	1,397	3.3%	5.4%	10.0%	32.1%	3.3%
Russell 1000 Value	1,243	1.7%	3.4%	5.7%	14.3%	1.7%
Russell Midcap	2,119	2.0%	3.8%	6.8%	18.9%	2.0%
Russell 2000	1,560	1.6%	3.0%	3.5%	15.2%	1.6%
Nasdaq	7,137	3.4%	5.6%	8.7%	31.6%	3.4%

International Equities

	Current	1WK	1MO	3MO	1YR	YTD
MSCI AC World (USD)	527	2.7%	5.0%	7.6%	25.0%	2.7%
MSCI EAFE (USD)	2,101	2.4%	4.8%	6.8%	25.3%	2.4%
MSCI Europe ex UK (USD)	2,170	2.9%	4.0%	4.0%	28.3%	2.9%
MSCI Japan (USD)	3,544	3.2%	4.8%	11.4%	23.7%	3.2%
MSCI UK (USD)	1,265	0.7%	6.4%	6.7%	21.6%	0.7%
MSCI EM (USD)	1,201	3.7%	7.7%	9.3%	39.2%	3.7%
MSCI Asia ex Japan (USD)	738	3.5%	6.9%	9.9%	43.0%	3.5%

Fixed Income

	Current Yield	1WK	1MO	3MO	1YR	YTD
U.S. Aggregate	2.8%	-0.3%	-0.2%	0.1%	2.7%	-0.3%
U.S. Govt/Credit	2.7%	-0.4%	-0.3%	0.2%	3.0%	-0.4%
U.S. 10 Year Treasury	2.5%	-0.5%	-0.8%	-0.6%	1.0%	-0.5%
U.S. TIPS (1-10YR)	2.3%	-0.1%	0.2%	0.4%	1.4%	-0.1%
U.S. High Yield	5.5%	0.7%	0.9%	1.0%	7.4%	0.7%
EM Bonds (Local)	4.8%	1.4%	2.5%	3.7%	15.0%	1.4%
Municipal Bonds	2.4%	-0.03%	0.2%	0.7%	4.9%	0.0%

Commodites

	Current	1WK	1MO	3MO	1YR	YTD
Bloomberg Commodity Index	88	-0.3%	3.4%	3.9%	0.4%	-0.3%
Crude Oil (USD/bbl)	$61.4	1.7%	6.6%	21.0%	14.3%	1.7%
Gold ($/oz)	$1,319.4	1.4%	5.8%	3.5%	12.6%	1.4%
Copper	$323.0	-2.0%	9.5%	6.8%	27.1%	-2.0%
Wheat	$430.8	0.7%	-0.5%	-6.3%	-11.5%	0.9%
U.S. Dollar	92	-0.1%	-2.0%	-1.9%	-10.0%	-0.1%
VIX Index	9.2	-16.5%	-18.6%	0.3%	-21.0%	-16.5%

*Footnotes: Data is weekly and as of January 5, 2018.*Time period reflects January 1960 to December 2007.*
Source: Bloomberg Finance LP, Verdence Capital Advisors.

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