IT’S IRRONIC THAT TIME, IN ALL ITS CONSISTENCY, IS KEPT BY A PENDULUM THAT PERPETUALLY SWINGS BACK AND FORTH.

The global economy is a combination of countless intertwined and continuously-shifting factors. These factors tend to swing (like a pendulum) in patterns that coincide with economic cycles.
The 2018 edition of the First National Bank Outlook is intended to help explain our views of the global economy and how we use those views to create better investment portfolios.

This year we chose to open with a discussion of our long-term expected return and risk assumptions. As illustrated, U.S. and international stocks have the highest expected return and risk, whereas cash, bonds and alternatives have the lowest.

Relative to historical returns, we have tempered our expectations for most asset classes, as seen in the table. This is due to the expensive valuations currently seen in the stock and bond market.

### Asset Class Returns

<table>
<thead>
<tr>
<th>INVESTMENT</th>
<th>HISTORICAL</th>
<th>EXPECTED</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Stock</td>
<td>9.7%</td>
<td>7.3%</td>
</tr>
<tr>
<td>International Stock</td>
<td>7.8%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Global Real Estate</td>
<td>10.1%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Alternatives</td>
<td>3.7%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Bonds</td>
<td>4.1%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Cash</td>
<td>1.2%</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

**Notes:**
- **HISTORICAL:** Last 15-year annualized return
- **EXPECTED:** Next 10-year annualized return
- **U.S. Stock:** S&P 1500; **International Stock:** MSCI EAFE
- **Global Real Estate:** S&P Global REIT; **Alternatives:** HFRI Comp.
- **Bonds:** Barclays U.S. Aggregate; **Cash:** Citi 3 month T-Bill

### Long-Term Expected Return/Risk

- **Return:** FNB capital market assumptions
- **Risk:** 10 year standard deviation
The single most important factor driving long-term returns is the strategic, long-term asset allocation. Staying disciplined with your investment strategy is crucial to meeting return goals.

We have a spectrum of options available to accommodate a client’s risk tolerance and investment objective. As shown, they range from conservative to aggressive.

In an effort to optimize performance, we make tactical decisions to take advantage of opportunities created by market swings. Our experienced investment professionals are continuously monitoring and researching these movements and their implications. At this point in time, we have identified five major themes and have characterized them as pendulums.

The theme with the most impact to portfolios is PENDULUM ONE where we describe why we favor stocks over bonds.

The rest of the pendulums listed explain our best ideas for investing in each asset class and how we manage portfolios.

- **PENDULUM ONE**: Global Economic Backdrop and Earnings Growth Favor Stocks Over Bonds. Pages 6–9
- **PENDULUM TWO**: Leverage to Global Growth Favors International Stocks Over Global Real Estate. Page 10
- **PENDULUM THREE**: Better U.S. Growth Favors Small & Mid-Cap Stocks Over Global Real Estate. Page 11
- **PENDULUM FOUR**: Low Defaults and Rising Interest Rates Favor Credit and Floating Rate Over Government Bonds. Page 12
- **PENDULUM FIVE**: Risks Require Disciplined Portfolio Management. Page 13
Synchronized global growth expected to continue

- Global economic growth accelerated from 3.2% to an estimated 3.6% last year. Economists currently forecast growth of 3.7% in 2018.¹
- As seen in the Citi Economic Surprise Indices, global economic data has been stronger than expected.
- A primary source of strength is the improved outlook for growth in the U.S. and Europe. Although emerging market positive surprises have recently slowed, 5.0% GDP growth is expected in 2018.¹

 Manufacturing contributing to global growth

- When the Global Purchasing Managers Index (PMI) is above 50, it signals growth. The latest reading of 54 is the highest since 2011, which is consistent with strong industrial production growth.¹
- As illustrated in the chart, developed and emerging markets have accelerated over the last two years.
- The strength in the readings provides confidence that manufacturing will be a primary contributor to growth in 2018.
U.S. consumer and business outlook supports growth

- As shown in the chart, domestic consumer confidence is at high levels, reflecting gains in private employment and personal income.

- Elevated confidence indicates a willingness to spend and should lead to continued U.S. consumption growth.

- Small business confidence has also increased, which may positively impact private employment.

Business investment contribution accelerating

- Heightened business optimism has led to a rebound in capital goods expenditures as seen in the chart. This increased business investment is attributed to better economic growth, improved profitability, and prior years of underinvestment.

- Increased business investment is beneficial because it helps improve productivity and the economy’s capacity to expand.
Structural:
Technological advancements have led to a number of deflationary pressures in certain industries. Specifically, competition from cellular companies and online retailers, like Amazon and Walmart, has led to lower prices for certain goods and services.

Cyclical:
We believe that inflation pressures are present as GDP is running close to 3% and unemployment has fallen to 4.1%. Increased business activity at this stage in the cycle could provide a nudge towards higher inflation, given the upward trend of labor force participation and wage growth.

Different Fed Chairperson, same expectations
- In 2018, Jerome Powell will become the Chairperson for the Federal Reserve (Fed).
- Monetary policy, which is accommodative, is anticipated to be consistent under new leadership. The Fed forecasts three rate hikes again this year.

Yield curve moves higher
- Slightly higher inflation and a reduction in the Fed’s balance sheet should exert upward pressure on long-term interest rates.
- As depicted in the chart, short-term rates, driven by monetary policy, are expected to increase twice as much as the 10 year Treasury yield. This would further flatten the yield curve.

Source: Bloomberg bond yield forecasts
Higher valuations consistent with global outlook

- Global stock prices, as measured by the price-to-earnings (P/E) ratio, are elevated as indicated in the table. We believe valuation premiums of over 20% are due to the following factors:
  - Broad-based global expansion
  - Moderate inflation
  - Low interest rates
  - Lower volatility

Earnings growth drives long-term stock returns

- Synchronized economic activity is driving strong earnings growth. Global earnings grew at 19.0% last year with 11.3% growth expected in 2018.²

- We believe earnings growth is the primary determinant of stock returns. As illustrated in the chart, forward earnings per share and price move together.

### 2018 Earnings Growth & Valuations

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>P/E</th>
<th>P/E Premium</th>
<th>EPS Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI All Country World Index</td>
<td>16.1x</td>
<td>20.3%</td>
<td>11.3%</td>
</tr>
<tr>
<td>S&amp;P 1500 U.S. Broad Market</td>
<td>18.2x</td>
<td>25.0%</td>
<td>12.1%</td>
</tr>
</tbody>
</table>

P/E - Next Twelve Months Price-to-Earnings Ratio
P/E Premium - P/E divided by 15-year average P/E
EPS Growth: Next Twelve Months Earnings Per Share Growth
Source: FactSet (calculation); as of 1/1/2018

PENDULUM ONE INVESTMENT IMPLICATIONS: **OVERWEIGHT STOCKS**

We prefer stocks relative to bonds because of broad-based global expansion and earnings growth. However, current valuations limit the extent of our overweight.
International economies benefit from low interest rates

- International central banks have kept interest rates at record lows. These low rates are intended to stimulate economies and tend to be positive for stock market returns.
- International markets are early in their economic cycle which provides central bankers added flexibility to keep rates low. As seen in the chart, limited increases are expected in the next two years.

International stocks attractively valued

- As depicted in the table, developed and emerging market equities offer solid earnings growth.
- International market P/E ratios are reasonable given these earnings expectations.

Weak U.S. dollar benefits international stock returns

- Currencies can be a major factor for international stock returns and historically trend in the same direction for multiple years.
- U.S. dollar weakness contributed +0.9% to international stock returns in 2016 and +12.5% last year.¹ Most economists expect a positive contribution from the dollar in 2018.

PENDULUM TWO INVESTMENT IMPLICATIONS: OVERWEIGHT INTERNATIONAL STOCKS

We are overweight international stocks to take advantage of the higher sensitivity to global economic activity, accommodative monetary policies, and the potential for U.S. dollar weakness.
Tax reform positive for U.S. economy

- Analysts estimate a +0.3% contribution to GDP growth in 2018 and 2019 as a result of tax reform. Survey data shows 39% of businesses expect to increase hiring and 51% expect to increase capital investment as a result of lower taxes.

- As seen in the chart, small and mid-sized companies have a higher tax rate and stand to benefit more from a reduction in corporate tax rates.

Return potential favors small and mid-cap (SMID) stocks

- SMID companies benefit more from U.S. economic expansion due to their higher exposure to cyclical industries.

- The table shows double digit earnings growth across all U.S. cap sizes. SMID stocks are trading at a premium, but present a tactical opportunity based on their higher earnings growth.

- U.S. large-cap companies benefit from the same economic trends, but currently trade at the highest valuation.

Real estate investment trusts (REITs) offer limited upside

- Commercial real estate is exhibiting strong cash flows given a growing global economy and acts as an inflation hedge over long-term time periods.

- We are underweight REITs due to their elevated valuations and leverage to interest rates, which are likely to trend higher in the U.S.

PENDULUM THREE INVESTMENT IMPLICATIONS: OVERWEIGHT SMALL & MID-CAP STOCKS

We are overweight SMID stocks due to a better earnings outlook stemming from improving U.S. economic fundamentals.
Low delinquencies provide support for credit

- Credit spreads are less than their historical average, consistent with low delinquency rates, as seen in the chart.
- The yield advantage for credit over government bonds is appropriate to compensate for the additional default risk.
- Sectors through which we gain credit exposure include investment grade corporate bonds, asset and mortgage backed securities, high yield, and floating rate.

Interest rate risk poses threat in rising rate environment

- Rising yields put pricing pressure on bonds with fixed interest rates.
- We reduce interest risk in portfolios by emphasizing short and intermediate maturity bonds, and have added a modest allocation to floating rate investments.
- Floating rate bonds have a variable interest rate, which is a benefit in a rising interest rate environment.

PENDULUM FOUR INVESTMENT IMPLICATIONS: OVERWEIGHT CREDIT AND FLOATING RATE

We are overweight credit given low delinquencies and have a floating rate allocation to protect portfolios from rising interest rates.
1. Policy Error:
If global growth leads to an inflationary environment, central banks would likely increase interest rates faster than expected and could potentially cause a recession.

2. Economic Slowdown:
The recent pickup in European and Japanese growth and stabilization in the Chinese economy could be temporary. This would result in a deceleration in global earnings growth.

3. Geopolitical Risk:
International turmoil such as a military conflict with North Korea would cause volatility. This would likely be temporary if the global economic outlook did not change.

4. Sentiment Risk:
The potential of a market decline from increased investor anxiety is present given high valuations. Sentiment change is difficult to predict.

1. Diversify:
Combining different asset classes optimizes portfolio return and risk. We further diversify portfolios within each asset class:
- U.S. stocks: Large-cap, mid-cap, small-cap
- International stocks: Large-cap developed, small-cap developed, emerging markets
- REITs: Global real estate
- Alternatives (alts): Multi-manager mutual fund with six distinct investment strategies
- Bonds: Credit, government bonds, high yield, floating rate

2. Maintain Discipline:
We work closely with you to confirm the appropriate investment objective. We rebalance portfolios to your asset allocation target based on identified goals.

3. Monitor:
As markets create opportunities, we make tactical adjustments to improve risk-adjusted returns. Effectively, we strive to take advantage of volatility by buying low and selling high.

PENDULUM FIVE INVESTMENT IMPLICATIONS: DISCIPLINED PORTFOLIO MANAGEMENT CRUCIAL
Disciplined portfolio management is crucial due to potential risks and the lower long-term return outlook.
For demonstration purposes, we selected one of our investment objectives to display how diversification and the pendulums fit in with portfolio management.

**Portfolio Construction:**
The foundation of a professionally managed portfolio is a diversified set of investments with different characteristics. Intensive research has been completed to construct optimal portfolios for the long run. For the **balanced** objective, target weightings are stocks 45%, bonds 45%, alts 7% and cash 3%. The long-term allocations are illustrated in the chart.

**Portfolio Management:**
We make tactical allocation decisions to increase returns or reduce risk. As reviewed, we are currently tilting portfolios to enhance returns. Specifically, we have an overweight to stocks (international and small and mid-cap stocks), and an emphasis on credit and floating rate within bonds. The current allocations are shown in the chart.

**Balanced Investment Objective**

**Long-Term Allocation**
- Core Fixed Income: 45.0%
- U.S. Large Cap-Stock: 24.0%
- U.S. SMID Stock: 9.7%
- International Stock: 8.6%
- Global Real Estate: 2.7%
- Alts: 7.0%
- Cash: 3.0%

**Tactical Allocation**
- Core Fixed Income: 35.3%
- U.S. Large-Cap Stock: 26.2%
- U.S. SMID Stock: 11.5%
- International Stock: 9.8%
- Global Real Estate: 1.5%
- High Yield & Floating Rate Bonds: 5.7%
- Alts: 7.0%
- Cash: 3.0%
Since the inception of the stock exchange, many investors have built wealth while others have lost it. This begs the question, “Why do some investors achieve their goals and others do not?” First National Bank believes the following is vital for success:

_Maintain a long-term, disciplined perspective and stay invested in a diversified portfolio consistent with your investment objectives._

As we enter 2018, challenges will inevitably arise that will test your investment resolve. Our wealth management team has stood the test of time and will be here for you as the pendulums swing.

Thank you for your interest in this year’s Outlook and the trust you place in us.

_Kurt Spieler, CFA_  
Chief Investment Officer

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**Sources**

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⁴Federal Reserve Bank of Atlanta