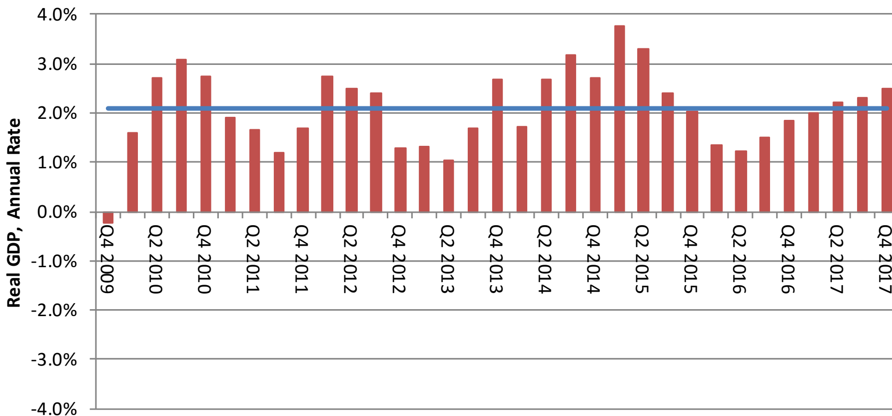
ASHDON
Investment Management

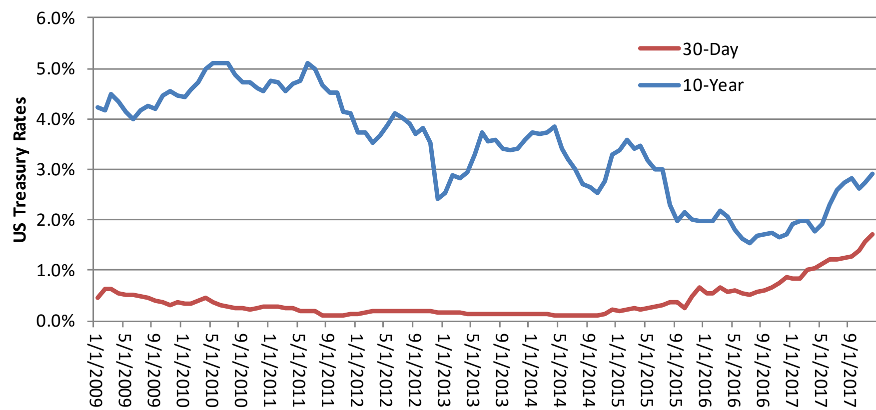
From beginning to end, 2017 was a remarkable year. While most of us are content to take the portfolio gains and look ahead expectantly to 2018, our duty to our clients requires us to ask "why" 2017 evolved the way it did and what does that tell us about expectations for 2018. In this letter, we'll take a look at those objective facts and test to see what is real and what is suspect. We'll follow that with a review of how we have responded in client portfolios. Looking ahead, we find that our economic fundamentals are largely improved, the quality of corporation balance sheets is high, and prospects for both are good.



A significant shift in the global economy occurred in 2016 and 2017 was the year in which it became widely accepted. The chart below shows GDP (annual, rolling real). Over the last several years we have continued to make the point that the growth of the US economy was stable, but confined to a moderate level, roughly 2% as indicated by the average (blue line). Most recently, economic growth has accelerated, beginning the second quarter of 2016. Subsequent growth has been good, but still well within the range that we would call "moderate".

There are other important data we use to understand what is happening in the economy. The chart below shows both short-term and long-term interest rates. Short-term rates began to increase in 2015 as the Federal Open Market Committee (FOMC – "the Fed") began the process of raising interest rates for the historically low levels put in place during the financial crisis. In spite of the increase in short-term rates, long-term rates (the 10-year rate, for example) continued to move lower. This signal (combined with other data) kept us cautions through the long rally. Declining long term rates supported the idea the real economic growth did not have traction and potential disinflationary forces were still at work and outweighing growth forces.

Global stocks were weak and volatile in the first quarter of 2016. Economic data and corporate earnings showed signs of rolling over. Our portfolio positioning and commentary reflected our concern for more pervasive weakness. Instead, the global economy picked up and began to grow again. We commented on the cause of this in our Second Quarter letter and are referencing that for two reasons. First, we now have the data that fully supports that turn. Second, we don't want investors to lose sight of the headwinds that are emerging as the economy evolves. The cause of both the recent turn in US (and Global) GDP and the turn in rates can be found in the growing momentum of price inflation. Beginning in 2015, prices around the globe began to increase. Earlier in the cycle, inflation was higher, but it was focused in energy and



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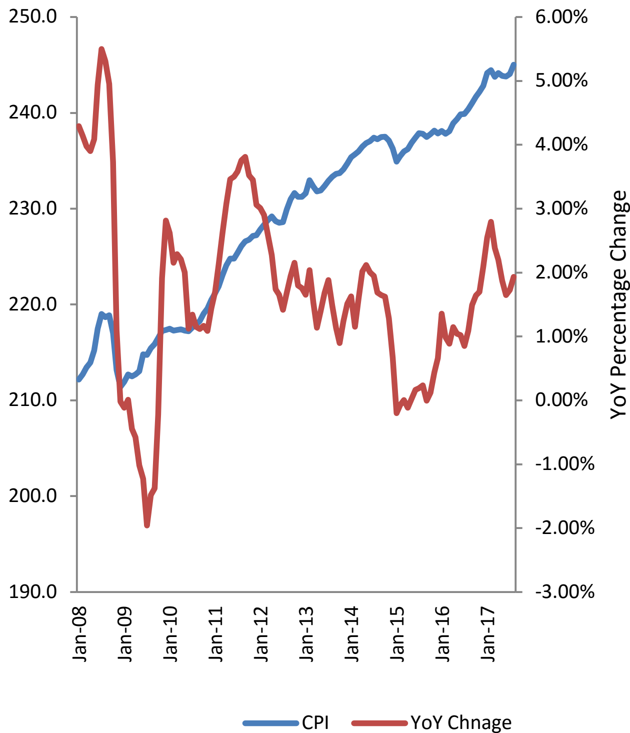
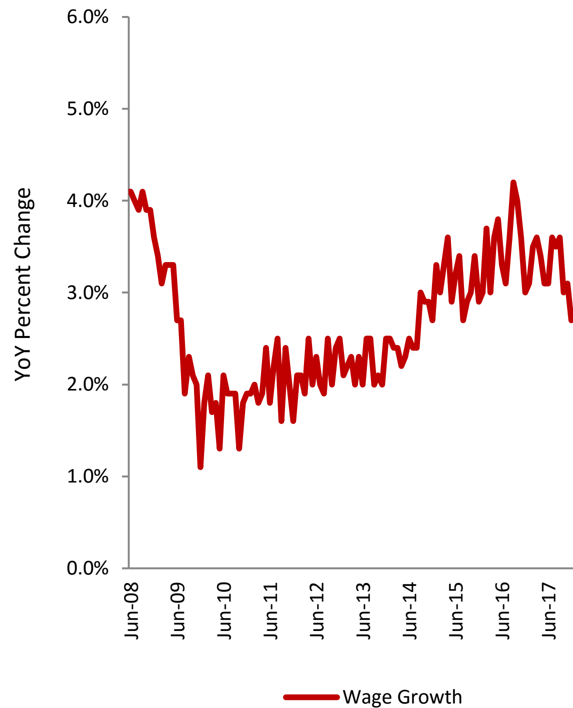


commodity sectors and reflected a rebound from near deflation in the wake of the financial crisis. Additionally, the inflation wasn't accompanied by broad wage growth. The recent price inflation is quite different. Prices are inflating across the economy, increasingly driven by wage increases. Also, the change in trend in bond yield confirms that this economic transition is distinct. I've used US data to illustrate the ideas. The global picture is similar with increasing growing GDP, rising inflation and (except for Japan) rising interest rates.

Stock and bond markets behaved accordingly. The US stock market advanced +22.6% through the year, including a +6.6% advance in the fourth quarter. International stocks were even stronger (in US Dollar terms), up +26.3% with a fourth quarter advance of +3.9%. Bonds lagged, up +4.7% for the year. Bonds were soft in the fourth quarter, up +0.4%. Portfolios allocated for growth participated nearly fully in the market rally. Our value bias did cause a lag as the highest returns in the market came from growth-oriented stocks. Our balanced portfolios also performed well as the bond allocation outperformed compared to the market. Finally, portfolios allocated for income lagged the broad market. Rising rates worked against price increases for dividend paying stocks as we had always expected. At the same time, the solid economy and strong corporate earnings means that quality dividend payers are very good assets. For income portfolios, price is a secondary consideration as long as the income is reliable. And if the income is reliable, price will follow in its time.



Moving forward, we expect to be focused on the progress of monetary policy, rates, and currencies. While the economic environment has improved notably, growth is modest even though central banks are still accommodative – the real yield on the 10-year note is less than 1%. It is good that the FOMC, ECB, PCOB and other central banks are slowly removing the support. But it must be done carefully.

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