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Investment Review and Outlook

What a way to cap another strong year in the global equity markets! While total returns for 2017 were far from an annual record, there were some unusual market dynamics that made this past year's performance quite noteworthy. Daily price volatility was historically rather low. Moreover, corrections of any magnitude were completely absent. Another factoid for market history buffs is that 2017 was the only year on record when the Standard & Poor's 500 index showed positive total returns during each and every month.

What kept the market participants so ebullient in the fourth quarter? As it became increasingly clear that Congress would muster the support to pass comprehensive tax reform, the market traded at successive record highs as investors anticipated a caffeine jolt to the economy from the expected fiscal stimulus. And Wall Street analysts fell over themselves to ratchet up earnings estimates for 2018 and beyond, as corporations will undoubtedly benefit from sharply reduced tax rates.

The reality is that there will be winners and perhaps even some losers as a result of the new tax legislation. For example, reduced caps for mortgage interest deductions could curb some demand for pricier homes. On the other hand, most domestically focused companies will likely see meaningful decreases in tax expense, leaving more cash flow that can be returned to shareholders.

While President Trump is trumpeting the notion of further strong gains in equity prices in 2018, we see a number of potential headwinds. First, we believe interest rates will continue to creep higher as federal trade deficits expand and the Federal Reserve continues to tighten monetary policy. Moreover, the pace of equity price appreciation since early 2016 is unsustainable in our view. An early 2018 sell-off could catch investors off guard and volatility has nowhere to go but higher. That said, we would welcome a healthy correction to take some air out of investor exuberance. We would relish the opportunity to be able to take advantage of market volatility, which historically has provided us with opportunities to deploy cash and reposition portfolios. So, we welcome the new year and look forward to seeing more traditional market dynamics.

Chomping at the Bit(coin)?

When a stock or asset class jumps fifteen-fold in just one year, investors take notice. While the equity and fixed income markets were relatively quiet this past year, the price of Bitcoin went on an unprecedented tear. Now some investors view cryptocurrencies as an asset class that has a legitimate place in their portfolios.

Before one considers investing in Bitcoin, we point out that there are some fallacies in the notion that Bitcoin is an investible asset class. While the price action of Bitcoin appears uncorrelated to other asset classes, and could arguably reduce portfolio risk, we have two strong arguments that dispel that notion. First, Bitcoin has no intrinsic value. Sure, one could argue that paper currencies have no intrinsic value either, but that brings us to a second point. Paper currencies have a long track record of relatively stable relationships to the prices of commodities and other goods and services. Second, while proponents argue that Bitcoin can be used as "a store of value," the fact that the price is so unstable undermines that hypothesis.

For an instructive analogy of what could happen, I take you back to 1979-1980 when the price of silver rose from about $5 to $50 in a matter of months. The price rise was attributable to the combination of rising inflation as well as a failed attempt by the Hunt brothers to corner the silver market. Ultimately the price came back down to earth and has never reached the highs again. Investors who got on the train late took a beating.

So, what does one do about an asset class which trades at ever higher levels for no apparent reason? Our advice? Stay away!