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DECEMBER 31, 2017 INVESTMENT MARKET COMMENTARY

2017 Recap

2017 was a remarkable year for the financial markets. **Stocks worldwide marched inexorably higher, completing the 9th consecutive year of positive returns.** The 4th quarter was strong, capping off a year with each month in the plus column, the first time that has ever occurred. **Equally unusual has been the lack of market volatility**, with the S&P 500 index having gone nearly 400 days without a 5% pullback, the longest such stretch since 1996. **Underlying the advance was 1) decent corporate earnings growth, spurred by a broad-based global economic recovery and 2) anticipated tax and regulatory reform expected to further augment business profitability.** It is atypical for most every asset class to appreciate simultaneously but this was indeed the case last year, not just in the US but virtually worldwide. In short, markets are not supposed to go up uninterrupted, but that is, seemingly anyway, what occurred in 2017. **From an investor perspective the scenario was near ideal.**

Bond returns were modestly positive as interest rates remained subdued. While monetary authorities have reduced the flow of cheap money, ample liquidity is still available across the global financial system. **Fixed income yields are absurdly low relative to inflation**, exemplified by the trillions of foreign government debt yielding less than 0%. Short-term yields rose in the US, as the Federal Reserve increased its benchmark rate several times, but longer maturities actually declined. There are important cross currents now impacting the bond market. With short-term rates rising and long rates declining, the yield curve has 'flattened', often an indicator of pending economic deceleration. However, inflation is showing signs of picking up, which should tug yields higher as well. **Our view is that current yield levels do not provide enough incremental return to merit assuming much price risk. Once bond yields are comfortably above prevailing inflation, we will gladly extend maturities to capture more reasonable returns.**

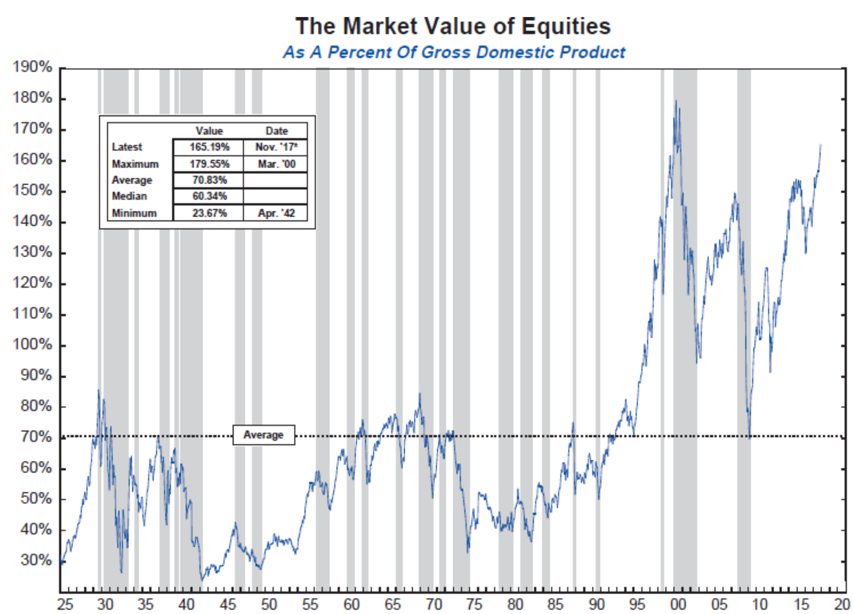
2018 Outlook

For the first time in a decade, the US is experiencing accelerating GDP growth. Employment is nearly full, and consumer confidence is at a 17-year high. Many believe that 3-4% growth is achievable in 2018, based on regulatory reform and lower taxes in the US, and continued recovery in the global economy. Earnings should grow nicely in 2018, and interest rates are likely to rise gradually as credit conditions 'normalize'. With this favorable fundamental support, market momentum is clearly positive.

With the backdrop encouraging, stock prices setting new records, and volatility at historic lows, there seems little to worry about. Indeed, most Wall Street prognosticators are focused on the bright side and predicting clear sailing ahead. As always, despite this heightened level of enthusiasm, we strive to assess future prospects objectively and dispassionately, and to consider all potential market environments. From this perspective, there are a number of risks for investors to eye warily, including: political turmoil in the US, China's considerable debt challenges, always present fragility in the Middle East, the unpredictability in North Korea, and the potential for unruly credit markets as the Fed unwinds its multi-year monetary expansion. These risks have been apparent for some time and, theoretically, have been accounted for in asset prices. As a result, the more pressing and pertinent questions are whether all the 'good news' is priced in to said asset prices, and are signs of budding excess setting the stage for an investor comeuppance?

Therefore, **in our view, there are two overarching concerns regarding the prospects for stock returns: 1) valuations are relatively high and have been so for an extended period, and 2) investor speculation has returned, which is typical during the late stages of major advances.** The coming year's market activity will confirm whether these two issues portend the waning stage of the 9-year bull market or whether the roots of this advance are durable enough to forge on.

Though not a good timing tool for identifying exact market tops and bottoms, valuation has consistently been a wonderful 'big picture' measure of future returns, and an accurate indicator of risk and reward. In short, stock markets purchased at 10X earnings have always been richly rewarded, while those entered at 20X far less so. The current price/earnings multiple is near the top of this range, as are several other key measures, including that shown in the chart below, the total value of all stocks in relation to the size of the economy (GDP). **These metrics reflect conditions that are expensive, when compared to historic norms, and suggest that current prices offer little margin of safety should the positive environment turn less favorable.**



*Data after September 2017 is preliminary.• Shaded areas represent Bear Markets.

Of equal concern is the recent and rapid change in investor sentiment from cautious to exuberant. Our October 2017 letter stated that "the lack of investor giddiness, despite the elongated market advance, is particularly surprising and important." That psychology has changed just in the past several months, as no price seems too high for certain assets these days. Indicators of market sentiment now reflect extreme optimism on the part of mutual and hedge fund managers (they were fairly cautious in the summer), and show that individual investors are returning to the stock market after having been scared off for years by the 2008-2009 market melt-down.

While emerging public euphoria is reason enough to get our attention, there is additional anecdotal evidence that suggests speculative juices are flowing. Most notably of late, the 'action' in Bitcoin and its cryptocurrency brethren has been breathtaking. In recent months, fortunes have been made and lost in a matter of days on this 'bet', despite the inability to reasonably assess the underlying value of this asset. Moreover, a number of stocks have soared recently based solely on changing their company names to include a cryptocurrency association. Our favorite example of this is Bioptix, a maker of machinery for the biotech industry. Having traded near $4 for the last three years, the company's stock reached $46 in December after a name change to Riot Blockchain (blockchain being the technology underlying cryptocurrency). Same business, new name, 1000% increase in stock price. Similar outcomes were seen for other public companies that announced business strategy shifts to areas related to Bitcoin and blockchain. This is the stuff from which bubbles are made, and should raise the antennae of caution.

In sum, a combination of rich valuation, low volatility, and budding euphoria seems like a recipe for at least a market correction. There are no rules concerning timeframe of course, but a retreat is long overdue. Indeed, stocks may well defy gravity for a while longer – markets are all about fear and greed, and the latter emotion is in full control these days. This presents a challenge for investors who remember the last two bear markets, nasty ones for sure, and wish to sleep comfortably. **It is increasingly difficult to find high quality stocks that are meaningfully undervalued, further suggesting that maintaining some liquidity through short-term reserves is warranted. While momentum and animal spirits may drive markets higher for some period, we are delighted to hit singles and doubles through ownership of high grade businesses, with real earnings, that are not outlandishly valued.** Markets ebb and flow, and structuring sturdy portfolios that can prosper during good times and, as importantly, weather the storms through the inevitable challenging times, provides the foundation for long-term success.