The Stock Market

The S&P 500 finished the year on a high note returning 6.64% in the fourth quarter and 21.83% for the year (CHART 1). In fact, 2017 was a "perfect" year. For the first time in its history, the S&P 500 Index generated positive returns in every month. The best performing sectors of the market were: Technology, Materials, Consumer Discretionary and Financial. Technology, the best performer by far, was up 38.8%. The worst performing sectors were: Energy, Telecommunications, Real Estate and Utilities. Energy and Telecommunications generated the only negative market sector returns for the year.

Once again growth stocks outperformed value stocks. The Russell 1000 Growth Index returned 30.2% compared to the Value Index return of 13.7%. This outperformance was largely driven by technology stocks and high growth consumer companies like Amazon. Growth has outperformed value in six of the last nine years dating back to the financial crisis. As value managers this has been a mild source of frustration for us. Why have growth stocks been favored? At the risk of over-simplifying we see at least three reasons: First, coming out of the financial crisis, many companies in the Financial Sector (the largest sector in the Value Index) were deeply wounded and became heavily regulated. Years were spent repairing their balance sheets and dealing with over-zealous regulators. At the same time the Federal Reserve's interest rate suppression severely limited net interest margins, the major source

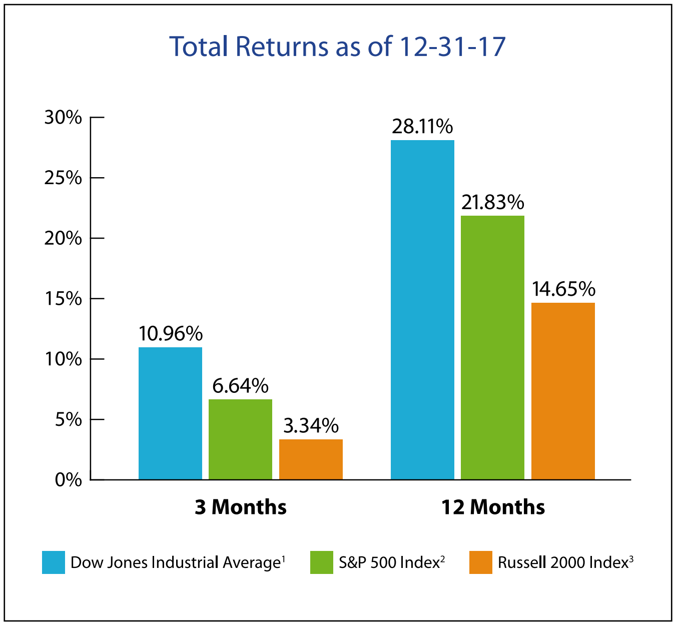

Chart 1

SOURCE: MORNINGSTAR DIRECT

Past performance does not guarantee future results. You cannot invest directly in an index.

[1] The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

[2] The S&P 500® Index is a capitalization weighted unmanaged index of 500 widely traded stocks, created by Standard & Poor's. The index is considered to represent the performance of the stock market in general.

[3] The Russell 2000® Index is an unmanaged index of the smallest 2,000 stocks in the Russell 3000® Index.

of income for lenders. Second, Energy, another large value sector component, entered the financial crisis with oil at $100 per barrel. Incentivized by high prices, the industry aggressively invested in projects that offered poor returns as prices collapsed below $30 a few years later. Third, when GDP growth is slow and interest rates are low, investors are willing to pay up for growth because it is scarce.

We are of the opinion that all three of these negative macro factors are in the process of reversing. The Trump Administration, for all its shortcomings, is aggressively rolling back damaging regulations, especially in the Financial and Energy sectors. These changes are not only helping these sectors but collectively enhancing economic growth. Banks are now better able and more willing to lend. Rising interest rates provide more opportunities to do so profitably. While we will not try to predict future oil prices, they have recovered somewhat. The industry is making adjustments to live in an era of "lower for longer" pricing. Most energy companies have shifted focus away from revenue growth at any cost toward generating better returns on investment, and returning more of their cash flow to shareholders.

Economic growth appears to be improving and interest rates are rising which should also favor value stocks. Provisions of the new tax legislation which encourage fixed assets investment provide greater benefits to many companies in the value category. Also, if recent headlines are any indication, many of the "FANG" tech companies are becoming the objects of intense regulatory scrutiny, especially overseas as antitrust, privacy and tax issues attract more attention. As experienced by IBM in the 1970s and Microsoft in the 1990s, such scrutiny can impede their ability to remain at the leading edge of innovation.

The Bond Market

After three rate increases in 2017, Fed Funds ended the year at 1.50%. The Fed anticipates three additional raises in 2018, dependent of course on the strength of the economy and inflation. The ten-year U.S. Treasury Note yielded 2.41% at year end, not much change during the year. The two-year Treasury, however, rose more in line with Fed Funds, rising from 1.2% to 1.9%. Actions by the Federal Reserve to gradually shrink its balance sheet have just begun. But for now, the world is awash in liquidity.

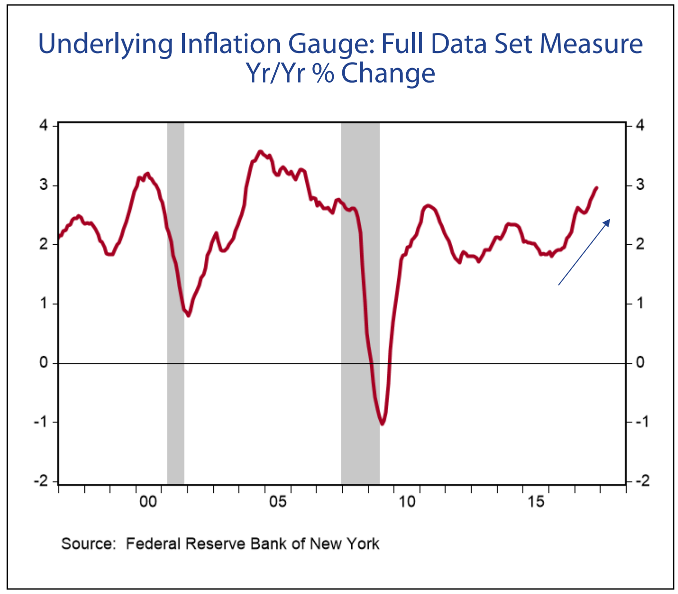

Chart 2

SOURCE: STRATEGAS RESEARCH PARTNERS
"ECONOMIC REPORT" — JANUARY 3, 2018

We are of the opinion that the 35-year trend of lower long-term interest rates ended in 2016 when the 10-year U.S. Treasury reached a 1.3% yield. While yields have increased a bit, both nominal and real yields remain historically very low. Looking back on 50 years of history, the nominal yield on the ten-year bond averaged 6.1% and core CPI inflation 3.7%, resulting in an average real yield of about 2.4%. At year end, core CPI was 1.7% resulting in a real yield of about 0.7%. There is considerable debate over the future direction of inflation. According to the Fed, core CPI inflation averaged 1.8% over the course of this recovery, and they expect it will remain at or below their two percent target in 2018. But is the core CPI index the best measure? A broader measure of inflation, the New York Fed's Underlying Inflation Gauge, encompasses consumer and producer prices, commodities and real and financial asset prices. This Gauge is now at an 11-year high, running a bit over 3% (CHART 2).

The world is now experiencing synchronized global growth, while the U.S. is entering its ninth year of economic expansion. Eight years after the worst recession since the great depression, the U.S. economy

Past performance does not guarantee future results.

is finally generating real GDP above its calculated "Potential GDP" (CHART 3). Historically when this occurs, inflationary pressures begin to build, but not always immediately. With unemployment at a 17-year low at 4.1%, workers' wages are beginning to rise. Overall, commodity prices are increasing. We believe inflationary pressures are building. Given historically low nominal and real interest rates, we expect both short and long-term rates will trend higher.

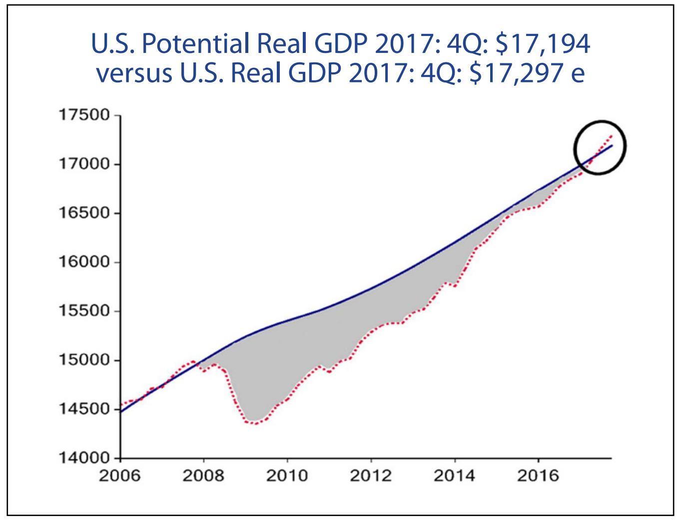

Chart 3

SOURCE: EVERCORE ISI
"AFTERNOON ECONOMIC REPORT" — DECEMBER 27, 2017

The Economy

The U.S. economy may be breaking out from a decade of below normal growth following the financial crisis of 2007-09. Misguided fiscal and regulatory policies likely extended the malaise longer than necessary. Real GDP growth modestly strengthened last year to 3% and we expect 3 to 4% growth in 2018. While it would be unusual for GDP to accelerate this far along in the business cycle, we believe there are a number of positive factors that will make it likely. Foreign economies are now growing and in most cases accelerating. China, Europe and Japan are surprising to the upside. The U.S. dollar dropped about 10% in 2017, providing a boost to U.S. competitiveness. Deregulation is lifting business optimism. Both consumer and business confidence are running high. Importantly, small business confidence recently moved to a record high. (CHART 4). Aided by the stock market and higher home prices, consumer net worth continues to power ahead, which is a reliable indicator for future GDP growth. Job openings are the highest since 2000. Eighteen states have raised the minimum wage but many corporations already pay more. While real wages in 2017 were up only 2.5%, we expect upward pressure to intensify.

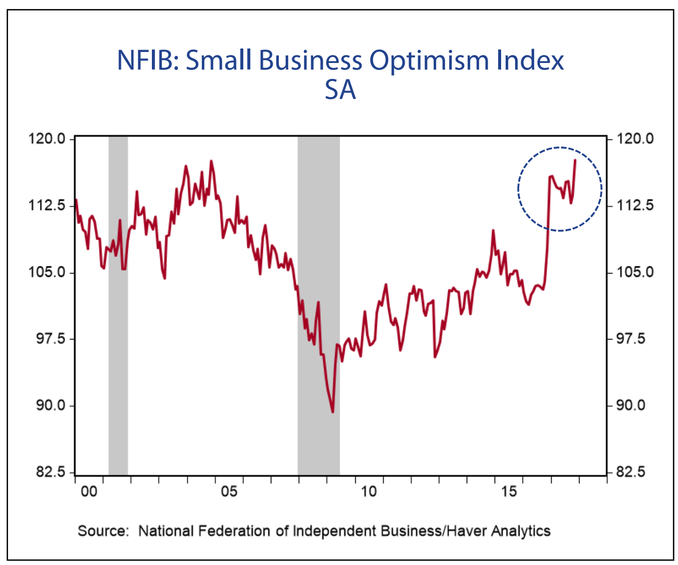

Chart 4

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS" — JANUARY 2, 2018

Net domestic capital investment in the U.S. has been flat for nearly a decade indicating potential pent up demand. Corporate profits were likely up about 9% in the fourth quarter and S&P 500 Index earnings could rise 10% or more in 2018. There has never been a recession in the U.S. while profits are rising.

Politics

Well, after many months of legislative frustrations and disappointments, there is finally something to cheer about on Capitol Hill. Tax cut legislation passed in December. The reduction of the corporate tax rate from 35% to 21% is expected to add over $100 billion to corporate earnings in 2018. The U.S. no longer has one of the most punitive tax regimes in the developed world. The popular media derides the legislation as a giveaway for corporations and the super-rich and not much help for the rest. With all the focus on the limiting of state and local tax deductions and the narrative around some tax cuts for individuals expiring in future years, they have created a negative belief that taxes will increase for most consumers. In reality, however, the tax cut for consumers and small businesses is substantially larger than the corporate cuts. It is estimated that the overall tax package will add 1% to real GDP in 2018 and perhaps more in 2019. The resulting higher consumer and business spending should also boost corporate earnings above and beyond the direct effect of the corporate tax cuts. The Joint Committee on Taxation estimates that roughly $775 billion of foreign earnings held overseas will be repatriated to the U.S. in 2018. This money, rather than sitting idle in foreign accounts, can now be used for investment, job creation, pay raises, acquisitions, share repurchases and dividends.

Although the S&P Index at year end was up nearly 300% from its 2009 low, it remains one of the least loved bull markets of all time, if judged by the net investments in U.S. equity mutual funds and exchange traded funds. 2017 marked the third consecutive year of net outflows. Even as the market hits record highs, its forward price earnings ratio (one measure of stock valuation) stood at 18x – not terribly out of line compared to its 25-year average of 16x. Its dividend yield was 2%, in line with the 25-year average. A note of caution: with yields on shorter-maturity U.S. Treasuries now also approaching 2%, the S&P 500 Index dividend yield may lose some of its luster for income-focused investors. When interest rates were held at essentially zero for many years, we referred to a concept called *TINA – There Is No Alternative* to stocks. Now, with short-term rates near dividend yields, there is a bit more competition between asset classes. That, combined with the stock market's record of nine consecutive positive return years, may make investors extra sensitive to any negative market developments.