MANAGED ASSET PORTFOLIOS

# MAPVIEWS
## 2017 Review --- 2018 Preview

Stocks around the world enjoyed a rollicking advance last year, as for the first time since the 2008 – 2009 financial crisis the global economy enjoyed synchronized growth. From an economic perspective, no one region has been knocking the cover off the ball, but it has been refreshing to see every region moving in the right direction. Couple this with still very low interest rates and the stage was set for higher stock prices.

Last year's action in the financial markets proved many Wall Street pundits wrong. Prior to the 2016 elections, most forecasted gloom and doom for stocks if Donald Trump was elected. These negative prognostications proved incorrect as the S&P 500 gained 19.6% in 2017 and, equally noteworthy, has not experienced a monthly decline of more than 2% in over 14 months. Globally, markets were even stronger with the MSCI All Country World Index (ACWI) up 24.62%. Heading into 2017, Wall Street forecasters were also calling for higher interest rates and a stronger dollar. This call also proved to be wrong. Despite the fact that the Fed raised interest rates three times during the course of the year, the yield on U.S. Treasury 10 and 30 year bonds were actually lower at the end of the year than they were at the beginning. Further confounding early predictors who believed our dollar would strengthen significantly in 2017, the dollar finished the year near three-year lows versus the Euro and it performed poorly against most other currencies.

Currently, the U.S. is enjoying the second best bull market in history, both in terms of performance as well as duration. The best bull market occurred in the 1990's. Given the current level of interest rates and inflation, an argument can be made that stocks are not excessively expensive, yet we have concerns about valuations.

Since 2012, the S&P 500 is up approximately 80%, while corporate earnings have increased about 30% - suggesting a large portion of the increase has stemmed from valuation expansion rather than earnings growth. As value-driven fundamentalists, we believe that over the long haul, higher corporate earnings are required to achieve higher equity prices. Recently passed tax legislation should provide a boost to corporate earnings and likely explains the recent strength in the domestic markets.

Interest rates have moved higher in the early weeks of 2018, as investors believe the recently passed tax package will boost economic activity. Yields on the US 10-year have bumped up about 12 basis points since the beginning of the year to 2.56%. This puts it fairly close to the 2017 high of 2.61% achieved in March. The tax package will have a modestly positive impact on the economy, possibly adding about one-half of one percent to GDP over the course of the year. Accordingly, rates will likely climb incrementally higher and create a headwind for bonds. As we have noted in past commentaries, we believe the three-decade plus bull market for bonds ended in the summer of 2016, when the yield on the 10-year Treasury hit 1.4%.

At this point, it is prudent to discuss what impact higher rates will have for bond prices. Let's assume that the 10-year Treasury bond yield moved up to 3.5% this year. To attain that yield, the price of the 10-year would need to drop 8%. That is a relatively big drop for an investment that is typically viewed as "safe". While we are not forecasting a sharp increase in interest rates, we do believe there will be an upward bias. In response to this bias, we will continue to keep maturities relatively short for our bond investments. Currently, the weighted average maturity for our portfolio is slightly over one year, with no bonds maturing past three years. By having such short-term positioning, we believe our clients will receive respectable levels of income, while simultaneously avoiding the interest rate risk associated with owning longer-dated bonds.

*Why Should Stock Investors Care About Bond Yields?*

About eighteen months ago, the dividend yield of the S&P 500 exceeded that of the 10-year US Treasury. This difference in yields made for a strong argument for owning stocks. Today this difference has nearly reversed as the yield on the two-year U.S. Treasury bond currently exceeds the dividend yield of the S&P 500. When rates do move higher, we believe stocks with the loftiest valuations will be the hardest hit as the discounting mechanism adjusts stock valuations. Throughout 2017, investors have embraced a risk-on mentality, which has greatly benefited many of the growth type names, sending their valuations to levels that are difficult to justify on a fundamental basis. We believe that when interest rates move higher, stock market volatility will increase (keep in mind stock market volatility is at historic lows) and this action will likely punish many of the current high-flyers.

*Our Two Cents on Bitcoin*

It may seem odd for a value investor to even bring up the subject of Bitcoin, but since the stellar ascent of Bitcoin was certainly one of the most frequently discussed subjects in the financial media during the most recent year, we decided to include a few of our thoughts on the matter.

1) The seemingly infinite percent gain in Bitcoin, and even sharper advances in other cryptocurrencies, demonstrates that there is a growing distrust in fiat currencies and demand for alternatives. Post the 2008-2009 economic crisis, central bankers flooded the financial system with liquidity (a fancy way of saying "printed more money") in an effort to stabilize the global economy. Such actions, while providing some short-term relief, caused some investors to grow leery of currencies whose supply can be easily increased. More money supply should ultimately mean that your dollar would buy less (i.e. inflation); cryptocurrency owners theoretically don't have to worry about such things because the supply of these currencies is allegedly limited.
2) While we see the attraction of cryptocurrencies, we doubt that governments will endorse any of them in their current format, as they cannot be traced, or more importantly for the government's perspective, taxed.
3) The cryptocurrency popularity of today reminds us a lot of the "dot com" bubble of the late 1990s. Seeing stocks double, just because they add the word 'blockchain' to their name, just is a bit too much like Déjà vu for us. Recall, back in the late 1990s stocks would sometimes double just because they added "dot com" to their name. In short, we believe blockchain technology is the "real deal" and will find many applications in the future. However, we do have less confidence in the long-term viability of Bitcoin and other cryptocurrencies. We believe the crypto mania today will face the same ending as the dot com bubble of the 1990s.

As both the current bull market and economic expansion (domestically) approach the longer end of historic norms, selectivity has become more important. During recent years, indexing and ETFs have become the darlings for many in the investment world. At some juncture, the music will stop, and many will be left without chairs. With this bull market entering what we believe to be the bottom of the 8$^{th}$ inning, we consider it prudent to stay the course and continue our relentless search for value rather than joining in the euphoric risk-on parade. We will continue to work diligently to deliver the best risk-adjusted returns for our clients.

Best wishes to everyone for a happy, healthy, and prosperous New Year.

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*The information contained herein represents our views as of the date above and does not represent a recommendation by us to buy or sell any security or securities mentioned. Past performance is no guarantee of future results.*