The Colony Group

MARKET PERSPECTIVES

QUARTER FOUR 2017

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During the nearly 150 years of Major League Baseball history, there have been 23 official perfect games, achieved when a pitcher (or pitchers) prevents the opposing team from having any player reach base. In 2017, the U.S. equity market achieved its own version of a perfect game, with the S&P 500 posting positive returns each and every month of the calendar year for the first time in history. Driven by synchronized global growth, which saw all 35 countries that are members of the Organization for Economic Cooperation and Development (OECD) showing positive GDP growth for the first time since 2007, most equity markets around the world reported strong returns. International markets generally outperformed the U.S., led by emerging markets, which returned 37.3% as measured by the MSCI Emerging Market Index.

2017 will be remembered not only for its robust returns but also for the relatively low level of volatility across most asset classes. Notably, the S&P 500 experienced no daily moves, up or down, of more than 2% and only eight moves of more than 1%. Many market observers have expressed concern that this was an indication of investor complacency. While we share this concern, we would note that the inherent volatility of many fundamental factors, such as economic and corporate earnings, was extraordinarily low as well.

One source of concern at the start of 2017, tighter monetary policy, proved to be a red herring. The Federal Reserve followed through on its guidance for three interest-rate hikes, after failing to deliver on its promises during the preceding couple of years. Nevertheless, yields on longer-term U.S. Treasury bonds remained stubbornly low, with the 10-year Treasury note closing the year with a yield of 2.41%, just below the 2.45% yield at the start of the year. Accommodative monetary policy outside the U.S., particularly in Europe and Japan, which continued their own versions of quantitative easing, depressed yields globally. As a result, returns from fixed income largely exceeded expectations, with corporate bonds also aided by tighter credit spreads.

Any 2017 market discussion would be incomplete without mentioning Bitcoin. We focus on Bitcoin and an under-the-radar risk we see for 2018 over the remainder of this letter.

Bitcoin

Bitcoin was the best performing investment in 2017 by a wide margin, gaining about 1,375%. Its blistering performance has piqued the interest of investors who are wondering what the so-called cryptocurrency might do for an encore in 2018. We are increasingly concerned that many Bitcoin investors may not understand what they are buying.

Bitcoin is the largest of a new breed of "digital currencies." There are currently just under 17 million Bitcoins in circulation, with a total market value of about $250 billion, comprising about 40% of the total market valuation of all cryptocurrencies combined. These cryptocurrencies are largely built upon blockchain technology, a verifiable distributed electronic ledger the practical applications of which extend well beyond cryptocurrencies. Its founders designed Bitcoin so that no more than 21 million coins can be "mined" in total. Mining is performed digitally by powerful computers that are required to solve complex algorithms to unlock each coin.

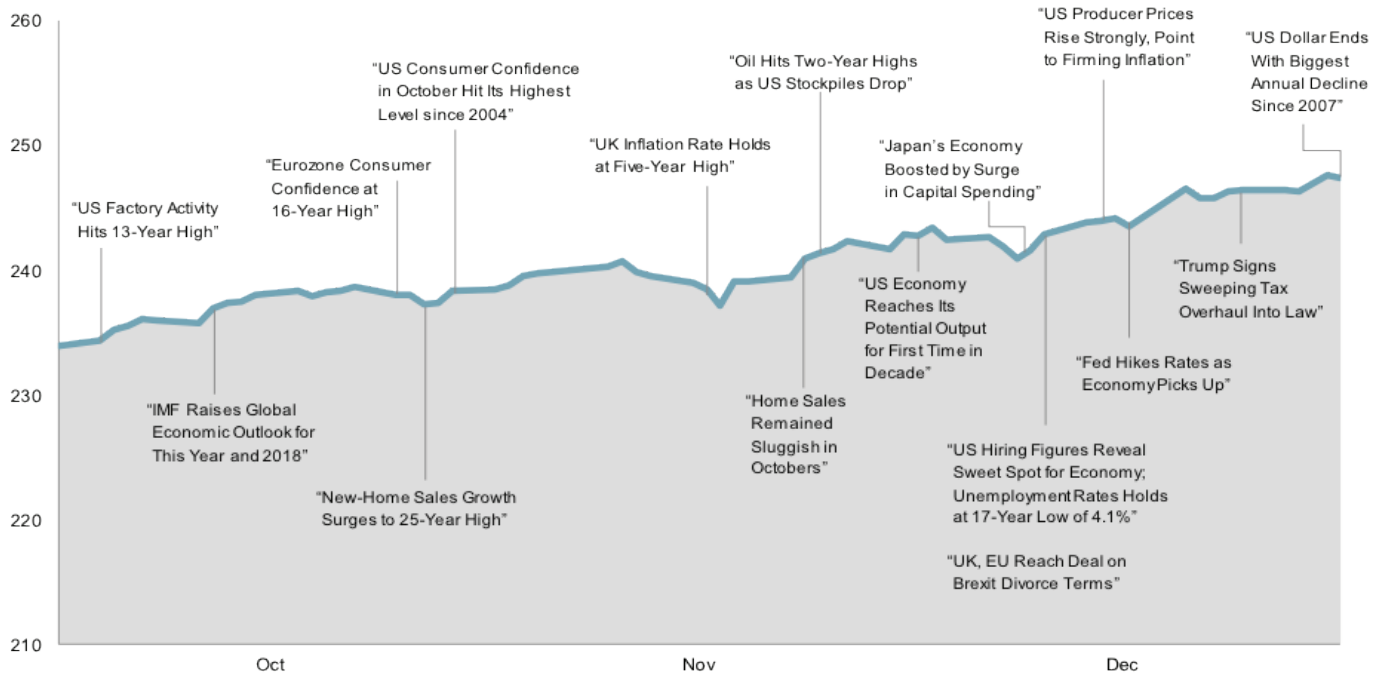
So what is Bitcoin? Most Bitcoin supporters argue it is a form of currency that is unencumbered by central bank policy makers. To qualify as a currency, however, it must meet two requirements: it has to be accepted as a medium of exchange, and it must serve as a store of value. We would argue that, currently, both requirements remain in question.

Bitcoin has made progress in its use as a medium of exchange. Unfortunately, it has gained the most traction as a facilitator of illicit transactions, primarily because the blockchain ledger is unregulated, anonymous, and irreversible. Nevertheless, Bitcoin has also gained some commercial acceptance. According to CNBC, over 100,000 merchants worldwide accept Bitcoin, including Microsoft and Expedia. While that may seem like a big number, it represents only a tiny percentage of the total number of merchants.

This brings us to our next requirement—its role as a store of value. Bitcoin started the year at $970 and rose to more than $20,000 in December, a gain of about 2,000%, before closing the year at $14,292, according to CoinDesk. During this period, Bitcoin experienced five drawdowns of more than 30%, including a decline of 45% in December. Most investors do not consider this kind of volatility to be representative of an effective store of value. Furthermore, these wild price swings limit its effectiveness as a medium of exchange. We believe that this volatility indicates that Bitcoin currently is more like an object of speculation.

Another comparison people often make with Bitcoin is to gold. Gold is the preeminent store of value, a title it has earned over thousands of years of human civilization. It has held its value through recessions, depressions, inflation, deflation, war, and peace. To say that

MSCI ALL COUNTRY WORLD INDEX FOR Q4 2017



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: Dimensional Fund Advisors. MSCIACWI Index [net div.]. MSCI data © MSCI 2018, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

Bitcoin, which is only eight years old, has not been tested the way that gold has is an understatement. It does share some similar characteristics, however. Neither gold nor Bitcoin generates income or produces cash flow, and, therefore, they are difficult if not impossible to value. Also, both are supply constrained. Lastly, neither is generally acceptable for broad use in daily commerce.

WHAT THIS MEANS

The future of Bitcoin is still to be determined. As of now, it still feels more like a medium for speculation. Some categorize it as a currency or precious metal, but we cannot recall a period in history where currencies or precious metals experienced the type of volatility that Bitcoin has in 2017.

At the risk of sounding too harsh, we are concerned that present-day speculators in Bitcoin are acting in accordance with the concept of "survivor investing," under which price is determined not by intrinsic value but instead by the expectations of other market participants. Survivor investing allows a buyer to rationalize a purchase today under the belief that another party will be willing to pay an even higher price in the future.

Regulators will have the ultimate say on Bitcoin's future. Governments have increased their scrutiny of cryptocurrencies. In China, regulators have banned cryptocurrency exchanges to curb speculation. Also, in 2014, the IRS ruled that Bitcoin should be taxed as property rather than as currency, which Fortune Magazine called "a potential barrier to wider adoption." Policymakers are concerned about the use of cryptocurrencies in illicit transactions and their susceptibility to cybertheft. More importantly, central banks are reluctant to relinquish control over the supply of money and their ability to restrict cross-border transactions. Some believe that central banks will eventually launch their own competing cryptocurrencies to help mitigate many of these concerns.

Bitcoin faces an uncertain future. We recommend that clients who wish to purchase Bitcoin do so with the understanding that it remains a speculative investment. Importantly, they should be prepared for the possibility of significant loss and, therefore, limit the amount they invest.

The Forgotten Risk

As usual, investors have identified plenty of risks to worry about as we start 2018. Near the top of most of their lists are escalating tensions between the U.S. and North Korea, high levels of political partisanship, extended equity market valuations, and a Federal Reserve intent on removing stimulus. One seemingly forgotten risk may come in the form of accelerating inflation.

We have written in the past about how inflation has been largely dormant since the financial crisis ended, as global economies slowly recovered from the deepest recession since the Great Depression. One reason for the low level of inflation is that it has taken longer than usual for the global economy to soak up excess capacity that was put in place before the contraction. Additionally, the globalization of the labor force and weakened unions have kept wages in check. Moreover, the labor force participation rate has remained low throughout the recovery as baby boomers retire and leave the workforce. Finally, advances in technology, notably the rise of e-commerce, have kept consumer prices low.

As a result, policymakers have kept interest rates low in an effort to fend off deflation. This has had the effect of driving up the value of select financial assets rather than boosting wages or the price of goods and services.

With 2018 global economic growth expected to reach the fastest pace since 2011, the chances that inflation picks up are rising. Indeed, U.S. economic growth has been running at a greater than 3% growth rate for the past two quarters and is expected to reach this milestone again when the fourth quarter 2017 figure is reported.

Moreover, the tax reform plan signed into law in December could spur business investment and employment, engendering stronger than expected growth. We are already seeing signs of faster wage growth. In 2017, wages rose more than 2.5%, the fastest pace since the end of the recession. Finally, President Trump's approach to trade could cause prices to rise as new tariffs and duties drive higher import prices.

WHAT THIS MEANS

Rising inflation could impact financial markets in several ways. First, it could prod the Federal Reserve and other central banks to raise interest rates more aggressively than is currently anticipated. By increasing the cost of borrowing, rising rates might slow growth. Also, inflation could negatively impact companies' profit margins, a measure of how much profit is generated for each dollar of sales. The biggest expense for most corporations is labor, and rising wages would likely put downward pressure on margins, which have expanded to record-high levels over the past several years. Lower margins mean lower earnings for shareholders. Another concern for investors is the impact that rising interest rates may have on equity valuations. Pundits often point to the low level of interest rates as a justification for high valuations, as higher yields provide investors with more alternatives to generate the returns they require.

Our base case is that inflation rises gradually and that its impact on financial markets is modest. Nevertheless, strong economic momentum experienced over the past several months could cause an unwanted inflation surprise.

Conclusion

2017 was a strong year for most investors. While it is unlikely that 2018 will be as good, we do not yet see too many worrying signs for risk assets. Certainly, the moves seen in Bitcoin and other cryptocurrencies may be a sign that investor enthusiasm is too high. The fundamentals support at least some amount of optimism, however, as earnings and economic growth stay strong and monetary and fiscal policy remain supportive of investment returns for the time being. We will be watching closely when or if the Federal Reserve and other central banks shift from accommodative to restrictive monetary policy, as this poses a risk to markets later in the year.

COLONY SPOTLIGHT

Invest in Others

The Colony Group's Boston and Hingham teams participated in Invest in Others to spread holiday cheer and help families in need.

Scratchworks

Colony's Michael Nathanson and the leaders of four other wealth management firms are empowering FinTech companies to accelerate the development of innovative financial services technologies. The group created the Scratchworks competition as a venue for FinTech firms to present their ideas. Out of many submissions, three Scratchworks finalists will present their ideas at the Barron's Summit in March. The finalists are competing for potential funding in order to bring their ideas to market.

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