The Cobblestone Advisor
Investment Brief

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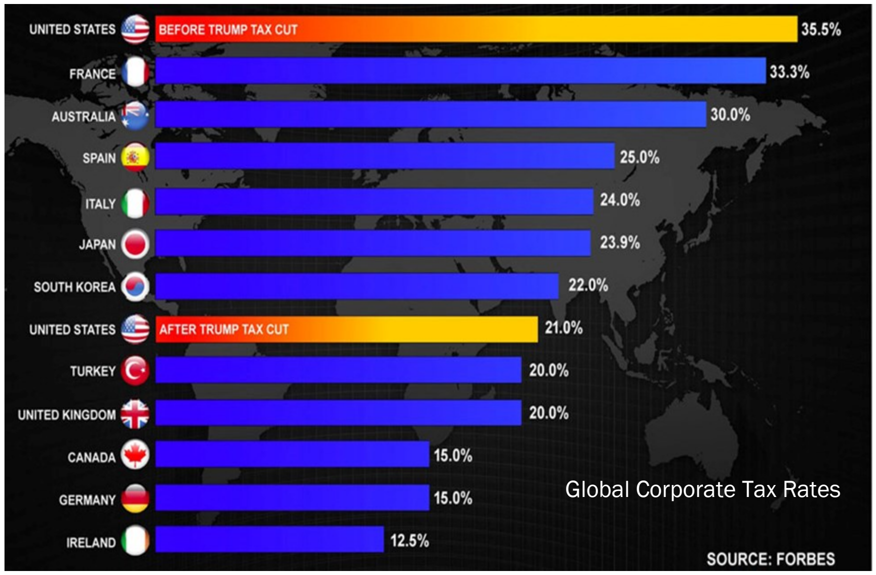
COBBLESTONE
CAPITAL ADVISORS

2017: A Historic Year



The global stock markets continued the positive momentum that has been in place since the 2016 U.S. presidential election and closed 2017 at all-time highs. U.S. markets finished up +21.1%. International markets performed even better, led by a 37.3% gain in the Emerging Market index. It is not unusual to have market returns of this magnitude. After all, the S&P 500 has been up at least 20% in a calendar year 30 times since 1938. Rather, what made 2017 a truly historic year was the lack of volatility and concentrated style leadership that accompanied the run-up.

December 2017 was the 14th consecutive positive month for U.S. markets, something that has never happened before. 2017 also saw the S&P 500 record the smallest ever calendar year peak-to-trough decline, at just more than 3%. Since then that index has gone over 300 days (and counting!) without a 3% correction, the longest stretch in history. Unsurprisingly given this backdrop, the CBOE VIX—a measure of implied future market volatility that is widely pointed to as a gauge of the amount of "fear" being priced into stocks—spent the bulk of 2017 hovering around all-time lows. There are more examples but, suffice it to say, it has been an incredibly smooth ride.

The divergence in performance between different styles of stocks was also unprecedented in 2017. Large-cap growth stocks outperformed small-cap value stocks by 22%, the largest positive difference between the two since index providers starting tracking style performance. For perspective, the next best three years for large cap growth stocks were 1998,

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Total Return Ending 12/31/2017				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	5.73%	23.97%	23.97%	9.27%	10.77%	4.63%
Russell 3000 Stock Index	6.34%	21.13%	21.13%	11.09%	15.53%	8.57%
S&P 500 Stock Index	6.64%	21.83%	21.83%	11.38%	15.74%	8.47%
Russell 2000 (Small Cap Stocks)	3.34%	14.65%	14.65%	9.93%	14.08%	8.68%
MSCI EAFE (International Stocks)	4.23%	25.03%	25.03%	7.77%	7.87%	1.93%
MSCI EMF (Emerging Markets)	7.44%	37.28%	37.28%	9.08%	4.34%	1.68%
Barclays US Aggregate Index	0.39%	3.54%	3.54%	2.23%	2.09%	3.99%
FTSE NAREIT All Equity REITs	2.48%	8.67%	8.67%	6.66%	9.80%	7.74%

CPI (through November 2017)	0.5%	2.2%	2.2%	1.3%	0.9%	0.6%

1999, and 2000, a period which corresponded with the final stages of the tech stock bubble. While we do not see the same speculative excesses building now, it is probably not prudent to completely ignore historic outliers like this.

A Bumpier Road Ahead?

So what lies ahead? We believe that we are at least 12 to 24 months away from the end of the current economic cycle that began after the 2008-2009 financial crisis. As the graphic on the previous page shows, the recently enacted tax reform package lowered the effective corporate tax rate on U.S. businesses to a level that is much more competitive with other developed countries. While the long-term impacts of this change are difficult to predict, it should help boost corporate spending in the near term. Given the low current unemployment rate of the U.S. economy, higher corporate spending is likely to lead to increases in both capital expenditures and wages for employees. These are two powerful drivers of economic growth.

However, there are signs that a variety of late cycle headwinds are starting to emerge. While overall financial conditions remain accommodative to growth, the dramatic flattening of the yield curve that began in the second half of 2017 certainly bears watching. We have also seen the disappearance of the U.S. economy's "output gap," which measures the difference between current economic growth and the estimated productive capacity of the economy. This suggests that future growth could be harder and more expensive to come by.

From a market perspective, we expect that a strong economy will continue to support the market in the coming year. However, the recent lack of volatility seems to be increasingly unsustainable, especially in light of recent spikes in investor sentiment and the above-referenced headwinds. So while we believe that 2018 could be another good year for the stock market, we expect that the road to higher returns will be bumpier than it was in 2017.

What's the deal with Bitcoin?

We have received a lot of questions about Bitcoin, which has become an increasingly popular topic as its price has risen in recent months. It is our opinion that Bitcoin is purely speculative and best avoided by anyone whose primary investment goal is the long-term creation and preservation of wealth. Bitcoin is the largest and most well-known of the 1,000+ cryptocurrencies being traded today. And there does appear to be significant promise in the decentralized transaction processing technology that underlies these cryptocurrencies, referred to as Blockchain. However, Bitcoin and Blockchain are not the same thing, so it is very difficult to see how the value of the Blockchain technology ultimately accrues to the owners of Bitcoin. Because these cryptocurrencies are created out of thin air, they have no fundamental value in the way that stocks, bonds, real estate or other productive assets have fundamental value. Perhaps someday Bitcoin, or one of its successors, will be widely accepted as a medium for exchange and stable enough in price to have value as a form of currency. But right now the only thing that gives Bitcoin any value is the hope that someone else will be willing to buy it from you for a greater price. And that's not a bet we are willing to make for our clients. So we remain comfortable watching this interesting story unfold from the sidelines.