Fourth Quarter 2017 in Review
and the Year Ahead

	Close	Total Returns	
	12/29/17	4th Quarter	2017
Standard & Poor's 500 Index	**2,674**	**+6.64%**	**+21.83%**
Dow Jones Industrial Average	**24,738**	**+10.96%**	**+28.11%**
NASDAQ Composite Index	**6,905**	**+6.55%**	**+29.64%**
Dow Jones Global (ex U.S.)	**267**	**+5.00%**	**+24.68%**
Barclays Aggregate Bond Index	**2,046**	**+0.39%**	**+3.54%**

Great Returns . . . . Now What?

In early 2009, the U.S. economy was struggling through the worst recession since the 1930s and investors were dealing with an unattractive proposition. They could keep their money in cash and earn nothing, invest in bonds and earn next to nothing, or summon the courage to invest in a stock market that had just declined by 50%. Here we are nine years later and returns on cash have edged higher, 10 year U.S. Treasury bonds yield a measly 2.4%, and the stock market has advanced some 300 plus percent. Now once again, the options for investors appear challenging. What to do?

After a 30 year bull market in bonds and a nine year bull market in stocks, different investors have taken different tacks to the current set of opportunities. Some large institutional investors, such as university endowments, have responded to the low interest rate environment by shunning publicly traded quality securities. They continue to opt for less liquid hard assets like real estate, private companies, and infrastructure projects. Other more aggressive investors, including a few hedge funds and fearless individual investors, have recently preferred to speculate in cryptocurrencies, such as Bitcoin, which have produced spectacular returns to date (more about Bitcoin later in the *Outlook*).

Bond Yields are Gradually Increasing

Our investment focus remains on "quality" financial assets since our clients have little use for privately traded assets or fledgling cryptocurrencies like Bitcoin. Of course, quality financial assets, such as highly rated bonds and well financed companies, do have market risk. When investors evaluate the risk of a potential investment, the starting point is usually U.S. Treasury securities. The comparative appeal of U.S. Treasury bonds is based on the belief that they will never default, are not callable, and are easy to purchase and sell in large and small amounts without high transaction costs. The yields on U.S. Treasuries are the standard upon which all other returns are compared. Unfortunately, for investors and savers seeking security, liquidity and reasonable returns, U.S. Treasury bonds still offer miserly low yields.

One year ago, most financial forecasts expected the yields on 10 year U.S. Treasury bonds to increase from these historically low levels. In fact, the 10 year U.S. Treasury yield ended the year essentially unchanged at 2.4%, which is also the same yield it produced in the heart of the recession in 2009. Why no increase in yield? One reason is that a 2.4% yield is relatively attractive compared with yields around the world. Japan's 10 year bonds have been the lowest in the world at near zero. France and Germany's 10 year government bonds have been yielding less than 1%. The highest yields in a developed market outside the U.S are in Italy, where you can earn close to 2.0%. So, the foreign appetite of the higher yielding U.S. bonds has been a major factor keeping a lid on yields.

Another attraction to U.S. Treasury bonds is that they are less volatile in price than other bonds and generally less volatile than other financial securities, such as stocks. This lack of volatility has been important to investors, such as large insurance companies, seeking to match bond payments to claims without the volatility of stocks. The preferences for steady interest rate payments and fears of a stock market correction have also attracted individual investors.

- Since 1981, the U.S. 10 year Treasury bond has generated a positive total return in 32 out of the last 36 years. The worst single year for the 10 year Treasury was 2009, when the total return was -11%. In contrast, the stock market experienced two historic, white knuckle declines in 2000 to 2002 and again in 2008. The worst single year for the S&P 500 Index was 2008, when it produced a negative total return of -37%. The annual stock returns, however, do not even fully account for the depth of some of the declines, which occurred over multiple years.

In brief, bond investors have enjoyed the bull market of a lifetime with relatively little volatility. Unfortunately, that bull market has resulted in unattractive yields that make the outlook for future strong returns unlikely. In the past three years, for example, as yields have come to rest in the 1.5-2.5% range, the total annual return on the 10 year U.S. Treasuries has been 1.28%, 0.69%, and 2.26% respectively. Obviously, there's not much to write home about.

We enter 2018 with a similar view to interest rates as we had one year ago. We expect the total return on intermediate Treasury bonds to turn negative over the next few years as a result of the following factors:

- The global economy appears even stronger than it did one year ago. This will push central banks to move away from their low interest rate, bond buying policies.
    - The U.S. Federal Reserve was the first to end that strategy one year ago. Foreign central banks are sure to follow over the next two years.
- Wage pressures picked up in the United States last year and should increase more as unemployment rates fall into the 3% levels.
- The U.S. deficit will expand with the new tax policies, which will result in greater bond supply going forward.

Higher Bond Yields and the Stock Market

Since low interest rates have been a tailwind for stock prices, what will stocks do if rates move higher -- if bond returns are negative, could stock returns actually be even worse? If rates only edge higher with stronger growth, stocks are likely to withstand the higher competitive yields. In fact, stocks could continue to advance with somewhat higher rates based on stronger economic growth that accelerates corporate profit growth. The break point for stock bull markets has always been, however, when interest rates reach a level that dampens economic growth. Many investors are familiar with the ups and downs of stock markets as shown below in the table that summarizes annual returns for the U.S. stock market since 1926. Most of the negative returns in stock markets occur during recessions, frequently on the throes of increasing interest rates. So all eyes are focused on the point at which rates may hamper economic growth.

Total Return of the S&P 500 Index on an annual basis	Number of years that the annual return was in this range
Positive 0-10%	14
Positive 10-20%	20
Positive 20-30%	15
Positive Greater than 30%	19
Negative 0-10%	14
Negative 10-20%	4
Negative Greater than 20%	6

The market has produced a positive total return now for nine straight years. We are not predicting a decline this year (like most forecasters, we rarely do), but history suggests we are probably overdue. We were also overdue for a correction when we began 2017, and it did not occur. One of the oddities of the U.S. stock market over the past twelve months has been the lack of volatility as the market advanced every month of the year. The market has now gone over a year without a 5% correction for the first time since 1996.

Why did the market advance so strongly without volatility, and could this pattern continue through this year? We think the aforementioned stability in intermediate bond yields combined with the prospects of greater earnings growth as a result of the cut in corporate taxes kept the wind in the sails of stock prices in 2017.

So, What is the Bottom Line Outlook for Stocks in 2018?

- Without the tailwind of low rates, the market will only be driven higher by some combination of higher earnings and investor enthusiasm. That is exactly what has occurred since rates bottomed in 2016. It could continue this year.
- Earnings have recovered strongly since the recession of 2008. With a stronger global economy in evidence this year, it is a safe bet that earnings growth will continue to advance. The big unknown is to what extent the new tax laws will accelerate earnings. We should get a better idea soon, once companies start reporting earnings and commenting on their outlooks for 2018.
- We continue to expect stocks to produce higher returns than bonds or cash going forward. However, we do expect more volatility.

Beside our focus on interest rate risks, what are the odds that other factors will cause a more severe correction? Over the past year, markets seemed to ignore political and geopolitical tensions and surprises, so it may take a more extreme development in these arenas to upset the apple cart. One area that we remain nervous about would be developments in foreign trade, as NAFTA negotiations and other trade issues are mediated. U.S. investors will be disappointed if U.S. based companies end up in weaker competitive positions globally as an outcome of trade negotiations. By the end of 2018, we should have a better idea of where the U.S. stands vis-a-vis Europe and China in terms of trade positions.

In the near term, we are likely to be taking some profits off the table where we think valuations have largely discounted earnings gains and individual positions have become outsized. We are also opting to raise cash early in 2018 for clients who need to have more liquidity during the course of this year. Otherwise, we will ride through what we expect to be a more volatile year in 2018 on the belief that long term investors are best served by allocating more to stocks than bonds and cash.

Happy New Year!

Bob Milnamow
President and
Chief Investment Officer

Our partner, John Youngman, has graciously taken on the task of summarizing everyone's favorite subject of Bitcoin.

Bitcoin: Currency of the Future or Modern Day Tulip Mania?

What is Bitcoin?

- Bitcoin is a virtual digital coin that was created in 2009 by an anonymous person with the pseudonym of Satoshi Nakamoto. The "coins" are created through a "mining" process that requires high levels of computing power to solve intricate algorithms. The maximum number of coins that can ever be mined is 21 million and about 80% of those coins have already been mined.
- Bitcoin can be traded on exchanges that have been set up expressly for trading in Bitcoin and other digital coins, such as Ethereum, Litecoin and Ripple. Today there are over 1,000 types of digital coins with a total market value in excess of $400 billion, but the largest coins mentioned above represent about 60% of the value of all digital coins.
- Due to the fact that Bitcoin ownership is very difficult to trace, the earliest adopters of Bitcoin were people who wanted to move money surreptitiously (e.g. criminals).
- Today, we are starting to see broader acceptance and potential legitimization of Bitcoin as many more people get interested in the potential of cryptocurrencies. The most recent sign of at least limited acceptance has been the listing of Bitcoin on the CBOE and CME futures exchanges.

How does it Work?

- Bitcoin and the other digital coins use a very sophisticated accounting technology called Blockchain. Blockchain is a distributed ledger system, essentially a database. Transactions on Blockchain are blocked together and go through an approval process that requires a consensus on the accuracy of the transactions within the block. Once approved, the transactions are settled and cannot be altered. This distributed ledger theoretically makes it difficult (some say impossible) to corrupt. Since the data is broadly disseminated, it also makes it very difficult for any group or government to control, track or shut down.

"I'll give you a HUGE bonus in bitcoins if you can explain to me what the hell they are."

CartoonStock.com

Argument for Bitcoin:

- First of all Bitcoin has "first mover" status that makes use of the highly innovative and potentially disruptive technology of Blockchain. Bitcoin is limited to a total of only 21 million coins that can ever be mined over time (currently around 16 million in circulation).
- In theory Bitcoin cannot be manipulated by any government and cannot be devalued by the repetitive minting of more currency as has happened with most state sponsored currencies.
- Bitcoin and other cryptocurrencies can reduce the "friction" or cost of making international transactions due to the fact that it may not need to be converted into a domestic currency.
- Further comfort and acceptance of Bitcoin could come with time and this might very well dramatically reduce its volatility.

Argument against Bitcoin:

- One of the greatest criticisms of Bitcoin is that there is nothing backing it up. It has been created by an unknown source and at least originally used by crooks and criminals as a way to surreptitiously pay for illicit goods.
- There is no way to value the intrinsic value of a Bitcoin because it has no intrinsic value.
- Due to lack of regulation, there is no one, or entity, in charge. Some see this as a positive, but this lack of control could easily lead to chaos at some point in the future.
- The underlying foundation of Bitcoin is tenuous at best as the exchanges that facilitate transactions are not regulated and lack the security and oversight that consumers expect of financial institutions.
- Several of the exchanges have been hacked leaving many people with empty "wallets" and no way of finding recourse. It is for these reasons that many governments around the world have cast a wary eye upon Bitcoin and its ilk with some governments, including China, shutting down the exchanges within their borders. If enough governments follow this path it will make it nearly impossible for Bitcoin to gain the confidence necessary to become broadly accepted as a currency or store of wealth.
- The current mania has led to a dramatic increase in demand, but as we have seen with other limited supply items in the past this can change swiftly, leaving people holding the bag. In many ways holders of cryptocurrencies are playing the ultimate game of Hot Potato.

Is it a Suitable Investment?

- Ultimately any "value" that Bitcoin has rests on supply and demand. As the price of Bitcoin has risen it has gained attention as a get rich quick scheme. This in turn has led to a mania whereby masses of people have rushed to acquire something they know little to nothing about with the hopes that it will continue to rise in price and that they will be able to cash it in at a future date for an economic windfall. In reality, these people are counting on the persistence of the "greater fool" theory.
- People are gambling on something they cannot value, that is unregulated and has very limited acceptance.

- The volatility of Bitcoin, sometimes well over 10% in any given day, would preclude it from being accepted as a real store of wealth or a state sponsored currency. Additionally there are significant safety risks as several "coin exchanges," which act as custodians, have been hacked resulting in client wallets being emptied, a virtual mugging if you will, with no recourse.

At this point in time, it appears that there is considerable merit to Blockchain as an innovative and potentially disruptive technology. This technology may very well have a dramatic impact on finance, commerce and logistics and warrants our further investigation. However, there are simply far too many concerns and unanswered questions to consider Bitcoin as a viable currency alternative, or even a store of wealth, at this time.

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*The **Standard & Poor's 500 Index** is an unmanaged broad-based index that is market weighted and used to represent the U.S. stock market. It includes 500 widely held stocks. Total return figures include the reinvestment of dividends. "S&P 500" is a trademark of Standard and Poor's Corporation.*
*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.*
*The **Nasdaq Composite Index** is the market capitalization-weighted index of approximately 4,000 common equities listed on the NASDAQ stock exchange. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.*
*The **Dow Jones Global (ex U.S.) BMI** (Broad Market Index) comprises the S&P Developed BMI and S&P Emerging BMI, and is a comprehensive, rules-based index measuring stock market performance globally, excluding the U.S.*
*The **Barclays Aggregate Bond Index** is a market capitalization-weighted index. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.*

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