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Bailard Wealth Management
Quarterly Review of Economic and Market Developments*

Q4 2017

It is with great sadness we inform you that our co-founder, Tom Bailard, passed away on December 11, 2017. Those who knew Tom understood what a wonderful man he was, both personally and professionally. Nearly 50 years since our founding, our company is so much of what it is today – its values, ethics and culture – because of Tom's guidance and his character. We will miss Tom dearly.

Q & A Economic and Market Outlook for the New Year

WITH BAILARD'S CHIEF ECONOMIST & INVESTMENT STRATEGIST ART MICHELETTI, CFA

The U.S. economy accelerated to a 3% growth pace in the second and third quarters of 2017 after two previous quarters of sluggish growth. Given this backdrop, how do you see the economy shaping up in 2018?

Since the Great Financial Crisis in 2008, the U.S. economy has been in what many call the "new normal", defined by slow growth, low inflation and super low interest rates. As readers of this newsletter know, we have been solidly in this slow growth camp for many years. While there are signs of growth acceleration, it is too soon to say if this is sustainable. Much of the third quarter's results were due to inventory accumulation, which contributed 0.8% to overall GDP growth. Inventories remain cyclically too high and need to come down, which will likely be a drag on future growth. In addition, economic activity has been impacted by rebuilding after last year's hurricanes. Although replacement demand for cars and houses may give a temporary boost to GDP, it is probably not sustainable as the impact of economic disasters on GDP growth is often exaggerated. Destruction does not boost growth; it only moves it around. As disaster victims replace cars and homes, they divert consumption from other areas.

How will tax reform impact the U.S. economy?

According to some short-term estimates, GDP could increase by 0.4% to 0.8% in 2018 due to tax reform, up from the 2.1% growth baseline. That would put GDP growth in the 2.5% to 3.0% range. Since the individual tax cuts are

Q&A continues on page 2 >

Inside Q4 2017:

*Please see page 18 for important disclosures.

continued from page 1

temporary, long-term growth estimates are less robust. Over the next ten years, the Brookings Institute's static analysis sees growth improving by only 0.03% per annum. On the other hand, the Tax Foundation's dynamic analysis predicts a 0.3% per annum increase. The Tax Foundation sees average annual growth over the next ten years of 2.13%, up from its current 1.84% per year. This is less slow growth but still slow growth. However, growth is front-loaded.

How will tax reform impact the financial markets?

If growth is front-loaded, we may see better than expected growth in GDP and corporate earnings, which could help propel stock prices forward. But the key question is how much of the impact of tax reform has already been discounted after such strong, persistent equity markets in 2017. U.S. stocks are extremely overvalued by most metrics, investors appear to be overly optimistic, and the market's low volatility likely indicates extreme complacency. All of this suggests that a change in the stronger growth narrative could finally send stocks lower and trigger a long awaited correction.

What do you see as the biggest risk to the equity bull market?

Outside of a full-blown debt crisis, the greatest risk to stocks will probably come from rising bond yields. The tax cuts are likely to boost the deficit, which is already high and rising, increasing the financing needs of the government and putting upward pressure on bond yields. In addition, bond yields are also likely to feel upward pressure as the Fed begins to liquidate its balance sheet and the European Central Bank (ECB) cuts back on its quantitative easing (asset purchase) program. Rising bond yields could be the pin that pricks the asset bubble in stocks and bonds. If yields rise, bond prices will take a hit. In addition, higher yields will offer stiffer competition for stock investors seeking income, and extreme valuation multiples on stocks would likely contract. Higher bond yields could also create a strong headwind for debtors and for the interest sensitive portions of the economy (housing, autos etc.), posing not only financial risks but increasing the risk of recession.

But, through year-end, bond yields haven't risen despite Fed tightening. Why?

U.S. monetary policy has been gradually tightening as our central bank has increased the Fed Funds rate five times to 1.5%. Nevertheless, bond yields have remained relatively stable and the yield curve has flattened. There is currently a contradiction between: 1) bond investors who continue to discount soft growth and low inflation; and 2) stock investors who are focusing on a pick-up in growth and inflation. Historically, when stocks and bonds have sent a mixed message, bond investors have tended to be right. If that's the case, we should expect continued slow growth and low inflation.

With the Fed raising short-term rates and bond yields remaining stable, the yield curve has flattened. Most analysts view a flattening yield curve as negative for growth. As the yield curve flattens, banks that borrow short and lend long restrict unprofitable lending. The Fed plans to raise rates three to four more times in 2018. If the bond market remains calm, the yield curve could easily invert in 2018, a situation in which longer maturity debt yields less than shorter maturity debt. An inverted yield curve generally either makes it unprofitable to lend as net interest margins contract or results in riskier loans to pick up yield. Historically, inverted yield curves have tended to lead to recession and a bear market for stocks.

If rising bond yields could be the catalyst for lower stock prices, what could push stocks higher?

The surprisingly strong stock market since last year's presidential election has been largely driven by Trumphopium, the hope that Trump's policies would lead to stronger economic growth and a more favorable environment for corporations, with the most recent leg up due to tax reform. Now that tax reform is in place and largely discounted, another narrative is necessary. That narrative could be that foreign profit repatriation will find its way into dividends, share repurchases, and mergers and acquisitions (M&A). This repatriation of potentially over $1 trillion could help offset the reduction in central bank liquidity. Moreover, rising defense spending and another $1 trillion for infrastructure spending could give the economy an additional fiscal boost. Unfortunately, more fiscal stimulus may lead to even larger deficits and higher bond yields. For a long time now, stocks have ignored excessive valuations and soft fundamentals in hopes of a better tomorrow. Repatriation and more aggressive fiscal policy may be the narrative to keep hope alive.

What is the best way to handle all these risks?

As always, we advocate strategic diversification over multiple asset classes such as U.S. stocks, U.S. bonds, international stocks, and, where appropriate, real estate and alternative investments. Since markets are driven by investor sentiment as well as by valuations and fundamentals, in our tactical asset allocation strategy, we try to stay in synch with positive price momentum and listen to the verdict of the markets. Currently, sentiment and momentum are very positive. While we are late in the bull market, no one rings a bell for you at the top, and bull markets can go on longer and further than expected.

U.S. ECONOMY

The Economy Is Likely to Stay on a Slow Growth Path Despite a Possible Short-Term Boost from Tax Reform

During the third quarter of 2017, final GDP grew 3.3%, down slightly from the previous estimate of 3.2%. This was the second quarter in a row of above 3% growth, after two quarters of sub-2% growth. Year-over-year growth increased 2.3%, in line with our slow growth forecast for the year. The increase in the third quarter was driven largely by inventory growth, which will eventually have to be reduced. The U.S. economy is likely to get a temporary boost from hurricane rebuilding during the fourth quarter, and we could see another quarter of about 3% GDP growth. However, inventory reduction will likely be a drag on the economy, while consumer spending should be limited by soft real income growth.

Impact of Tax Reform on Taxpayers

As we move into 2018, the focus will be on the impact of tax reform, which will provide a one-time tax break for over 90% of income earners. Low and middle income taxpayers will receive the benefit of lower tax rates, a doubling of the standard deduction and a doubling of the child tax credit. Those hurt the most will be itemizing upper income individuals living in high tax states, since state income tax, local income tax and property tax deductions will be limited to a total of $10,000. Offsetting the loss of these deductions will be a lower top marginal rate and a higher standard deduction, which should lead to fewer tax itemizers. In addition, there will be fewer high income individuals falling into the alternative minimum (alt-min) tax, as the alt-min exemption has been raised and the income phase-out levels of certain deductions have been increased.

According to the Urban-Brookings Tax Policy Center, the final bill "would reduce taxes on average for all income groups in 2018 out to 2025." Compared to current law, only "5% of taxpayers would pay more tax in 2018, 9% in 2025 and 53% in 2027". Taxes move higher after 2025 as many individual tax changes revert back to their current levels. In this way, the plan has been front-loaded, with lower taxes now and reversion later on. This was done to enable tax reform to be adopted via the reconciliation process, which allows budget legislation to pass both houses of Congress with a simple majority (51 votes rather than 60 votes in the Senate) if certain conditions are met. One of the conditions for the tax reform legislation was that the maximum deficit the government could accumulate over ten years would be $1.5 trillion. The final tax plan, which was smaller and more complex than originally discussed, was able to meet this requirement, allowing the legislation to pass Congress without a single supporting Democratic vote.

Impact of Tax Reform on Growth

The Brookings Institute study cited earlier in this newsletter used static analysis rather than dynamic analysis to estimate the impact of tax reform on federal deficits. Static analysis takes tax changes literally and does not take into account any of the dynamic changes in the economy which occur as a result of changes in tax policy. Under static analysis, tax cuts for budgeting purposes are considered a revenue loser whether or not they potentially could generate more revenue growth. The Brookings Institute study has forecasted a one-time 0.8% boost to GDP in 2018, but little effect after that. Over the full ten years, the study predicts a 0.03% per annum (i.e. virtually no) increase in GDP.

Pro–tax cut advocates say that, since the economy is dynamic, GDP will grow at a stronger pace, generating higher tax revenues. The Tax Foundation uses dynamic forecasting and has projected a ten-year cumulative 2.9% increase in GDP as a result of tax reform. Over the next decade, the Tax Foundation estimates average growth would be 0.3% per annum higher or 2.13% compared to the current 1.84% per year. This is only a modest increase in GDP. The projected increase in GDP would be higher if the individual tax cuts were permanent and didn't revert back to current levels. If the individual tax cuts were made permanent, the Tax Foundation forecasts that GDP would increase a cumulative 4.7% over the next ten years.

Everything else being equal, tax cuts should be growth positive because they return income and capital to the private sector, which tends to be more productive than the government sector. In addition, the private sector tends to make more effective economic decisions, as it is generally not subject to the same social welfare or political considerations as the government.

However, everything else is not equal. As we stated over a year ago, past tax cuts (such as the Mellon tax cuts in the late 1920's, the Kennedy tax cuts in the 1960's and the Reagan tax cuts in the 1980's) had a positive economic impact because they occurred in a lower debt environment that allowed growth to be reinforced by increased leverage. These tax cuts also happened at a time when interest rates were high and growth was supported by accommodative monetary policy. Today, the economy is already extremely leveraged, interest rates are at historic lows, and the Fed is tightening. Given these structural differences, we may not get as strong a growth response to this tax cut.

While the U.S. economy may receive a one-time short-term boost, it may not be as large as expected given the secular (i.e. long-term) drags from massive overleverage and high and rising budget deficits. Unless the boost to growth is stronger than expected, tax reform will likely expand the deficit by $1.5 trillion above the baseline and add another $10 trillion in debt over the next ten years. It is also not clear whether these deficits can be financed without higher interest rates. The savings rate is low, while the Fed is tightening monetary policy and shrinking its balance sheet. To further complicate matters, federal expenditures and the budget deficit may increase further if Congress expands defense spending and passes an infrastructure bill. In the second week of January, we saw the first signs that yields may rise in response to these deficit issues, although rates still have remained low.

Tax reform accompanied by responsible spending in Washington would be growth positive; however, there has been no effort to rein in spending and, unless entitlements are addressed, we will likely have deficits and debt accumulation as far as the eye can see. Growing deficits and debt accumulation are probably not sustainable in the long run, as either: 1) debt will grow to an unsustainable level; or 2) interest rates will rise and further blow out the deficit with higher interest expense.

Impact of Repatriation

The tax reform legislation's one-time repatriation of foreign profits is expected to increase capital spending and provide a boost to growth. Under the previous tax law, companies owed the full 35% U.S. tax rate on globally generated profits. They got credits for the foreign tax paid but didn't have to pay the difference between foreign and U.S. rates until they brought the money home. As a result, companies held these funds overseas to avoid this added tax. Under the new rules, a deemed repatriation of foreign sourced income is taxed at a rate of 15.5% for liquid assets and 8% for illiquid assets.

Unless tax changes lead to real value creation, the U.S. will not get sustainable growth.

The U.S. has also moved to a territorial tax system where foreign profits are taxed at the source and dividends paid by foreign subsidiaries are 100% deductible. Analysts expect repatriation to raise about $350 billion in revenues, which was a key factor in helping to keep tax reform's ten-year debt accumulation below the $1.5 trillion limit set by Congressional rules.

As far as the economic impact goes, it is not clear whether these repatriated funds will be directed toward capital spending or whether, as in prior repatriations, the proceeds may be used for dividends, share buybacks and M&A activity. Repatriated money may help provide liquidity to financial markets and help keep a bid under stock prices; however, it remains to be seen whether repatriation can really help boost long-term economic growth.

Limitations of Forecasting

As a caveat, long-run projections about the impact of tax changes are rarely accurate. Budget estimates face real world circumstances (geopolitics, financial risks, dynamic changes and unexpected events) that can dramatically change expected outcomes. Nevertheless, unless tax changes lead to real value creation, the U.S. will not get sustainable growth. That requires expanding rather than reallocating the economic pie.

Continued Slow Growth Most Likely

Given the uncertainty of forecasting even a year out, the difficulty in long run forecasting is magnified. Our investment disciplines pay attention to what is actually happening and how markets are responding, rather than long-term forecasting and what we think should be happening. We hope we're wrong and the dynamic impact of these tax changes is more robust than we currently expect. The critical factors to watch are bond yields and capital spending. If monetary policy continues to tighten, eventually bond yields should rise, potentially offsetting any fiscal stimulus from the tax cut. Capital investment is a critical factor for bending the economic growth curve higher. For now, we are sticking with a slow growth forecast with the potential for a upside surprise.

INTERNATIONAL ECONOMIES

Growth Has Improved but Is Likely to Remain Slow

CHINA

China's GDP growth has remained just under 7% and the consensus estimate for 2018 growth has fallen to 6.4%. Ahead of the October 2017 Party Congress, efforts were made to keep growth up and credit expanded. Now that the Party Congress is over, the credit impulse in China is fading. Yuan loan growth, M2 (a measure of money supply), and overall household and corporate debt growth have all slowed. The People's Bank of China has also tightened credit.

With debt totaling over 300% of GDP, much of China's growth has been debt driven. Debt has continued to increase faster than GDP and nonperforming loans have still been rising. The Chinese authorities are aware that the country has a debt problem and have been working to deleverage. They are likely to continue slowing credit creation in an effort to restrain real estate speculation. Nevertheless, China needs to be careful that its efforts to deal with the debt issue don't trigger a hard landing.

Retail sales, industrial production and fixed asset investment have continued to trend lower but remain relatively robust by global standards, rising 10.2%, 6.1% and 7.3%, respectively on a year-over-year basis as of November 30, 2017. The Li Keqiang Economic Index, which tracks electricity usage, rail freight and credit growth, has slowed since the Party Congress, suggesting more growth moderation. Commodity prices have also been falling. We believe the most likely outcome for the Chinese economy is a continued, gradual and moderate slowdown.

Despite the slower growth outlook, there are a number of positives for Chinese stocks on the horizon. First, there is a concerted effort by authorities to move household assets away from Wealth Management Products (WMPs) and real estate into stocks. Second, institutional investors' interest in Chinese stocks is likely to rise as China becomes increasingly represented in MSCI's international stock indices.

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The Trouble with WMPs

Turning to the first factor, in a search for higher yields, hundreds of millions of Chinese have flocked to WMPs. As of June 30, 2017, they had placed a total of $9 trillion in these accounts in which investors give their money to banks who lend it out at high rates to property and commodity speculators. Although investors have been acting like these accounts are low risk bank CDs, they are not regulated or guaranteed by the government. In addition, smaller regional banks, those sitting on the most bad debts and the most vulnerable, have been selling the largest amount WMPs and pose the greatest risk. Smaller banks have also been using WMP funds for "short-term financing" to help shore up their own finances.

The Chinese authorities are planning a big crackdown on WMPs to defuse their financial risks. The changes are so big that China is postponing implementation until June 2019, so that the banking industry can prepare for the switch. Last October, President Xi Jinping told the Communist Party Congress that he is willing to accept slower growth in order resolve the WMP problem. As a secondary goal, he suggested incentives to increase equity investment over real estate speculation. Morgan Stanley estimates that, by the end of 2019, $1.7 trillion will move to stocks as the Chinese financial system is reformed.

Impact of Inclusion in MSCI Indices

Despite being the second largest stock market in the world behind the U.S., China is underrepresented in global stock market indices. But this is about to change. MSCI, the world's leader in benchmark indices, has voted to gradually include Chinese stocks in its indices. As a result, over $1 trillion of passive money is expected to flow into Chinese stocks beginning in 2018. This could be another source of demand for Chinese stocks over the next few years.

JAPAN

Japanese GDP increased at an annualized 2.4% pace in the third quarter and 2.1% year over year. Global economic growth has been synchronizing on a slow growth path at around 2%. The bounce in Japan's third quarter GDP was driven by a surge in government public works spending. Real household income and spending were up 2% year over year in the third quarter, supporting the slow growth outlook. With real industrial production rising 5.9% and retail sales falling 0.1% year over year, inventories have risen. Although inventories supported third quarter growth, they are likely to be a drag going forward. Capital spending grew at an annualized 9.9% year-over-year rate in the third quarter as Japan has been offsetting negative demographics with increased automation. The consensus outlook for 2018 GDP is for growth to slow to 1.3% annualized from 1.9% in 2017.

The Bank of Japan (BOJ) is the one major central bank that has left its monetary policy unchanged. Unlike the Fed and the ECB, the BOJ has yet to scale back its quantitative easing program, leaving it unchanged at ¥80 trillion. While quantitative easing has done little to stimulate growth or inflation, it has provided plenty of liquidity to drive interest rates lower and stock prices higher. The overnight rate has remained negative at -0.1% and the ten-year generic government yield has fallen to zero as of September 30, 2017. Low interest rates and asset purchases should help keep a bid under Japanese stocks.

EUROPE

Eurozone GDP rose 2.4% annualized in the third quarter and 2.6% year over year. Both statistics are above the long-term average growth rate of 1.5% but below the 4% growth pace seen at this stage of the prior two cycles. As has been the case throughout this economic expansion, European growth is being led by Germany, which grew 2.8% over the last year. Europe is better but not booming.

Most recent data show Europe's fourth quarter GDP off to a slow start, with real retail sales falling 1.1% in October and decelerating to a 0.4% year-over-year growth rate. Real industrial production slowed to 0.2% in October but was up 3.7% year over year. The decline in retail sales and increase in industrial production indicate inventories are building again, after jumping in the third quarter. Inventory liquidation is likely to be a drag on future growth.

Despite massive monetary creation, the ECB's target inflation rate of 2% has been elusive. Although the year-over-year consumer price index was 1.4% as of December 31, 2017, the core inflation rate, which excludes energy and food, was up only 0.9%. Since the Great Financial Crisis in 2008, the swings in headline inflation have been driven primarily by the changes in energy prices. Core inflation has been relatively stable at around 1%.

The Bank of Japan is the one major central bank that has left its monetary policy unchanged.

Impact of Quantitative Easing

The ECB's quantitative easing, like that of other central banks, has thus far failed to ignite growth or inflation. It has driven interest rates into negative territory, flooded the financial markets with liquidity and bailed out debtors. It has also helped boost financial asset prices. Now that the Fed has begun to shrink its balance sheet and the ECB is reducing the size of its quantitative easing program, there will be less liquidity finding its way into the financial markets. The ECB is scaling back from €60 billion to €30 billion in asset purchase per month until September 2018. This is still a very healthy dose of liquidity, particularly since the BOJ continues to aggressively print money.

FIXED INCOME

The Yield Curve Flattened in the Third Quarter

Intermediate term interest rates ended 2017 near where they began, with ten-year U.S. Treasury yields finishing the year at 2.41%. Relatively slow economic growth and low inflation have continued to support these historically low interest rates. Geopolitical concerns did drive ten-year Treasury yields to a low of 2.04% in early September, but then investors began to focus on Trump's pro-growth tax cuts, the Fed's plan to unwind its massive balance sheet and the ECB's plan to reduce its bond purchase program. All these programs resulted in a return of yields to the higher levels that existed earlier in 2017. Short-dated maturity rates rose significantly over the year. Two-year Treasuries, which are highly correlated to the Federal Funds rate, increased 0.70% in 2017. Conversely, long yields declined by 0.31%. This resulted in the flattest Treasury yield curve (maturity curve) in ten years.

The Barclay's U.S. Aggregate Bond index (a broadly diversified index which includes Treasuries, agencies, corporates and mortgage-backed securities) increased 0.39% over the fourth quarter and 3.54% for the year. The BofA Merrill Lynch 1-10 Year U.S. Corporate index returned 0.20% for the quarter and 4.08% for the year. The Barclay's 1-15 Year Municipal Blend index gained 0.15% for the quarter and 4.33% for the year.

Federal Reserve Monetary Policy

In October, the Fed began its program to "re-normalize" its massive $4.5 trillion balance sheet of Treasury and mortgage-backed bonds by allowing $6 billion of Treasuries and $4 billion of mortgage-backed securities (MBS) to mature each month without reinvesting the principal. The maximum amount permitted to roll off the Fed's balance sheet will most likely be increased on a quarterly basis until the central bank allows a total of $20 billion in MBS and $30 billion in Treasuries to expire each month. This means that in a little over a year the asset declines will jump from $30 billion total to $150 billion total on a quarterly basis, and, in 2019 alone, the Fed would see a $600 billion reduction. The Fed has stated it will monitor the market's reaction to determine if it needs to slow down the rate of the reduction. Reducing the amount of bonds the Fed is reinvesting may cause intermediate and long-term interest rates to move higher. However, the bulk of the impact will probably be felt in the five and seven year maturity areas of the yield curve where the Fed has been most aggressively purchasing. The Fed has stated that it will increase short rates another three times each in both 2018 and 2019. The market is, however, expecting less than this.

> In October, the Fed began its program to "re-normalize" its massive $4.5 trillion balance sheet.

Jerome Powell will become the next Chairperson of the Federal Reserve when Yellen's term ends on February 3, 2018. Powell has worked in the private sector, including employment as an investment banker. He has also had several private sector businesses and served as Under-Secretary of the Treasury for Domestic Finance in the early 1990's. He is not an economist by training, so although it is believed he favors a low interest rate environment like Yellen, it remains to be seen what programs he will promote when he takes control of the Fed.

Bond Market Recap

The ECB, the Bank of England and the Bank of Canada are all on tightening, or at least less easing, monetary paths. The ECB's reduction in its bond purchases could cause further upward drift in interest rates. Many of Trump's proposed policies would not only increase economic growth but also reduce government revenues. As noted earlier in this newsletter, tax reform could significantly swell the Federal budget deficit.

The tax reform plan had a dramatic impact on municipal bond supply toward the end of the fourth quarter as issuers rushed to the market in anticipation of changes in their tax-exempt status. The tax plan eliminates the tax deductibility of allowing a municipal bond issuer to advance refund its bonds (as a homeowner would do when interest rates decline by refinancing to take advantage of lower interest rates). Although earlier versions of the bill also eliminated the tax deductibility of many private activity bonds (such as hospitals, airports and stadiums), the final bill upheld the deductibility of most of these private issuers. As a result, December had one of the heaviest issuances in over 30 years as issuers rushed to market in advance of the changes. The heavy supply was met by heavy demand as investors realized fewer deductions, such as the lower SALT (state and local income tax) and property tax deductions, might result in higher taxes for those who lived in high-taxed states with high home values. This boosted the demand for double tax-free bonds. Governor Cuomo has announced that the state of New York will file a suit challenging the constitutionality of the new tax law.

Overall, tax reform will lead to higher federal deficits and the need for increased debt issuance at a time when the U.S. has over $20 trillion in Federal debt. Lawmakers have a January 19th deadline to agree to a new debt ceiling or the government will need to reduce spending by using extraordinary measures to prevent the U.S. from defaulting on at least some of its debt until sometime in March. Congress and the White House will need to work together to determine how to resolve this issue.

The Treasury yield curve has been continuing to flatten as short-maturity bonds have risen with the Fed Funds rate, while longer-maturity bonds have stayed low in response to slow economic growth and inflation. This flattening helps bond portfolios with barbell positions

Short-maturity bonds have risen with the Fed Funds rate, while longer-maturity bonds have stayed low.

– that is a concentration of bonds maturing near term and then another concentration longer out on the maturity curve – in the ten+ year range.

Bond Market Outlook

Despite higher than expected U.S. economic growth under the Trump Presidency, we believe low, but positive, global growth and inflation should keep a lid on the absolute level of rates. With so many foreign sovereign bonds trading at negative yield levels, demand for U.S. bonds should remain high. However, as more central banks around the world move to more normal monetary policies from current simulative policies, rates may come under some pressure to rise moderately from their current historically low levels.

DOMESTIC EQUITIES

Stocks Ended 2017 on a High Note

2017 ended on a high note as the S&P 500 advanced 6.6% for the fourth quarter. It was a very good year for most domestic equity investors, and a fantastic year for owners of large cap growth stocks. These days, the largest and growthiest stocks tend to be in the technology sector, and this was reflected in the S&P North American Technology index's impressive 37.8% return for 2017. The S&P 500 index returned 21.8% for the year, more than twice its long-term historic average of 10% per annum. This should not be surprising as the S&P 500 index is capitalization weighted, meaning that the larger the company, the greater percentage weight it holds in the index. As a result, when large cap stocks do well, the S&P 500 typically follows suit.

After a stellar 2016, value stocks of any size and small cap value stocks in particular could not keep up in 2017. We believe small value investors should remain patient, as these types of stocks have historically done better than either large cap or growth stocks over the long term.

Outlook for 2018

Looking forward, one might be tempted to put a new spin on an old New Year's saying, but "Out with the old, in with the same" somehow doesn't have quite the same ring to it. Regardless, this has been the S&P 500's story for the past several years. Rich valuations and rising interest rates have not yet put a damper on investor enthusiasm. With economic growth accelerating and consumer confidence remaining at high levels, it might seem hard to argue against the continuation of the market's upward trajectory.

As has been discussed in this newsletter many times, ultimately the new year's stock market performance will be shaped by events. Minor negative events are likely to shrugged off by investors and positive events embraced, just as they have been in the recent past. Should a major negative event occur, however, valuations and expectations are stretched enough at this point that the subsequent disappointment and stock market sell off would likely be substantial.

While it would be easy to compile a list of potential major negative upcoming events, it would inevitably be incomplete. Moreover, predicting which if any of these events would actually occur is largely a fool's game. Brexit, President Trump and Caitlyn Jenner are just three recent examples of the unexpected coming to pass. People (investors included) do hate uncertainty, however, and therefore tend to crave and overvalue prognostication, be it from sports commentators, fortune tellers or supposed investment gurus.

Predictions for Fun

For entertainment's sake only, we therefore offer several predictions for 2018 based upon the unchanging nature of human behavior.

1. *The decline of traditional retailers will accelerate.*

   Consumers, like all people, tend to follow the path of least resistance. This phenomenon was first described in print by Guglielmo Ferrero and later formalized by George Kingsley Zipf as the Principle of Least Effort. The principle states simply that people will apply the minimum mental or physical exertion necessary to achieve their desired goals. This principle is not to be confused with laziness, as even the first climbers attempting Mt. Everest chose what appeared to be the easiest path to the summit.

   The principle of least effort is the reason online shopping is displacing brick and mortar retailers. One click purchasing with rapid delivery to your door makes the overall shopping experience an easier path to the same end. Following the principle of least effort, this trend will likely continue until an even easier alternative presents itself.

2. *Social media will face a backlash.*

   While coveting is an eternal human trait and even "Keeping up with the Joneses" (the title of a 1913 comic strip from the New York Globe) has been with us for over a century, its downside has long been recognized as well. The Old Testament warns against it, and former president and Joneses' contemporary Teddy Roosevelt (T.R.) was quoted as saying that, "comparison is the thief of joy."

2017 was a fantastic year for owners of large cap growth stocks.

With that backdrop, we predict that social media usage will come under increased scrutiny in the coming year, especially from parents looking out for their children. Several studies have established links between the number of social media sites visited and time spent there with depression and anxiety, particularly among the young. T.R. seems to have summed it up nicely. No one should be surprised that constantly comparing your real life with the idealized representations presented by your peers on social media would tend to lead to dissatisfaction and unhappiness.

What this potential for increased scrutiny will do to social media companies remains to be seen. Nevertheless, a backlash seems possible, particularly with sites popular with children and teens.

3. *There will be some reversal of stock market leaders and laggards, but perhaps not as much as people expect.*

   Reversion to the mean is a long-observed characteristic of the fortunes of companies, industries and stocks. It has typically been driven on the one hand by above average profits attracting competition and below average profits driving out rivals, and on the other hand by excessively optimistic or pessimistic investor expectations leading to asymmetric returns to new information.

   Currently, technology stocks are basking in the glow of high expectations and their 2017 returns reflect that. However, they have continued to exhibit a profitability that justifies those expectations. Eventually, there will be a tech stumble, but any substantial reversal of fortune does not appear imminent at this time absent a correction in the overall stock market.

   After a great 2016, small cap value stocks lagged the broader market significantly in 2017. While tax reform is a potential catalyst for small companies in 2018, the valuation gap between small and large and between growth and value is not currently at extreme levels. We believe small cap value should have a better year in 2018 and that it is well positioned to be a possible big winner over the next couple of years. Nevertheless, those expecting 2018 to be a relative performance miracle may be disappointed.

INTERNATIONAL EQUITIES & FOREIGN EXCHANGE*

International Stocks Also Had a Great Year

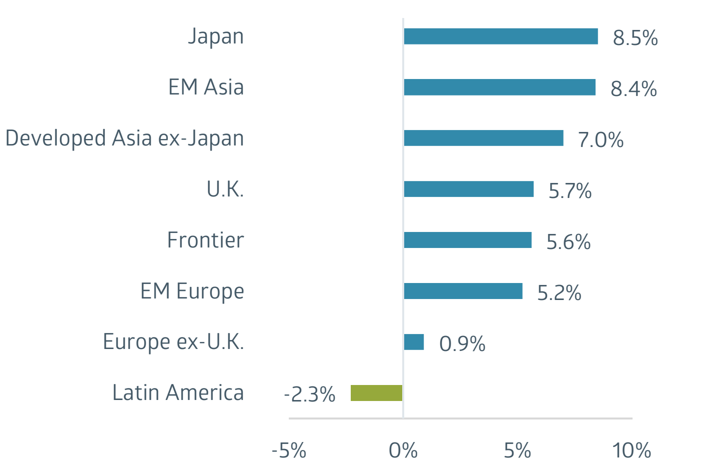
The range of global anxieties in 2017 did little to dent investor enthusiasm across asset classes, and non-U.S. stocks were no exception. Although international stocks didn't quite keep pace with U.S. equities in the fourth quarter, for the full calendar year, developed market stocks returned 25.0% and emerging market stocks returned 37.3%, according to their respective MSCI indices. This was their best performance in eight years, topped last by the snapback rally of 2009.

A strong economic backdrop hasn't hurt. For only the third time in the past fifty years, all 45 OECD (Organization for Economic Cooperation and Development) countries have been experiencing simultaneous growth. For two-thirds of those, it appears that their growth rate is increasing. And, this is occurring in an environment with modest global inflation.

A Stellar 2017

Returns were uniformly good for the year and regional results reflected that. The poorest regional return for the year came from Eastern Europe, which rose 20.5%; the best performing region was emerging Asia, which advanced 42.8%. Leading developed markets was Austria's 58.3% return. No developed markets lost money in U.S. dollar terms; the worst was Israel's 2.1% rise. Poland outpaced all emerging markets for the year, advancing 54.7%. Pakistan, one of only two emerging markets to decline for the year, lagged with a -24.4% return. Among the frontier markets we monitor, Argentina's country index rose 73.5%.

Total Returns for Selected MSCI International Stock Indices, Fourth Quarter 2017



Source: Bloomberg. ***Past performance is no indication of future results.*** *All investments have the risk of loss.*

Even with the year's spectacular results, international stock valuations have not become much richer, as earnings growth (along with a tailwind from a weak U.S. dollar) largely drove the returns. At the end of 2016, a look back at year-over-year earnings growth would have shown a contraction of more than 16% for the EAFE markets and largely flat results for the emerging space. In contrast, for 2017, EAFE's earnings grew 31.7% while growth from emerging markets was 27.4%. Due to this, based on the one-year trailing price-to-earnings ratio, developed market stocks at the end of 2017 were cheaper than they were a year ago and emerging stocks were only slightly more expensive. In both cases, they have continued to trade at deep discounts to U.S. stocks on the basis of earnings, book value and dividend yield.

Quarterly Results

As the chart on the left indicates, for 2017's final three months, the best returns were focused in Asia. Japan's equities rose 8.5%, emerging Asia advanced 8.4%, and developed Asia ex-Japan picked up 7.0%. Latin America, with weak results in Mexico and Brazil, was the only region to experience negative returns.

Developed Markets

Challenging news flow muted investment results in Europe for the fourth quarter of 2017. Brexit negotiations have been proceeding slower than anticipated as the U.K. and the Continent work through a multi-stage process toward separation in March 2019.

The goals of the first stage were threefold: 1) determining a price for the "divorce bill" between the parties; 2) establishing the status of the more than three million EU citizens residing in the

U.K.; and 3) resolving how to handle the now-ambiguous border between Ireland and Northern Ireland. Of these, the first now has a range, based on future negotiations, of between €40 billion and €65 billion less than many commentators feared. EU citizens will enjoy special status living in the U.K., although the details haven't been fleshed out. Likewise, while Northern Ireland will retain much of its status as a member of the EU, the myriad implications of that remain unaddressed.

Stage two revolves around the thorny issues of trade. As we have long said, the EU doesn't want to create a situation of "EU-light" for the U.K. out of fear that other countries may perceive that as a not-so-draconian alternative to full EU membership. Still, so far in the negotiations, European authorities have been more deferential than many expected. On the home front, though, Theresa May was again humbled by Parliament, which voted that any final Brexit bill will require its approval.

Elsewhere on the Continent, Italy dissolved its government, setting the stage for an election during 2018's first quarter. Like many European elections in 2017, a broad range of political parties will likely result in no outright winner and a challenging environment in which to build a coalition (despite the fact that last year Italy adopted procedures designed to expedite the coalition formation). With economic growth gaining traction on the Continent, even an anti-EU Italian ruling coalition may not reverberate among EU members as much as it might have in the previous couple of years.

Asia delivered the top four developed country returns in the fourth quarter, led by Singapore but including Japan, Hong Kong and Australia as well. These economies share the characteristic of being highly mercantilist and so represent likely beneficiaries of strong global economic and trade growth. The new stock exchange connections between the Mainland and Hong Kong have prompted Chinese investors to eagerly snap up Hong Kong shares, making them a bit expensive. In Japan, improving economic conditions are loosening corporate treasurers' purse strings; 2018 should be the peak year for pre-2020 Olympics spending, especially on non-residential construction. That, combined with a continuing labor shortage, could help generate some much-needed inflation this year.

Changing Monetary Policy

A fundamental shift in developed market monetary policy is likely to shape the investment landscape this year. In a continuation of a critical theme of 2017, global central bankers (with the noted exception of the BOJ) are in the process of increasing their use of traditional policy tools and of pulling back from the extreme quantitative easing measures adopted to deal with the aftermath of the Great Financial Crisis. Canada increased short rates twice in 2017; it is expected to hike three more times in 2018, bringing its discount rate to 2% for the first time since 2008. The ECB is also expected to hike its deposit facility rate, which has remained in negative territory. Elsewhere, the U.K., Norway, Sweden, New Zealand and Australia are expected to raise short-term rates at least 0.25% this year.

Moreover, outside of Japan, the end of quantitative easing is nigh. The ECB, under Mario Draghi, has begun to taper its buying of securities from €60 billion to €30 billion a month. More broadly, global central bank asset purchases, which were running at about $180 billion per month in mid-2016, are likely to get to a net zero level by the end of 2018. Ultra-low global interest rates are among the reasons analysts use to explain the low volatility across investment markets; decreasing central bank activity will be a good test of that.

Emerging Markets

2016 and 2017 were strong years for emerging market stocks, with a total MSCI index cumulative return for the two-year period in excess of 50%. This was the sector's best two-year run since 2009 and 2010. Investors can fairly ask if the last two years' results represent "as good as it gets" or the beginning of a longer secular cycle. We believe we could be seeing more of the latter. After underperforming U.S. stocks for much of the 1990s and through the dot-com era, emerging market stocks staged a five-year rally during calendar years 2003 to 2007 that saw their values rise more than 380%. This cyclicality has historically been a common feature of emerging markets stocks; investors felt the painful side of it in the five-year period from 2011 to 2015, when the group declined more than 20%.

According to the International Monetary Fund, economic growth for 2018 is expected to be about 2% for developed markets but rises to 4.9% for emerging and developing markets. At the same time, the monetary picture is similar to that of the developed markets. Although emerging market central banks eased rates more than they hiked in 2017, the expectation is that the skew will be toward rate hikes in 2018. Combined with subdued inflation rates, already high real interest rates should expand further, continuing to help attract capital to the space.

Changes in Composition of Stock Markets

The emerging markets are a distinctly different market than they have been for much of their history. Investors often still think of these markets as largely based on

> The end of quantitative easing is nigh.

commodities like metals or oil and gas. However, at the end of 2017, the technology sector was a larger component of the MSCI Emerging Markets index (the EM index) than of the S&P 500 index, at 27.9% versus 24.0%. Financials were 23.3% of the EM index and just 14.7% of the S&P 500. The stuff you dig for? 14.2% for the EM index and 9.2% for the S&P 500. There are a number of countries whose equity markets and economies are dominated by raw materials, but this is decreasingly true.

The current reality is that the forces that drive success in the U.S. are increasingly similar to those that drive returns in emerging markets. Moreover, emerging markets generally have a technology cost advantage and healthier lending environments in their banking sectors (due to a bigger difference between short-term interest rates [banks' borrowing cost] and long-term interest rates [banks' revenue from lending]).

FOREIGN EXCHANGE

U.S.-based international equity investors enjoyed a year of strong foreign currency results in 2017, as a weak dollar created a tailwind for total returns. Over the full year, the euro gained more than 13% relative to the dollar, the British pound rose almost 10%, and emerging market currencies as a group rose just under 7%.

The dollar weakness theme was less clear in the fourth quarter, since the major developed market currencies traded in a fairly tight range with the greenback. Emerging market currencies produced more disparate results. The South African rand was the quarter's top performer, rising almost 10% as gold found some footing and December's election of Cyril Ramaphosa to head the African National Congress spelled the political end for Jacob Zuma. The Korean won also rose almost 7% to a multi-year high versus the dollar. The other side of the ledger saw steep quarterly declines in the Mexican peso, Argentinian peso and Turkish lira.

As we have said in previous quarters, the recent weakness of the dollar was largely a reflection of how overvalued it had become over several years. Absent that overvalued status, 2016 and 2017 were environments where investors might have expected dollar strength given the Fed's multiple rate increases and the reduction of its broader balance sheet. The U.S. has been a high yield market relative to most developed markets but a low yielding one compared with much of the emerging space, excluding Eastern Europe. Given the potential stimulus from the recently signed tax legislation and the prospect for larger deficits, the Fed may take a more aggressive stance with short-term rates. Such moves could continue to put pressure on currencies whose underlying economies exhibit current account deficits and large amounts of debt denominated in dollars.

** Unless otherwise indicated, the equity returns cited in this section of the 9:05 are based on their respective MSCI region or country indices. The returns of these indices along with those of the MSCI EAFE and the MSCI Emerging Markets indices are presented in U.S. dollar terms on a total return basis (with net dividends reinvested).*

REAL ESTATE

Publicly-traded REITs Own Properties But Don't Give Investors All the Benefits of Private Real Estate Ownership

It is commonly accepted wisdom that, for appropriate investors, a diverse portfolio of direct private real estate can substantially diversify an overall investment portfolio because of its history of lower volatility and very low correlation with publicly-traded equities of all types (both real estate and otherwise). Yet, it has also offered substantially similar returns. In short, adding real estate may reduce both volatility and risk in a prudently-structured investment portfolio without sacrificing potential return.

Yet, there is one factor that typically restrains some investors from committing more than a token amount to private real estate: the often lengthy and cumbersome process of obtaining liquidity. Fair market transactions in the private property market can often take three to six months or more. Thus publicly-traded REITs are often viewed as a solution to this problem. Publicly-traded REITs hold portfolios of properties that do indeed look a lot like those held in private portfolios, yet they also offer investors shares that can be quickly sold over the listed stock exchanges or on the over-the-counter market. Voila! Exposure to institutional quality real estate without the usual pesky sluggish liquidity.

The Trouble With Publicly Traded REITs

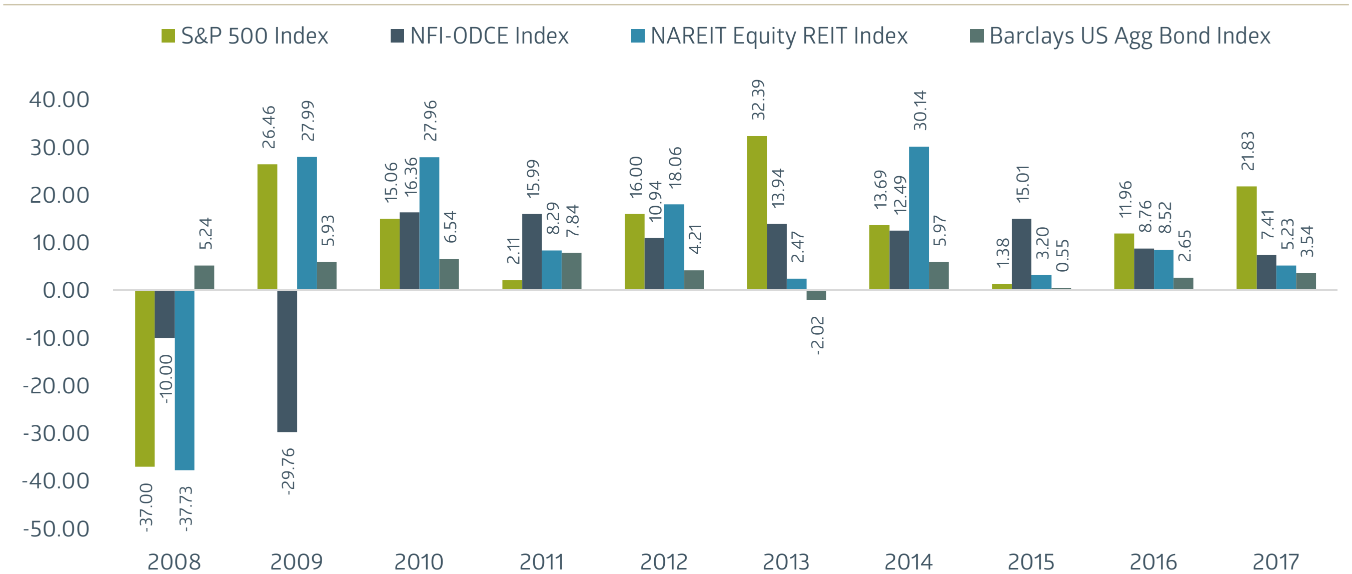
Except the problem is, that's not entirely accurate. The very characteristic of immediate liquidity is actually what causes the publicly-traded REIT investor to lose the connection to, and some of the benefits of, the underlying property portfolio over shorter time horizons.

Public stock markets are subject to the complex, changing and powerful forces of greed and fear that drive investor behavior. These forces can cause prices to swing wildly, to overshoot on the upside for years in a bull market trend and to undershoot disturbingly on the downside in a market downturn. Thus, it is rare for an investor to purchase shares in a publicly-traded REIT at just the right price, i.e., at the aggregated net value of all of the individual assets within the portfolio. The publicly traded price is usually either higher or lower, and can vary significantly depending upon lots of other factors… many of which are totally unrelated to the underlying value of the assets in the portfolio.

Reviewing the Return History

Let us examine the data in Exhibit 1, a bar chart showing the annual returns for the last decade in four common

Exhibit 1: Total Returns of Market Indices (%)



Source: Morningstar. ***Past performance is no indication of future results.*** *All investments have the risk of loss.*

areas of U.S. investing: stocks, bonds, real estate and public REITs. Stock market returns are represented by the S&P 500 index, bonds by the Barclays Aggregate US Bond index, private real estate by the NCREIF Open-end Diversified Core Equity Fund index (NFI-ODCE index) and public REITs by the FTSE NAREIT U.S. Real Estate Equity index (NAREIT Equity REIT index).

The first year on the bar chart, 2008, was a standout anomaly, with all different types of equity declining dramatically. The one prior comparable time for such an event was in the crash of 1929. Since the recovery in 2010 and after, private real estate has returned to its historically more typical steady, low volatility performance, in stark contrast to the wild swings experienced by stocks and publicly-traded REITs. As a result, real estate has been back to performing its diversification function for investment portfolios. The same cannot be said for public REITs, in which boom years have been interspersed with lackluster years.

The total returns for each asset class are summarized for various periods in Exhibit 2 below. Over most time series, the NAREIT Equity REIT index appears to perform about the same as the NFI-ODCE index. However, when one considers the higher leverage taken on by equity REITs (typically 35-45% loan to value) versus the funds in the NFI-ODCE index (20-30% loan to value), the fact is that public REIT stocks should have outperformed. In any case, private real estate generally has competed favorably in returns to the other equity assets.

Comparing Volatility

The real differences in behavior between public and private real estate shows up when one considers differences in volatility (standard deviation of returns) as shown in Exhibit 3, below, and in the correlation of returns shown in Exhibit 4 on page 16.

For the ten-, fifteen- and 20-year time periods presented in Exhibit 3, the private real estate markets, as shown by the NFI-ODCE index, were more volatile than bonds, but generally only about half as volatile (or less) as the S&P 500 stocks and even less volatile than small cap value stocks, as measured by the CRSP US Small Cap index. Publicly-traded equity REITs, on the other hand, were clearly high risk with a volatility higher than even small cap value stocks! Thus, based on this historic data, if one substitutes publicly traded REITs for the real estate portion in a mixed asset portfolio, one is potentially more than doubling the risk of that allocation.

Analyzing Correlations

The final chart on correlation of returns (shown on the next page) is probably the most negative for advocates of publicly-traded REITs. If the point of investing in real estate is to diversify the portfolio, then one wants to invest in something that behaves differently from the other equity securities. Private real estate, as represented by the NFI-ODCE index, clearly has historically offered that diversification, with essentially very low correlation to either the S&P 500 or the CRSP US Small Cap index. Publicly-traded REITs on the other hand, owed 69% of their return to the same forces that drove

Exhibit 2: Total Market Index Returns for Periods Ending December 31, 2017

Return	S&P 500 Index	CRSP US Small Cap Index	Barclays US Agg Bond Index	NFI-ODCE Index	NAREIT Equity REIT Index	NAREIT Equity REIT Index Vs NFI-ODCE
1 Year	21.83%	16.24%	3.54%	7.41%	5.23%	-2.18%
3 Years	11.41%	9.81%	2.24%	10.34%	5.62%	-4.72%
5 Years	15.79%	14.54%	2.10%	11.48%	9.46%	-2.02%
10 Years	8.50%	10.03%	4.01%	5.01%	7.44%	2.43%
20 Years	7.20%	NA	4.98%	8.93%	8.95%	0.02%

Source: Morningstar. ***Past performance is no indication of future results.*** *All investments have the risk of loss.*

Exhibit 3: Standard Deviation of Quarterly Market Index Returns for Periods Ending December 31, 2017

Standard Deviation	S&P 500 Index	CRSP US Small Cap Index	Barclays US Agg Bond Index	NFI-ODCE Index	NAREIT Equity REIT Index
10 Year	16.35%	20.30%	3.30%	8.53%	24.85%
15 Year	14.46%	18.54%	3.30%	7.37%	22.43%
20 Year	16.50%	NA	3.43%	6.50%	20.53%

Source: Morningstar. ***Past performance is no indication of future results.*** *All investments have the risk of loss.*

the S&P 500 and 76% to those of the CRSP US Small Cap index. Private real estate was a true diversifier, public REITs were not. It is as simple as that. If one added REITs to a mixed asset portfolio, one was simply taking on more of the same stock market risk that was already in the portfolio.

The Case for Publicly-Traded REITS

Nevertheless, for investors for whom private real estate ownership is not appropriate, publicly-traded REITs are the best remaining alternative. They provide liquidity and attractive yields. If held for twenty years or more, they historically have offered comparable returns to private real estate investments, despite getting there a different way. And, they can be a good solution for IRAs, 401-Ks and other retirement accounts that don't allow investments in private real estate.

Conclusion

For those investors looking to achieve the maximum benefits of a diversified investment portfolio, the preceding analysis seems pretty clear. Based upon this historic evidence, if one wants the returns, the low volatility risk and the real diversification benefits inherent in real estate investments, one should invest in a well-diversified portfolio of privately-held real property rather than in publicly-traded REITs.

Exhibit 4: Correlation of Quarterly Returns, January 2002 to December 2017

	S&P 500 Index	CRSP US Small Cap Index	Barclays US Agg Bond Index	NFI-ODCE Index	NAREIT Equity REIT Index
S&P 500 Index	1.00	0.95	-0.28	0.20	0.69
CRSP US Small Cap Index		1.00	-0.26	0.14	0.76
Barclays US Agg Bond Index			1.00	-0.21	0.07
NFI-ODCE Index				1.00	0.21
NAREIT Equity REIT Index					1.00
NAREIT Equity REIT Index					

Source: Morningstar. ***Past performance is no indication of future results.*** *All investments have the risk of loss. CRSP US Small Cap index data not available prior to January 2002.*

BAILARD INVESTMENT STRATEGY

An Overview of Our Strategic and Tactical Asset Allocation

U.S. Bonds

After rallying in early 2017, bonds traded in a volatile sideways pattern for the rest of the year. The 30-year Treasury bond returned 6.5% in 2017, much better than cash or inflation but well behind global stocks. At year end, bond yields were near record lows and threatening to break above the long-term down trend line, the Fed was tightening, the budget deficit was widening, and savings were relatively low. All of these factors should increase pressure on the long end of the maturity curve. Nevertheless, at least through the end of 2017, the long end of the market was immune to Fed tightening and the yield curve was flattening.

With little value in the market, we have continued to be underweight bonds in the strategic portion of our portfolios. We prefer other assets to bonds and are unlikely to increase our strategic targets for bonds until yields move back toward normalization. Historically, long Treasury bond yields have averaged about 5% and real yields have averaged 3%. At year-end, the 30-year Treasury bond was yielding 2.76% and the real yield was only 0.6%. With absolute and real bond yields at low levels, the potential volatility of bonds has increased.

That said, U.S. government bonds have been yielding over 2% more than in Germany and Japan, the yield curve has been flattening, and the repatriation of foreign profits should be stimulative. These factors may increase the likelihood that foreign purchases of bonds could offset the decline in domestic purchases.

U.S. Stocks

Large-cap U.S. stocks, as measured by the S&P 500 index, had a total return of almost 22% in 2017. This was the opposite of the consensus expectations ahead of last year's presidential election, should Trump win. The stock market took little time post-election in rallying on the basis of Trumphopium, seeing tax reform, deregulation and the slow death of Obamacare as positives for economic growth and corporate earnings. In 2017, the S&P 500 did something it has never done before: rise in every month of the year. Volatility continued to decline to record lows last year, suggesting that little risk was being priced by investors.

This could change in 2018, since it is possible we will revert to two way markets. As outlined in the U.S. Economy section of this newsletter, although the American economy may get a temporary short-term boost in growth from tax reform, investors are likely to be disappointed longer term, with both cyclical and secular fundamentals working against sustained growth. Expectations are now running very high: investors are over-optimistic and most stock valuation metrics are in the 99th percentile of historical valuations. The stock market has continued to ignore valuations and fundamentals in its upward climb. However, momentum-driven markets can become even more overvalued. There could be enough positives this year to help keep a bid under stocks. A large part of repatriated foreign profits is likely to find its way back into stocks as dividends, share buybacks and M&A activity. Outside of a renewed financial crisis, the primary risk for stocks could be a sustained rise in bond yields as the Fed continues to tighten and liquidate its balance sheet.

International Stocks

International stocks had a strong 2017, with developed markets rising over 25% and emerging markets advancing over 38% as measured by their respective MSCI indices. This was the first year since 2010 that international stocks outperformed U.S. stocks. International stocks historically have tended to move in five to seven year cycles of under and over performance relative to U.S. stocks. We may be ending a period of international underperformance and starting a new relative upcycle. As of the end of 2017, international stocks remained undervalued relative to U.S. stocks, with lower P/E's and higher dividend yields. International economic cycles have become more synchronized with the U.S. and, outside of a financial shock, we believe international stocks are likely to perform in line with U.S. stocks.

Real Estate*

Real estate has continued to appreciate as cap rates have fallen and rents, particularly in the apartment sector, have still climbed. Despite declining capitalization rates, real estate valuations are more attractive than those of bonds or stocks. Rising long rates could be the catalyst that bursts the stock and bond bubbles. While rising interest rates also pose a risk for real estate, the yield spread over Treasuries has remained high, and real estate could hold up better than stocks or bonds in the next downturn. As a result, we believe real estate should continue to be a good portfolio diversifier.

Alternative Investment Strategies*

We believe that, for appropriate investors, some types of long/short strategies have the potential to provide important diversification benefits in scenarios where more traditional asset classes experience declines. With bond yields at record lows, bonds may provide less defensive characteristics at this point in the market cycle. While short-term money market yields are rising, they remain very low. As a result, certain types of long/short strategies may provide an opportunity to potentially enhance cash returns while providing potential downside protection in down markets.

Tactical Asset Allocation Strategy (TAA)

TAA had a strong 2017, as this momentum based strategy remained heavily allocated to global stocks throughout the year. TAA selects four among thirteen different asset classes each month in an effort to stay in synch with the investment markets on short-term basis. It is designed to be both opportunistic and defensive, seeking to gravitate toward asset classes that are in an uptrend and to help mitigate losses by moving to the sidelines when asset classes are in a downturn.

**Real estate and alternative investment strategies have significant risks and are not appropriate for all investors. †A cap rate is a measure of a property's net operating income relative to its market value.*

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12/31/17

MARKET PERFORMANCE

U.S. Interest Rates	3/31/2017	6/30/2017	9/30/2017	12/31/2017
Cash Equivalents				
90-Day Treasury Bills	0.75%	1.01%	1.05%	1.38%
Federal Funds Target	1.00%	1.25%	1.25%	1.50%
Bank Prime Rate	4.00%	4.25%	4.25%	4.50%
Money Market Funds	0.87%	1.07%	1.12%	1.36%
Bonds				
30-Year U.S. Treasury	3.01%	2.84%	2.86%	2.74%
20-Year AA Municipal	3.48%	3.21%	3.09%	3.17%

Source: Bloomberg, L.P.

Global Bond Market Total Returns (US$) through 12/31/17	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
BofA Merrill Lynch U.S. Treasury Index	0.11%	0.51%	2.43%	2.43%
BofA Merrill Lynch Agency Index	0.00%	0.51%	2.15%	2.15%
BofA Merrill Lynch Corporate Index	1.12%	2.50%	6.48%	6.48%
BofA Merrill Lynch Municipal Index	0.75%	1.95%	5.42%	5.42%
International Bonds				
Citigroup non-US$ World Government Bond Index, fully hedged	1.10%	1.81%	2.06%	2.06%

Sources: Bloomberg, L.P. and Morningstar Direct

Global Stock Market Total Returns (US$) through 12/31/17	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
Dow Jones Industrial Average Index	10.95%	17.13%	28.07%	28.07%
S&P 500 Index	6.64%	11.42%	21.83%	21.83%
NASDAQ 100 Index	7.26%	13.87%	32.97%	32.97%
Morningstar Small Value Index	4.02%	8.97%	8.40%	8.40%
International Stocks				
MSCI Japan Index, net dividends	8.49%	12.80%	23.99%	23.99%
MSCI Europe Index (includes UK), net dividends	2.21%	8.80%	25.51%	25.51%
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	4.23%	9.86%	25.03%	25.03%

Sources: Bloomberg, L.P. and Morningstar Direct

Real Estate Total Returns (US$) through 12/31/17 (estimated)	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	1.87%	3.77%	7.41%	7.41%

Source: The National Council of Real Estate Investment Fiduciaries

**Since the fourth quarter 2017 NFI-ODCE index return is not yet available, we have estimated it by using the previous quarter's return. This estimate is used for all time periods presented.*

Past performance is no indication of future results. All investments have the risk of loss.

ABOUT *THE 9:05*

Since 1978, we've held a weekly company wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05". Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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