Investment Update

Fourth Quarter 2017

Another strong quarter capped a 2017 that proved a better year to be an equity investor than most expected. International stocks from both developed and emerging economies maintained their outperformance over the stocks of large US companies. While smaller companies lagged significantly, they have outperformed over the slightly longer period since the Presidential election after which they rallied more than 10% within weeks on the presumed tailwind any substantive tax reform would provide. The Federal Reserve raised the Fed Funds rate three times over the course of the year, but the 10-year Treasury yield stayed near flat throughout.

Equity Markets (Total Returns)	4Q17	1-Year
Dow Jones Industrials	11.0%	28.1%
S&P 500	6.6%	21.8%
S&P Mid-Cap	6.3%	16.2%
S&P Small-Cap	4.0%	13.2%
MSCI All-Country World	5.7%	24.0%
MSCI Foreign Developed Markets	4.2%	24.2%
MSCI Foreign Emerging Markets	7.4%	37.3%
US Bond Markets	**4Q17**	**1-Year**
Barclays US Gov't/Credit Intermediate	-0.2%	2.1%
Barclays US Gov't/Credit Long	2.8%	10.7%
BAML Municipal Intermediate	-0.3%	3.2%

2017 was also a year in which digital currencies achieved mainstream awareness. Bitcoin, currently the largest of all, appreciated twenty-fold by December, with many rapid moves both up and down along the way. There are over 1,000 other digital currencies, and while their aggregate value is much smaller than the amount of headlines they generate would suggest, they have made real money for many investors and have captured the attention of many more. Bitcoin defies valuation by most traditional means of analysis, but whatever its price, we think that the underlying technology called blockchain will be transformational, allowing transactions to happen more quickly and securely once it is more widely adopted by the financial services industry and others.

Tax "Reform"

Just before Christmas, Congress delivered a hastily prepared tax bill to the President, who, in turn, signed it in to law. While many individual taxpayers' filing process will be easier thanks to the doubling of the standard deduction, and companies now have a single tax rate, our tax code was not simplified nearly as much as had been hoped or promised. It was also a distinctly partisan legislative effort in contrast to the three-step process of tax reform that played out over several years during the 1980s. Much of what comes out of Washington in recent years has been done without the other party's support, virtually assuring a never-ending cycle of repeals as the balance of power shifts back and forth across the aisle.

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That said, the changes to corporate taxes in the bill should be a positive for the economy, despite the risk of negative consequences from potential increases in the Federal debt over time if predictions for growth fall short. Cynics have wondered why companies needed a tax cut when many large corporations were already paying well below the statutory maximum rates on average. The hope is that these companies will now be able to make decisions based on what makes economic sense rather than engage in all of the allowed machinations previously necessary to drive their tax rates down. In other words, rather than requiring companies to run clockwise around the baseball diamond to get to first base, they can now simply trot down the first base line. It is hard to predict how such an intangible benefit will play out, or quantify its magnitude, but we believe it will be significant. Smaller and domestic-focused companies that tended to pay the highest rates will see significant increases to their bottom lines and should drive more of the clear and immediate changes to investment activity and hiring.

Most individuals should see a reduction in tax burden, but for some the elimination or limitation of certain deductions will outweigh the rate and bracket changes. Which camp a taxpayer will fall into is not readily obvious, and it was not possible to categorically say with certainty that someone should accelerate or postpone deductible activities in the closing days of the year after the bill was signed. It is worth noting that there were not many changes to the taxes on the investing activities that we engage in on behalf of our clients.

More Market History

Six months ago we highlighted data from J.P. Morgan showing that during every year there is a point at which the stock market has pulled back from a recent high and things look much worse than they ultimately turn out for the calendar year. This was a reminder of the need to stick to your plan in those seemingly dire moments. The current market environment could hardly be considered dire, but for some there seems an impending sense of doom that after a 20%-plus return the market cannot keep going up as it has of late, and is bound to tumble.

To address those fears, we wanted to provide some interesting context provided by DataTrek Research. Their work shows that 20% returns are neither exceptional nor are they necessarily harbingers of a reversion to the mean by way of an off-setting selloff. Since 1928, the S&P 500 has risen 20% or more in a calendar year 31 times, or 35% of the time. The average return in the following year is 11.5%, actually higher than the average 11.4% return for the entire time period, and while eight of the following years did have a negative return, the worst was only negative 9%. While we, as investors in stocks, always need to be prepared for 10% pullbacks no matter what the starting point, the US stock market was propelled last year by earnings reaching record highs, expansion in the manufacturing sector, and simultaneous growth in all developed economies globally. With that fundamental backdrop still in place, and the effects of tax cuts set to show up in earnings in coming quarters, it is reasonable to expect the upward trend in stock prices can continue even if 2018 proves more volatile than 2017.

The information contained in this investment update has been taken from sources which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.

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