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2018 INVESTMENT TRENDS, ISSUES, & CHALLENGES

It has been our practice in past years to provide clients and investors with our economic and market forecast for the upcoming year. We peer into our crystal ball and we construct a "base case", essentially our view of the events that have some probability of impacting client portfolios. We then construct a number of scenarios and choose, what we perceive to be, the most likely case as a guidepost. As the year progresses and events unfold we become either more or less confident based on our anticipation of market reaction. We then act accordingly.

Since we are always dealing with uncertainty, the picture may at times appear hazy. In some years the uncertainties are magnified because the probabilities vary widely. Each forecast presents its own challenges. Where the range of potential outcomes is narrow, and the event has a low probability of occurring, there is often very little impact on our conviction.

What if the range of probabilities, however, is wide and the impact of a particular event is significant?

For example – if the hostilities on the Korean Peninsula increase and war becomes more probable, what would that do to our market forecast? Most forecasters tend to ignore high-impact, low probability events such as all-out war because the effect is difficult to estimate. However, to ignore this type of event, we believe, adds a risk dimension that may destabilize the base case forecast.

More probable factors of a base-case, however, are easier to gauge. If, for instance, inflationary pressures were to build rapidly because labor tightness results in higher wages, then the Federal Reserve's response might be to tighten monetary policy with more intensity and future corporate profit margins could narrow. Also, if the U.S. dollar were to continue to weaken, import prices and commodities likely would rise. Corporate borrowers could, then, have a harder time financing projects, the yield curve could invert, investor sentiment could shift, and the economy could stagnate. All of these could diminish a so-called "Goldilocks" economic forecast.

We are not predicting, at this time, that doomsday scenarios are likely in the short run, but they are not outside of the realm of possibility either – and therefore there are fat-tail risks that we expect to pay close attention to as the year goes on.

We believe that it is our job to weigh probabilities to a whole series of events - not just in our base case scenario, but also in other scenarios where risk mitigating strategies may act as shock-absorbers and even, potentially, influence performance. Risk mitigation, in our view, therefore should remain a high priority and an important investment theme as we allocate capital in the portfolios we construct.

With this in mind, we are approaching the year with a positive, constructive, stance because the economy appears to be responding to plans and programs that promote growth both in the U.S. and globally. Inflation is, thus far, under control. Domestic and international earnings are growing above trend, labor markets are strengthening, borrowing costs are low, and consumer and business spending are picking up. Last year we predicted that the Eurozone would show some signs of green-shoots, and we believe that the developed market, non-US recovery could continue to spill over into emerging economies.

When things are this rosy, though, we believe it is wise to step back and do some soul searching. What could we all be missing? We believe our focus is to seek the highest returns from a diversified portfolio of assets, commensurate with risk. In our case, we spend a considerable amount of time finding ways to protect and preserve capital and earn a decent return while attempting to grow the capital base for a time when the income from portfolios may be required to fund future obligations. (We also take into account, though, that certain clients may have more appetite for risk than others, and may have a preference for a particular style, sector, or industry.)

Given this focus, we explore ways to balance and diversify assets in an effort to mitigate the impact of surprises that could affect the portfolios. Since various factors can produce pleasant as well as unpleasant outcomes, we monitor the base case with the proviso that we may vary our portfolio approach as 2018 progresses.

The Upcoming Year Outlook

We enter 2018 with nearly one year of Republican control of the Whitehouse, Senate and the House of Representatives – with a President elected by less than a majority of the population with a low approval rating and an unconventional approach to governance. The 2016 election was, perhaps, less about issues than it was about the impressions that Government has been ineffective and out of touch with the everyday needs of middle-class American citizens. The message sent in

November 2016 was clear – the country wanted new, albeit unconventional, leadership even if the candidate elect may have been of imperfect character.

In 2017, with the economy accelerating, and corporate earnings surprising on the upside, confidence returned to the equity markets worldwide. Despite the high levels of financial asset valuation and economic liquidity, central banks have remained extremely accommodative - and as a result the synchronized global growth story, gathered momentum.

Now, as we approach 2018, there is a widespread belief that US tax reform, further deregulation, and fuller employment will sustain the expansion. As long as central banks do not remove liquidity from the markets by tightening credit, gradual interest hikes can be absorbed and markets should remain well behaved and fairly predictable. We perceive the return of inflation as one of the biggest disruptive risks, along with the threat of higher rates in fixed income markets, rising protectionism, and political shocks.

Set against this backdrop here are our 2018 Predictions which could affect the currently euphoric investment climate. Some of these predictions are positive social trends, others are potentially negative headwinds. While they may not all occur, as a whole they have led us generally to have moderate, rather than outsized, expectations for overall return on financial assets this coming year.

First Forecast:

The markets remain complacent and upwardly biased for the first part of 2018, but could gradually become choppy and volatile as investors realize that the structural imbalances could require sacrifices by the citizens who may be unwilling to accept them.

In early 2017, the administration set the tone that deregulation and tax reform were the keys to spurring growth. The campaign promise, we all recall, was that we would go back in time to an America where prosperity was the reward from hard work, savings, and personal sacrifice. The profits in the corporate sector were expected to trickle down to workers and as a result consumer spending and business spending ensure sustained prosperity. As the year progressed, tax reform was passed, providing sizable relief for US Corporations and marginal relief for most individuals. While tax cuts may be a welcome development for many Americans, we believe there is an inherent flaw in the design. The reform, thought

to simplify the code, has not reduced complexity. The promise that everyone benefits from lower taxes is likely false because the benefits do not seem to be spread evenly or equitably. The upper class will pay less in taxes while the middle class will feel marginally better off for only a short period of time. The lower-class wage earner gets some nominal relief but inflationary costs, particularly health care expenses, could easily eat away at their minimal tax gains and savings. Many voters who saw the promise of tax simplification and reform as benefiting them may, in the end, realize that they voted against their own best economic interests.

There is no question that as we enter 2018, confidence in non-governmental institutions abounds. Additionally, better than half the country believes that a government run by businessmen founded on capitalistic principles can solve the country's problems. As a result, for now, more than a majority seem willing to adopt a wait and see attitude. By mid-year we predict that there will be less confidence that hasty business-oriented solutions can deal with other large-scale systemic problems effectively. It goes without saying that tax policy is only one of many items the Administration intended to address. This leaves Welfare, Social Security, Medicare, Medicaid, Health Care Reform, and Immigration Policy to be tackled in 2018. These issues each have a far-reaching impact on our society and economy and deserve a great deal of study and diplomacy to address adequately. It would be hard to imagine they will be dealt with in a year in which there are mid-term Congressional elections.

Second Forecast:

The foreign policy implications of the desire to "Make America Great Again" will be felt in all corners of the Globe - with unpredictable short-term consequences, and possibly greater long-term risks.

In the view of the widely-respected Eurasia Group, "America First, and the policies that flow from it, have eroded the US-led order and its guardrails, while no other country or set of countries stands ready or interested in rebuilding it….significantly increasing global risk".

So, as we enter 2018, you may ask what makes this year any different from prior years. Essentially, US Foreign Policy under the current administration has a much more "unilateralist" agenda that has shaken some long-standing relationships to a point where foreign governments cannot assume that the U.S. will provide the same level or type of support going forward. The potential consequence of this

policy of isolationism could be a lack of trust in our country's motives. With our credibility called into question, there is the risk of losing our standing and influence in the world.

As far as markets are concerned, we have always dealt with geopolitical risk and the economic consequences of upheaval. And, for the most part, such worries have been short-lived. So why is this a greater risk than usual? Perhaps the stakes are higher.

At turning points in history, where the specter of war could destabilize an already unstable situation, military conflicts take on lives of their own. Diplomatic alliances, therefore, become more important in attempting to avoid violence. If we distance ourselves from our partners, the world becomes less secure. If, through miscalculation, the only alternative to peace is a military response, then each nation in an alliance has to weigh the consequences of remaining on-side when and if that day comes. The markets currently seem to have quantified the risk of military conflict as simply a lot of hot air. When speaking of the potential US North Korean conflict, Alex Lockie, (Editor of the ***Business Insider***) stated: "Remember: there is tremendous leverage in threatening to initiate the end of the world with nuclear war, but nothing is to be gained by actually doing it".

That may be so under normal circumstances, but we have never had to consider that this risk is being managed by unpredictable, if not volatile, world leaders. The win-at-any-cost attitude and the desire to prove who has the stronger hand is a danger that can bring the US to the brink of war. Nothing would shake confidence in the markets from their lethargy more than the realization that when the chips are down, we act impulsively and alone.

Third Forecast:

Globally: Populism confronts authoritarianism. Domestically: Federal control collides with states' rights. Divided government remains a reflection of divided citizenry.

"Why can't we just all get along?" 2018 may be the year when the world asks this very question. And, the answer is ….? There will be winners and losers and the costs to the losers will be significant, politically, economically and societally.

Each referendum and election across the globe is rife with intrigue: Italy, sometime this spring; Russia in March; Sweden in September; Mexico in July; Brazil in

October and the US Midterm elections in November. Unlike 2007, where business-friendly leaders overcame left-leaning opponents, 2018 appears to offer the prospect of the opposite result.

Markets in 2017 were conditioned to expect significant positive changes globally. Investors shook off the effects of Populism in the UK, France, and Argentina. Markets have repriced assets, anticipating the impact for winners based on rhetoric and personalized warnings using a system of rewards and punishments delved out by edict.

In America, while change itself can be upsetting, change imposed by someone who has a flair for the dramatic can set off unanticipated emotional responses that detract from effectiveness. Reduction of State and Local Income Tax Deductions has set off a firestorm pitting the Federal IRS against the governors of high-tax, largely Democrat-controlled, states. The next stop on this journey in 2018 will be the reduction of reimbursements for so called entitlements to the very same states, many of which pay more homage to Washington than they receive back in benefits.

The structural problems embedded in pension fund obligations will most-assuredly be another battleground in 2018. As a result, we can expect that 2018 will see more than its fair share of economic controversy at home and globally. On a societal note, Immigration Reform and the connection to Sanctuary Cities and States will also produce a battle royale. It is highly unlikely that things will go along without a hitch, politically and economically. This is particularly the case when markets are affected by daily tweets where the risk of personal communication can be misperceived. While the world seems to be getting used to, or even ignoring, tweets from politicians, it is our belief that this sort of frequent, impetuous messaging could at times produce a spillover effect into the capital markets with unintended consequences.

Fourth Forecast:

The US Equity Markets by mid-year will be quite volatile, with swings creating a 10% to 15% correction - shaking the belief system of investors who have gotten much too complacent.

Volatility is the product of risk perception. It is generally referred to as a measure of fear. While market participants do not like uncertainty, they can manage it by

attempting to mitigate risks. Federal Reserve policy vacillation, cyber-attacks, imbalances in the supply-demand relationships in energy markets, tariff and border restrictions, are just examples of catalysts which could disrupt the market's gradual churn higher. Throughout 2017 the big surprise to us was that there was virtually no volatility. In times like these, professional money managers try to offset risk by using market-neutral strategies with balanced portfolios; a strategy that doesn't work particularly well when there is little volatility or fear. This year, however, may represent a turning point if we see signs that the economic expansion cycle is nearing full maturity. When valuations are as extended as they are now it is only prudent to risk mitigate client portfolios.

Fifth Forecast:

Global problems and challenges are more daunting than expected. The world in 2018 is more interconnected, hence any change can imbalance a system that is more fragile than at any time in history.

There is a belief that global growth is expanding, the pie is getting bigger and everyone's slice is larger. Our view is that global growth is indeed advancing, but perhaps not accelerating uniformly across the board. The problem with the growth thesis has been described by Ruchir Sharma in his book the Rise and Fall of Nations. In essence he sees that there are forces that define this phenomena:

Depopulation
De-globalization
Deleveraging
De-democratization

He points to a net decrease in the world working age population, trade contraction with discriminatory trade measures, a slowdown in cross-border banking flows, net migration from emerging markets to developed markets, deleveraging headwinds in China and the Eurozone, de-democratization with declines in freedom, and the emergence of nationalism and populism. The net result is that there are a growing number of world hotspots, each of which may require delicate diplomatic measures to keep the world stable. One place that this is particularly true is in the Middle East where the Iranian situation requires attention from both the U.S. and Russia, two countries not naturally allied. This is further complicated by the persistent belief that the Russians have interfered in US elections with complicity of White House occupants. A Middle-East peace plan to be fashioned by Jared Kushner

along with President Trump's attempt at moving the U.S. embassy to Jerusalem has inflamed the Arab World and emboldened the militant group Hamas. Naturally, widespread unrest and destabilization in that region, or in other areas of the world for that matter, would not bode well for 2018.

Sixth Forecast:

Large fiscal stimulus funded by increased borrowings fail to produce expected growth at a time when monetary policy is becoming more restrictive, causing inflation in the things we need and deflation in the things we want.

If there is one factor that deserves particular attention during 2018 it is the level of debt the US is willing to assume to extend an economic recovery. In the past, each new dollar of debt was expected to produce at least some increase in Gross Domestic Output. The number in the 1950's was estimated to be $1.00 of GDP output for each $1.00 of government borrowings. In the more recent past the number was less than 20 cents for each incremental $1.00 of debt.

With the advent of Trump tax and infrastructure policy initiatives, there is an immediate cost and a future cost. The immediate cost is a down payment, a kick starter so to speak, resulting in a fiscal budget deficit. The sustained cost of borrowings is the interest cost on an exponentially growing debt load. Creating a digital debt that is supposedly covered by tax revenue on increased profits from future production seems naïvely optimistic to us, but that is precisely what has been put forth.

In a sane and rational world, there would be enough predictable revenues to cover the interest and pay back the incurred debt. In the real world of 2018, there is no intention to ever pay back the debt. Instead, that debt, in the eyes of policy-setters, would be eternally rolled over when it comes due. Few if any are asking the most important questions: Who is going to buy all the newly-minted debt? How much interest will future lenders require?

The market for competitive, minimal-risk debt has traditionally produced active buyers. And, indeed, the U.S. can be expected to raise as much in the way of borrowings as it needs at current low rates – largely because other sovereign debt is even more mispriced than ours. It is more difficult, however, to count on that robust demand in perpetuity as the overall debt load eclipses $21 trillion and is soon expected to surpass 100% of US GDP without looking back.

Inflationary expectations are on the rise with the Fed announcement of expected rate increases for 2018, and perhaps beyond. The aggressive stance is based on an improving economy with job creation, productivity enhancements and stable prices. Even if everything turns out better than expected, we are curious how much longer the U.S. stock market can maintain its performance relative to the rest of the world. The U.S. economic recovery and expansion are already running notably long at nine years and counting. One has to wonder, then, if assuming more sovereign debt at this time is, in fact, stimulative in the long run, or are these efforts just temporarily delaying or deferring the normal dynamics of the economic cycle.

Seventh Forecast:

Emphasis on US' position on foreign trade becomes more important as the year goes on. The dollar's value as the reserve currency of the world will be called into question by our trading partners who see the need for devaluations to compete; the Chinese, because of the desire to include the yuan in a basket of currencies at the IMF, and the Russians, because they want to maintain the status as a Superpower.

If there is one wild card to any meaningful forecast for 2018 it is the delicate relationship we need to cultivate with countries like China and Russia. China's avowed purpose is to fill the leadership vacuum left by the U.S. on the world stage. China has its own set of challenges to slow down its growth, deal with its own debt overhang, stimulate consumer spending, and reverse capital flows. However, up to this point, with their economic surge in the past 15 years, they seem to be the primary authors of the 21st century narrative.

China, and less so Russia, certainly need access to western markets to sells their goods, but America's recent policy to bring back manufacturing jobs threatens their economic interests. There is a real possibility that China and Russia could enact policies, including active currency devaluation, which could roil international markets. At home, we see some enactment of trade restrictions actually penalizing consumers with higher import prices, while interest costs rise, negatively affecting growth in spite of reductions in certain taxes. We believe that in 2018 we are going to find out that the U.S. economy is not an island unto itself. The global debt crises will take its toll because central banks around the world have been unwilling to raise rates while believing that growth would be impeded if they did.

The currency of the United States came under pressure in 2017, thanks in part to differentials in government bond yields between the U.S. and the rest of the world. We see the dollar as still in an overvalued state, and this could be a contributor to inflation when compared to the price of commodities and foreign goods. If the dollar should weaken further it would largely come with an inflation spike – potentially upsetting both the bond and equity markets. We believe 2018 could see the making of a Russian-Chinese Alliance with gold in a basket of currencies at the IMF and the creation of new SDRs with the intent of creating a competing world currency. We believe that this not only a possibility but more probable if Chinese and Russian interests are threatened by U.S.-initiated trade restrictions.

Eighth Forecast:

GDP growth in the U.S. reaches an annual real rate of 3% because tax reform results in an increase in discretionary spending starting in the first quarter of 2018. By year-end, the hope for meaningful increase in wages does not materialize. Federal government tax receipts are less than forecast and the fiscal deficit widens. States that challenge the non-deduction of State and Local Income taxes are moderately successful, adding to the shortfall in Federal tax revenues.

Corporate earnings are difficult to predict because of the one-off effects of tax reform and bringing back of foreign profits. Each sector and industry has its own dynamics creating competitive winners and losers. But, overall, we see the economy reaching the intended near term goal of 3% with 2% inflation. For 2019, however, all bets are off as global flows may remain lackluster post tax-reform.

By the fourth quarter, despite optimistic forecasts by Wall Street economists, there is some feeling that we may be entering a growth recession. Valuations remain at historical highs that are well in excess of historic norms. Stimulative monetary policy will be de-emphasized or eliminated. At the same time, the fiscal policy outlook, post the midterm election, is more uncertain if the Republicans lose their majority in Congress. The geopolitical market environment becomes increasingly difficult to successfully navigate and the U.S. stock market remains in a fragile state at the close of 2018.

Ninth Forecast:

Cybersecurity threats likely will impact institutions and individuals creating the potential for a possible crisis environment in 2018.

Because the digital world has made us more connected and reliant on technology solutions in our every-day lives, the risk of denying access to services we take for granted is amplified by cybercriminal behavior. Breaches in security that safeguard data or identity, even if supplied by government or large institutions, likely will accelerate in 2018.

The likely response will be the creation of new technologies such as blockchain to counteract the potential for future threats. It is one thing for cyber-criminals to be motivated by political, social or military gain, it is another if their motivation is financial gain as reported by Forrester Research in a recent report. With the midterm elections in 2018, we can expect greater attention on cybersecurity than ever before. The battle-lines will be formed by strengthening the legal system to penalize the companies who have been lax and negligent. It is entirely possible that corporate spending in cybersecurity will be at the same heightened level that we saw prior to the clock striking twelve at the turn of the millennium.

Tenth Forecast:

2018 is the year when two societal issues will rise in prominence: Inequality and Women's empowerment.

Inequality as an issue has risen because of obvious observations that fairness has been lacking in so many areas that have humanitarian importance.

Immigration is front and center with the children of undocumented residents living in America being threatened with expulsion – the so called DACA individuals whose lives are being disrupted by a lack of a cohesive immigration policy. Another area is the divide between policies that favor the rich, pressure the middle class and widen the gap with the poor.

Then, of course, there is gender inequality where women are paid significantly less than men to perform the same work. This brings us to declaring that 2018 will be the year of empowerment for women. With the election of Donald Trump and the revelation of sexual harassment in a number of industries, more women have risen in anger making their desire to participate in politics greater than ever before.

Women have spoken out about social injustice and sexism. At the heart of their argument is that they feel a compassion for humanity and a concern for the country. Their voices will be a crescendo in 2018.

Eleventh Forecast:

Technology directed at disruption in conventional industries gains greater importance with 2018 rewarding risk takers and punishing those that oppose change.

Machine learning, predictive analytics, blockchain utilization, artificial intelligence, authentication, connectivity in the internet of things, and electric driverless cars are just some of the areas where breakthroughs are expected to materialize. Similarly advances in medical technology, instrumentation, genetic profiling to both treat certain diseases and extend life will continue to draw investor interest like never before.

Initially, certain industries and companies will resist change but in an environment where capital is plentiful and inexpensive, regulations are more relaxed, and citizenry is more educated, innovation will continue to flourish.

The equity markets in some ways reflect the future growth for innovators but have perhaps not yet fully punished those companies that are resisting change. This is not true in retailing. Online retailing has taken its toll on conventional stores with a promise that there is more to come.

We predict that many companies in 2018 will use the opportunity to change strategies at a faster rate. Also, mergers and acquisitions and share buybacks should reach record levels but may be somewhat impeded by higher costs of capital and extended valuations. It is a good time for sellers but ‘buyer beware’ should be the mantra going into 2019-2020.

Conclusion:

All of this highlights the particular importance of true diversification to create an investment portfolio whose goals include elements of capital maintenance and preservation as well risk mitigation. We expect to manage portfolios by owning a combination of fixed-income securities, equities (many with income components), and actively-managed mutual funds, and passive ETFs.

We recognize that the management of accounts may have multiple (sometimes competing) objectives because of the need to distribute income for current expenses while providing for longer-term appreciation. The importance of pursuing adequate investment returns through risk mitigation in the uncertain environment we are forecasting in 2018 cannot be understated.

We believe the best strategy for 2018 is to invest tactically, but generally to have a balanced portfolio of equities and strategic-satellite investments, core fixed income investments, diversified alternative strategies, and cash awaiting opportunity for deployment, in what should be an eventful year.

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