CARMICHAEL CAPITAL INC.

CLAUDE R. CARMICHAEL CFA, PRESIDENT
339 MAIN STREET, 2ND FLOOR, FRANKLIN, TN 37064
(615) 595-5800 – NYC (212) 580-5200 – FAX (615) 595-5825
claude@carmichaelcapital.net

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2017 Year End Review
"The Calm Before the Storm"

Stocks had a good year with the S&P 500 Index advancing 19% and the small-company Russel 2000 Index gaining a less robust 13%. Even as interest rates began to climb, bonds held up in price with the Barclay's Long Term Treasury ETF gaining 6%. Bitcoin went parabolic and grabbed headlines around the world. The combination of reduced regulation and lower taxes gave a boost to stocks as the year ended. The rise of asset prices appeared to be unrelenting even as valuations became extreme by many if not most measures. The unrelenting nature of the rise was best exemplified by the tidbit that the statisticians tell us about the market putting together the longest string of advances in market history without so much as a 3% pull-back. The average investor may not appreciate just how rare this smooth ride higher has been. We should also not count on the market to continue being so well-behaved.

We always keep an eye out for signs of excesses, either optimistic or pessimistic. The recent parabolic rise of Bitcoin was just such a red flag that speculation might be getting out of hand. The even more recent collapse in Bitcoin may be a sign that the fever of speculation might be breaking. It is very possible that the block-chain technology on which Bitcoin and other crypto-currencies are based will have a meaningful impact on security and commerce as applications develop. It is also very possible that Bitcoin may not succeed on the long-term as an alternative currency. The risk in these situations is not just that some speculative investors will lose money when the bubble bursts, but that extreme market moves like those can imperil some financial institutions and cause a cascading effect that more seasoned investors have seen several times before. The dramatic market sell-offs after the Long-Term Capital Management crisis of 1998, the bursting of the Internet bubble in 2000, and the bankruptcy of Lehman Brothers in 2008 are good examples of the ripple effect that we need to be aware of. A problem in one market can cause problems in others as well.

All investors need to be aware of interest rates and how they affect the value of all asset classes. As short term interest rates neared zero after the financial crisis, we actively avoided long-term bonds because of the lower income accrued and the higher potential losses from rates rising from historically low levels. Recently, short term interest rates have risen dramatically with the US 2-year note yield going from ¼% to over 2% since 2014. At this level, the yield of the 2-year US Treasury note is higher than the dividend yield on the S&P 500. Not only do rising rates push down the prices and value of bonds, but at some point, this rising "risk-free rate" may provide a headwind for further stock market advances.

Recent changes in the tax law were followed by a drop in the value of the US dollar. This may be due to the fear that fiscal restraint has been abandoned by the majority party in Congress, and that the value of the currency will be debased by excessive government spending and increasing budgetary deficits. If the weakness of the dollar continues it could usher in an era of higher inflation. In anticipation of an increase in inflation, we maintain small investments in precious metals market as a beneficiary of higher inflation. If a lack of fiscal restraint causes further devaluation of the dollar, inflation may return and push metals prices higher, producing gains that may offset weaknesses elsewhere.

One more legislative boon to the market may be an infrastructure bill. A necessary precursor may be the return of "pork." We all know that the Congress is deeply divided, but that they all want to brag about getting some legislation passed that would include infrastructure improvements. The Republicans are in a hurry in case a backlash in September should cost them the control of the House, the Senate, or both. "Earmarks" (special unrelated addenda to bills) were voted out of existence many years ago, but recent legislation has sought to bring them back in order to garner votes in a deeply divided legislature. Consequently, it would not be surprising to see a piece of legislation that is both sweeping in scope (legislation plus immigration plus ….) and that contains enough "pork" to gain enough Democrats' votes for passage. The bill would have to be sweeping enough to let everyone claim a partial victory. If this happens, it could boost the stocks of companies that would directly benefit from the increased spending on infrastructure, and perhaps boost the market in general. Beyond that possibility, it may be time to see if corporate profits will rise to meet the heightened expectations (and stock prices) accompanying a stronger economy and lowered tax rates.

Feel free to call and discuss your portfolio and your level of investment in the stock market at your convenience. Any level of participation less than 100% feels like too little on the way up, and any exposure at all may feel like too much on the way down. I want to make sure that your portfolio investments align with your long-term goals and your tolerance for volatility in what may become an increasingly volatile market.

Enclosed you will find your statements and reports for 2017, including your capital gains reports. As a reminder, you should rely on your Schwab form 1099 when filing your taxes unless the information is missing on their form and is provided on ours.

Please review these reports and statements at your convenience and contact me with any questions or suggestions you might have.

It has been a pleasure helping you with your investments and we hope to continue to provide value to you in the coming year.

Sincerely,

Claude Carmichael CFA