Fourth Quarter 2017 Review and Outlook

"The individual investor should act consistently as an investor and not as a speculator." **- BENJAMIN GRAHAM**

The fourth quarter of 2017 was another positive one for U.S. equities and contributed to another very strong year for equity investors. The widely followed S & P 500 Index had a total return of 6.6% for the fourth quarter and a 21.8% total return for the full year 2017. While the U.S. markets often outperform world markets, the past year witnessed a synchronized worldwide economic expansion resulting in the MSCI EAFA (Europe, Australia and Far East) Index returning 25.0%. according to Bianco Research.

The recently concluded fourth quarter was the first full calendar quarter for MVP. Our three value strategies each outperformed their benchmarks. Our concentrated Value strategy had a total return of 7.0% for the quarter, outperforming the S & P 500 Index that returned 6.6%. The MVP International Value strategy had a total return of 5.6 % compared to the MSCI EAFA return of 4.2%. Lastly, the MVP Worldwide Dividend Income Equity strategy had a total return of 8.3 % compared to a 3.8 % return for DJ Global Select Dividend Index.

As in previous quarters, growth stocks continued to outperform value stocks although the differential was smaller than earlier in the year. During the quarter, the strongest sector performer was natural resources as OPEC maintained production cuts and crude advanced towards $60 a barrel for the first time since 2015. The technology sector was the second best performing sector while telecom and real estate were underperformers as the Federal Reserve gradually raised short term interest rates.

As we evaluate the strong market performance of 2017, it is apparent the advance was supported by global economic growth, declining regulatory pressures within the U.S. and higher corporate earnings. In addition, as year-end approached, the markets were further encouraged by the tax reform bill that was passed by Congress and signed into law on December 22. The tax bill, reducing corporate rates from 35% to 21%, is most important for domestically focused companies that have not been able to shelter income in overseas entities. This boost to corporate earnings is estimated to increase S & P 500 earnings by $8 to $10 per share in 2018.

Needless to say, this increase in earnings serves to support the rising stock market and makes valuation levels more reasonable. Importantly, as corporations repatriate foreign earnings back to the United States, this may have the salutatory effect of increasing domestic capital spending to improve productivity as well as funding various capital intensive growth strategies. Lastly, with the tax bill successfully concluded, there is renewed optimism that a much needed infrastructure program may be addressed in the New Year.

Importantly, the U.S. economy slowly gathered momentum during 2017 with GDP growing better than 3.0% in the third quarter and very likely maintaining that pace in the fourth quarter as Christmas sales were stronger than expected. It is noteworthy that several major retailers including Kohl's, Penney, Macy's and Target had relatively solid sales figures which came as a surprise to those who thought that Amazon was an unstoppable juggernaut. The year closed with the official unemployment rate at a 17-year low of 4.1%. With the economic strength, the Federal Reserve raised short term interest rates three times in 2017 and appears on track to raise rates two or three more times in 2018 subject, of course, to fresh economic data.

One other characteristic of the 2017 equity market was the lack of volatility evident throughout the year. The VIX, often referred to as the *fear gauge*, has hovered near all-time lows for much of the year and certainly supports the view that investors have become complacent. The very fact that the broad market averages have not seen even a 3% correction for almost 400 trading days is absolutely remarkable. With investor confidence near all-time highs, the feeling of well-being is bordering on excess.

While investors have welcomed the encouraging economic and market news, their enthusiasm is already approaching euphoria in certain assets. While signs of excess are not widespread, the thirst for corporate debt in a zero interest rate environment was demonstrated by Societe Generale's selling Euro 500 million 3-year senior unsecured zero-coupon bonds of Veolia, a former water and wastewater treatment provider turned global entertainment wannabe, (rated BBB) at a yield -0.026% (Yes, buyers paid the company for the privilege of loaning the firm money for three years). In another sign of inflated asset prices, a recent auction of Leonardo de Vinci's *Salvator Mundi* (of questionable authenticity) was sold by Christie's for $450 million, having previously sold in 2013 for $127.5 million. As if those facts aren't amazing enough, the very same painting sold in 2005 for $10,000 and in 1958 sold for an incredible $126. And, lastly, another sign of speculative excess is the meteoric rise of Bitcoin during 2017. In early January, 2017 Bitcoin sold for $755 but surged in volatile trading to almost $17,900 by mid-December before plunging by more than one-third in 24-hours and finally closing the year at $14,155. During the year, Bitcoin advanced a rather startling 1,330% making the cryptocurrency the talk of the town. However, a look at the parabolic price history of Bitcoin suggests a classic bubble.

What both Bitcoin and the price of fine art do is demonstrate beyond any reasonable doubt the absurdity of suggesting there is no inflation in this economy. Inflation of the asset price variety has been rampant for those lucky enough to benefit from the central bank's monetary spigot which, over eight years, has flooded the system with many trillions of dollars of fuel. Unfortunately, those further down the financial food chain have not been so fortunate.

Outlook for 2018 As we look at the prospects for the year ahead, we are reminded of a term most frequently associated with physics…….*inertia*. In physics, inertia states that a body in motion tends to remain in motion and a body at rest tends to remain at rest. So it is with the U.S. economic expansion and the synchronized global expansion currently underway. There is renewed optimism that economic growth will maintain its current momentum of 3.0% growth along with a continuation of corporate profit growth nicely enhanced by the recently enacted tax cut. These critical elements provide much needed support for current stock market levels even though there is little reason to believe that the markets will perform anywhere close to the sterling performance of 2017. Most pundits feel the total return for equity market averages in 2018 will be in the 8 to 10% range.

Having given that encouraging outlook, consideration must be given to what could go wrong to derail this favorable outlook. As always, there are the usual geo-political risks (North Korea, Iran and the Middle East) that could upend the market along with the ever-present possibility of a black swan event. On more mundane matters, there is the changing of the guard at the Federal Reserve with Janet Yellen stepping down as Chair and Jerome Powell assuming the chairmanship role. With this change in leadership, it is always possible that the newly constituted Fed could shift gears by raising short-term interest rates faster than currently envisioned. Raising rates may not be a problem if the action is in response to stronger growth but it could be a problem if rates are raised to counter a resurgence of inflation. In addition, rising interest rates could make fixed income assets more attractive and take away some of the appeal of equities. Lastly, rising rates makes it extremely unlikely that there will be any expansion of the price/earnings ratio meaning that any market advance will be totally dependent on the growth of corporate earnings.

Furthermore, the Federal Reserve has begun to shrink its four trillion dollar balance sheet at the same time that other central banks around the world are taking a less expansive role than in the immediate past. It is important to point out that capital assets have benefited handsomely from the quantitative easing that has been pursued for the last eight years. However, it has been estimated that about $1 trillion in excess liquidity will be drained from the system in 2018, the effects of which are unknown. Lastly, there is the ever-present concern over a meaningful slowdown in China and the possible worldwide impact such an event would have on the capital markets.

In conclusion, the generally favorable outlook for equities in 2018 comes with the usual caveats. The equity markets, in general, are fully value if not overvalued. At MVP, we are disciplined value managers focused on balance sheet analysis and always taking the long term view of any investment opportunities. We continue to find attractive companies using our time-tested process and are optimistic that we will continue to produce favorable results for our valued clients.

Stephen Kent, Jr.

Stephen K. Kent, Jr., CFA
Chief Investment Officer

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