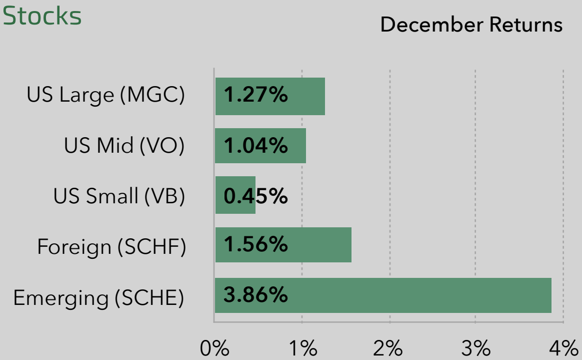
December 2017

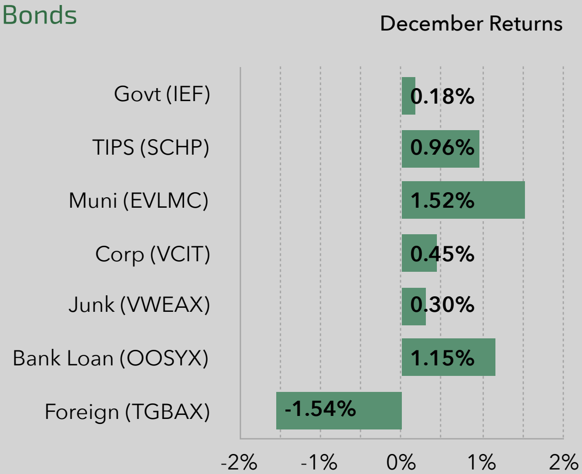
Economic Data

- A lower-than-expected 148,000 jobs were added in December, and wage growth and the unemployment rate stood pat at 2.5% and 4.1%, respectively
- Existing home sales had their strongest read of the recovery, up 5.6% in November to a 5.81 million pace
- Gasoline prices drove year-over-year inflation (CPI) up a further two-tenths to 2.2% in November, but the core rate edged down one-tenth to 1.7%
- Retail sales surged 0.8% in November on strong holiday spending

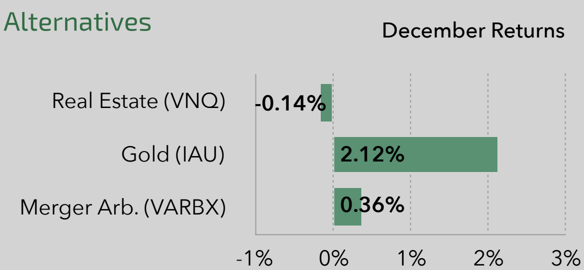
Stocks



Bonds



Alternatives



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system – type 2 – that we want in control of our investment portfolios.

2017 in Review

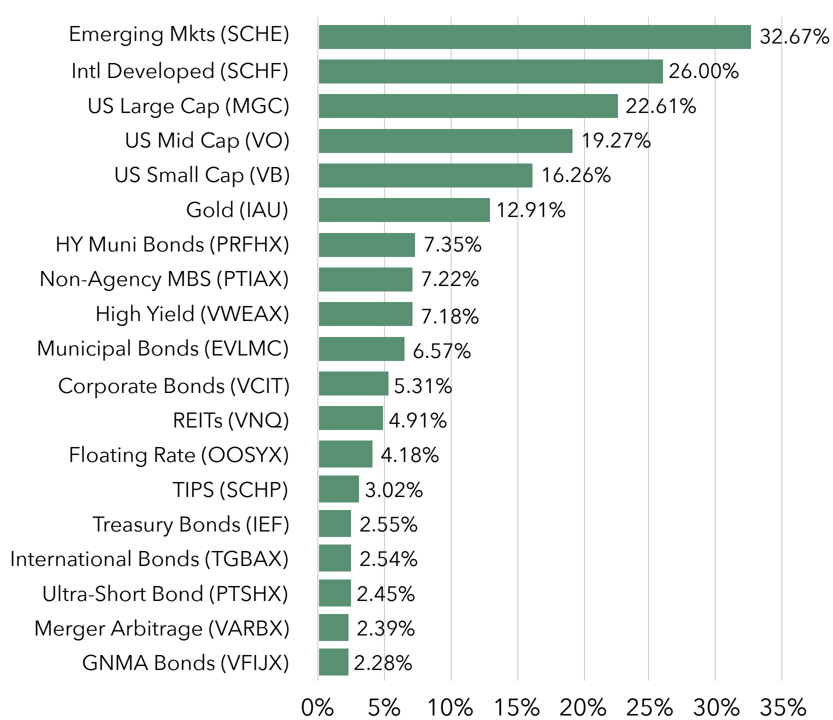
Expectations for corporate tax reform fueled another banner year for stocks, with the S&P 500 up 21.83%. But it wasn't just stocks that were up, as the 'everything bubble' continued expanding almost unabated.

Our underweight to stocks since before the election has been a drag, but our allocations within equities were spot on. We favored emerging markets after the initial post-section scare passed, which paid off as they topped the charts in 2017 with a 32.67% return. Meanwhile, we moved to an extreme underweight in small cap stocks after they rallied strongly in the aftermath of Trump's victory. Small caps brought up the rear for equities for the year, climbing "only" 16.26%.

Our expectation for rising rates and corresponding underweight to bonds had a somewhat negligible effect, as the Barclays US Aggregate Bond Index returned a middling 3.54%. Municipal bonds and corporate debt had good years, while treasury bonds clocked in at the low single-digits. Positioning within the bond portfolio leaned more towards lower-risk holdings, but it was the swan song of riskier bonds that continued to play.

Our overweight to alternatives was somewhat of a mixed bag. Merger arbitrage was hit by the DOJ challenge of the AT&T/Time Warner deal, but still did what it was supposed to, delivering low-single-digit returns. Gold, which was also overweight, had a solid year returning 12.91% in the face of rising rates. The underweight to real estate was the right call as REITs disappointed, up only 4.91%. Tax reform was a benefit to REITs on a standalone basis, but the change in corporate tax codes reduces the relative advantage of the REIT structure over that of the traditional C corp.

2017 Investment Vehicle Performance



2017 Predictions Postmortem

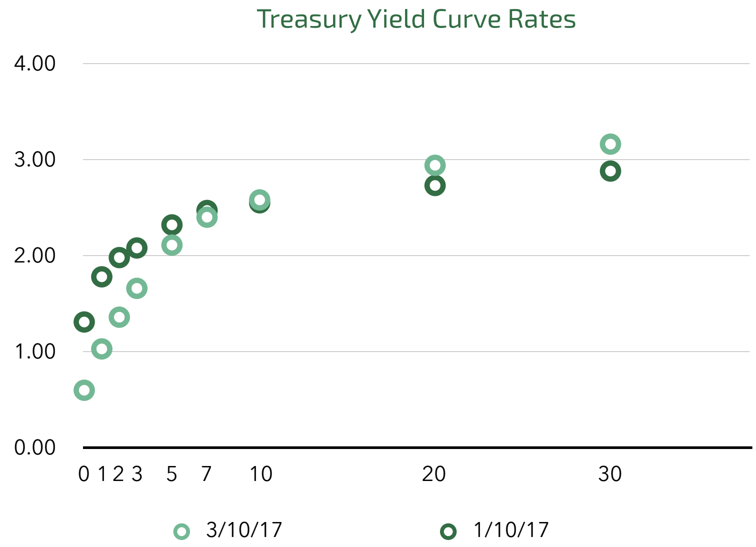
Despite knowing full well humans are bad at predicting the future, like most others I engage in this futile exercise frequently. Most predictions are soon forgotten after they are made, and only remembered later if the original prognosticator obnoxiously reminds you of them. For some reason people aren't so quick to bring up the predictions they get wrong, but I will, as I think it is a worthwhile exercise and helps keep overconfidence in check.

As I do, let's keep in mind psychologist Phillip Fetlock's list of the five most common excuses forecasters use when their predictions don't pan out:

1. **The "if only" defense:** "The strong dollar is going to hurt profits for large, exporting companies." I mean, it probably would have. But this call sort of implied the dollar would remain strong. A 9.7% in the USD index for the year would argue otherwise.
2. **The "ceteris paribus" defense:** something outside of the model of analysis occurred, so it's not my fault. Like when a series of devastating hurricanes damaged 1 million cars in September, ruining my April 11 call that December 2016 would prove to be the peak of U.S. auto sales.
3. **The 'I was almost right' defense:** like when I predicted inflation would get close to 3% in February. It hit 2.74%. Is that close to 3%? If not, it's certainly close to being close to 3%.
4. **The "it just hasn't happened yet" defense:** like when I predicted that Sears would shutter all of its doors and sell off its properties. They closed over 350 stores in 2017 and already put 63 on the chopping block for early this year. But that's not all of them. Not yet, anyway!
5. **The "single prediction" defense:** just because I was (thankfully) wrong about Marine Le Pen winning the French election, doesn't mean I will be wrong about everything else!

With that painful exercise out of the way, it's time to gloat about what I got right:

- Way back in July 2015 I wrote about Venezuela's economic crisis, closing with "the government has about $5 billion in debt payments due in October, so don't be surprised if we see another sovereign default then." We did in fact see Venezuela default in October. Never mind that it was in 2017.
- I cautioned at the beginning of 2017 that tax reform wasn't likely to look as sweet as Trump's promise of a 15% corporate rate, and in fact 21% ended up being the number they passed.
- "The jump in interest rates should pull the share-buyback rug out from under the market, as companies will no longer be able to finance the purchase of their own stock at ridiculously low rates." The most recently available data shows a 14.4% drop in S&P 500 buybacks over the previous 12-month period.
- I predicted that all forecasts from top strategists for the year-end price of the S&P 500, which were in a tight 2300 - 2500 range at the beginning of 2017, would be wrong. I was right, as the index ended the year at 2,674. Point for me. Unfortunately I picked 2,200 as my price target. Point lost. But, was also "almost 100% confident" I *would be wrong*, so… I win, I guess?
- Analysts were estimating a 44% y/y increase in S&P 500 earnings from 3Q16, whereas I called those expectations "pure fantasy" and pegged the number at a much lower 18%. Earnings grew by 20% over the period.
- On March 13 I lambasted SNAP's $25 billion valuation, which made it worth more than more venerable companies like Hershey (HSY), Royal Caribbean (RCL), American Airlines (AAL), Hilton (HLT), and Yum Brands (YUM). SNAP has since fallen 30% to a market cap of only $17.5 billion, and is still overvalued in my opinion. Meanwhile, those aforementioned five other stocks were all up and some semblance of order in the universe has been restored.
- In the same newsletter I said, "our expectation is for the curve to flatten out, because that's what yield curves do at the end of the growth phase of the business cycle. If we're right, most of the increases in interest rates will be felt on the shorter end of the curve, and we may actually see some of the intermediate and longer-term yields drop a little." See chart below:



2018: the End of the 'Everything Bubble'?

Now the fun part. Undeterred by a flawed record, I will proceed to make bold predictions about the year ahead:

- One of my favorite predictions for the year was going to be that we'd see the first bitcoin kidnapping. I mean, what a perfect crime! Kidnap a Winklevoss twin – I don't care which one – put a gun to his weirdly-shaped head, and say "your bitcoin or your life!" They transfer the bitcoin to your anonymous wallet, and you go about your merry way. This actually happened before I could write this, though! Pavel Lerner, who runs a UK-registered cryptocurrency exchange, was kidnapped on December 26 in Kiev and released after he payed a ransom of over $1 million in bitcoin. The lesson is: if

Binge Box

The Good Place (Hulu)

The delightful Kristen Bell stars alongside the venerable Ted Danson in this NBC comedy that is in the middle of its second season. The story follows Eleanor (Kristen Bell), who dies in the first episode and, by way of a clerical error, ends up in the "Good Place" in the afterlife. She is welcomed to this fro-yo filled utopia by Michael (Danson), who is the architect of their community and runs things. And I really don't want to say anything more about the story than that.

What I will say is it is funny, enjoyable, and definitely binge worthy. And I really can't imagine a more entertaining way to explore moral philosophy and ethics.

you have a bunch of bitcoin, don't tell anyone about it! Looking at you, Novogratz!

- Bitcoin will crash. So will Ripple. And Ethereum, and Litecoin, and Dogecoin, and KodakCoin, and every other stupid crypto token out there. It might take years, but the eventual value of each is much closer to zero. How they get there is of no concern to me.
- Unfilled Tesla Model 3 pre-orders will be cancelled en masse later this year after the company hits its 200,000 car limit for the $7,500 federal tax credit. TSLA shares get trounced.
- The economy will continue to grow for at least the next 12 months, as there is no indication of an impending recession.
- However, combined stimulus from the FED and ECB will turn net negative in the second half of the year, triggering the end of the everything bubble.
- S&P 500 earnings will get a one-time bump of roughly 10% in 2018 from the corporate tax reform, but growth will normalize beyond that. Analysts are estimating S&P 500 earnings growth of 23.5% over the next four reporting quarters (3Q y/y). I think the number will be closer to 14.5%.
- Now for the obligatory "guess the S&P 500 price by the end of the year" game. The average year-end estimate from strategists surveyed by Bloomberg is just below 2900. If I take my 14.5% earnings growth and apply a 20.7x trailing P/E multiple (right in between the historical average of 15.7 and the current 25.7), I get 2538. That's an 8% decline! But don't worry too much; these estimates are always wrong.

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Cash				●	
Fixed Income		●			
Core Domestic		●			
TIPS				●	
US High Yield	●				
Bank Loans				●	
Foreign Bonds			●		
Equities		●			
Large Cap		●			
Mid Cap		●			
Small Cap	●				
Developed Intl.		●			
Emerging			●		
Alternatives				●	
Real Estate		●			
Commodities					●
Hedging					●

Ryan P. Layton, CFA
p: 612-810-2230
e: ryan@emeraldspark.com

About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select individuals. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.

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