Macro Summary

- The economy is performing well – low unemployment, accelerating growth, and rising corporate earnings. This trend is likely to continue in the year ahead;

- The Tax Cuts & Jobs Act of 2017 reduces taxes on businesses and individuals and likely to increases wages, create jobs, and have a positive affect on the economy;

- The Federal Reserve is expected to increase interest rates 3 - 4 times in 2018; however we do not believe the bond market has entered bear market territory;

- Consumer and small business confidence hover near generational highs;

- The bull market for stocks extends into a 10th year but we expect gains to be more moderate than double digit returns of last year;

- The average return for the S&P 500 Index following a 20 percent gain has been 12 percent. But four of the six negative years - 1962, 1981, 1990, and 2000 - had one thing in common: The Federal Reserve was dramatically raising interest rates;

- Risks include: corporate earnings, the Federal Reserve, geopolitical disruptions, inflation, and valuations; and

- The proven principles of successful long-term investing remain intact: diversification matters, embrace the powers of compounding, and don’t let volatility derail you.
The past year has been nothing if not filled with change - a new administration and a new Congress. Back in January there were very few optimists on Wall Street. After all, the economic expansion and bull market had gone on for almost nine years, making it one of the longest on record, and all good things come to an end sometime. Investors were worried about hard economic times in China. We all worried about a military conflict with North Korea and continued fighting in the Middle East. Perhaps most important, investors didn’t know what impact a Donald Trump presidency would have on the financial markets or the world economy.
From an investment perspective, 2017 was better than almost everyone expected. Real growth finally reached 3 percent in the United States, both in the second and third quarters, after being mired near 2 percent since the recession. Inflation remained below 2 percent as measured by the Consumer Price Index and the 10-year US Treasury yield stayed below 2.50 percent, while unemployment dropped to 4.10 percent. Household net worth reached an all-time high and so did the Standard & Poor’s 500 Index. The mood in Washington shifted to pro-business, leading to expectations of less regulation and lower taxes. China continued to grow at an impressive rate, and Europe and Japan were doing well. It was a good year for investors.

- Last year we witnessed only 8 one-day fluctuations of +/-1 percent. The only other year that saw an equal or lower number of 1 percent days happened in the mid-1960’s.

- The S&P 500 hasn’t had a 3 percent decline from a high in 409 calendar days going back to November 4, 2016 just before the election. This was easily the longest stretch of time without a 3 percent pullback on record dating back to 1928.

- It’s been even longer since we have had a 5 percent pullback. Investors have gone 567 days without a 5 percent drop which is the second longest stretch on record behind the 593 days stretch that went from December 1957 to August 1959.

- The length of time without a ten percent correction is not at or near a record like the three or five percent streaks, but the 698 days we’ve gone without a ten percent decline dating back to February 2016 ranks as the ninth longest.

- There was never a single point during the year (either on a closing or intraday basis) where the S&P 500 was down year-to-date; and

- Finally, in terms of longest bull markets on record (periods without a 20 percent decline), the current streak of 3,227 days going back to March 9, 2009 is the 2\textsuperscript{nd} longest on record (the record is 4,494 days).
Optimism is pervasive regarding United States economic growth in 2018. Based on the solid 3 percent plus growth rate during the last three quarters of 2017, this optimism is well-founded. The acknowledgement by the Federal Reserve (The Fed) is evident: they have outlined a continued pattern of increasing the federal funds rate over the coming year. The recent enactment of The Tax Cuts and Jobs Act of 2017 (TC&J Act) is expected to increase US economic growth in the year ahead. Well-regarded economic research suggests a 2.50 - 3.50 percent growth rate in 2018 with stable inflation. The Matrix of Economic Indicators below summarizes the y/y change by month (unless otherwise noted) in economic indicators over the year.
Consumer spending, the economic heavy lifter of US economic growth, has expanded by 2.70 percent over the past year (as measured by real personal consumption expenditures, or PCE, as of November 2017). This is similar to the past eight years of the expansion, with real PCE averaging 2.50 percent. What is interesting to us about the increase in spending is that incomes have failed to keep pace. Real disposable personal income rose by only 1.90 percent over the past year. It was only the ability to borrow that supported the spending increase. In economic terms, borrowing is a form of dissaving. The saving rate for consumers dropped from 3.70 percent a year ago to 2.90 percent in November, a 10-year low.

History suggests that the economy will register a slower rate of expansion following a low saving rate. This positive correlation between current saving and future consumption means a low saving rate should be followed by a lower level of consumption and vice versa. Therefore, considering that the only period in which the saving rate was lower than it is today was 1929 - 1931, it is more likely that spending in the future will be moderately lower than Wall Street estimates.

Finally, the actions by The Fed could cause borrowing to slow in 2018. The 125 basis point increase in the federal funds rate since December 2015, and its magnified effect on short-term interest rates, should continue to reinforce the slow-down in borrowing at the consumer level. Slower borrowing and modest income expansion, along with a potential reversal in the near historic low saving rate, means consumer spending may be one major area to monitor for economic disappointment in 2018.
The Federal Reserve

Although the economy may slow due to a softer than expected consumer spending outlook, the real roadblock for economic acceleration in 2018 is past, present, and possibly future monetary policy actions. The Federal Reserve began raising interest rates in December 2015. A year later the Fed implemented another 25 basis point increase. Three more rate hikes occurred in 2017. To raise interest rates the Federal Reserve takes actions that reduce the liquidity of the banking system. From a historical perspective this has caused a reduction in the supply of credit through tighter bank lending standards. The demand for credit is also diminished as some borrowers are priced out of the market or can no longer meet the higher quality standards.

The impact of this tightened Federal Reserve policy on money, credit, and eventually economic growth is slow but inexorable. The brunt of these past and current policy moves might begin to be felt this year. Irving Fisher, the legendary American economist, provided the arithmetic formula that money times its turnover equals price times transactions, or nominal Gross Domestic Product (MV=PT). This simple equation provides a roadmap of ebbing growth next year. Velocity (V) is currently low. At 1.43, velocity is standing at its lowest level since 1949, well below the 1.74 average since 1900.
Money (as defined by M2) expanded by 7 percent in 2016; however, as a result of Fed actions the money growth slowed to a 5 percent year-over-year growth rate at the end of the third quarter 2017, a 2.50 percent reduction from the previous year. In the fourth quarter of 2017, the Fed planned to reduce its balance sheet by $30 billion which has and will continue to put additional downward pressure on money growth; a $60 billion reduction is expected in the first quarter of 2018, a $90 billion reduction is expected in the second quarter of 2018, and an additional $270 billion in reductions are expected following the second quarter of 2018. That said, it is important to note that historical comparisons and analysis are unavailable as the magnitude of this balance sheet reduction is unprecedented. We will be closely monitoring the monetary environment in 2018.

Fixed Income

While the Federal Reserve’s slow-and-steady approach to the normalization of its target fed funds rate has successfully increased the short end of the Treasury yield curve, longer-term rates have remained stable. There are three primary reasons for this, from our viewpoint: persistently low inflation, the tethering effect of low global interest rates on the United States, and the disconnect between the Fed and market prices.

That said, we believe interest rates across the Treasury curve likely will remain well below historical levels in 2018 and beyond. And though the amount of bonds offering negative yields worldwide seems to have peaked, it remains substantial at about $6 trillion. As a result, yield-hungry investors may continue to look to other areas of the markets, with varying degrees of risk, in search of increased yield potential.

For example, we continue to see tremendous inflows into US credit markets from non-US investors; this may become a problem as non-United States investors are vulnerable to a pause in economic growth, rising rates, and rising hedging costs.

Real interest rates in the emerging markets have continued to attract capital flows as well, and emerging markets have delivered solid returns over the past twelve months. Reflation and an upward bias on global bond yields can pose a risk to the performance of emerging market debt assets; however, a reprieve is likely to come from the consolidation of the cyclical improvement in a large majority of emerging economies and ongoing reforms in key markets.

In terms of our fixed income strategy for 2018, we remain steadfast in our opinion that fixed income remains an important asset class of a properly diversified portfolio - even in a rising interest rate environment.
The US Markets

The full year 2017 was unique in that the S&P 500 Index witnessed positive returns in each month of the year. In fact, it has now seen positive monthly returns for 14 straight months (October 2016 was the last month with a negative return). Meanwhile, the Barclays US Aggregate Bond Index returned near 3.50 percent for the year. All things considered, these results are extraordinary and investors should be extremely pleased as the returns across all asset classes were better than most on Wall Street envisioned, including the Next Generation Wealth Management team.

As previously mentioned in Solving For 2018 & Beyond, 2017 saw some of the lowest volatility in history. There were only a few short bursts higher that were quickly stomped down by market participants. The year began with concerns including above average equity valuations and the likelihood of interest rates moving higher as the Federal Reserve had set its intentions and seemed committed to following through. When everything was said and done, stock prices pushed higher supported by steadily improving corporate earnings, synchronized global economic growth, and the anticipation of tax reform.

Looking ahead to 2018, institutional strategists are anticipating mid-single digits returns for the S&P 500 - an average 7 percent return - slightly higher than the 6 percent 2017 prediction, but below the 10 percent ‘normal’ expectation. This year the forecasts are notably skewed to the low end, with the consensus expecting less than 5 percent returns for the S&P 500. It would be remiss if we didn’t remind you that consensus expectations for any given year have proven to hold a poor track record, historically speaking.
The S&P 500 Index now trades at 22 times forward earnings according to the Wall Street Journal (above the 19 times level at the start of 2017). Market valuations increased slightly over the course of 2017 as investors applauded the corporate earnings growth recovery that coincided with stronger global economic growth. While we do not believe the domestic stock markets are inexpensive, we expect the current bull market to extend for a 10th year. It’s hard to argue 2018 returns will match 2017’s impressive results. We enter the new year with modest expectations, but may have better confidence once first quarter earnings are released and more important, how The Tax Cuts and Jobs Act of 2017 impact compares to economic forecasts.

As many of our loyal readers are aware, we are strategic investors that prefer to focus on maintaining a disciplined long-term positive perspective on the global financial markets. While short-term market disruptions and turbulence are inevitable, no attempts are made to make substantial portfolio adjustments as markets ebb and flow over the short-term. Our preference is to make meaningful and purposeful allocations to portfolio strategies, and adjust them occasionally, once again for the long term, as needs arise.

International Markets

We have long been constructive on the non-US developed financial markets on a relative valuation basis. Heading into 2018, this conviction is fortified by the upturn in global Gross Domestic Product (GDP) growth that could help the export-led economies of the Eurozone and Japan, as well as the likelihood that the respective central banks will maintain an accommodative monetary policy. As you can see from the chart below, earnings growth over recent quarters has turned upward after years of languishing.

![Earnings Growth Picks Up Pace in Developed Markets](chart.png)

Note: Prices and earnings rebased to 100 on 12/1/2007
Source: Thomson Reuters Datastream as of 11/30/2017
Our team continues to believe the Eurozone is at an earlier point in the economic cycle than the United States, and with consumer and producer sentiment at its highest since 2000, there’s reason to believe its GDP and profit growth trends can continue. In Japan, the stock market hit a 26-year peak in December on a pick-up in Gross Domestic Product growth and improving profitability. There are signs this momentum could be sustained in 2018.

Even as GDP growth picks up, inflation expectations remain below target in both the Eurozone and Japan. We think share prices could benefit from the continuation of monetary stimulus by the European Central Bank and the Bank of Japan.

Even after their outstanding 2017, we believe Emerging Markets stocks offer an appealing long-term investment opportunity. They are cheap relative to the United States and other developed markets on a valuation basis, and their earnings growth is projected to rise faster than that of Developed Markets over the next two years. History tells us that Emerging Market trends can last over multiyear periods, and we’re still early in the current upswing.

The constant caveat for Emerging Market investing is that their somewhat shallow capital markets often make its stocks more volatile than the deeper developed markets. Investors need to always be mindful that even an enjoyable ride upward will likely include some bumps along the way.
A Special Focus: Blockchain Technology

It seems that investors are ready to throw their money at just about anything that has the word ‘crypto’, ‘coin’, or ‘blockchain’ in it. While this new technology may be disrupting to traditional industries, it’s important to consider why blockchain is useful and what problems it can solve.

Blockchain, at its core, is essentially a decentralized database, with a set of agreed upon rules (the rules vary and are dependent on implementation). While Bitcoin may have been the first and most well known use of the blockchain, people are finding use for it outside the realm of digital finance. One such example is the use of blockchain for a decentralized file storage system. The decentralization of file storage removes the barrier to entry from an industry dominated by technology giants, and allows anyone to rent out space on their hard drive in exchange for digital tokens. Another use for blockchain is tracking real-estate and property records. It is unlikely that all of the uses for blockchain have been discovered, and it will be interesting to see where this technology will be applied in coming years.

Unfortunately, the current blockchain investment culture is somewhat reminiscent of the dotcom bubble, perhaps worse. However, this also provides those in the know with a unique opportunity to scout out legitimate startups and profit from their success. With the right business and technical knowledge, it is not too hard to determine which of these startups could provide real utility, and which ones are totally bogus. In that spirit, our friends at Bespoke Investment Group have come up with a few common sense guidelines if you want to invest in blockchain technology.

*Read the documentation.* Any person with a computer science background will be familiar with this golden rule. Any blockchain startup worth their salt should have detailed, clear, and easy to understand documentation on how their technology works. If you can’t understand it, or it seems like a bad application of blockchain tech, then forget about it.

*Trust your gut.* If you have a nagging feeling that the whole thing is a scam to make the creators money, then it probably is. As of now, Initial Coin Offerings (ICO’s) are not regulated in any meaningful way, and investors should be careful because they may not be legally protected from a scam artist.
Drawbacks
Despite the hype, blockchain tech has plenty of drawbacks and risks. These include, but are not limited to, the following.

1. **Efficiency.** The act of mining Bitcoin uses an enormous amount of electricity. Some have argued that this has incentivized the creation of more energy efficient technology, but the reality is that it has only incentivized the creation of more energy efficient *bitcoin mining* technology, which unfortunately is not useful for general computing.

2. **Regulatory.** You may have heard that China recently banned ICOs. While the Securities and Exchange Commission (SEC) has remained fairly quiet on the topic, they have said that certain cryptocurrencies may qualify as securities, and will be regulated as such. The regulation of the crypto-ecosystem may have beneficial long-term impacts, like protecting investors as well as giving legitimacy to crypto assets, but the short term effects might cause volatility in the market.

3. **Competition.** There are plenty of Bitcoin enthusiasts who believe cryptocurrencies could replace modern payment systems, but there are many scaling issues due to the energy limits with a blockchain only solution.

4. **Economic Utility.** As a currency, Bitcoin would be an utter failure. It’s slow and difficult to transact, and lacks a flexible monetary policy. Prices of goods and services are constantly falling because the money supply can’t rise.

5. **Implementation Complexity.** In the frantic rush to get blockchain startups off the ground, code integrity is sacrificed for development speed. This may be true for any software-driven business looking to get on its feet quickly, but the consequences for a blockchain based company can be dire. For example, users of the ‘Parity’ wallet for ethereum had over $30 million worth of ethereum stolen from them due to poor implementation in the wallet software.

Viewing bitcoins as a store of value might make more sense. There’s a limited quantity of bitcoins that will ever be in circulation, which bears some similarities to gold, but there’s still too much uncertainty around what sustained demand might look like. In other words, for a store of value to actually store value, it must have some intrinsic worth. For the US dollar, the intrinsic worth is the ability to purchase goods and services within the United States economy and in other dollar-denominated markets around the world.
world, trade financial instruments, and pay taxes. Currently bitcoin offers nothing like this.

Gold and Bitcoin also diverge when it comes to volatility. Investors see gold as a safe investment during times of uncertainty, but at the moment, bitcoins are anything but safe. Wild price fluctuations make bitcoins unattractive to anyone trying to curb their risk or minimize exposure in traditional markets. Eventually these price fluctuations may settle but we are still in the very early stages.

In addition to the honest business activity that goes on in the blockchain world, there is a dark side. Cryptocurrencies are the money of choice for tax evaders, money launderers, and black market operators. With the recent FBI seizure of Alphabay, Bitcoin has come under scrutiny for its role in facilitating illegal activity. It’s still a possibility that the US could declare Bitcoin or other crypto assets illegal and bring the party to screeching halt.

The interest has been growing steadily, and may continue to grow for the next several years as more blockchain applications come out. While this technology may not be as revolutionary as the internet, it is still changing the way we think about applications, and challenging current data storage paradigms. The technology is exciting and will yield new applications. But we caution investors against large exposure to volatile cryptocurrencies; the current market is being driven by speculation. Instead, we encourage you to learn about the space and innovations taking place within it, investing rather than simply trying to get a piece of the explosive price action of cryptocurrencies like bitcoin, and always keeping in mind that investment of any kind entails significant risk. For blockchain-related investments, those risks are much higher than most investors are used to.
Concluding Thoughts

While The Tax Cuts and Jobs Act of 2017 is encouraging, corporate earnings are strong, and the regulatory environment should positively contribute to economic growth, these benefits must be weighed against the low level of personal savings rates, higher interest rates, geopolitical disruptions, government deficits, inflation, and valuations.

As always, we will adjust and communicate our views accordingly should the economic, financial, or monetary policy change materially over the course of 2018. If you’d like to have a personal conversation regarding your investments please call one of our team members at (414) 257-4248.

Respectfully yours,

David A. Massart
President & Founding Partner