

# Review & Outlook

FOURTH QUARTER 2017



119 N. Commercial St., Ste. 191 • PO Box 1618 • Bellingham, WA 98227  
P: 360.671.0148 • P: 800.292.8794 • F: 360.671.8936

## Review and Outlook

The S&P 500 index continued to make strong gains in the fourth quarter of 2017. Despite the uncertainty surrounding tax reform and news about geopolitical unrest, the market moved steadily upward. This steadiness was surprising given that the market does not typically go a full year without experiencing a five percent correction in stock prices. But, in one of the longest stretches on record, we haven't seen such a correction since the summer of 2016.

One reason for the stock market's unexpected calm might be the support it has received from central banks injecting money into the economy, keeping interest rates low. Another may be the

lack of attractive alternatives. With bond yields so low, and real estate prices so high in many markets, investors had few options for higher returns. But now people are starting to wonder when the tide will turn.

We do not see an obvious catalyst for a correction or significantly higher volatility, so we expect U.S. equities to continue to move up in early 2018. The U.S. Federal Reserve is helping to stimulate the economy, consumer confidence is high, unemployment is low, and now there is tax reform to fuel investor optimism. The factors that we think will be most disruptive to the market, such as higher interest rates, will take time to develop. In the near term, we think consumer sentiment and tax reform will continue to drive the stock market upwards.

The major beneficiaries of the new tax bill appear to be corporations that will profit from significant, permanent tax cuts, which will provide a boost to corporate earnings growth

in the upcoming year. It remains to be seen what those corporations will do with increased earnings, and if they will drive future economic growth. The hope is that increased economic activity will boost GDP growth sufficiently to make up for the anticipated \$1.5 trillion decrease in tax revenue, though few economists believe that this will happen<sup>2</sup>.

Nevertheless, we believe that in the short term higher earnings will result in higher dividend payouts and increased

Indices <sup>1</sup>	Total Return as of 12/31/2017	
	Q4 2017	Trailing 12 Months
S&P 500 Index (Large Cap)	6.64%	21.83%
S&P 400 Index (Mid-Cap)	6.25%	16.24%
S&P 600 Index (Small Cap)	3.96%	13.23%
Morningstar Short-Term Bond Index	0.03%	1.12%

share buy backs, which should support equity prices for some time. Wealthy individuals who benefit from the tax cuts may also help push equity prices even higher in 2018.

While international and emerging markets did not perform quite as well as the S&P 500 index in the fourth quarter, they still increased just over 6%. It is hard to imagine the U.S. having as strong of a year in 2018, and many people are predicting that international and emerging markets will outperform the U.S. We agree that returns in U.S. markets are likely to be more modest in 2018, so having exposure to international markets will be important.

Though stocks had a great year, the bond market remained lethargic. The 10-year Treasury yield moved very little in the fourth quarter, and ten-year and longer-term bond rates remained low. This indicates that investors are not particularly concerned about inflation, and do not expect much economic growth in the future.

Current bond rates also invite questions about the yield curve, a graphical representation of the relationship between duration and yield. When the curve flattens or inverts

(because short-term bonds have yields that are similar to or even higher than the rates for longer-term bonds), people start to worry that trouble lies ahead.

Many people think that short-term yields are likely to move up as the Fed raises short term interest rates, while long term rates will remain low based on expectations for slower economic growth. The current yield curve is quite flat, but not yet inverted, so there is some worry because an inverted yield curve has preceded the past seven recessions. Moreover, the last two inverted yield curves were in 2000 and 2006 respectively, just before major stock market corrections.

We know that we could see an inverted yield curve, but that does not mean a market correction is imminent in 2018. First, an inverted yield curve may be correlated with recessions and market corrections, but it does not cause those things. Second, quite a bit of time can pass between when the yield curve inverts and when we experience a recession or correction. And third, regardless of the shape of the yield curve, any increase in bond yields could threaten stock prices. While we are aware of the yield curve and what it potentially signals, we are paying closer attention to the changes in bond yields, because those changes will have a direct impact on stock prices.

## In Focus

A major financial industry preoccupation in recent months has been with cryptocurrencies, particularly Bitcoin. Motivating the creation of Bitcoin was the desire for a currency that exists outside of government regulation, an attempt to remove trust concerns from money, including pitfalls such as counterfeit cash and governments' debasement of currency through the printing press.

Bitcoin itself relies on the ingenious pulling together of a number of technologies only possible in today's age of high

speed data networks and super powerful computer processing chips. While the underlying technology is fascinating to a relatively small number of people, Bitcoin has become a dinner table conversation piece because its price has skyrocketed from \$1,017 at the end of 2016 to a high of \$19,345 on December 15, 2017. Returns for buying Bitcoin a few years ago are in the thousands of percent, and a lot of people are starting to feel like they missed the boat. But exactly what kind of ship is the USS Bitcoin?

One challenge to investing in Bitcoin is that there is no tangible way to value it. Bitcoin has no earnings stream, and no underlying capital assets with market value. The value lies in what people are willing to pay for it. But how is this different from a one-hundred-dollar bill, or an ounce of gold? Both have the core qualities of money: a store of value, a unit of account, and a medium of exchange. Bitcoin does have many of the qualities of money; however, as something that is appreciating like a rocket going to the moon, with single day moves of 20% or more, it is a terrible unit of account, and a risky medium of exchange. At present, it appears more like past infamous bubbles, such as the famous Dutch tulip bulb mania in the 1600s, golf club memberships in Japan in the 1980s<sup>3</sup>, and dot com stocks in the 1990s. With the price around \$18,200 at the time of this writing, it is difficult to know if it will go to \$100,000 or \$0 (or both) in the coming years.

Wall Street has recently allowed Bitcoin to be traded on the futures market through the Chicago Board Options Exchange (CBOE) and the CME (an American financial market company that owns and operates derivatives and futures markets). For now, Waycross views Bitcoin and other cryptocurrencies as so far into the realm of speculation that we do not consider them investable assets for any of our clients. If you do decide to join the frenzy, you should exercise great caution, and understand the very real possibility that you could lose it all.

1. Index Return Source Data: S&P 500 Index, <http://us.spindices.com/indices/equity/sp-500>. S&P 400 Index, <http://us.spindices.com/indices/equity/sp-400>. S&P 600 Index, <http://us.spindices.com/indices/equity/sp-600>. Morningstar Bond Index: <http://news.morningstar.com/index/indexReturn.html>.

2. "37 of 38 Economists Said the GOP Tax Plans Would Grow the Debt. The 38th Misread the Question." 22 Nov. 2017, [https://www.washingtonpost.com/news/wonk/wp/2017/11/22/37-of-38-economists-said-the-gop-tax-plans-would-grow-the-debt-the-38th-misread-the-question/?utm\\_term=.57edd1157445](https://www.washingtonpost.com/news/wonk/wp/2017/11/22/37-of-38-economists-said-the-gop-tax-plans-would-grow-the-debt-the-38th-misread-the-question/?utm_term=.57edd1157445)

3. "Want to Play Golf in Japan? Got a Million?" The New York Times, 25 Sept. 1987, <http://www.nytimes.com/1987/09/25/business/want-to-play-golf-in-japan-got-a-million.html>

This publication is intended to be used as an informational resource only. It is not meant to provide any financial, investment, insurance, legal, accounting, or tax advice, and should not be relied upon by the reader in that regard. We do not receive compensation from any company whose security may appear in our publications. Investments of any type can go up as well as down, and all involve the risk of loss. Please be advised that past performance does not indicate or guarantee future results.