CLS's WEEKLY 3

What You Need To Know About the Markets

DECEMBER 19, 2017

1. Bitcoin and other cryptocurrencies have gone parabolic.
2. ETFs have had another spectacular year for both flows and launches.
3. Sentiment is high, but it shouldn't matter for a properly diversified investor.

CLS INVESTMENTS

Market Performance

Equities	LAST WEEK	QTD	YTD '17
Total U.S. Market[1]	+0.84%	+6.22%	+21.00%
Domestic Large-Cap Equity[2]	+0.95%	+6.67%	+21.86%
Domestic Small-Cap Equity[3]	+0.61%	+2.91%	+14.17%
International Equity[4]	+0.26%	+2.28%	+23.89%
Developed International Equity[5]	+0.14%	+1.99%	+22.34%
Emerging Market Equity[6]	+0.71%	+3.53%	+32.29%
Fixed Income	**LAST WEEK**	**QTD**	**YTD '17**
U.S. Investment Grade Bonds[7]	+0.29%	+0.48%	+3.64%
Cash Equivalent[8]	+0.02%	+0.20%	+0.76%
Commodities	**LAST WEEK**	**QTD**	**YTD '17**
Commodity[9]	+0.08%	-0.23%	-3.09%

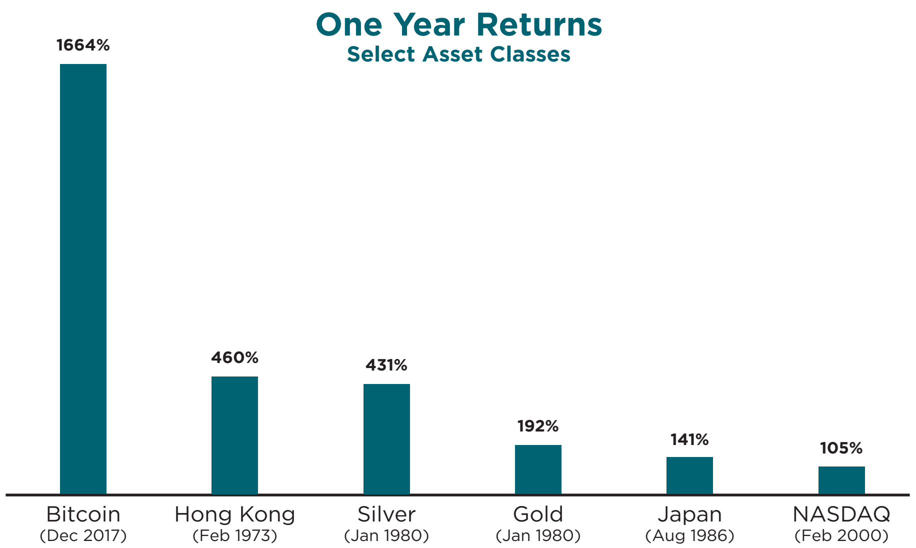
[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity Index

As of 12/15/2017

Week in Review

All major asset classes closed higher last week. The Federal Reserve raised its target federal funds rate for the third time this year, a move that was widely expected. Tax overhaul continues to be a focus in the media, as it appears legislation could be signed as soon as this week. Major economic reports consisted of Purchasing Managers' Index estimates from around the world that showed continued economic momentum.

Large-cap domestic equities led major asset classes, with developed international equities and commodities lagging somewhat on the week, but still positive. Broad fixed income was positive on the week and is still registering a positive year-to-date return despite the third interest rate hike of the year. The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX, closed below 10, a level it has hovered around all year.



Source: Morningstar
MSCI indices used for countries, S&P GSCI indices used for commodities

We have written about Bitcoin a few times already, but I can't help myself! Besides, the price has *doubled* since our last published piece on the topic, the CBOE launched Bitcoin futures a little over a week ago, and the Chicago Mercantile Exchange (CME) followed suit over the weekend, so there is plenty to talk about.

Just to rehash (bad crypto joke), Mark and Marc have defined, discussed, and postulated about what some are calling a new asset class. Keep in mind Bitcoin isn't the only crypto "currency" in existence. There are thousands of these out there, many of which have had equally blistering returns this year. These other cryptocurrencies (some are tokens) that can be used for purposes that range from transacting across borders, buying computer storage space, upgrading your gaming avatars, or even buying a digital kitten for more than 100,000 USD (not kidding). Most of these cryptocurrencies are built on blockchain technology secured by cryptography, which is basically a continual and unchangeable ledger. There are many potentially game-changing uses for this technology, which may be the primary reason there is such an interest in the space. Some observers are even comparing blockchain to the beginning stages of the internet. Many large financial institutions are exploring the space, and a whole lot of people are just trying to figure this thing out.

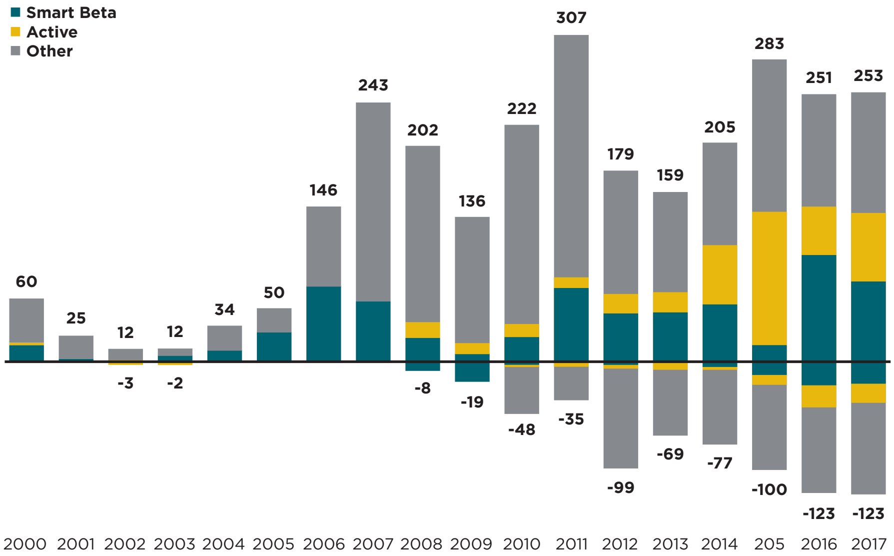
So far, with limited investable blockchain companies, many people seem to be investing via the currencies themselves, most notably Bitcoin. Or maybe, it's all just pure speculation. Either way, it's not just happening in the U.S. – Japan and Korea may be experiencing the craze even more fervently. But, the first step towards legitimizing Bitcoin in the U.S. took place recently when the CBOE and CME launched the first Bitcoin futures contracts. This is very interesting for those watching this mania unfold (like us), as futures contracts allow for shorting and also will be able to provide some positioning data that can be used to gauge sentiment.

Just how wild has Bitcoin been? The one-year return through December is around 1600%, so far! It's difficult to precisely pinpoint that number because it's changing every second and undergoing large swings. This has been compared to the Dutch Tulip Mania of the 1600s, the South Sea bubble of the 1700s, and to a lesser extent the U.S. stock market bubble in the late 1920s. But in recent times, there have been few asset classes with returns even remotely close to what we've seen in Bitcoin. There will be penny stocks and frontier currency pairs with multiple-thousand percent returns, but nothing as well televised as Bitcoin.

I'm not going to even attempt to predict what will happen to Bitcoin going forward (I'll leave that to an upcoming article from our Chief Investment Officer, Rusty Vanneman) Historically, Bitcoin prices have experienced large (85% and more) crashes. Remember, volatility goes both ways. But there are seemingly many, many more players in the game now. What we can hope for is with more institutional investors coming on board through futures and options, volatility will decrease and the price will settle around a reasonable level. But, who knows what that level will be ($500, $5,000, or $100,000?) or when it will happen? There are dozens of other questions that need to be answered before many consider this investable or feel safe doing so. However, if cryptocurrencies are indeed a new asset class, it's definitely exciting to be a witness.

An Active Year for ETFs

As we near year-end, it's time for my usual update on ETF launches and closures. This year has been remarkably similar to last from an ETF launch perspective. As of December 12, 2017, there have been 253 launches and 123 closures as compared to 251 launches and 123 closures in 2016. There are bound to be a few more launches this year, but in general it's been a solid year for launches and another record year for asset gains. The composition of those launches has changed a bit. This year, we've seen the highest number of active ETF launches on record and continued smart beta launches, but less so than the prior two years.



Source: Morningstar

More than $400 billion has flowed into ETFs so far, with active and smart beta funds taking in more than $70 billion. Not only have we seen a record number of active ETF launches, but flows have followed, too. More than $14 billion has flowed into active funds this year, over twice that of the next highest year on record for active flows. Smart beta flows haven't been too shabby either, with more than $55 billion flowing into the space.

There have been an equivalent number of closures in 2017 as last year. We contend this is healthy for the industry as it helps to inspire creativity and innovation. The plain vanilla parts of the market are already cornered and racing towards zero management fees. New products need to be more innovative, cheaper, or in some cases have a strong active manager who wants to enter the space behind them. These are all great for the end ETF investor.

Grant Engelbart, CFA, CAIA
Portfolio Manager

Grant Engelbart manages CLS's aggressive mutual funds and several ETF and mutual fund separate account strategies, including CLS's American Funds portfolios. He also leads the alternative broad asset class team and serves on several committees across CLS's parent company, NorthStar Financial Services Group, LLC.

Mr. Engelbart first joined CLS as an intern in 2007. He returned in 2009 and held several roles in trading and investment research prior to accepting the role of Portfolio Manager in 2013. He previously held positions at TD Ameritrade and State Street Corporation.

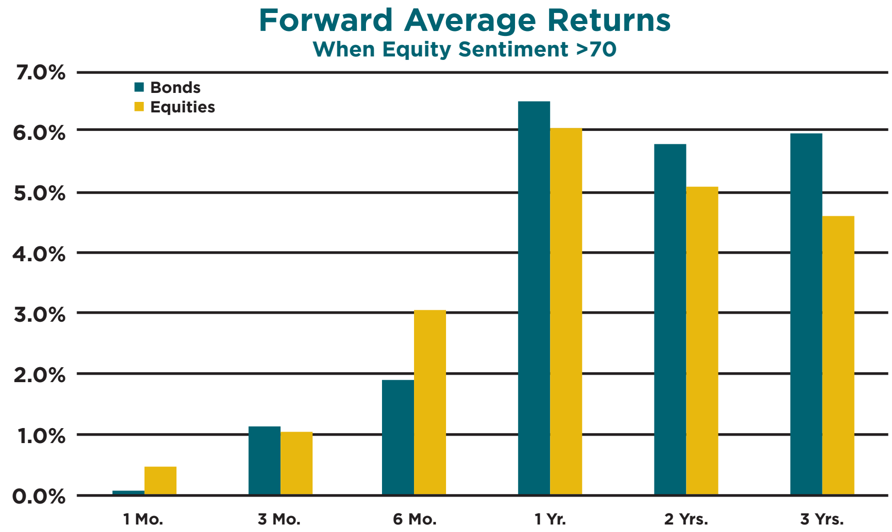
Mr. Engelbart received his Bachelor of Science degree in Finance from the University of Nebraska at Lincoln. He holds the Chartered Financial Analyst® (CFA) designation, Chartered Alternative Investment Analyst (CAIA) designation, and FINRA Series 65 license. He is a member of the CFA Society of Nebraska and the CAIA Chicago Chapter.

Did you know? Grant invested in his first fund at age 13.

Sentiment and the Future

We've written on sentiment an increasing amount lately. Gauging sentiment can be insightful. One sentiment composite we utilize is a combination of various survey and positioning data points from Ned Davis Research. This gauge and others have decent predictive power for future returns. For example, "extreme" values for this gauge are above 70 and below 35. When sentiment is very low (below 35), investors are extremely fearful, which happens to be the best time to invest. For the last 20 years or so, readings below 35 have been tied to significantly higher future equity returns. So much so, that deeply depressed sentiment has predicted positive returns one to three years forward with perfect accuracy.

Unfortunately, sentiment is currently quite the opposite. It's actually above 70. Now, before you go selling everything you own, hold on for a second. While low sentiment levels have been very predictive of future returns, high sentiment readings are less clear. For instance, when sentiment is above 70, future returns are, on average, still positive 50-70% of the time from one month to three years out. Average returns, however, are lower. This coincides with what we've preached for some time at CLS about higher U.S. valuations leading to lower future expected returns.



Source: Ned Davis Research and Bloomberg
Equities represented by S&P 500 and bonds by 7-10 Year Treasury

There is a silver lining for the balanced and diversified investor. A well-diversified portfolio should hold plenty of other asset classes, all of which have lower sentiment readings than the U.S. stocks we are measuring here. Forward returns (chart above) for the classic diversifier – high-quality bonds – are higher than stocks one to three years out when equity sentiment gets this high! So, while we don't know what's going to happen in the short-to-intermediate term (markets could climb a lot more), it pays a ton to stay diversified.

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