2017 YEAR END REVIEW

THE YEAR OF SURPRISES

Last year at this time the pundits thought they had a pretty good idea of what 2017 would bring. The experts were all wrong.

The 2016 presidential election totally blindsided political forecasters, but 2017 was supposed to be more predictable. With the Republicans in control, the first one hundred days would entail a new health care bill, a major infrastructure initiative and significant tax cuts. Additionally, the Federal Reserve was committed to raising the Fed Funds rate and signaled that it would pare down its bond purchases. With deficit funded fiscal stimulus and decreased monetary support, interest rates were supposed to soar.

The hedge funds knew that if there was one trade that would make their year, it was to short the dollar. When interest rates go up, the dollar goes with them. Add in strength in commodity prices and US political uncertainty, and the dollar was sure to climb. Yet somehow, the dollar weakened and ended the year near decade lows.

With P/E ratios in the stock market at elevated levels, it was certainly the year to see the FAANG stocks come crashing down. Facebook, Amazon, Apple, Netflix and Google (Alphabet) were just too popular not to teach speculators what happens when manias turn to panics. The crash never came, with the average FAANG stock up 50% last year.

If there was a bubble more ridiculous than the FAANG stocks, it had to be the crypto-currencies. Who in their right mind would put sound money into a baseless, unregulated, untraceable scheme? Surely 2017 would be the year that it all ended badly. Instead, we got the first ever pyramid scheme listed on a US exchange.

The predicted crash in FAANG and Bitcoin was expected to lead the stock market lower. After eight years of positive returns and more than tripling in value, there was a good chance that there would at least be a significant correction, if not a bear market. The potential causes included: A trade war aggravated by a strong dollar as Trump made good on his promises to build a wall and tear up international trade agreements. A real war with Iran or North Korea, or at least a major terrorist attack. A spike in commodity prices and rising interest rates on top of stretched valuations. Again, the stock market ignored these predictions and went straight up without even a modest correction.

The pundits were right on a few things. The fed did raise interest rates three times and began unwinding its balance sheet. Although it took the entire year, Congress eventually came through with deficit funded tax cuts. But somehow most of the bond market didn't seem to care. In fact, the ten year treasury ended the year almost exactly where it started.

Yes, we know we disparage the "pundits" a lot, but we do so because we help our clients understand that no matter how sophisticated or brilliant a forecast sounds, trying to make long-term investment decisions based on the unknown is a losing formula.

That's because there are two main problems all prognosticators have to solve. ***The first is that they not only have to predict the future, but to be useful, they have to predict something most people don't think will happen*.** Yes, the Fed raised interest rates three times, but that didn't make them a dime, because that was exactly what traders thought they would do.

The second problem is that they not only have to make a prediction that is different than the consensus, they have to predict the effect that event will have on the market. Commodity prices rallied, but the dollar continued to fall. The yield curve flattened, but the stock market keeps making new highs. The president is threatening to tear up NAFTA, but Boeing was one of the best performing stocks last year despite being one of the biggest beneficiaries of free trade.

Gullible investors will continue to cling to the false promise of risk free investing guaranteed by the infallible predictions of Wall Street's soothsayers despite their obvious shortcomings. It's just something humans are programmed to do. Accepting uncertainty is more frightening than following a false profit. Some people believe the pundits, others think they have found the Holy Grail but the result is the same; panic when the predictions don't come true.

There is an alternative to living in fear that the world won't turn out the way we were told it would. Don't believe them! The best way to avoid being busted in a bubble is to stay away from it. You would think that would be an easy thing to do when you realize that you could get wiped out overnight. Turns out that for most people, the promise of certainty and profits masks the truth. **Once you liberate yourself from the nonsensical idea that you can predict the future, investing becomes much simpler.**

All the things that could have happened last year, both good and bad, could happen again this year. The fact that they didn't happen last year makes them no more or less likely to happen this year. The best strategy is to be prepared. We always assume that we could wake up any morning to find our stock portfolios down 20-30% before we have our first cup of coffee. When it happens (again) we won't be surprised. That's why we advise not having any money in stocks that you will need for at least the next five years. It just might take that long to get a good return after a major crash.

Just as important, we assume that while the stock market is unpredictable in the short run, it is the greatest source of wealth that the world has ever seen. That we know. Guessing what will happen in the next few months is a game not worth playing. It can also be detrimental to your financial health.

As always we raised a little cash on the way up last year so we can take advantage of a stock market correction. The correction never came. It was a year of surprises, but it was still the right thing to do because you can't change rules just because there is an exception. We only held one of the FAANG stocks and were scared of Boeing because we feared a trade war, but we held on to commodity and energy stocks that did almost as well. Value was supposed to be out of favor in a market dominated by tech and social media stocks, but we had a pretty good year thanks to having well diversified portfolios including some out of favor consumer cyclical stocks and better performing financials.

If there is a lesson to be learned from 2017, it is that while markets are unpredictable, following a disciplined asset allocation and value oriented approach to investing helps our clients achieve and exceed their financial goals. We look forward to 2018 regardless of what it brings.

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