Songbird Capital Research
2017 Yearend Letter and Market Commentary

2017 and early 2018 Market Reviews:

The Anticipated Volatility Returned by Surprise

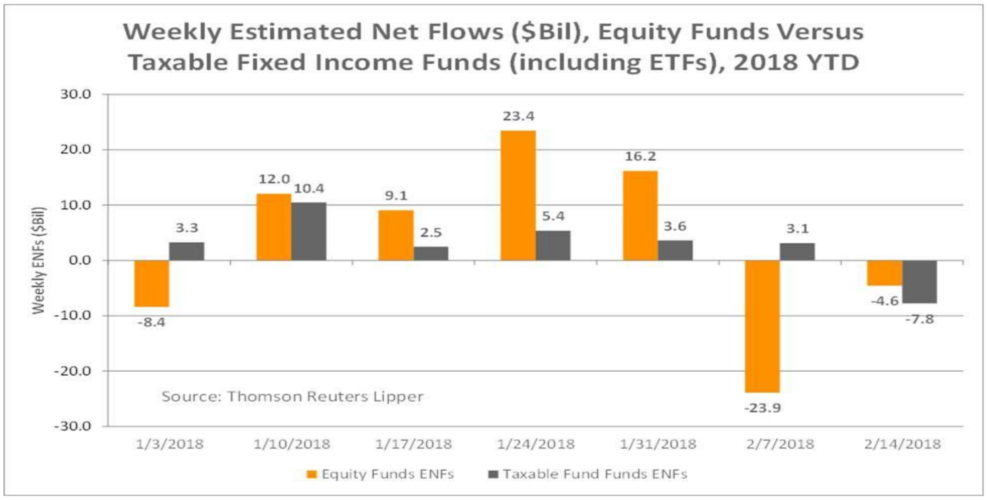
Strong equity performance continued into 2018. As of January 26th, 2018, the S&P 500 gained ***7.55%***. Songbird aggregate composite was up ***6.84%*** benefiting from the tailwind of strong investor consensus and confidence in global equities. However, in the following two weeks, the market took a dramatic turn as the S&P 500 dropped precipitously by 10% from its peak before it rebounded above the 2017 yearend level to positive territory for 2018. The return of volatility has been anticipated for a while, however it was unpleasant for a lot of investors, particularly the ones who invested with short volatility funds/ETPs.

The sudden market drop in the middle of strong economic growth led to various debates and arguments on the causes of the recent market movements. Although there are no conclusive explanations, the following three highlights may provide you some insights:

1) Synchronized globe growth coupled with extremely low volatilities for over a year further induced investors' confidence and risk appetite, which was evidenced in strong fund inflows in January (See chart below). According to Thomson Reuters Lipper, the net inflows of $52 billion in equities in January coincided with global equities rallied in the first three weeks of the month. Whenever there is a strong consensus combined with strong inflows, any shift of sentiment can rock the market.

2) "In the short run, the market is like a voting machine." - On February 5th, 2018, the new Fed Chairman Jerome Powell swore in, the same day that the Dow fell 4.5%, the worst fall since January 2016. On one hand, strong labor data indicates strong economic growth. On the other hand, it also increased the chance that the Federal Reserve will raise interest rate faster than anticipated to avoid market overheating. The uncertainty caused a sudden change in investors' confidence and sentiment, resulting profit taking selling from investors.

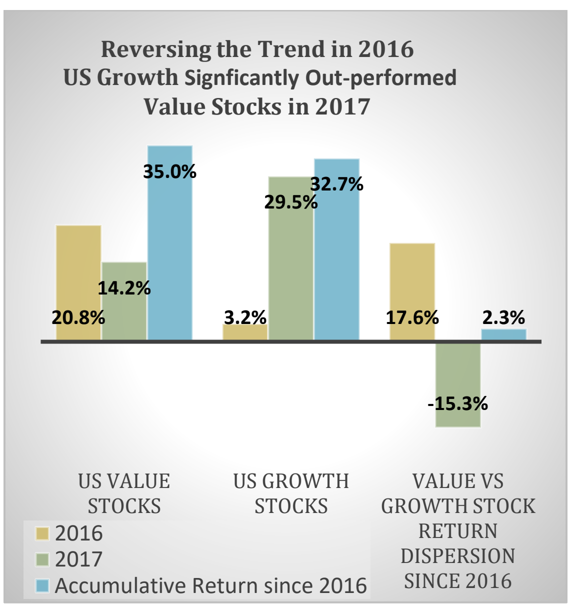
3) Trouble in several short volatility funds exacerbated the selling and led to further concerns over potential large structural issues in the market, driving large outflows in the first two weeks in February (see chart below).

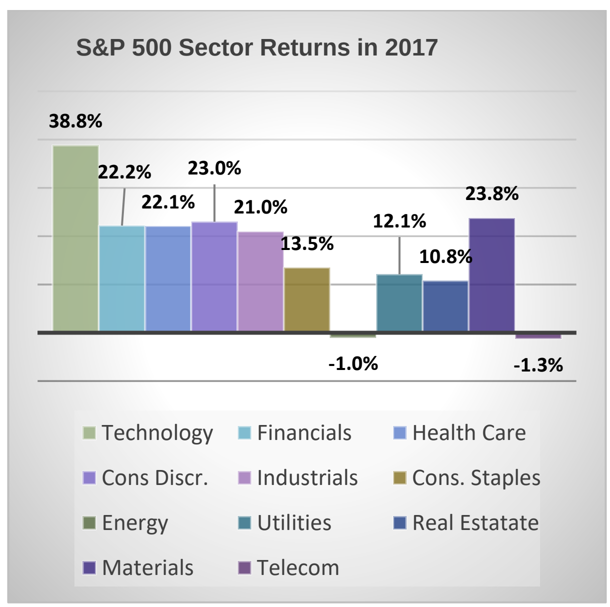


Market Highlights in 2017

- **US Equities –** The S&P 500 delivered a total return of ***21.8%*** in 2017 with growth outperforming value stocks. At the sector level, Technology returned ***38.8%***, contributing ***42%*** of S&P 500 return in 2017. The top five sectors combined contributed ***94%*** of the index's return. In comparison, the bottom 6 sectors in aggregate only contributed ***6%*** to the S&P 500 return for the year.

- **Growth stocks are closing the gap with value stocks** since a 17.6% dispersion was created in 2016 (see Songbird 2016 yearend letter), delivering 15% outperformance in 2017 (see charts below).



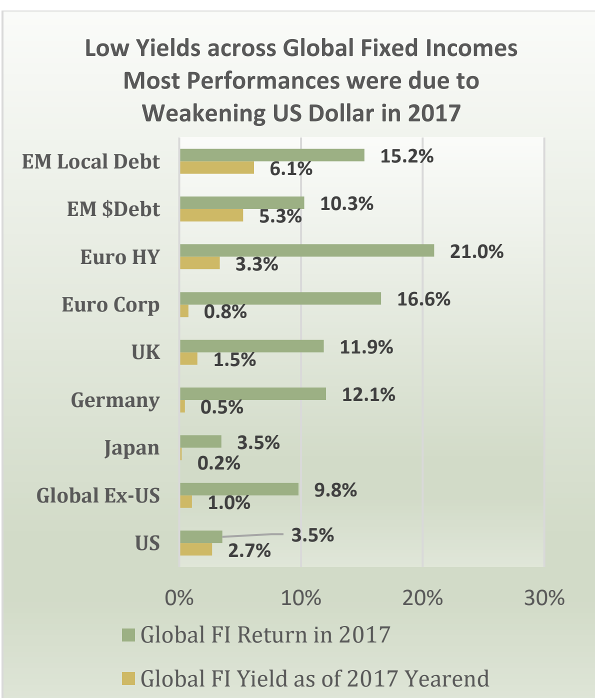


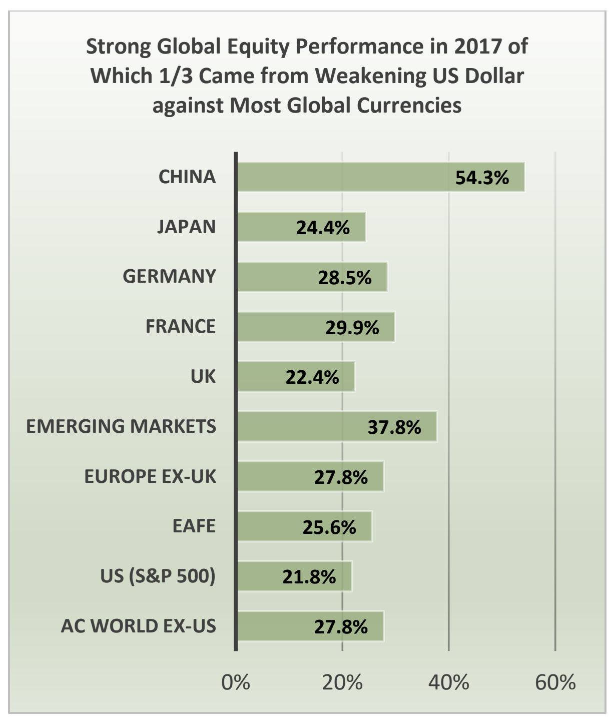
Data sources: Standard & Poor's, JP Morgan AM, Morningstar and Songbird Capital

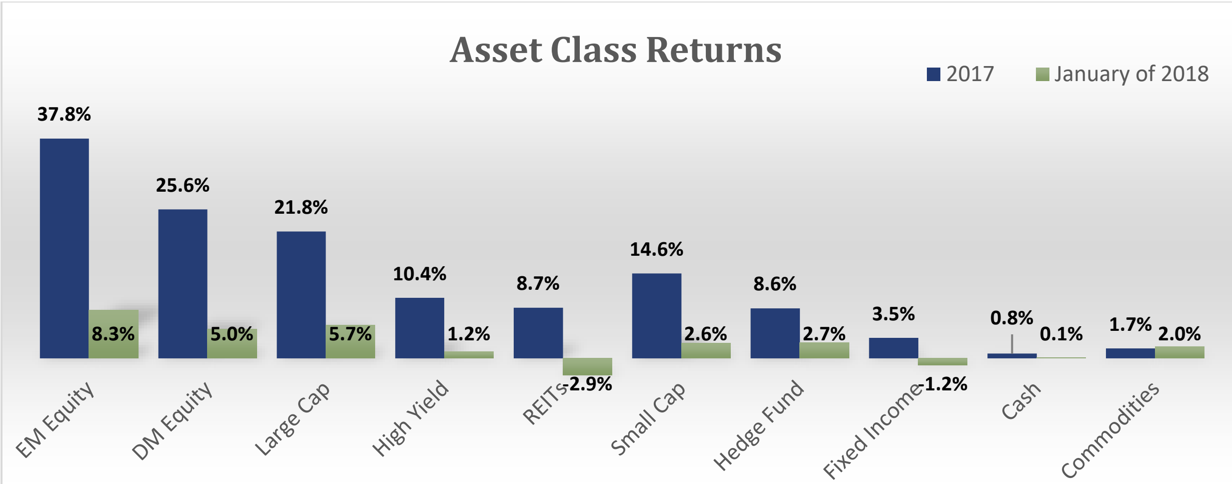
- **International equities -** ***<u>Weakening dollar combined with strong global equity markets</u>*** propelled the best international equity returns since 2010 and resulted a return of ***<u>37.8%</u>*** in emerging markets and ***<u>27.8%</u>*** in MSCI World ex-US in dollar term. In 2017, the US Dollar Index was down 9% followed by further down 3% in the first month of 2018. The weakening US dollar against most international currencies helped to drive strong international equity performance since the second half of 2016.

- **Global fixed income –** ***US 10-year Treasury yield ended at 2.4% for 2017 and was unchanged from the previous yearend. Global fixed incomes had lackluster returns in local currencies terms but yielded low double digit return in US dollar term due to the weakening of the US dollar against most international currencies.*** With low yields and increased durations across developed countries, fixed income investments are approaching to an inflection point. A fast and steep rise in interest rate will have a dramatic impact on fixed income investments. For instance, just 1% rise in interest rate can cause 17% decline for 30-year Treasuries and 8% decline for US 10-Year Treasuries.

- **Alternative Investments** such as Hedge Funds, REITs and Commodities relatively underperformed against other asset classes in the momentum driven markets in 2017. Although Hedge fund index – HFRI Asset Weighted Composite had its best year since 2013, it was only up 8.6% for the year. REITs returned 8% in 2017. However, its 3-year annualized return is barely positive, reflecting the concerns of rising interest rate on high yielding asset class. Global commodities were flat in 2017. In the past 10 years, commodities have experienced a bear market as the Bloomberg Commodity index generated -8% annualized return for the decade. However, don't give up these asset classes too soon as picking up inflation and weakening dollar can benefit commodities, and eventually REITs.







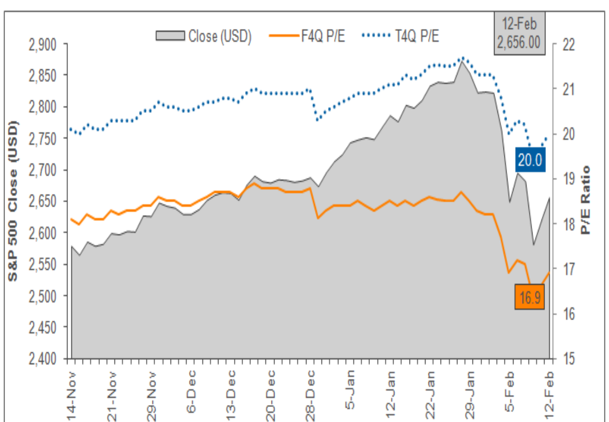
Data sources for 3 charts above: Barclays, Bloomberg, Russell, Standard & Poor's, MSCI, NAREIT, Morningstar, Songbird Capital. EM Equity (MSCI EME), DM Equity (MSCI EAFE), Large Cap (S&P 500), High Yield (Barclays Global HY Index), Small Cap (Russell 2000), Fixed Income (Barclays Aggregate) and Commodity (Bloomberg Commodity Index), Hedge Fund (HFRI Asset Weighted Composite)

Investment Outlook:

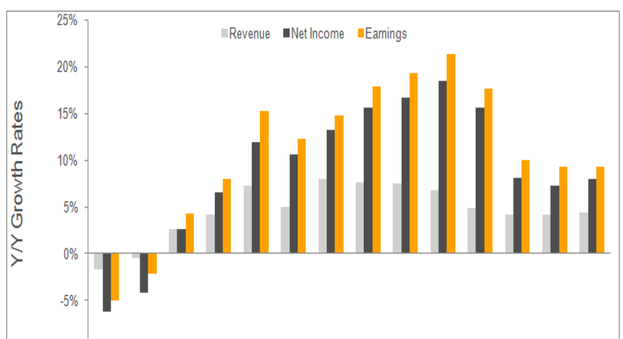
The S&P 500 index got cheaper after the recent correction.

After the recent drop in the S&P 500 Index, the index's forward PE, the metrics for stock valuation fell to 16.9x from over 18x in late January, taking it back to mid-2016 levels. The earning's growth is expected to accelerate till 3Q 2018, and the positive trend continues in 2019. (See the two charts below.) The estimated earnings per share (EPS) and PE for the S&P 500 is around $156 per share in 2018 and $172 in 2019, which translate to **16.9x PE** for 2018 and **15.4x PE** for 2019 given the S&P 500 Index closing level at 2656 on February 12th, 2018.

In the near term, investors may see a rebound in global equities driven by fundamentals although volatility will likely stay and the path to recovery won't be straight line as the US economy goes through transitional period and policy uncertainties and possible mistakes may destabilize the global markets.



Sources: Thomson Reuters I/B/E/S, Thomson Reuters Proprietary Research, S&P 500 Earnings Scorecard (Exhibit 21, page 8)



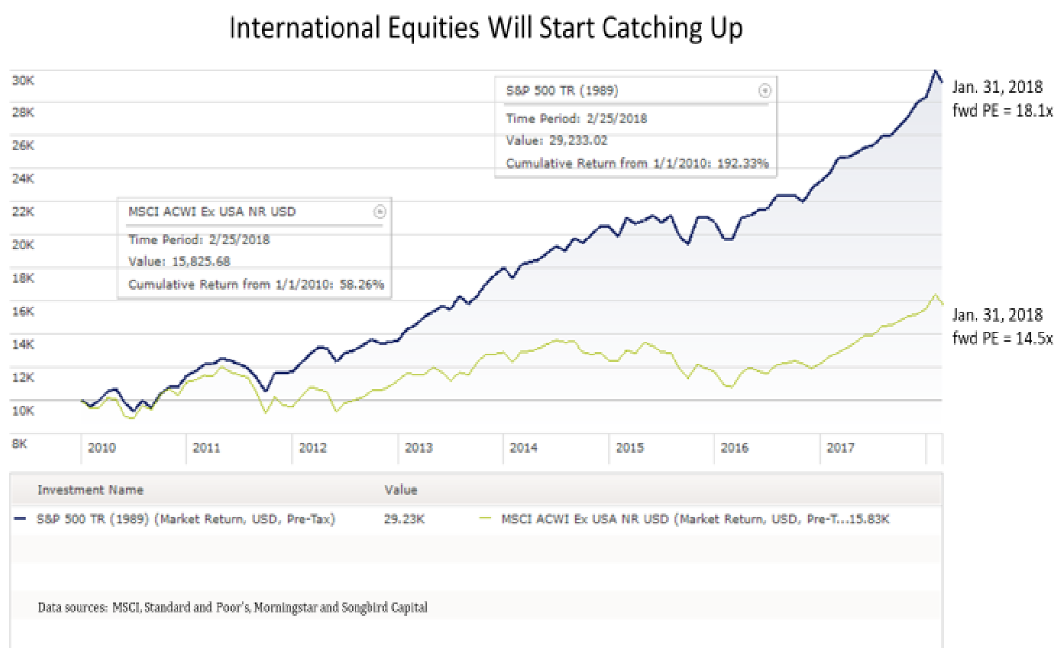
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	8.0%	7.6%	7.5%	6.8%	4.9%	4.2%	4.1%	4.4%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	13.2%	15.7%	16.7%	18.5%	15.6%	8.1%	7.3%	7.9%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	14.8%	17.9%	19.3%	21.3%	17.6%	10.1%	9.3%	9.2%

Sources: Thomson Reuters I/B/E/S, Thomson Reuters Proprietary Research

Global Opportunities and Risks

The opportunities outside US remain attractive on relative and absolute basis as the recoveries in Europe and Asia are still early to mid-cycle and equity valuations in these regions remain below historical averages, while US economy is late cycle and its equities are fully valued and sensitive to rise in interest rates from the current level.

Are US equity and international equities reaching the point where international equities, particularly emerging market equities will outperform US equities? They are likely, particularly is emerging markets given the strong EM fundamentals driven by earnings' growth and business confidence, attractive valuations. In addition, commodity prices are gradually rising after declining in the past decade and weakening dollar will further help international returns.

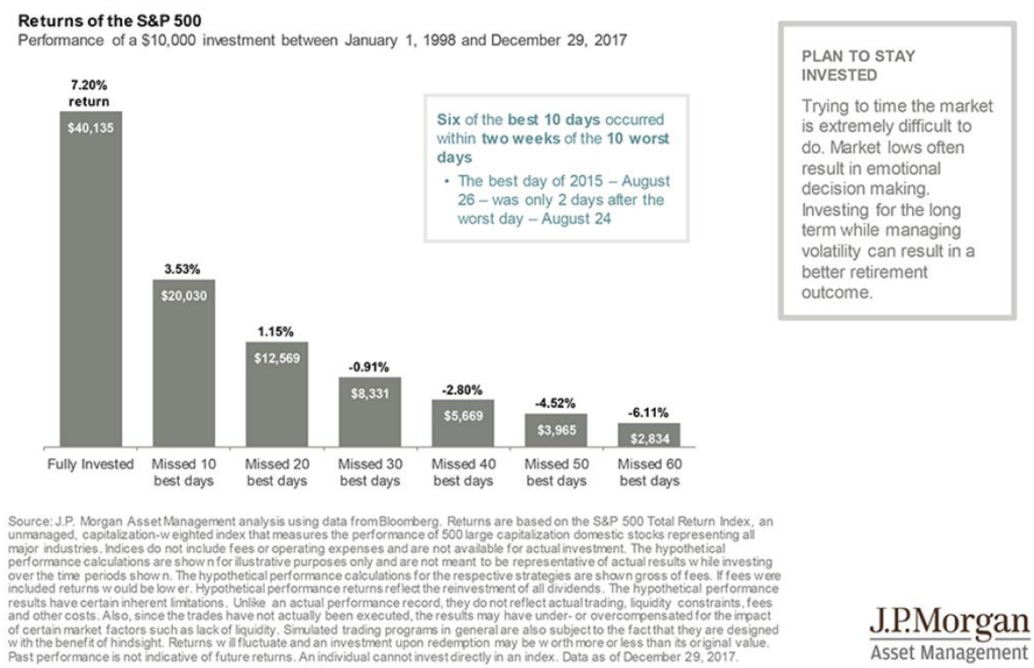


As the US economy is entering its 9^{th} year expansion, it becomes the 3^{rd} longest expansion in the US history, but also the slowest recovery with accumulative GDP growth only 14% since 4^{th} quarter of 2007. By comparison, the longest expansion in the 90's and the second longest in the 60's had over 50% and 40% respective accumulative GDP growth during the expansion.

At the recent Brookings event "A Fed Duet: Janet Yellen in a Conversation with Ben Bernanke", the moderator asked, "What could bring an end to the current expansion?" Benanke was concerned that *geopolitical risks* are not fully priced in by the market, while Yellen stressed that *economy overheating* would be her primary concern. For the time being, market volatility will continue as investors are pondering how higher interest rates will offset strong earnings and put pressure on valuations

Staying Invested is the key to long-term investment success

JP Morgan's research has demonstrated the power of staying invested as investors are unable to time the market. The chart to the right shows that in the past 20 years if an investor missed 10 best days, its annualized return would have cut by more than 50% because six of 10 best days occurred two weeks after 10 worst days. This tells us that investors should focus on achieving medium and long-term financial goals by staying invested in the market through properly structured portfolio that can sustain through volatile periods.



Songbird Capital has institutional experience in portfolio and risk management and is specialized in asset allocation across multiple asset classes and strategies. We provide valuable services for investors by capturing investment opportunities while navigating risks and staying invested. ***Songbird's competitive fees in the industry always helps our clients to keep more along the way. (See Songbird fees against industry average and "Savings from fees compounded over 20 years" on our website) .***

Sincerely Yours,

Jie Hayes / Principal of Songbird Capital

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