January 2018

Welcome to 2018! The stock and bond markets did much better in 2017 than most participants expected, by my reckoning. This has led to an unusually large proportion of the forecasts for this year predicting dire outcomes, also by my reckoning. Predicting the future is impossible, of course, but that doesn't stop everyone from trying. Simple bromides such as, "This past year was so good that this coming year must be worse," or "What goes up must come down," have the patina of wisdom, but really declare nothing useful. Markets don't submit to simple maxims and they definitely don't obey the law of gravity.

Markets are made up of hundreds of thousands of individuals (and more than a few computers) making independent decisions every day. The great quantity of individual decisions leads some to think that this data can be analyzed to predict the future, as we can with thousands of observations of natural phenomena. But trying to make an educated guess about the future of the stock market isn't like predicting the movements of the planets, which follow long-established rules of physics. It's more like trying to guess what your children are going to do next: you have a pretty good idea (because you know them well), but they never cease to surprise you. Human beings don't all make the same decisions under the same circumstances. When the world is tranquil they tend to do the same things, but under stress people often make emotional and irrational decisions (like those children you think you know). This is why forecasting financial markets, even with lots of data in hand, is so hazardous. As you may have heard me say before, *we are not forecasters, we are odds-makers.* Successful investing involves putting yourself in the best position to be prosperous in an uncertain future.

Getting back to the outlook for the current year, dire projections are everywhere, but, as we noted in last quarter's letter, *fears by so many that a recession and bear market are just around the corner is good evidence that they are not. Recessions and bear markets are usually the product of complacency, not fear.* The economy is doing rather well, unemployment is low, consumers are spending at a slightly faster rate than in recent years, and business optimism is high. These conditions correlate better with continued stock market appreciation than with a bear market.

While we have our doubts as to how positive of an impact the recently enacted tax bill will have on economic activity, we have no doubts as to its impact on American stockholders: very positive. Lower tax rates should result in higher net income and cash flow going forward, even with U.S. business profit margins already at historically high levels. As the cash piles up and as overseas cash is repatriated, we expect increased dividends, share buybacks, and acquisitions from U.S. corporations. All of these events are favorable to the stock market.

Is there anything to worry about? Indeed! The Federal Reserve is famous for "taking the punch bowl away just as the party gets going." They have forecasted four increases in the fed funds rate this year, or one full percentage point. If they follow through with that intention, the economy's rate of growth could slow. There also are plenty of geopolitical and economic risks that could throttle back our markets. But the biggest risk I fear is not yet present: a sense among investors that the market can go nowhere but up. The conditions that could produce such complacency seem to be coming together in 2018. So, while we presently aren't as pessimistic as most forecasts for the current year, we can imagine a world where we would be much more worried: a world where everyone else is optimistic!

Here's an old adage that we swear by*: Be bold when others are cautious and cautious when others are bold.*

Thank you for your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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