SDCERA

CIO Markets Report

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Key Observations and Implications

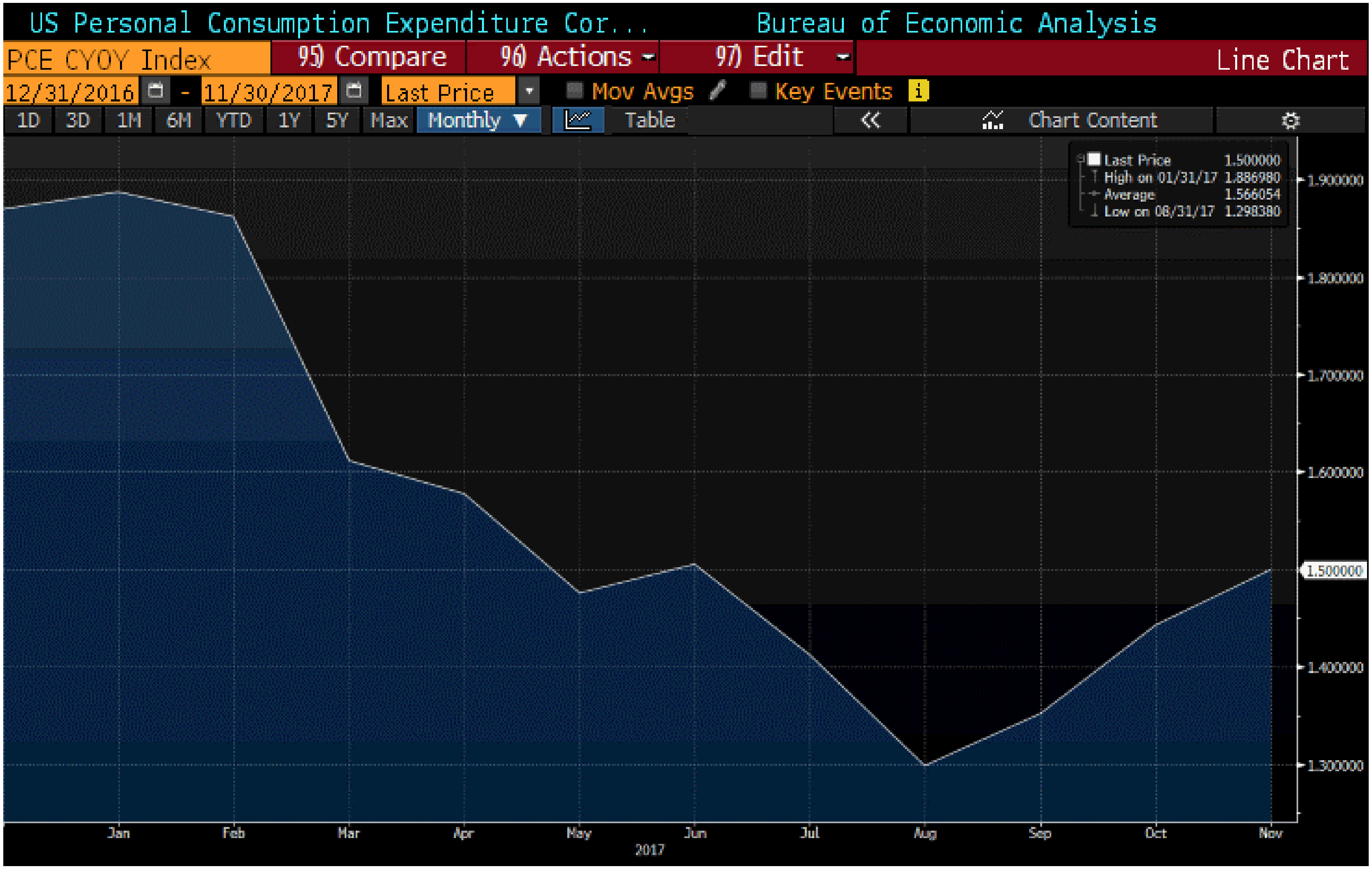
1. **2017 in Review.** Equity returns around the world were great. The MSCI All-Country World Index posted a total return of 24.6%. Emerging markets turned in the best performance, up 37.5%. International markets were up 25.5%, and the United States up 21.9%. Perhaps most notable was the complete lack of volatility during the year. The CBOE S&P 500 Volatility Index, or VIX, spent much of the year at or near record-low levels. U.S. inflation was subdued during the year. The Personal Consumption Expenditure Core Price Index remained below the Fed's target rate of two percent through November (Chart 1). The Fed hiked interest rates three times. At the end of the year, the Fed Funds rate stood at a range of 1.25% - 1.5%. Short-term interest rates went up 0.9% while longer-term rates fell 0.3% (Chart 2). Overall, a flatter yield curve but bond returns were positive. Intermediate governments and corporate bonds returned 3.5% and high yield bonds returned 6.5%.

2. **A Look Ahead to 2018.** A repeat of 2017 equity market returns is unlikely due to valuations combined with the transition from Quantitative Easing (QE) to Quantitative Tightening (QT). For bonds, success will be earning the current coupons with no capital losses caused by higher interest rates or defaults. Like 2017, political uncertainty is high. The U.S. will hold midterm elections. In the Eurozone there will be Italian general elections. Italy, like Germany, is expected to find it difficult to form a ruling coalition as the Eurocentric leaders struggle with emerging nationalist groups. Ongoing concerns include Brexit negotiations and nuclear tensions on the Korean peninsula. Jerome Powell is likely to become the next Federal Reserve Chair in February and will take over a Fed that has already begun removing monetary stimulus from the economy. The European Central Bank is also scheduled to begin winding down its own quantitative easing program in September. The U.S. economy should receive a tailwind in the form of corporate tax cuts and continued deregulation (Charts 3 and 4). More uncertainty may arise from the legislative agenda. Investor sentiment is very high entering the new year (Chart 5).

3. **Fees and alignment.** SDCERA relies upon the skill and expertise of its investment managers to manage Trust Fund assets. For active managers, the goal is returns in excess of passive index funds. Hedge funds hold out the prospect of absolute returns while charging high fees to do so. The back-to-back Bloomberg news stories in Chart 6 suggest that while high fees are a certainty, the returns are not. SDCERA does not have any hedge fund investments.

4. **Implications.** The prudent course of action is to maintain a diversified portfolio and be prepared to allocate to investments where risk spreads have moved higher and valuations are such that expected returns are higher. We will also continue to work to align the incentives of our investment managers with long-term Trust Fund goals. This is our course for 2018.

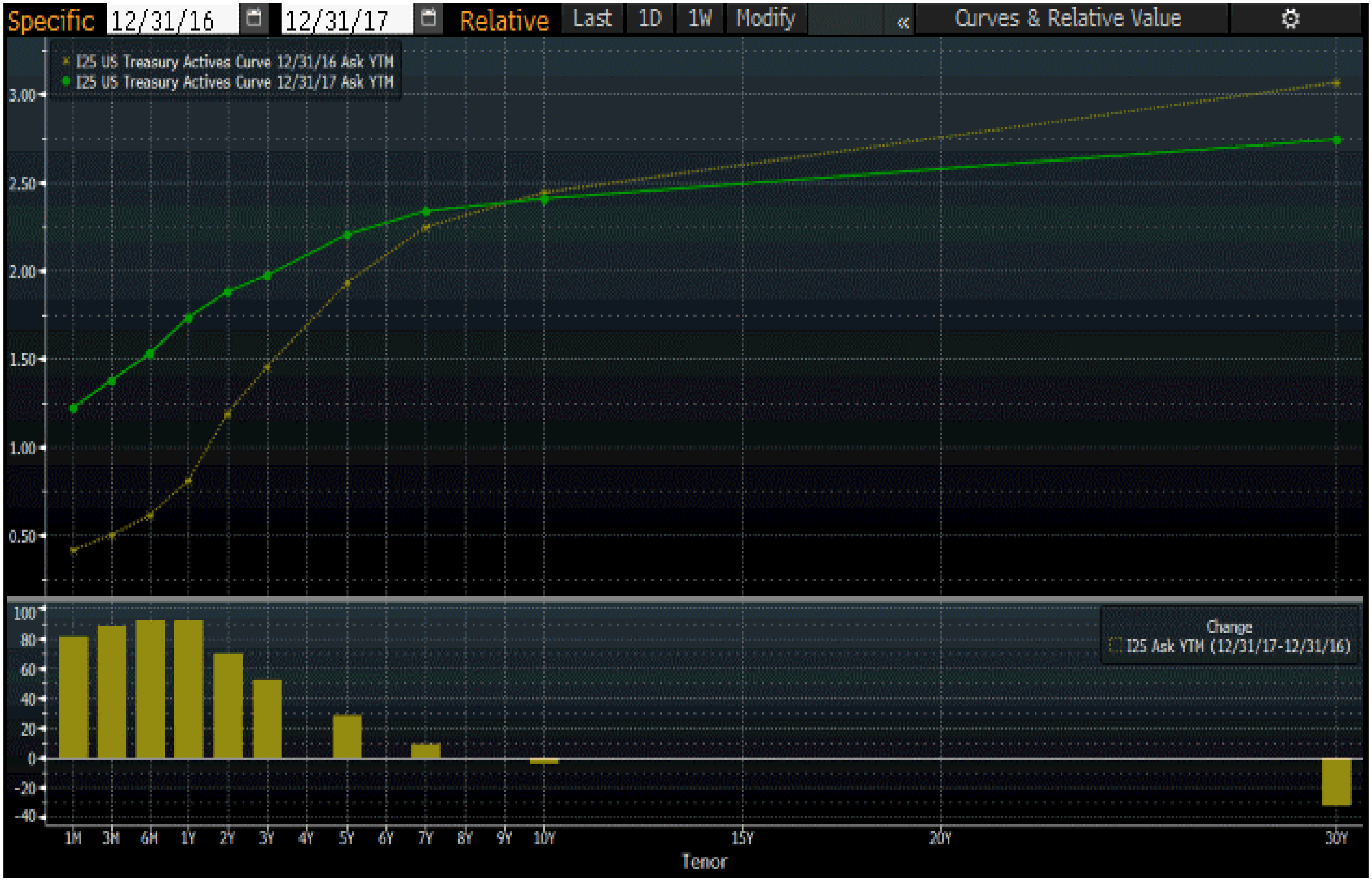
Chart 1
U.S. Core Personal Consumption Expenditures Jan-Nov 2017



Source: Bloomberg

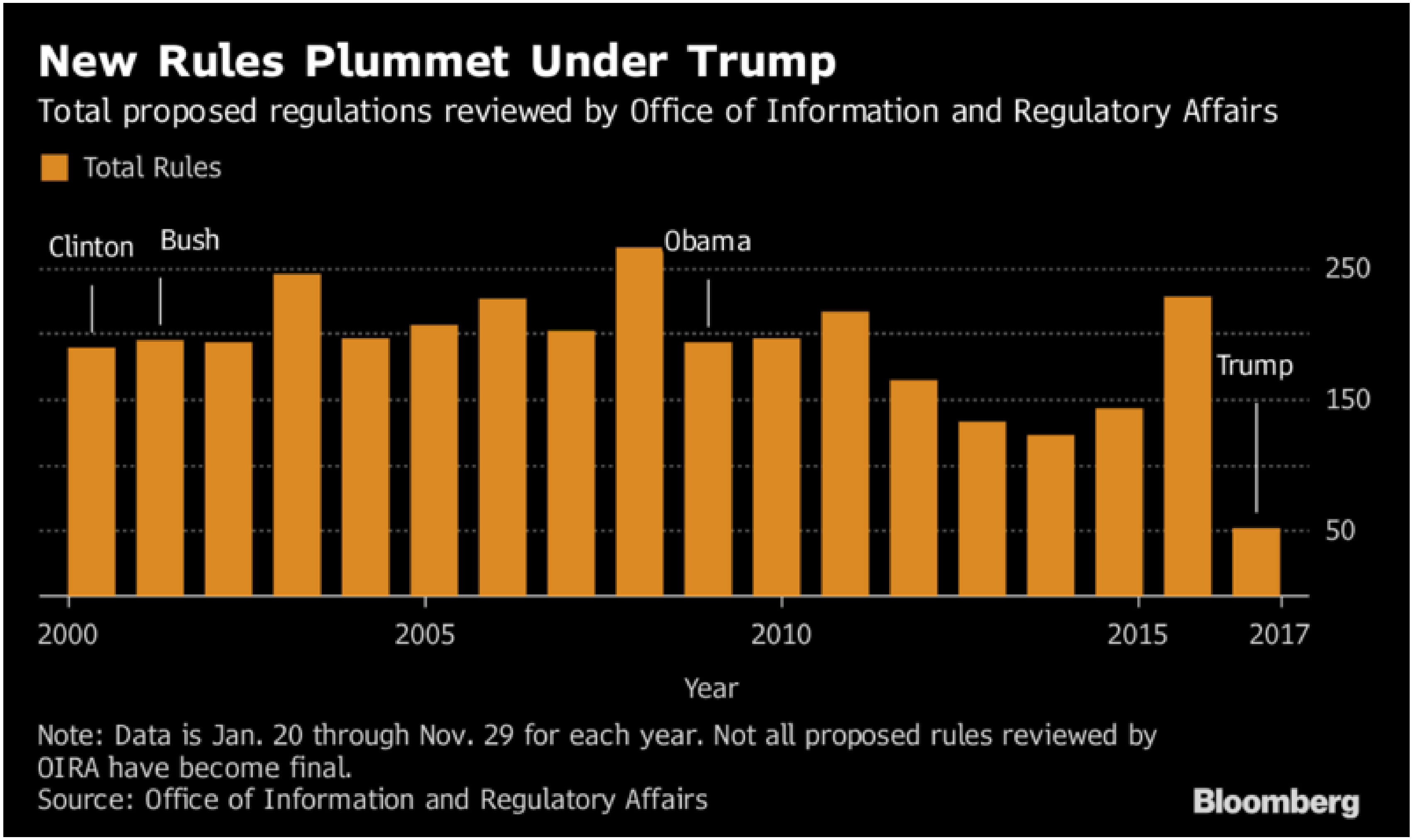
Chart 2

The U.S. Treasury Yield Curved Flattened in 2017



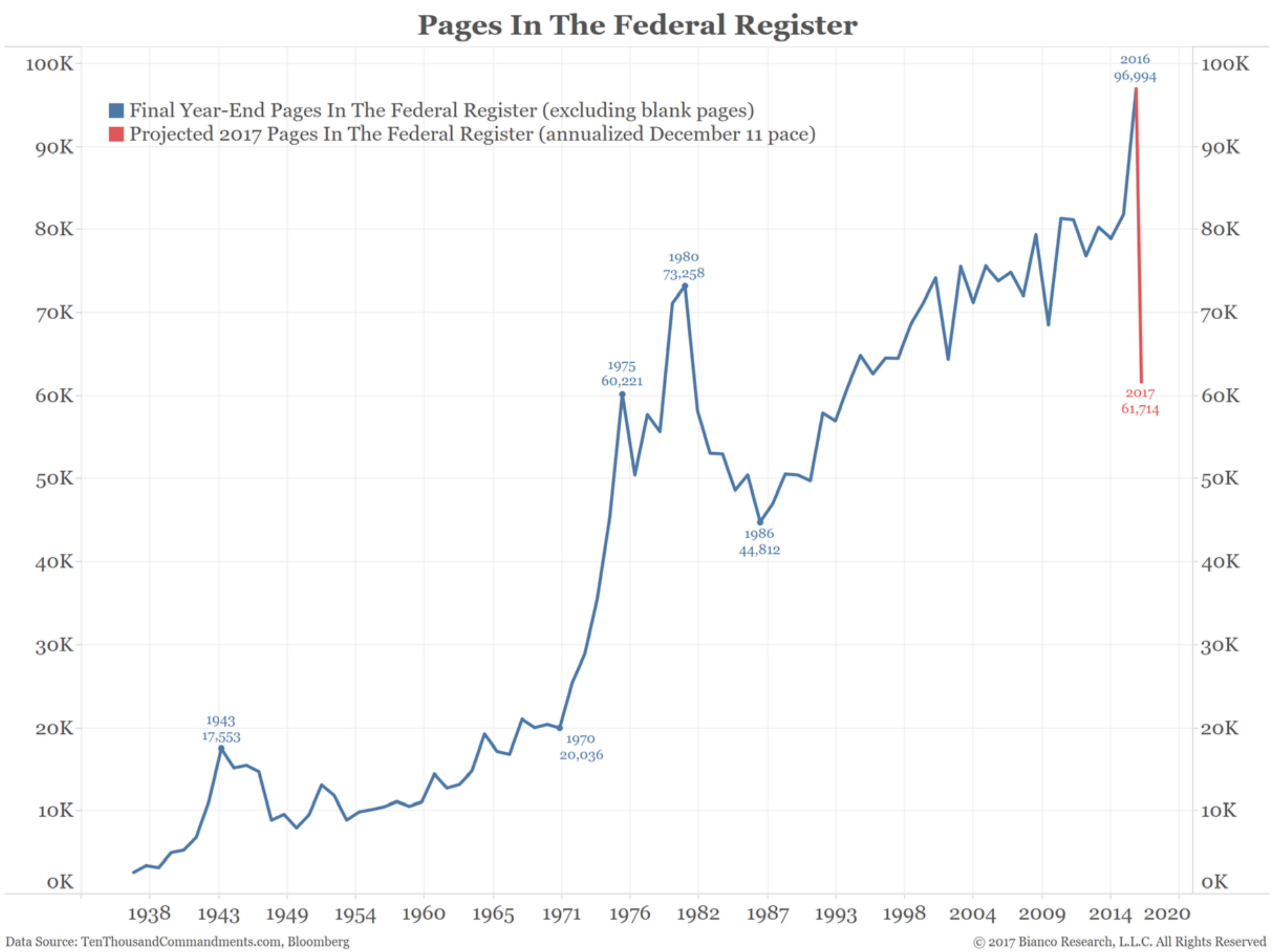
Source: Bloomberg

Chart 3



New Rules Plummet Under Trump
Total proposed regulations reviewed by Office of Information and Regulatory Affairs
Total Rules
Clinton
Bush
Obama
Trump
250
150
50
2000
2005
2010
2015
2017
Year
Note: Data is Jan. 20 through Nov. 29 for each year. Not all proposed rules reviewed by OIRA have become final.
Source: Office of Information and Regulatory Affairs
Bloomberg

Chart 4



Pages In The Federal Register
Final Year-End Pages In The Federal Register (excluding blank pages)
Projected 2017 Pages In The Federal Register (annualized December 11 pace)
100K
90K
80K
70K
60K
50K
40K
30K
20K
10K
0K
1943
17,553
1970
20,036
1975
60,221
1980
73,258
1986
44,812
2016
96,994
2017
61,714
1938 1943 1949 1954 1960 1965 1971 1976 1982 1987 1993 1998 2004 2009 2014 2020
Data Source: TenThousandCommandments.com, Bloomberg
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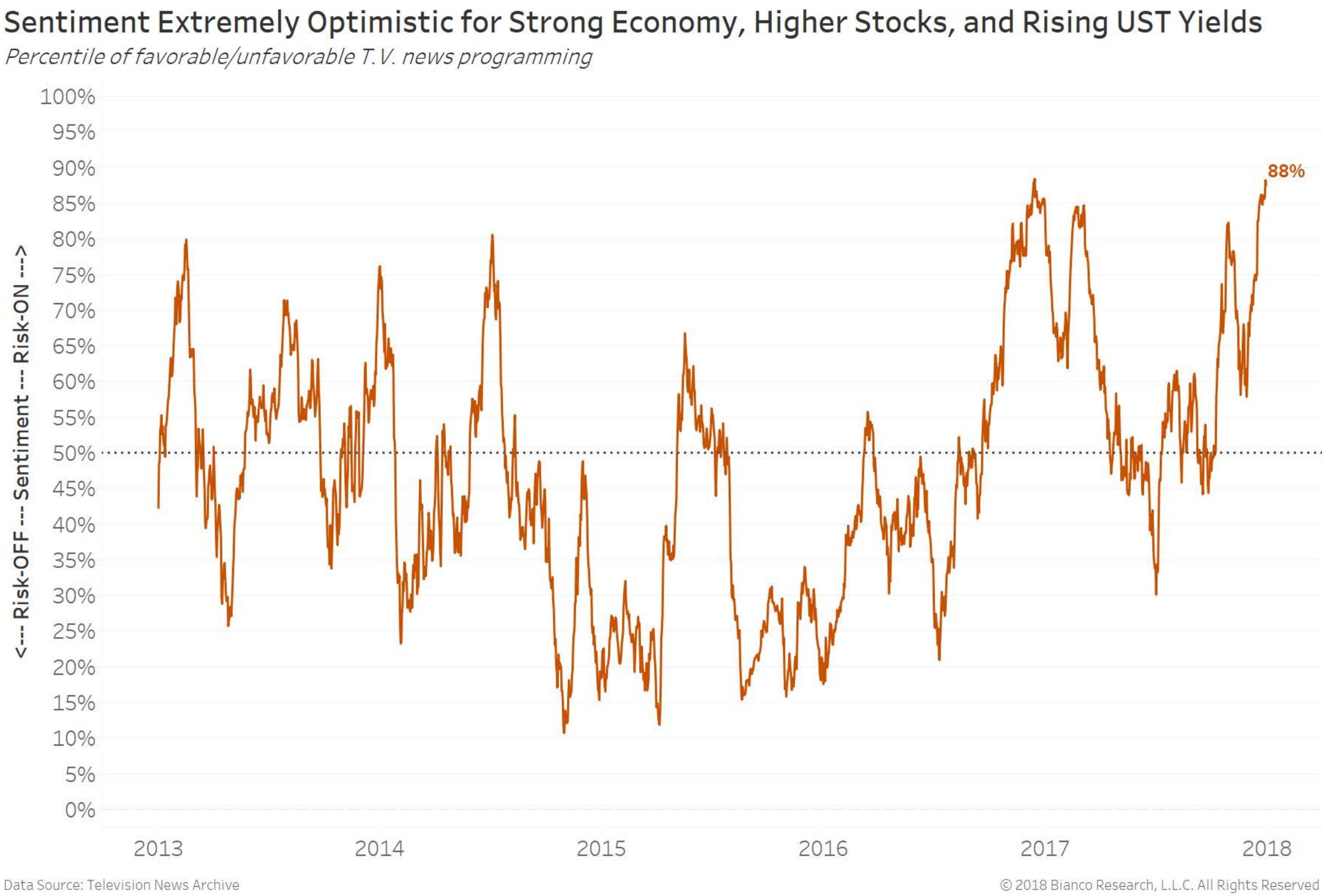
Chart 5



Sentiment Extremely Optimistic for Strong Economy, Higher Stocks, and Rising UST Yields
Percentile of favorable/unfavorable T.V. news programming
100%
95%
90%
85%
80%
75%
70%
65%
60%
55%
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
<--- Risk-OFF --- Sentiment --- Risk-ON --->
88%
2013
2014
2015
2016
2017
2018
Data Source: Television News Archive
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Chart 6

Source: Bloomberg