Investment Tally & Perspective

Fourth Quarter Review and 2017 Highlights

Market Activity

Equities- Stocks posted strong returns in the fourth quarter and the year. For the year, the S&P 500 advanced 21.8% while international equities posted even stronger returns. The S&P 500 Growth Index generated total returns of 27.4% in 2017 while the value counterpart posted 15.4% total returns; this is the largest divergence between the two since the dot-com bubble.

Fixed Income- Bonds, as measured by the Barclays U.S. Aggregate Index returned 0.4% for the quarter as rates rose modestly. For the full year, fixed income returned 3.5%. Corporate credit and emerging market bonds did materially better due to higher yields, but also spread compression. We continue to favor higher grade bonds and shorter duration securities.

Other Assets- A large outperformer in the quarter was crude oil, as the fourth quarter pulled the full year price change into positive territory. Fueling this rise (pun intended) was positive developments on the supply side against a solid demand backdrop. Major oil producing nations agreed in November to continue to withhold supply from the market until the end of 2018; additionally, global crude inventories have begun to decline, helping to alleviate the massive glut weighing on prices since 2014. REITs and gold were relatively tame in the quarter.

MAJOR ASSET CLASS RETURNS

	4th Qtr. 2017	1-Year	3-Year	5-Year
Equities				
S&P 500	6.6%	21.8%	11.4%	15.8%
MSCI EAFE	4.2%	25.0%	7.8%	7.9%
MSCI Emerging Markets	7.4%	37.3%	9.1%	4.3%
Fixed Income				
Barclays Capital US Aggregate	0.4%	3.5%	2.2%	2.1%
Barclays Capital US Corp. Inv. Grade	1.2%	6.4%	3.9%	3.5%
Barclays Capital Emerging Market	0.6%	8.2%	6.4%	3.9%
Other Assets				
MSCI US Reit Index	1.4%	5.1%	5.4%	9.3%
S&P GSCI	9.9%	5.8%	-7.5%	-12.2%
ICE WTI Crude Oil	16.9%	12.5%	4.3%	-8.0%
Comex Gold	1.9%	13.7%	3.4%	-4.8%

Source: Capital IQ — All returns greater than one year are annualized

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Economic Development

Global GDP has continued to move strongly forward with few areas of concern at present. In the U.S., the economic expansion appears to be gathering momentum. The third quarter saw GDP increase 3.2% and the estimate for fourth quarter GDP has ranged from 2.75% to 3.50%. If the 4th quarter comes in above 3%, this will be the first time since 2005 that the U.S. has posted growth greater than 3.0% for three consecutive quarters. U.S. inflation has yet to see a significant jump. In November, prices excluding food and energy, were up 1.7% from the prior year. We think there are developments underway that will alter this trajectory in 2018. We are watching the unemployment rate which may drop below 4% in the near future.

The big news this quarter was the passage of the Tax Cuts and Jobs Act of 2017. With a total cost of $1.5 trillion over the next decade, the plan is likely to create an added boost (whether short-term or lasting can be debated) to our $18.6 trillion economy. Many analysts project a boost to annual GDP between close to 0.0% to 0.5%. Although an accurate mathematical formula is desirable to pinpoint the exact impact the bill will have on the economy and our lives, we are unfortunately left with best guesses in a complex and interrelated world. We are hopeful, and will be watching how this long-awaited policy plays out.

Monetary Developments

Central bank policy maintained the course we described last quarter- in totality, global central banks continue easy policies, but "less easy" than those seen 12 months ago.

The big news in the quarter was the nomination of Jerome Powell as the next Chairman of the Federal Reserve Board of Governors. Powell is currently on the Board of Governors and is believed to be aligned with Janet Yellen's views on monetary policy. On regulatory matters, many place Powell as more open to change than his predecessor. Janet Yellen will step down from the Board of Governors once Powell is sworn in.

President Trump has an extraordinary opportunity to shape monetary policy. The Federal Open Market Committee votes on monetary policy decisions (raising rates, quantitative easing, etc.). The FOMC is comprised of 12 members- the 7 members of the Federal Reserve Board of Governors (which are picked by the President and confirmed by the senate), the President of the Federal Reserve of New York (gets a permanent seat on the FOMC) and 4 seats go to the regional bank presidents (Boston, San Francisco, Philadelphia, etc.), these 4 seats rotate annually. As of today, there are four people on the Federal Reserve Board of Governors, one of which Trump already nominated (Randall Quarles). After Yellen leaves, Trump will have the opportunity to directly nominate, or stamp approved (in Powell's case, since he is already on the Board) 6 of the 7 Board members, which represents ½ of the FOMC. To boot- Powell gets to break any tie! Though President Trump has considered candidates with many viewpoints, it is expected that he would prefer those with a lighter regulatory touch and a penchant for low interest rates.

Valuation & Investor Sentiment

Not much has changed on the valuation front- stocks are still on the expensive side, and credit spreads and absolute interest rates are low. Although earnings grew strongly last year, stocks did better, extending price to earnings ratios (next twelve-month P/E ratios started the year around 17.8x, while they stand at 18.9x today).

Investors appear more optimistic now compared to our last communication. According to a Bank of America Merrill Lynch fund manager survey, fund managers are holding more cash than usual, though this balance has been whittled down from the levels seen in the fall. The real change since our Q3 report has been in the American Association of Individual Investors survey. In the week ending December 28th, bullish sentiment hit the highest level since November 2014. This level is more than one standard deviation above the long-term mean.

Lincoln Capital's Investment Outlook & Strategy

One year ago, as President-Elect Donald Trump was preparing to officially be sworn into office, we stated our expectation that the new administration would begin reducing business regulations immediately, and that the administration would work with Congress to lower business and individual tax rates. Our expectations were fulfilled though not necessarily according to plan. While it is natural to focus on what these changes mean to each of us individually, the business changes may turn out to have a much greater impact than generally perceived.

In the same writing last year, as we expressed our optimism for the long-term investment outlook, we encouraged clients to stay the course if financial markets weakened. With 2017 now behind us, it's clear that our expectation for a market pullback or correction was not fulfilled. In fact, stock indices such as the S&P 500 completed 2017 with positive returns for each calendar month, a feat never before seen, as major market indices rose to new high levels.

Looking forward and barring an unexpected event, corporate profits will rise commensurate with increasing economic activity providing needed support for stock prices trading at elevated levels. The increased fiscal stimulus from tax cuts and higher levels of government spending will augment the momentum in the economy, and be another catalyst for driving stock prices higher. Yet there are several potential "flies in the ointment" that could alter the sanguine complacency of investors in the months ahead. A summary list of probable and potential developments and surprises in 2018 follows.

Probable - The Fed raises short term interest rates two to three times in 2018
Potential - Inflation pressures force the Fed to raise rates four times

Probable – Bond interest rates gradually rise in sync with the Fed
Potential – Foreign governments that have been massive buyers of bonds change direction; short term rates rise higher than longer term rates (an inverted yield curve which is a pre-cursor for a recession)

Probable – Stock prices move higher with periodic pullbacks and support from rising profits
Potential – Investor confidence is shaken from unexpected events
- Massive accounting fraud, North Korea, cyber-terrorist attacks

Major Potential Unexpected Development - President Michael Pence

- President Trump resigns for health or personal reasons prior to either the elections this fall or by 2020, and Republicans retain control of Congress

Given the length of this expansion and the amount of time since the last significant market decline, it's natural for investors to get complacent and act as if economic and market cycles are a relic of the past. Yet this remains a high-risk environment that warrants close attention, periodic adjustment to an investor's asset allocation, and ongoing reviews of the risk/reward relationship of each portfolio holding. Following a strong year like 2017 expectations are naturally high and the positive momentum in global economies and financial markets will likely produce stock returns that exceed returns from cash and bonds in the months ahead. Yet markets cannot rise at double-digit rates forever and while we continue to favor stocks over bonds in the near term, we stay cognizant of the need to adhere to portfolio disciplines, as there will be a time when investors put more emphasis on "return OF capital" than "returns ON capital".

Bitcoin and Blockchain Technology

If you have been following the news recently, you have surely come across the terms "Bitcoin" and "blockchain", and if you are confused on what they are and why it's a hot topic, you are not alone. It's been a form of controversy, even though it is not well understood by many of the people currently investing in it. Bitcoin is a virtual currency with a digital ledger, similar to how banks use ledgers to track customer records. There are merchants, even in the U.S., who currently accept Bitcoin as payment, though the current transaction fees for processing can be extremely high. The key difference is that Bitcoin's ledger is available to all Bitcoin users and is constantly being updated on all user computers. This communal use in which transactions are recorded and distributed is known as blockchain. Because there is no single point, or location, where the transaction data is being recorded, the records are truly public and verifiable, and supposedly cannot be corrupted by a hacker. Blockchain technology has spiked the interest of many banks and financial institutions that view it as a new technology that offers increased security and faster transactions at less expense.

The life of Bitcoin began after the 2008 credit crisis and gained popularity due to provided anonymity, superior processing capability, and the inability of governments to alter the supply (Bitcoin creation is capped at 21 million). There are a few reasons why the price of Bitcoin has risen dramatically (and fallen just as dramatically) in recent months. Some of the largest countries have allowed Bitcoin to be used as a virtual currency, or a means of exchange, which has helped to fuel the growth. These countries include the U.S., Canada, Australia, Japan, South Korea and the U.K. Other countries, like China, have banned its use as a payment, though individual investor interest remains high. Another bump in the price came when investors were able to trade Bitcoin futures on the Chicago Board Options Exchange (CBOE) and the Chicago Mercantile Exchange (CME). However, the primary reason the price of Bitcoin rose drastically in 2017 is because of investors FOMO (the Fear Of Missing Out). The speculation around Bitcoin has enticed investors to buy based on expectations that others will buy it from them at a higher price (the Greater Fool Theory).

The sharp increase in Bitcoin price, and investor interest along with it, comes with many concerns. With FOMO being the primary reason for a price increase comes the concern that Bitcoin is a bubble waiting to burst. Some analysts believe the use of futures expands the risk of Bitcoin throughout the financial system. Futures allow risk to be leveraged and magnified. The ability to trade Bitcoin futures, specifically being able to short Bitcoin, could put a lot of downward pressure on the price. While blockchain technology is supposedly "incorruptible", that doesn't mean Bitcoin can't be hacked and stolen from an investor's digital wallets (where investors store their Bitcoin). Since it is not currently regulated (and thus not insured), once it is stolen there is no way to change the blockchain, and investors are left with empty pockets and no recourse.

While we can't help but wonder how high Bitcoin will rise, Lincoln Capital views Bitcoin and other cybercurrencies as pure speculations, and reminds investors of the distinction between speculations (does not produce income) and investments (produces income). Still, we wouldn't be surprised to see even higher prices in 2018, and if one were to invest, no, speculate in Bitcoin then we extend best wishes with our primary advice being to make sure it's an amount you are willing and able to totally lose. Please view Lincoln Capital's research and financial planning tools as resources for related information and assistance, and contact us if we may be of assistance.

Sources: Shane, Daniel. (2017, December). Bitcoin: What's driving the frenzy? http://money.cnn.com/2017/12/07/investing/bitcoin-what-is-going-on/index.htmlBlockgeeks.
What is Blockchain Technology? A Step-by-Step Guide for Beginners. https://blockgeeks.com/guides/what-is-blockchain-technology/