WILKINS
INVESTMENT COUNSEL

2018 INVESTMENT OUTLOOK

The year 2017 was an exceptional one for capital market returns, notably common stocks, as returns benefitted from rising corporate profits, the anticipation of even higher profits from the recently passed tax reform bill (Tax Cuts and Jobs Act) and benefits from ongoing deregulation by the Trump administration. A ninth year of unprecedented easy money policies (a recent 25 basis point increase in the Federal Funds rate was the one notable exception) by the Federal Reserve kept interest rates from being an impediment to higher stock valuations and a growing number of investors are now viewing dividend paying stocks as bond substitutes. The low interest rate environment also benefitted a plethora of private equity and institutional real estate transactions. A surge in crypto currencies such as bitcoin introduced a whole new element of speculative fever at year end. In summary, 2017 was a year for risk assets.

The US and global economies provided support for the bull market thesis and run. Real GDP growth in the US has picked up to a rate of 3%+ since mid-year while the global economy has also moved to a higher rate of growth. The Eurozone is recording its best rate of gain in five years and China is maintaining a sound 6% real GDP growth rate despite growing financial strains within that highly controlled system.

Ever bitter partisan politics in Washington, the ongoing special counsel probe into possible Russian meddling in the 2016 Presidential Election, and the many geo-political concerns in the Middle East, North Korea, and South China Sea were no match for the bullish sentiment.

Year to date total returns for representative indices are shown below. This will be the ninth consecutive year of gains for the three US indices, which is now a statistical outlier. Stocks as measured by the S&P 500 have outperformed bonds as measured by the 10-year US Treasury for seven straight years, something which hasn't happened since 1928.

Equity Markets 12/31/17

	Index Price Level	2017 Total Return
Dow 30 Industrials	24,719	+27.5%
S&P 500	2,674	+21.8%
NASDAQ Composite	6,903	+29.6%
MSCI All Country World Index ex-USA	306	+27.8%

Outlook

On a very near term basis and barring a black swan event, the outlook is generally positive. The tax reform bill will provide a short term stimulus to the US economy as companies enjoy the windfall of a lower corporate tax rate of 21% compared to the current 35%. Those companies doing more business inside the United States will fare better than multinationals which already benefit from lower taxes in foreign jurisdictions. It is estimated that the new corporate rate will boost 2018 earnings for the S&P 500 by a high single digit percentage. It appears to this firm, however, that most if not all of this benefit has already been baked into the record stock market valuations. Companies are expected to use the higher profits to reward shareholders with higher dividends and share buybacks, while also investing in new capacity and higher wages for skilled workers. Merger and acquisition activity is also likely to increase over the near term.

A pickup in the economy may very well lead to faster wage growth given today's low unemployment rate, and higher wages and consumer demand normally result in rising levels of inflation. Inflation has been remarkably dormant in the 1-2% area since the last recession which ended nearly nine years ago. An acceleration could lead the Fed to hike rates more than the three one-quarter point increases they have signaled for 2018. A greater than anticipated increase in interest rates could provide common stocks competition for the marginal investment dollar for the first time in nearly ten years. Higher inflation accompanying higher interest rates also typically leads to downward pressure on price-earnings valuations.

Another interest rate development to watch closely in the New Year is the slope of the yield curve or the differential between the 10-year US Treasury and the 2-year US Treasury. It is important to watch this trend as recessions are often preceded by a negative yield curve. A negative yield curve results when this differential disappears and the 2-year rate eventually yields more than the 10-year rate near the end of a monetary tightening cycle. This differential has narrowed from over 125 basis points a year ago to 55 basis points today. While a recession appears unlikely in the near term, one cannot be categorically ruled out over a longer horizon.

The tax reform bill, while stimulative in the short run, is scheduled to add some $1.5 trillion to the accumulated Federal deficit over the next 10 years. Historically, stimulative tax packages are normally introduced during recessions and not after a lengthy expansion period such as the present. Nonetheless, academic proponents of the bill argue that the ensuing pickup in economy activity will raise incremental revenues and limit any additional deficits under the so called "dynamic scoring" method to buttress their case. While the true economic impact of the bill will not be known for some time, it does appear that Federal deficit for 2018 will rise some 10-15% from the $666 billion level in 2017 and perhaps again by that amount in 2019. The Treasury has announced plans to borrow one trillion dollars this year and again next year. While one hopes this large supply can be financed without any major imbalances, it will occur when the Fed is gradually disengaging from its easy money polices along with other important players such as the European Central Bank. It is worth noting the US national gross debt as a percentage of gross domestic product is already one of the highest in the world at 108.1%. While it can certainly go higher there are limitations.

The present environment is quite different from previous post WWII expansion periods and has its own set of unique circumstances. For one thing the lengthy period of low interest rates has resulted in high levels of leverage throughout the financial system. This has benefitted private equity funds and institutional real estate investors who, with easy access to low cost credit, have been willing to bid up the prices of assets in their respective domains. In another development, many companies rather than going public with an initial public offering (IPO) have remained private and become known as unicorns. These are typically technology driven start ups with a private market capitalization of over one billion dollars. In a recent article Barron's notes there are some 170 companies now in this category. The concern and challenge here, according to Barron's, is "that with private companies there is basically no limit on the terms investors can request." Hence more favorable terms are being given to investors in later rounds and higher valuations of financing via preferred share rights which essentially devalues the underlying common of earlier round investors. Many of these unicorn companies are often held within large mutual fund organizations and valuations for the same entity can be quite different across the organizations. A slowdown in Silicon Valley of any magnitude would have large repercussions for unicorn investors.

Another new development is the crypto currency area as there are now over 1,300 so-called digital currencies in existence with bitcoin being the most popular. These products are a function of the very useful blockchain technology but have no official backing and should be viewed as highly speculative. There is a steady stream of new offerings and their scarcity value could implode just as Dutch tulip bulbs did centuries ago. The inability of regulators to trace transactions makes them highly attractive to criminal elements and responsible regulators should take heed. Unsophisticated retail investors have driven the bitcoin to record levels in what can be best described as a buying panic.

A third and important new element in the current bull market is the dramatic growth of index funds and exchange traded funds (ETF's). A record $437 billion flowed into these products in 2017 and many large and small investors have soured on active investment management and chosen the passive route. The concern here is that index funds mirror the popular sentiment of the moment and by definition buy those stocks that are rising. Technology and social media stocks, for example, account for 23.8% of the S&P 500 index at the moment, the highest technology weighting since the dot com bubble of 1999-2000. The technology weighting in the very popular MSCI Emerging Market Index is an even higher 28%, which is something for investors in that product to seriously consider.

This and every great bull market is characterized by enthusiasts noting "how things are different this time" and that previous rules and learnings no longer apply. Possibly so, but as Mark Twain once said, "While history may not repeat itself, it certainly does rhyme."

Investment Conclusion

This firm, while clearly delighted with the exceptional progress made in the stock market over the last nine years, has concerns regarding the wide spread bullish sentiment and high valuation levels in the market place given underlying realities noted above. Appropriate profit taking will hence be done in issues that have run well ahead of underlying fundamental value. Simultaneously, individual pockets of opportunity can be found in companies that Wall Street has overlooked or has discarded for the wrong reasons. Our firm will continue to buy and hold the common stock of individual companies that fundamental research identifies as having sustainable distinctive competence features and able managements. Pooled products that typically have high fees and rapid turnover of holdings are not used in our programs.

The bond market appears to remain well over valued by historical standards and high debt levels throughout the global economy are a concern. Bank lending standards have been eased and the reemergence of covenant light (inadequate protection for the bond holder) bonds is a worry. The fact that over $11 trillion of bonds in the fixed income global marketplace carry a negative yield (i.e., the investor pays the issuer rather than receiving interest) is an anomaly waiting to be corrected. Easy money policies of the world's central banks have contributed to these conditions and may continue to, but this does not change the fact that risk abounds in fixed income markets. Our firm in this environment continues to invest only in short term investment grade issues. Returns on high quality cash equivalent money market funds are now rising and provide a safe haven for funds awaiting long term investment.

January 2, 2018

Our beloved friend and colleague, Peter Smith, was lost in a tragic accident on November 22, 2017. He will forever be in our hearts and in the spirit of this firm.