INVESTMENT OUTLOOK

A PUBLICATION OF QUADRANT CAPITAL MANAGEMENT

FOURTH QUARTER 2017: SEX, LIES AND BITCOIN

What a tumultuous year. A billionaire New York real estate developer obtained a lease on the White House. Hurricanes and fires. Charlottesville. A total eclipse of the sun. Nuclear arms in North Korea. Harvey Weinstein, Al Franken, Matt Lauer, Charlie Rose and even Garrison Keillor. Cleveland Browns 0-16. Macron, Merkel, May. Half a million women marched on Washington. Repeal and replace, no. Tax cuts, yes.

So who woulda thunk that, from an investment perspective, 2017 would be a near-perfect year? That global stock markets would grow $9 trillion in value? That volatility would practically disappear? That oil would be strong, and the dollar weak? That copper would shine (+31%) and orange juice sour (-31%)?

In an environment of globally synchronized economic growth, stock markets around the world rallied. The Bombay Sensex rose 28%. The Hong Kong Hang Seng rose 36%. The Brazilian Bovespa rose 27%.

US markets were none too shabby, as economic acceleration translated into higher revenues and higher profits. In the fourth quarter, larger US companies levitated, but smaller US companies generated strong returns as well. International equities demonstrated continued robustness, with emerging markets particularly buoyant. Real estate securities posted more modest returns against a backdrop of rising short term interest rates—which also muted returns on bonds. Commodities rebounded nicely, with positive contributions from oil and copper. Returns on cash continued to edge higher in response to modestly rising interest rates.

Asset Class	Index	4th Quarter Results	Full Year Results
US Large Cap Stocks	S&P 500 Total Return	6.6%	21.8%
US Small Cap Stocks	Russell 2000	3.3%	14.7%
International Developed Markets Stocks	MSCI EAFE	4.2%	25.0%
Emerging Markets Stocks	MSCI EM	7.4%	37.3%
Real Estate	MSCI US Real Estate	1.4%	5.1%
Commodities	Bloomberg Commodities Futures	4.4%	0.8%
Bonds	Barclays US Aggregate	0.4%	3.5%
Cash	Citigroup 3 month UST Bill	0.3%	0.8%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, CITIGROUP, MSCI, BLOOMBERG, RUSSELL INVESTMENTS

For the year as a whole, investors basked in lofty double digit returns across domestic and international equity asset classes. Real estate and fixed income returns were respectable, and commodities were able to eke out small gains.

We are pleased to have been well positioned in 2017. Our tactical over-weightings in US Large Cap and Emerging Markets stocks were constructive. Within the US Large Cap portfolio, our over-weighting in faster-growing technology stocks, and under-weighting in utilities and telecommunications stocks, contributed to positive relative performance.

BITCOIN MANIA AND ETHEREUM DELIRIUM

Fame, fame, fame
I think it's got me goin' crazy
Oh oh
I get lost in this game, game, game
I'm gettin' tired of all you naysayers
--Eminem, Going Crazy

There was every reason to be content—nay, delighted—with portfolio growth from traditional investments (stocks and bonds). After all, a conventional balanced portfolio returned something north of 10% for the year—a very attractive neighborhood.

But long-running bull markets induce amnesia, as investors let greed conquer fear of downside risks. That, combined with rising distrust of institutions, central banks and fiat currencies, led investors and speculators to engage in a torrid romance with digital alternatives.

With cryptocurrency Bitcoin rising more than 1,300% in 2017, you want to know what we think of it. Or why we haven't invested in it. Or if you should jump on board.

But forget Bitcoin. I have a better idea how to get rich quickly. Not, not the latest and hottest IPO. For those of you wise enough or fortunate enough not to watch CNBC daily, you may not be aware of the rise of initial coin offerings (ICO's). (I am not making this up.) *The Wall Street Journal* has reported that ICO's have raised more than $4 billion—even though some ICO's back companies that don't have active products or services.

Next month, I plan to launch "Jeffies"—digital coins which will be backed by, well, nothing. Buyers will be able to exchange their debased US dollars, backed only by a profligate, financially irresponsible government, for the opportunity to participate in the surefire rapid appreciation of the Jeffie, driven by artificially constrained supply and rising demand. And best of all, there'll be no pesky SEC registration red tape. Call me for instructions on where to wire your funds.

'Nuff said about Bitcoin?

HONESTY, INTEGRITY, TRUST IN A POST-TRUTH WORLD

To believe all men honest would be folly. To believe none so is something worse.
-John Quincy Adams, Writings of John Quincy Adams

It was not as good a year for the truth. In a year that began with claims of the largest inauguration attendance ever and ended with claims of the most first-year signed legislation ever, it's understandable how some cheeky wags have come to refer to the Oval Office occupant as Liar-in-Chief. (To be sure, lying is a bipartisan issue, as Hillary Clinton's questionable veracity no doubt contributed to her defeat.) Ironic that, contrary to the President's claim that Time was to name him Man of the Year, that distinction went to Silence Breakers—victims of sexual harassment or assault who found their voices.

Hyperbole, even exaggeration, is fair game in trying to make rhetorical points. But when patently false statements become acceptable because they are daily fodder (frequency appears as normalcy), excused as a special form of communication, the moral fabric of our nation is rent. There can be little trust if "alternative facts" are peddled, when truthful explanations or even apologies are called for.

But why wade into this political morass? We raise this issue of truth-telling because investing requires confidence that rests on a foundation of honesty. We have to believe in the integrity of financial data that companies report. We have to believe in the integrity of company managements as stewards of corporate cultures. And we have to believe that companies strive to meet their goals without mistreating customers, employees, investors, and other stakeholders.

This comes to mind after another year in which there were once again numerous bad corporate actors. Wells Fargo, previously cited for fraudulently opening millions of accounts without customers' permission, is now on the hot seat for ripping off its customers on foreign exchange transactions. Construction equipment maker Caterpillar agreed to pay a criminal fine to settle charges that it cheated customers by performing unnecessary repairs of railroad freight cars. (According to *The Wall Street Journal*, employees deliberately broke functioning parts and dumped them in a lake. SMH.) United Airlines, in a most viral video, forcibly removed a passenger from an over-booked flight, in order to give his seat to an airline employee. In Japan, Kobe Steel and Mitsubishi Materials were among companies that admitted that they falsified data on the strength and durability of their products.

So, take a note, managements. We investors don't care only about whether or not you can make your numbers. We care how you go about doing it. Investors are increasingly paying attention to environmental, social and governance issues, and surveys indicate that millennials are especially attuned to such concerns. And they—and we—will vote with our dollars for those companies that honor and respect stakeholders.

TAX CUTS, YES. TAX REFORM, NO. JOB CREATION, TBD.

Borrowing and spending is not the way to prosperity.
We need to stop spending money we don't have.
-Paul Ryan, Republican National Convention Speech

While we are on the soapbox, can we talk truthfully about the recently passed tax legislation? The rhetoric on both sides of the aisle has been melodramatic, with extravagant promises of economic and jobs growth from the Republicans, while Democrats claim that the code changes will literally kill people.

First things first. However well- or ill-conceived, the legislation represents the Republicans' effort to make good on their campaign promise to foster faster economic growth, more job creation, and higher wages. The tax bill is merely the means toward that end.

Will it work? The centerpiece of the legislation is a 40% cut in the statutory top corporate income tax rate, from 35% to 21%. There is also a provision to provide for immediate and full expensing of capital expenditures. We believe that, at the margin, some business investments will be brought forward by these new tax law provisions, and the lower tax rates will increase the potential return on investment for some projects.

How will companies deploy the higher share of operating profits they'll retain from reduced tax liabilities? There have been some highly publicized instances of companies announcing one-time bonuses of $1,000 (ATT, Comcast) and some increases in minimum wages (Wells Fargo, Fifth Third Bank). These compensation boosts amount to $100-300 million for companies proceeding in this fashion. But it must be acknowledged that these benefits pale next to some of the announced share buybacks following the enactment of the new legislation. In the last few weeks, companies announcing share repurchases include Boeing ($4 billion), Oracle ($12 billion), Home Depot ($15 billion), Honeywell ($6.5 billion), Bank of America ($5 billion), Anthem ($5 billion)—you get the idea. Let's just say that benefits to shareholders appear to be vastly larger than benefits to employees.

Another significant provision in the legislation is a reduced tax rate on overseas profits. This, in principle, will encourage corporations to repatriate cash held overseas that had not been subject to taxation. We think it unlikely that there will be significant job creation, however, from this tax relief. Here, history is informative. A similar tax holiday on overseas earnings that was enacted in 2004, according to one study, resulted in 94 cents of every repatriated dollar being returned to shareholders, whether through stock buybacks or increased dividends. As shareholders, we are beneficiaries of such cash repatriation. From an economic perspective, however, there is limited impact on jobs, growth, or productivity.

As for other provisions in the legislation, it must be admitted that they fall far short of promised sweeping reform, simplifying the tax code, lowering individual rates and "broadening the base"—that is to say, closing loopholes and targeted tax benefits. It is true that most individual tax payers will see lower tax liabilities, and it is also true that the most affluent tax payers will enjoy the biggest aggregate tax reductions. (The one significant base-broadening provision—the sharp limitation on state and local income and property taxes—will hurt upper middle income taxpayers in blue states.) The favorable carried interest treatment for private equity has been preserved, and real estate investors will fare well from accelerated depreciation schedules. The hated alternative minimum tax is retained, though fewer taxpayers will be subject to it.

In short, there is likely to be some modest economic benefit in the near term from the new tax legislation. This is not a surprise, as increased deficit spending generally serves as economic stimulus. The degree and duration of this stimulus is highly uncertain. The necessity, utility, and timing of this stimulus is questionable, too.

What we do know is that this legislation assumes that higher future economic growth will compensate for lower statutory corporate tax rates—even as non-partisan scoring of the legislation suggests cumulative trillion dollar deficits. Additionally, the individual tax cuts (but not the corporate tax cuts) sunset in 2025; the bill's supporters blithely—and cynically—assert that in the future, new legislation will be passed to continue the individual tax cuts. In other words, the sunsetting provisions are a fig leaf to get the bill passed through the Senate's so-called reconciliation process.

Note to Congress: this is clever but not smart. Your dishonesty, too, is recognized.

BOND MARKET OUTLOOK: HIGHER RATES AND LOWER RATES

I go up, I go down
I go crazy when you're not around
-Pet Shop Boys, Up and Down

So we know that in the near term, the federal government faces reduced tax revenues. Absent massive spending cuts higher deficits will ensue, which in turn means more issuance of new government debt. The US Treasury is poised to issue $1 trillion in new bonds in both 2018 and 2019—about double the issuance in 2017. This dramatic increase in the supply of government debt is slated to occur at the same time that the Federal Reserve is gradually reducing its bond holdings.

This would, in ordinary times, be a prescription for higher interest rates—investors would demand more compensation from a more indebted borrower. But these are clearly not ordinary times. Long term interest rates, as measured by the 10-year Treasury, declined in 2017, as they have every year since the Great Recession—even as bond market pundits have consistently predicted higher rates. The persistently high demand for Treasury bonds stems from pension plans and insurance companies seeking to match their long term liabilities with long term assets, from aging boomers seeking income from their investments as they move into retirement, and from overseas investors whose home country bonds' yields are dramatically lower than those of US government bonds. That high demand, combined with stable, low inflation, has served to suppress long term interest rates for almost a decade.

2018, however, could just prove to be the year that the experts get it right. The Fed has been lifting short term interest rates—granted, at a leisurely pace—beginning in December 2015, and is on a path to continue normalizing interest rates in the new year. Indeed, the 2-year Treasury yield has risen from 0.26% at the end of 2012 to 1.89% at the end of 2017.

The economy appears to have picked up steam in 2017, and enters 2018 with positive momentum. The Citi US Economic Surprise Index, which measures the degree to which economic activity exceeds expectations, is at its highest level since 2011. Elevated business and consumer confidence are beginning to translate into re-energized economic activity. Consumer spending is healthy; retail holiday sales are estimated to have risen 4.9%, the biggest increase in six years. New home sales surged in the fourth quarter, hitting their highest level in more than 10 years. Unemployment is low (4.1%) and falling, more than 2 million new jobs were created, and wages grew 2.5%. Business spending on capital equipment, until recently a laggard in the economic recovery, is picking up as well.

This momentum is supported by the broader global economic environment. Growth in Europe appears to finally have taken hold, while emerging markets are proving to be resilient across Asia, eastern Europe, and Latin America. Japan has experienced seven consecutive quarters of economic growth.

These favorable developments are evident before any impact from lower US corporate and personal income tax rates kicks in.

A beautiful landscape, but the sky is not entirely cloudless. Income inequality is unlikely to reverse any time soon. Bank loan demand, seen as a proxy for future economic growth, is tepid. Lenders to consumers are experiencing higher delinquencies in their student loan, credit card, and automobile loan portfolios. The US dollar, which should be rising in light of increased growth and comparatively high interest rates, is sagging. Geopolitical hotspots from North Korea to Syria to Iran to Ukraine to Venezuela threaten to upend established order. Populist movements, nativist sentiments and distrust of elites have hardly disappeared. Midterm elections could shift the balance of power in Washington.

Still, taken all in all, the US economy is poised to experience some acceleration and, with it, there may at long last be a pick-up in inflation. And that would be a formula for higher interest rates, driven by market forces as well as our central bank. That suggests a focus on shorter maturities in bond portfolios. An extended economic expansion is favorable for corporate bonds, as defaults have been falling. Municipal bonds also remain attractive for high income earners, as top income tax rates were not substantially lowered.

GOOD NEWS: PRICED IN, OR MORE TO COME?

I want it, I want ta...
I want to take you higher!
I want to take you higher!
Baby, baby, baby light my fire
I want to take ya, take ya higher
I want to take you higher...
-Duran Duran, I Wanna Take You Higher

The 2017 narrative of equity markets, a narrative that resonated for us, was that faster economic growth around the world drove corporate revenues higher, pushing profits higher. It is now estimated that earnings for the S&P 500 were up 9.6% in 2017. Yet US large cap stocks appreciated by better than twice that amount. Said another way, stock prices out-paced underlying earnings growth. As a result, stocks are now valued at a historically rich 23 times their past 12 months' earnings (versus a 10-year average of 17 times), and 18.8 times forecasted 2018 earnings.

This suggests that investors are highly optimistic that earnings growth will accelerate. Consensus earnings estimates for 2018, according to FactSet, are projected to grow 11.8% over 2017 earnings. One explanation for the upbeat assessment: the passage of the Tax Cuts and Jobs Act will provide a lift to net profits. Poised to benefit particularly are domestically focused and smaller companies that have not been able to engage in offshore profit shifting techniques. Prominent among them are companies in the financial services, utilities, and telecom sectors.

Financial markets, mirroring the economy, are benefiting from positive momentum. A constructive backdrop suggests there may still be further gains ahead, but lofty expectations are a set-up for potential disappointments. This causes us to focus on under-appreciated downside risks.

In equities, we are, at the margin, trimming US large cap stocks in favor of small cap value stocks and, particularly, international stocks. International markets are at an earlier stage of economic expansion and feature significantly lower valuations, particularly emerging markets (notwithstanding very robust returns in 2017. We note that practically all of the increase in international developed markets stock prices, and 70% of the increase in emerging markets stock prices, are attributable to rising earnings.)

Within the US large cap portfolio, with the potential for economic acceleration in 2018 we are adding more cyclical exposure, in financial services, industrials, and materials. By contrast, our outlook for utilities and telecommunications is less constructive, in a rising interest rate environment, and consumer staples, facing disruption from retailers and changing consumer preferences.

Real estate fundamentals, while decelerating, remain constructive, but the asset class may be held back by rising interest rates. Commodities, on the other hand, may well get a lift from stronger global growth.

In sum, the bias is to the upside but the risk is to the downside. That makes us particularly zealous about searching for value in a world in which a Bitcoin sells for $14,000 and a Leonardo sells for $450 million. Alas, there are precious few assets experiencing under-valuation.

The current environment also encourages greater focus on context, on the external environment. In 2016, too little attention was focused on middle class disaffection. In 2017, it became clear that victims of sexual harassment had not been heard. What new voices will be heard in 2018?

We begin every new year with hope, however guarded. The year of the dog, according to the Chinese horoscope, is going to be a good year in all respects, but it will also be an exhausting year. We are delighted with such a prediction…but we are guided by dogged devotion to hard work, sound principles, and prudence. It's exhausting work…but it's good work.

May the year bring health, peace and prosperity—and less tumult.

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