Redhawk Quarterly Commentary

December 31, 2017

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic topics designed to help make decisions affecting your long-term financial strategy.

Market Commentary

U.S. Market

The S&P 500 ended a strong year with a fourth-quarter gain of 6.22%. Two Republican defeats in Senate contests in Alabama and Virginia during the quarter spurred House and Senate Republicans into action. The Republicans feared that the defeats were a sign of things to come in next year's mid-term elections and they agreed to the long-awaited tax reform bill. Markets rallied on the news, with significant incentives for corporations as the centerpiece of the package.

U.S. equities were also supported by positive macroeconomic data, including better-than-expected third-quarter GDP annualized growth of 3.0%. Employment data over the period was partly skewed by the effects of the hurricane season. However, non-farm payrolls rose by a stronger-than-expected 228,000 in November although wage growth remained subdued.

As had been widely anticipated, the U.S. Federal Reserve (Fed) lifted interest rates by 0.25% in December. The Fed also raised its growth forecasts for 2018 to 2.5% from 2.1%. The quarter also saw robust corporate earnings, particularly from the technology sector. Cyclical areas of the market performed well, with gains led by the consumer discretionary sector, technology, and financials. The utilities sector underperformed.

Typically, threats of a nuclear conflict between the U.S. and North Korea, a stalled administration agenda, and a number of major hurricanes would lend to a pullback and a flight to quality. However, the rally in the U.S. equity market continued at a pace consistent with what investors experienced in the first half of the year.

There was a strong move in U.S. small cap companies due to the announcement of a meaningful corporate tax cut proposal which would primarily benefit U.S. small businesses, as they tend to pay a higher effective tax rate. On a sector basis, energy stocks rebounded nicely in the quarter as crude oil prices moved higher and appear to be trading in a sustainable range. Financial names benefited in the quarter from the Fed's move to tighten coupled with the tax cut proposal. Overall, the laggards in the market in the quarter were consumer staples, health care, and utilities stocks.

The chart below shows the returns for the fourth quarter.

- The S&P 500 was up 6.22%.
- The NASDAQ was up 6.27%.
- The Dow was up 10.33%.

Source: Morningstar.

International Markets

International stocks have performed well throughout 2017, and the fourth quarter was no exception. Europe, which continues to reflect a modest level of growth supported by a favorable monetary policy, posted the strongest equity returns of any region of the developed world in 2017. While the threat of terror attacks and the weight of the Syrian refugee crisis have continued to fuel anti-immigration sentiment, the improving employment picture and a strengthened position in Brexit negotiations have created a calmer political environment. The reality of a post-Brexit economy looms in the UK, but stocks have moved higher as relative valuations of multinational firms still prove attractive.

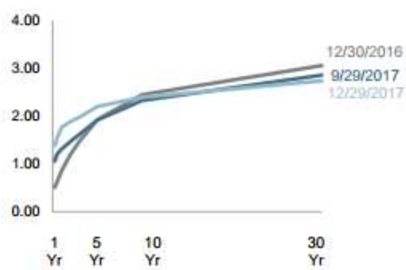
The Japanese economy has provided enough of a foundation to support inflows, and the government's move to buy equities as part of its overall monetary program has continued to push asset prices higher. Emerging markets equities continued their winning ways for the year.

Fixed Income Markets

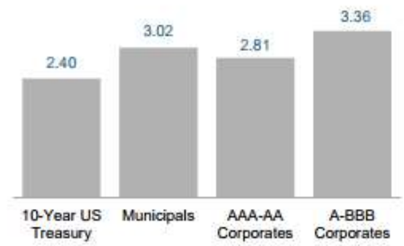
Fixed income returns were slightly positive in the quarter. While demand has continued for U.S. Treasuries against a backdrop of lower yields in developed Europe and Japan, the combination of higher interest rates, the slow sell-off of the Fed's balance sheet, and a potential influx of new debt to fund a tax cut for individuals could finally push yields higher in 2018. Credit continues to outperform government bonds and high yield bonds have outperformed investment grade issues as the appetite for risk continued. Municipal bonds have performed well this year, outperforming taxable issues.

Interest rate changes across the U.S. fixed income market were mixed during the fourth quarter. The yield on the 5-year Treasury note rose 0.28%, ending at 2.20%. The yield on the 10-year Treasury note increased 0.07% to 2.40%. The 30-year Treasury bond yield decreased 0.12% to finish at 2.74%. In terms of total returns, short-term corporate bonds declined 0.04% during the quarter but increased 1.85% for the year. Intermediate-term corporate bonds gained 0.17% for the quarter and 3.92% for the year. The total returns for short-term municipal bonds were 0.65% for the quarter and 1.61% for the year. Intermediate-term municipal bonds fell 0.09% for the quarter but gained 4.70% for the year. Revenue bonds outperformed general obligation bonds for the year.

US Treasury Yield Curve (%)



Bond Yields across Issuers (%)



Period Returns (%)

** Annualized*

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
Bloomberg Barclays Long US Government Bond Index	8.53	2.85	3.49	6.49
Bloomberg Barclays US Corporate High Yield Index	7.50	6.35	5.78	8.03
Bloomberg Barclays Municipal Bond Index	5.45	2.98	3.02	4.46
Bloomberg Barclays US Aggregate Bond Index	3.54	2.24	2.10	4.01
Bloomberg Barclays US TIPS Index	3.01	2.05	0.13	3.53
Citi World Government Bond Index 1-5 Years (hedged to USD)	1.13	1.21	1.23	2.13
ICE BofAML 3-Month US Treasury Bill Index	0.86	0.41	0.27	0.39
ICE BofAML 1-Year US Treasury Note Index	0.57	0.49	0.38	0.90

One basis point equals 0.01%. **Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Yield curve data from Federal Reserve. State and local bonds are from the S&P National AMT-Free Municipal Bond Index. AAA-AA Corporates represent the Bank of America Merrill Lynch US Corporates, AA-AAA rated. A-BBB Corporates represent the Bank of America Merrill Lynch US Corporates, BBB-A rated. Bloomberg Barclays data provided by Bloomberg. US long-term bonds, bills, inflation, and fixed income factor data © Stocks, Bonds, Bills, and Inflation (SBBI) Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Citi fixed income indices © 2018 by Citigroup. ICE BofAML index data © 2018 ICE Data Indices, LLC. The S&P data are provided by Standard & Poor's Index Services Group.

Economic Outlook

U.S. Equity Markets

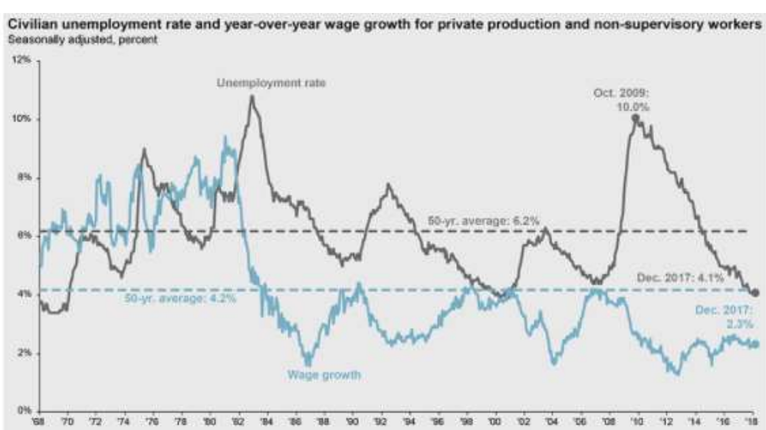
This economic expansion has been slow but steady. As of December, the expansion is in its ninth year, making it the third longest expansion since 1900. Growth accelerated in the fourth quarter and rebuilding following a series of natural disasters, alongside tax reform, should add to growth.

U.S. growth may be limited moving forward by structural constraints. Growth should accelerate and stabilize through the end of 2018, reflecting a pick-up in exports, inventories, government spending, and fiscal stimulus through tax reform. Stronger investment spending and an improving global economy should also add to the growth. Regardless, weak productivity and labor force dynamics should prevent sustained growth at 3.0%, with growth likely slowing to 2% or less in 2019 and beyond.

While the economy maintains a slow-but-steady pace of growth, the labor market has continued to tighten. This reflects two key trends:

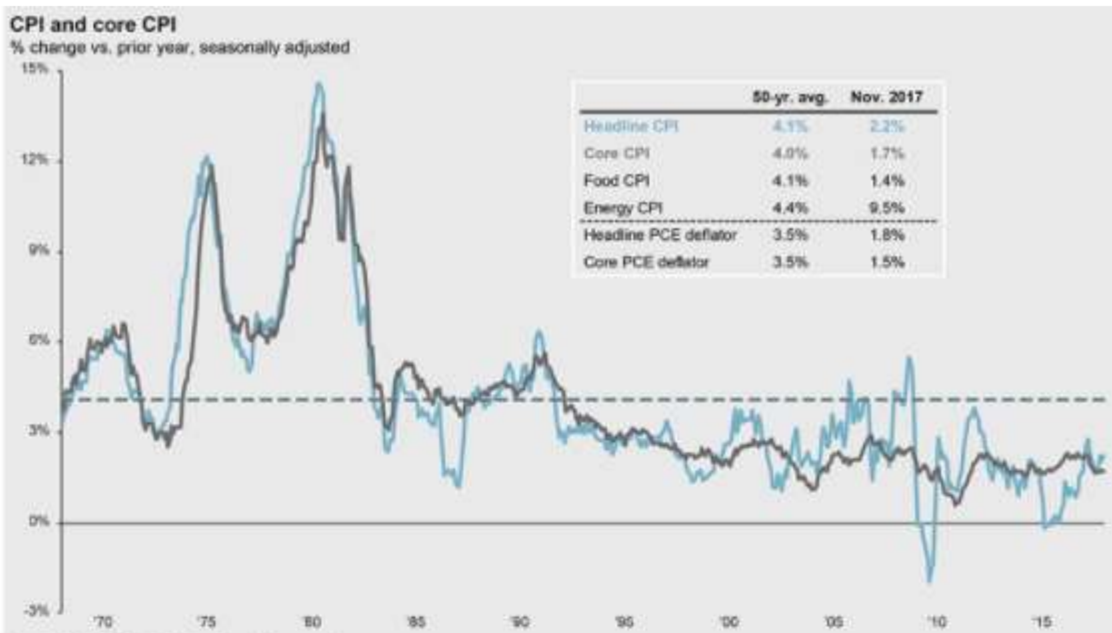
1. Low productivity growth, which implies most GDP growth has to come from employing more workers, and
2. Low labor force growth, which means that much of the job growth has come from re-employing the unemployed rather than new workers entering the labor market.

Solid GDP growth in 2017 and 2018 should cut the unemployment rate further having already fallen close to 4% by the end of 2017. While wages have been slow to react to a tight labor market, extra pressure to find workers spurred by tax cuts could finally boost wage growth in 2018.



Source: BLS, FactSet, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of December 31, 2017.

After showing signs of strength early in the year, a fall in oil prices and heavy competition amongst consumer cellular services prices has put downward pressure on CPI. However, we expect this weakness to be temporary and inflation to edge up through 2018, helped by a weaker dollar, higher oil prices, and tightening labor and housing markets.



Source: BLS, FactSet, J.P. Morgan Asset Management.

International Markets

The global economy started to show signs of life at the end of 2016 and it does not appear that things will cool off anytime soon, with the global aggregate manufacturing purchasing managers' index reaching six-year highs moving into 2018.

The Eurozone is growing particularly fast because of an undervalued currency, rising confidence, and considerable pent-up demand. Other developed markets like Japan, Canada, and the U.S. continue to accelerate. The UK appears to be weathering the impact of the Brexit vote better than many had feared, thanks to more competitive exports on a weaker currency. Meanwhile, a rebound in demand for commodities continues to be a positive for Latin America, Canada, and Australia.

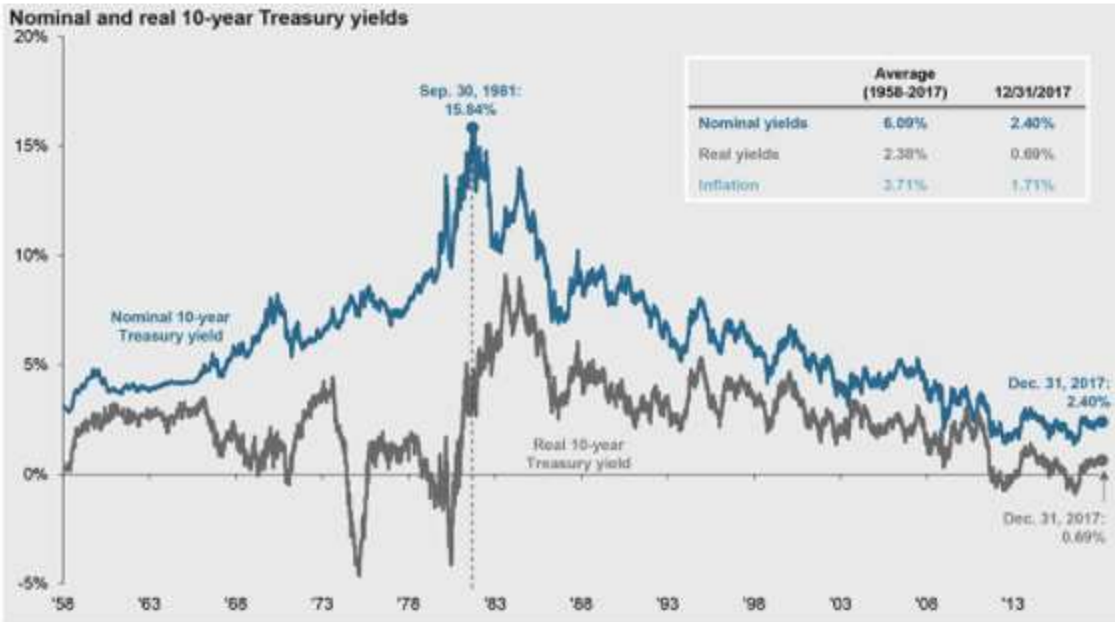
Earnings in Europe remain far below their pre-financial crisis peaks, while Emerging Markets (EM) earnings are below peaks achieved in 2011. A long cyclical recovery in Europe and an improving banking system should lift European earnings while EM profits should rebound on firmer commodity prices. Both European and EM earnings appear to have more room to grow than in the U.S. While U.S. P/E ratios are above their 25-year average, Europe and EM look more attractive from a valuation perspective:

- European P/Es are somewhat lower, and comparison to local bond yields makes for an even more compelling case.
- EM Price-to-Book ratios remain at just average levels. If the U.S. dollar falls to more reasonable levels, this could add to the returns on international equities.

Source: FactSet, MSCI, Thomson Reuters, Standard & Poor's, J.P. Morgan Asset Management.

Fixed Income Markets

Long-term interest rates remain very low, especially compared to historical averages, despite a clearly improving global economy and Fed tightening. However, in 2018, some forces like further hikes in the federal funds rate, stronger economic growth, and lessening accommodation by other central banks should push yields higher. This increase in rates should result in weak total returns on Treasuries and some high-quality corporate bonds. This suggests that other fixed income sectors, like high-yield debt or emerging markets will perform better relative to other asset classes.



Source: BLS, Federal Reserve, FactSet, J.P. Morgan Asset Management.

Summary

Despite a very long and powerful bull market, the case for an overweight to U.S. stocks over bonds persists. As it currently stands, many valuation measures show the U.S. equity market to be expensive relative to history, with forward P/E ratios trending higher than long-term averages. Let's take a look at two topics that are on everyone's mind – recession and rising interest rates.

Guggenheim's Model Points to Recession in Late 2019 or 2020

We utilize several of the Guggenheim mutual funds in our models and we closely follow their market model in order to determine if the U.S. is heading into a recession. The business cycle is one of the most important drivers of investment performance. It is critical for investors to have a well-informed view on the business cycle and at this stage, with the current U.S. expansion showing signs of aging, Guggenheim's focus is on projecting the timing of the next downturn.

Predicting recessions well in advance is notoriously difficult. Using history as a guide, however, Guggenheim finds that it may be possible to get an early read on when the next recession will begin by analyzing the late-cycle behavior of several key economic and market indicators. Guggenheim's analysis of these metrics suggests that the current expansion will end as soon as late 2019.

Guggenheim's Recession Report Summary:

- *The Labor Market Becomes Unsustainably Tight.* A strong labor market prompts the Fed to tighten because an unemployment rate well below the natural rate is unsustainable and can lead to a spike in wage and price inflation. Looking at the current cycle, the labor market is in the early stages of overheating.

- *The Fed Raises Rates into Restricted Territory.* Leading up to past recessions, the Fed has usually hiked rates beyond the natural rate to cool the labor market and get ahead of inflation, only to inadvertently push the economy into recession. Looking at the current cycle, Guggenheim expects quarterly rate hikes to resume in 2018. This will put Fed policy well into restrictive territory next year, barring a sharper increase in the natural rate than expected.

- *Treasury Yield Curve Flattens.* Recessions are always preceded by a flat or inverted yield curve, usually occurring about twelve months before the downturn begins. This occurs with T-bill yields rising as Fed policy becomes restrictive while 10-year yields rise at a slower pace. Looking at the current cycle, Guggenheim expects that steady increases in the fed funds rate will continue to flatten the yield curve over the next 12–18 months.

- *Growth in Hours Worked Slows.* Other indicators of the real economy, including aggregate weekly hours, decline in the months preceding a recession as employers begin to reduce headcount and cut the length of the workweek. Looking at the current cycle, aggregate weekly hours growth has been steady, albeit at weaker than average levels, reflecting slower labor force growth as baby boomers retire. Guggenheim expects growth in hours worked to hold up over the coming year before slowing more markedly in 2019.

- *Consumer Spending Declines.* Real retail sales growth weakens significantly before a recession begins, with the inflection point typically occurring about twelve months before the start of the recession. Consumers cut back on spending as they start to feel the impact of slowing real income growth. This shows up most noticeably in retail sales, which are made up of a higher share of discretionary purchases than other measures of consumption. Looking at the current cycle, real retail sales growth has been steady at around 2 percent. This is weaker than the historical average, but is consistent with slower-trend gross domestic product (GDP) growth in this cycle.

What Will Happen to Bonds in a Rising Rate Environment?
Rates spiked after the U.S. presidential election and in the closing days of 2017, the same concern is resurfacing due to signs of stronger U.S. economic growth and the advantages provided by tax reform. The yield on the 10-year U.S. Treasury note is approaching 2.5%, which is up over 0.40% from early September.

It's helpful to frame the discussion of the impact of rising rates in terms of the type of rates we're talking about (short-term or long-term) as well as the specific categories of bonds. There are two key questions facing bond investors:

1. Should bond investors focus on moves in longer-term rates, which have a greater impact on the broader bond market?
2. Should bond investors watch the changes in the overnight rates directly controlled by the Fed, which have a more profound effect on short-term bonds?

Long-Term Rates
As long-term rates rise, longer duration government related bonds tend to suffer the most. Lower-duration and more credit sensitive bonds do better in a rising interest rate environment and include:

- Short-term corporate bonds.
- High yield corporate bonds.
- Floating rate bank loans.

Short-term corporate bonds feature a far lower duration than longer maturity securities. As a result, short-term bond prices are relatively stable during periods of volatility in interest rates.

Short-Term Rates
Many investors assume that when the Fed raises short-term rates and the yield curve flattens, shorter maturity securities will suffer. Short-term yields tend to rise more than long-term yields during Fed tightening cycles and the bond categories that have done well in this environment include:

- Short-term corporate bonds.
- Short-term commercial mortgage backed securities and asset backed securities.
- Securities with floating rate coupons.
- Floating rate notes.

As rates have been moving higher, short-maturity strategies have the benefit of regular cash flows from coupon payments, which can be re-invested at prevailing higher rates.

It's not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You have to be patient and disciplined, too. With our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk advisor to learn more.