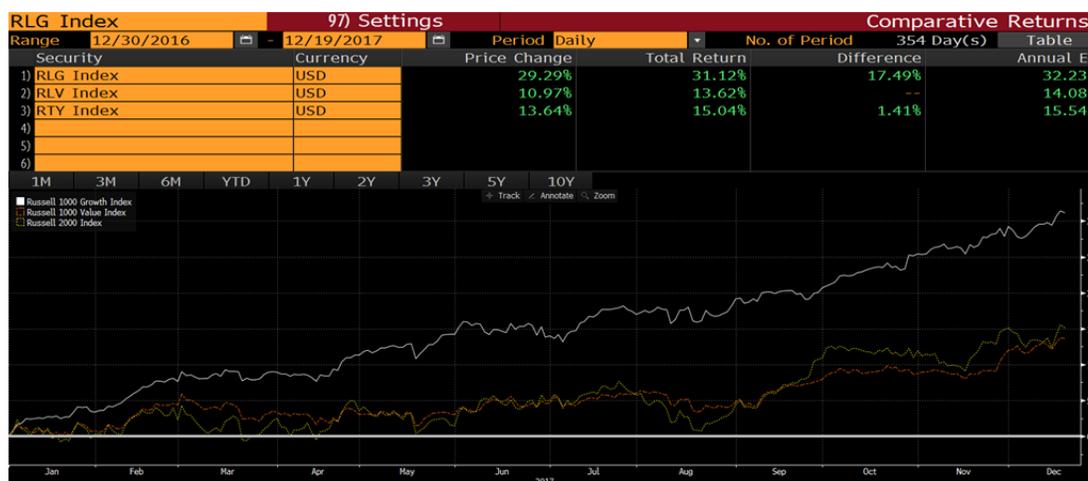


December 22, 2017

Dear clients and colleagues,

2017 was a very strong year for stock markets around the world as major economies saw synchronized growth for the first time since 2006. Emerging markets led with a YTD return of 34% (all US\$ returns). The Nasdaq, led by the FANG (Facebook, Amazon, Netflix, Google) and Microsoft, is up 31%. The Nikkei reached a 26-year high, up 22% YTD. The S&P/TSX, the Canadian benchmark, was the laggard, up 13%.

Also in 2017, small caps underperformed their large cap counterparts and value benchmarks underperformed growth benchmarks by the widest margin since 1999.



Source: Bloomberg

Since bottoming in March 2009, the MSCI World Index has returned over 200%, and the S&P 500 has been up every year for the last nine years.

Given the strength of the economy, and the fact that the US Federal Reserve (Fed) raised rates three times in 2017, US 10-year bonds are only up 2 bps for the year. Only China saw bond yields increase substantially in 2017.

With such strong returns, what should we expect for next year? I will refer you to our October 13, 2017 commentary.

We do not foresee a recession in 2018; the economic momentum from 2017 should carry forward. However, we see inflationary pressures rising. The following chart shows the producer price index, a leading indicator for consumer price inflation, at a five-year high. Most companies that we meet have indicated that rising costs are a major risk, but they also said they will raise prices.

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Source: Bureau of labor statistics

Since bottoming in early 2016, oil prices have more than doubled.



Source: Bloomberg

Wage increases, although still modest, are in an uptrend. Most companies we meet say finding qualified labour is their main challenge and as a result they are offering higher wage increases. The following chart shows the uptrend in wages.

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Source: Bureau of Labor Statistics

If we do have higher inflation in 2018, it would prompt the Fed to increase rates. We also see the European Central Bank (ECB) becoming more hawkish in 2018. The People's Bank of China will seek to reduce risk in the financial system and try to engineer a soft landing for its economy.

In the past when interest rates were rising, we saw small caps generally outperform. However, longer duration assets such as real assets (infrastructure and real estate), private equity and long bonds are usually negatively impacted by rising rates. Technology and high multiple companies would also be affected as the discount rate (denominator) would increase.

For Global Alpha, the last five months of the year were difficult from a relative performance perspective; however, we are positioned to finish the year with strong absolute performance. Our International Small Cap Fund outperformed its benchmark, and our Global Small Cap Fund slightly trailed its benchmark as the US component of the index, over 55%, comprises a lot more unprofitable and high beta companies.

We are well-positioned for 2018 and would like to thank you for your confidence in our team, our investment philosophy and process.

This will be our last commentary for 2017; we will resume in January 2018. Our team would like to wish you a happy holiday season and a wonderful 2018 filled with health, happiness and success.

The Global Alpha Team

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