Fourth Quarter 2017

Quarterly Letter to Clients

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January 23, 2018

As we bid adieu to 2017 and welcomed in 2018, we were amazed how quickly last year passed. It was a year full of wonder, intrigue, and change – and of course the challenges that all change tends to bring with it. Most of the change was unexpected: the change from electing a new president that was not expected to win, and the challenge of dealing with the politics and policies surrounding a new administration; the change in weather, as the U.S. experienced the extremes of hurricanes and wildfires for the better part of the last decade, and the challenge of rebuilding in the aftermath of these disasters; the change in the Federal Reserve's accommodative monetary policy, and the challenge of adapting to rising interest rates; the change of a stock market that appears to see no downside risks as it registers record highs (without as much as a negative month during the entire year), and the challenge of preparing for the inevitable shift in sentiment and the price declines that follow; and finally, the much anticipated change in the tax laws and the challenge of balancing the short-term benefits taxpayers will receive with funding the long-term deficits that are the consequence of the change.

The Economy in the final quarter of 2017 continued its progress toward becoming the longest post World War II expansion, while also sharing the dubious distinction of being one of the slowest recoveries on record. No expansion in U.S. history has lasted for greater than 10 years, so this one has a chance of eclipsing prior records if it can continue past the second half of 2019. The old adage is that expansions don't typically die of old age, but instead turn due to the seeds of success planted during the recovery, nurtured by the animal spirits of consumers and business, until growth overheats to a point where policy makers intervene to cool things down. Thus, with most economists agreeing that the economy is approaching its full potential, the recession watch has started.

Labor statistics continue to provide a mixed picture. Unemployment has reached a 17-year low at 4.1%. However, the labor force participation rate remains stubbornly low at 62.7%, significantly below its prior peak of 67.1% set in 2000. Hiring has begun to slow, with the level of monthly non-farm payroll gains falling below 200,000 per month. Normally at this stage of a recovery, a low jobless rate would put additional pressures on businesses to offer higher wages to attract and retain qualified workers. Yet, rising wage growth has been suspiciously absent from the reported economic figures.

Americans have accumulated more debt than assets and income to service their debt, which leaves the consumer vulnerable to interest rate increases and provides an additional headwind to future real GDP growth. This trend could partially explain why the two major drivers of most economic recoveries, housing and autos, have exhibited signs of fatigue and softer growth. Despite seeing the inventory of

homes for sale hit an all time low, housing starts and permits remain relatively flat. Housing affordability has deteriorated, as both home prices and interest expenses have climbed. Many first time buyers continue to have student debt to pay down before they can consider the "joys of home ownership". Likewise, strength in the auto markets, which benefited from the improving employment picture over the past few years, has begun to show some sales weakness. The combination of above-average production and excess inventory produced the first annual decline in auto sales since the 2008 financial crisis. To bring production and inventories back in line, auto industry executives expect that auto sales will continue this trend, dipping below 17 MM in sales in 2018.

This brings us to the recently passed tax bill, Tax Cuts and Jobs Act of 2017[1], which could provide a boost to consumer spending and business investment over the next few years. Experts are still working on summarizing the bill's potential impact. However, at first review it appears that most consumers will see a small bump in their after-tax disposable income, while US businesses will generally see a reduction in their effective tax rate. A big winner will be multinational companies that can now repatriate cash from income earned overseas at a significantly reduced tax rate. The major question here will be what the funds will be used for? Certainly shareholders will most likely see some benefits, as special dividends, stock buybacks and debt reduction will all be potential uses of the funds. In addition, a number of companies have already announced one-time bonuses for all employees, an unexpected holiday bonus for many.

Of course, the tax cut has the real possibility of increasing the already difficult fiscal situation. The U.S. Budget deficit will increase, requiring more U.S. Treasury debt to be issued to fund the Federal government's operations. As of the 4th quarter of 2017, the U.S. government debt as a percentage of GDP rose to 108%, exacerbating the already persistent and looming fiscal challenge of rebalancing the debt burden of the nation, before the combination of rising interest rates and rising costs of funding social entitlement programs become unmanageable. However, in the near term the Tax Plan may provide a short-term window of fiscal stimulus to offset the impact of the Federal Reserve's Monetary Policy shift. This may give the Fed the necessary breathing room to take their foot off the stimulus pedal, as they simultaneously raise short-term interest rates and reverse the now infamous Quantitative Easing (QE) program and begin to lean toward Quantitative Tightening (QT). One thing is for certain, Real GDP growth greater than 3% will make policymaker's lives more bearable. The 4th quarter of 2017 will most likely mirror the 3rd quarter's 3% rate, putting more pressure on policy makers to avoid a mistake at this critical juncture of the economy.

BONDS

The main focus in the fixed income market continues to be the mixed messages of the flattening yield curve, which many times precedes an economic slowdown, and the narrowing of corporate spreads across the risk spectrum, which would imply an expectation of better times ahead by Corporate America. During the 4th quarter of 2017, the 10-2 year maturity spread declined to 51 basis points,

[1] See https://en.wikipedia.org/wiki/Tax_Cuts_and_Jobs_Act_of_2017

down from 86 basis points at the end of the 3rd Quarter 2017, the flattest curve since the 2008-09 financial crisis. Many fixed income managers believe that the unorthodox monetary policy of the past 8 years has distorted the yield curve by so much, that the past indication given by the flattening yield curve may not apply this time. Nevertheless, historical precedent has repeatedly shown that "while recessions are always preceded by an inverted yield, not all inverted yield curves are followed by a recession." [2]

Corporate credit spreads continued to tighten, as fixed income investors accepted lower compensation for the risks of bankruptcy, recession, and volatility. Corporate spreads are now near multiyear lows, while high-yield (junk) bonds are following a similar path. This could be a result of the combination of reduced regulatory costs, less debt being used for financial engineering or capital enhancement strategies, reduced expected tax expenses due to the Tax Reform legislation, and generally improving balance sheet metrics.

During the quarter just past, the bond market saw mixed results, with longer-dated and riskier corporate bonds outperforming short-maturity, high-quality credits. The U.S. Government 10-year Treasury bond ended the 4th quarter yielding 2.40%, up from the 2.33% yield at the end of the prior quarter. The prospect of further rate hikes, and the aforementioned Quantitative Tightening, both have combined to keep U.S. interest rates attractive relative to other global sovereign bonds. Federal Reserve Fed Funds increases have put upward pressure on short rates, causing the two-year U.S. Treasury Note to end the quarter at 1.89%, up 42 basis points from last quarter, and near the highest level in almost a decade.

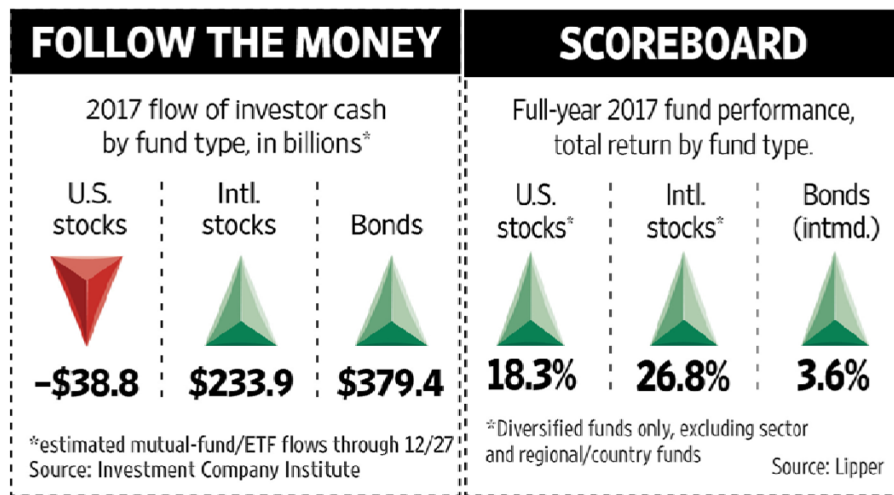
Morningstar Bond Indexes			*As of 12-29-2017*	
Style	**Quarter**	**1-Year**	**3-Year**	**5-Year**
US Core Bd TR Bond	0.40	3.64	2.41	2.25
US Inter Core Bd TR Bond	(0.04)	2.63	2.27	2.24
US Shrt Core Bd TR Bond	**(0.24)**	**1.12**	**1.12**	**1.00**
Corporate				
US Corp Bd TR Bond	**1.10**	**6.40**	**3.87**	**3.42**
US Inter Corp Bd TR Bond	0.08	4.49	3.42	3.06
US Shrt Corp Bd TR Bond	**(0.04)**	**2.33**	**2.01**	**1.88**
Government				
US Gov Bd TR Bond	0.10	2.41	1.43	1.29
US Inter Gov Bd TR Bond	(0.52)	1.53	1.48	1.11
US Shrt Gov Bd TR Bond	**(0.33)**	**0.53**	**0.71**	**0.64**

[2] "So Long 2017 – Next Stop Euphoria" by Vito J. Racanelli **Barron's**, December 30, 2017.

STOCKS

The capital markets produced robust returns for 2017, raising the spirits of stock market participants. Sentiment toward stocks is weighted to the bullish side on most measurement scales, with professional and individual investors alike professing their most optimistic stance since 2010. Fear has abated and expectations are skewed in favor of stocks providing similar returns in the 2018. ***Market participants should begin to gird themselves for the possibility of a change in the market's direction, as U.S. equities continue their breakneck ascent toward valuation levels not seen since the dot.com era.***

Stock prices continued to climb the now familiar "wall of worry", ending the year in fine fashion. As the graphic below shows, the average return for mutual/exchange traded funds that invest domestically in U.S. based companies was 18.3% for the year, while those mutual funds/ ETFs that focused on international stocks rose 26.8%. During the year, the flow of investments made by fund type showed withdrawals from U.S. Stock funds of $38.8 billion, while significant cash investments were again made in bond and international stock funds.



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The Lipper Performance table below displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 5-year, and 10-year time periods. For the fourth quarter of 2017, the table illustrates that smaller capitalization stocks underperformed their larger capitalization brethren. In addition, for the fourth quarter in a row, lower quality stocks outperformed their higher-quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased +10.9%, while the S&P 500 was up +6.6%. The tech-heavy NASDAQ posted a gain of +6.3%. The average mutual fund, represented as General Equity in the table, saw a gain of +5.1% for the quarter.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, JANUARY 15, 2018

	Qtr	1 year	5 year	10 year
S&P 500	6.8	21.5	15.2	8.0
S&P 500 Index P	6.1	19.4	13.4	6.2
Dow Jones Ind. Average P	10.3	25.1	13.5	6.4
NYSE Composite P	4.9	15.8	8.7	2.8
General Equity	5.1	18.3	12.7	6.9
Multi-Cap Growth	6.2	28.0	14.8	8.1
Large-Cap Growth	6.4	29.6	15.7	8.4
Large-Cap Value	5.8	15.9	13.3	6.6
Mid-Cap Growth	5.9	24.7	13.8	7.7
Mid-Cap Value	5.3	12.9	13.1	8.0

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

VALUATIONS

We are now firmly in one of the highest priced markets in U.S. history. The psychology of the public's attitude toward stocks appears to be coalescing in one of two distinct camps. Either they mistrust stocks and are seeking safety, or they are afraid of missing the widely touted "melt-up" in stocks and are buying stocks indiscriminately. Our admonition from last quarter still applies and bears repeating:

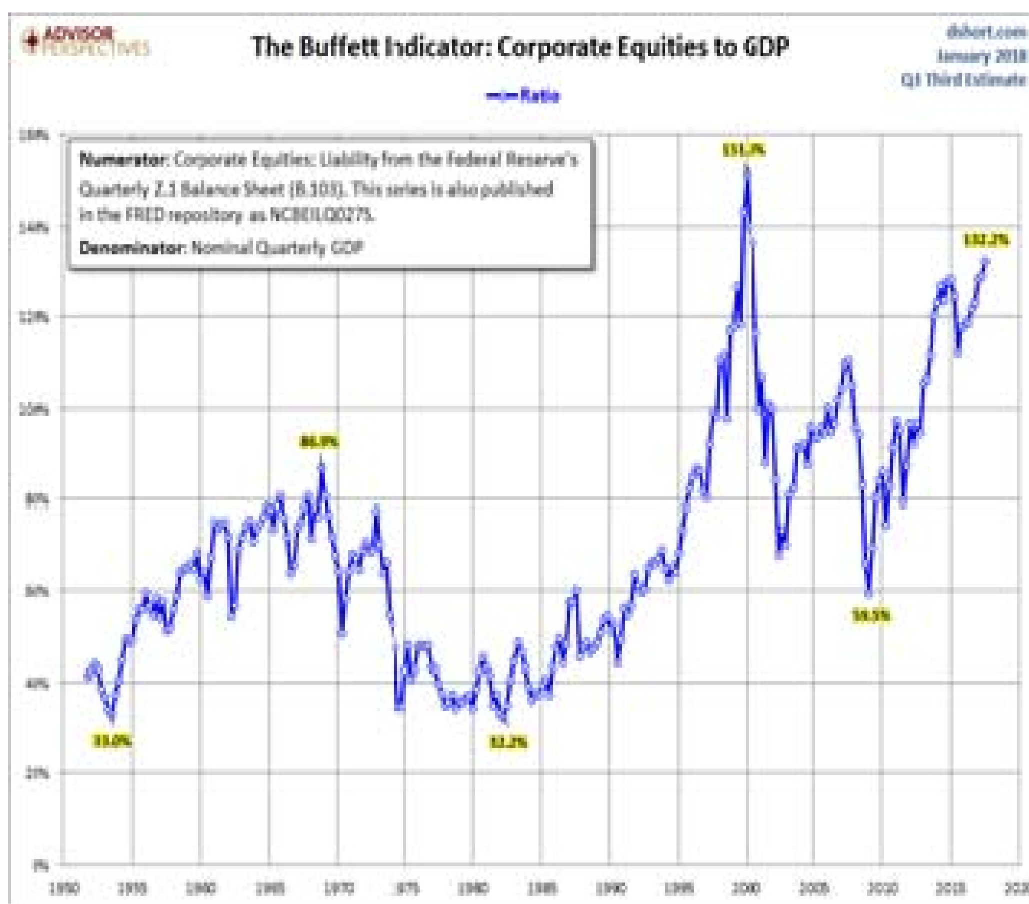
> *Equities are not being bought because of the quality of their earnings, their long-term prospects, or because they are a screaming value. Instead, investors are buying ETFs and Index funds and rationalizing their investment decisions using strategies like FOMO (Fear of Missing Out), Big MO (the momentum is pushing the price up, it can't go down) and NEW (Nothing Else Working).*

Much like a weather watch, conditions are unfolding in a manner that could be hazardous to the average investor's stock portfolio. During the past year, the popular indices performance was largely driven by a subset of the largest market capitalization stocks, which for the most part are technology related. Popularly called the FAANG[3] stocks, these securities are priced for perfection. FAANG stock price increases paused temporarily during the quarter, only to return to their prior trajectory, despite not seeing much change in their fundamental outlook. In addition, insider sales (sales made by corporate officers, directors, and employees) are occurring in a more regular fashion, while the stocks themselves

[3] FAANG stands for Facebook, Apple, Amazon, Netflix, and Google (now Alphabet).

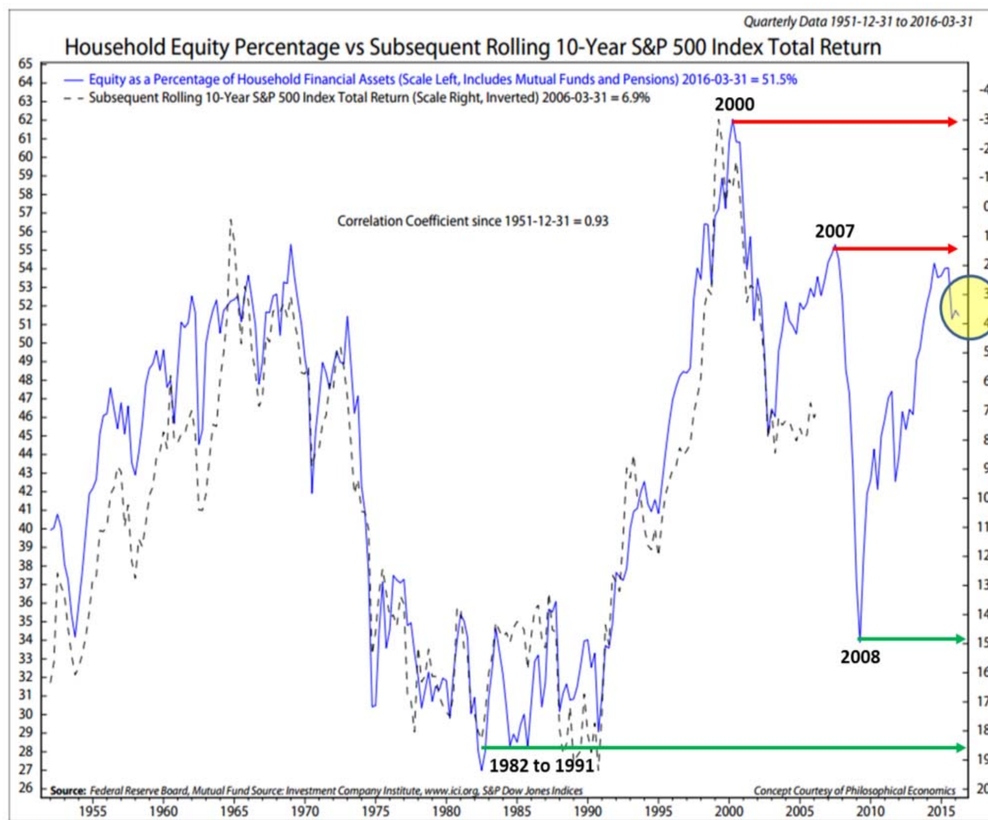
in many cases have not seen a meaningful correction in two years. With these tailwinds, valuations continue to ascend toward all-time record levels.

Additional warning flags are being raised. Jim Paulson of the Leuthold group was recently quoted as saying "The VIX is too low, valuations are too high, and the recovery is too old and the Fed is tightening…For an old market dude like me, that is a scary list."[4] Institutions are fully invested, with cash holdings near record lows. According to the ICI, mutual fund liquidity is at an all-time low, with holdings in money markets at similar levels. With somewhere near 10% of their portfolios in cash, the retail investor, traditionally the last to join the party, has sufficient dry powder to jump on the bandwagon and move the market tenor from handwringing to cheerleading. And as the chart below -- entitled The Buffett Indicator -- shows, the path of stock valuation continues to move toward an extreme level relative to its historical range.



[4] "A Bull Market Should Make Investors Happy. This One Isn't." by Landon Thomas, Jr. **The New York Times**, November 5, 2017.

The relationship between buying an expensive market and an investor's subsequent returns has been discussed in our past quarterly letters. However, a picture truly is worth a 1,000 words if it shows the relationship of something as clearly as the chart below shows (hat tip CMG Wealth / Ned Davis Research). This chart below, entitled Household Equity Percentage vs. Subsequent Rolling 10-Year S&P 500 Index Total Return, depicts the relationship of household stock ownership and the subsequent returns that these investors experience.[5] Basically the chart shows that when capital allocated to stocks is at the high end of the range, buying demand is stunted and additional funds available to invest in stocks wane. At that point, the momentum reverses and stocks either are sold or stock price declines cause the allocation to fall. The result of the subsequent 10-year returns (the dotted line in the chart) shows that high allocations lead to low subsequent returns and vice versa. Obviously we are currently near the high end of the most recent range, implying poorer long-term returns over the next 10 years.



[5] https://www.cmgwealth.com/ri/radar-game-town/

History repeatedly shows that stocks can be deemed expensive (or cheap for that matter) for an extended time frame before seeing a price adjustment. Nevertheless, our attention will continue to be on tailoring portfolios to meet your long-term goals, while minimizing risks of permanent capital loss. Our strategy remains consistent with our process of purchasing stocks that can be bought at prices that meet our investment standards, while still providing an acceptable margin-of-safety. While identifying specific investment opportunities that meet our criteria is becoming ever more challenging, rest assured that we will continue to focus on being patient and disciplined in managing your assets, while taking advantage of opportunities as they arise, irrespective of general market levels.