BEDELL FRAZIER
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2018 OUTLOOK - MEAN REVERSION

What Went Up Will Come Down, Then Go Up Again... 2017 was a record year for the US Stock Market. In fact, there were 66 new record highs for the S&P 500 last year. The S&P actually recorded a "perfect year." It saw 12 consecutive months of higher closing prices through a calendar year, when you include dividends. It never before happened in the history of the US Stock Market. 2017 was a year like no other.

The primary driver of stocks was earnings, and the growth accelerated. The global economy took off too. Despite the vast number of threats and issues that could have derailed the rally, the Bull kept charging higher. The Market just didn't care about risks if earnings weren't threatened.

There hasn't been a mere 3% sell-off in a year and a half. That is a very rare occurrence. 2017 was a Market driven by momentum. The rallying cry was "Buy the dip." That strategy worked. No matter what caused any slight sell-off in 2017, the dip was bought, selling was short-lived, and stock prices surged. Risk was not adequately priced in. We think change is coming.

As we begin the new year, the underlying strength of the Stock Market is healthy. Despite entering its 10th year, we do think the Bull Market has more life in it. For the first time in a decade, the global economy experienced synchronized growth. **International Markets came back to life,** and are poised to continue strong performance as they play catch-up to the S&P. **Corporate earnings growth accelerated last year.** The new tax law added fuel to the earnings fire, as **Corporate America was amongst the biggest beneficiary of tax cuts.**

Earnings growth should be solid again in 2018, with another double-digit increase looking doable. Earnings drive stock prices. Our sense is a lot of selling was pushed out to the new calendar year for tax purposes. A mean reversion would be healthy. Stocks that are overbought and overvalued could see a needed correction. Stocks that were beaten up early in the year came back to life and rebounded. We see more of this behavior in early 2018. We see more volatility ahead too.

TECH – INNOVATION & GROWTH

The growth engine of this Bull has undoubtedly been Technology. The Digital Age has brought exciting innovation which has changed the way we live our lives. Phones and other electronic devices keep getting smarter and smarter. How about this for perspective, an iPhone has more computing power than all of NASA had for its Apollo 11 mission to the moon. According to Google, just one action taken on its search engine by a single user uses the computing power of the entire Apollo space missions. It is simply remarkable how far innovation and technology have come over the decades, and we use these high-powered systems daily. Cars are getting smarter too, and in some cases, drive themselves. The internet of things and Artificial Intelligence continue to disrupt the status quo and are investable.

The Tech sector was the best performer in the S&P last year. It was a stellar year for many high-flying momentum stocks.

Some areas in Tech are grossly over-valued, some are simply over-bought, and are due for consolidation. For perspective, Tech is now a quarter of the S&P 500 weighting, the largest by a long-shot. It was less than 20% just 3 years ago. The Bitcoin craze infiltrated the semiconductor space, which sent some chip stocks racing to the moon. Since sell-offs were so shallow and the Buy the dip mentality kept a strong bid under these stocks last year, we believe the laws of gravity will play a role in 2018. A lot of good stuff has already been priced into Tech. Not to mention, some of these Tech Titans have become behemoths. The law of large numbers starts to play a role too. A correction is needed and will be healthy to clear out the excesses. The investment opportunities within Artificial Intelligence, Blockchain, and the Internet of Things are powerful and sustainable, at the right price. We think weakness will be buyable and believe many great days remain ahead for Tech.

AMERICAN CONSUMER & THE US ECONOMY

The US Economy finished the year strong. In fact, the pace of growth accelerated at the close of 2017. If you recall, Consumer spending represents roughly 70% of the economy. Consumers opened their wallets last year. It was the best holiday season for retail since 2011. No surprise, e-commerce led the charge.

The tax cuts will put more money into many people's pockets this year. A stronger consumer could put a jolt into an already accelerating US Economy, which has been growing 3% the last two quarters. It's the fastest rate in years. It should continue in 2018.

STAYING GLOBAL – INTERNATIONAL GROWING FASTER

After being basically void International investments for a number of years, **we built up a position in Emerging Markets and plan to add to it in 2018.** Things have been stronger overseas, which is new. International stocks outpaced the U.S. for the first time since 2012. It's been the best year for International Markets since 2013. The global economy experienced synchronized growth last year and we see it accelerating this year. **The Global economy is expected to grow 3.5% in 2018, the fastest since 2010**. Growth has been broad-based. For the first time in over a decade, all Top 40 global economies grew simultaneously. India, China and the US are the most powerful engines.

Demographics are strong and consumption is on the rise overseas. The world's population is projected to grow by one-third by 2050, to 9.3 Billion people. Emerging markets will account for 99% of the expected increase. India's working-age population will be larger than China's by 2025, and will continue to expand until 2050. India's economy is growing just under 7%, which is expected to accelerate over 7% in 2018. That is faster than China's economic growth, which is estimated at 6.5% this year.

Importantly, most International stock markets remain below their all-time highs reached in 2007. In fact, many of them are still below levels reached in 2011. International stocks have not participated in the Bull Market rally like the S&P and the DOW. **International stocks are cheaper in valuation too and many pay bigger dividends.** The catch-up play continues and we see it accelerating in the new year. We plan to expand our allocation to International Markets this year.

COMMODITIES

Commodities = the Stuff that fuels economic growth.

Copper and Oil are at 3-year highs. Both have historically been good barometers for global growth. It's also a sign that inflation is picking up.

Inflation has been noticeably absent throughout this 9-year recovery from the Financial Crisis. Commodities tend to benefit from a weaker Dollar because they trade in Dollars. However, pure correlations have pretty much broken down over the years.

Raw materials are under strong demand. The re-building process from Hurricanes and California fires is just beginning, which will see a substantial increase in Copper, Lumber and other materials. A speculated Infrastructure bill from Washington would further that demand for building materials. We're also seeing an increase in food consumption around the globe, which could put a charge under agricultural. Rising food prices is very inflationary. A change appears at hand.

ENERGY - WORST TO FIRST TO WORST TO FIRST

The Oil Market is about booms and busts. It's very cyclical. It always has been. The cycle is spinning fast. Energy was the best performing sector in 2016, after starting out the worst. It was the worst performing sector last year into Summer, and then finished the final 3 months the best. 2018 opened with a boom for Energy. After long periods of frustration, investors dumped Energy stocks, which helped put a floor under them last Summer. Mechanically, **Energy is under-owned and we see investors jumping back in as the momentum builds.** WTI is above $60 for the first time since June of 2015. We see the boom continuing for the first half of 2018.

Demand for Energy really picked up as the global economy accelerated. Most of the demand is found overseas. China consumes 12 Million barrels of oil per day, second only to the US. But its growth rate doubled in 2017. OPEC worked hard last year to keep prices elevated with substantial production cuts. US production kept a solid pace, pushing out 10 Million barrels a day for the first time, and beat the previous record of 9.6 Million barrels set in 1970. North American Shale, and specifically the Permian Basin in West Texas has been a complete disruptor in the Energy space. It drives OPEC nuts. It had the Saudi's developing plans to diversify to be more competitive in the Digital Age. But higher oil prices are certainly good for large producers. The Saudi's still are. **Russia has made a big comeback.** The price of Oil plays a big role in geopolitics. It's why it's called "The Prize." Helping higher Oil was a weak Dollar, which saw its biggest slide since 2003.

CENTRAL BANKS & THE PRICE OF MONEY

Borrowing costs are on the rise. Interest rates have been ticking higher. They're still historically very low, but the trend has reversed quite a bit. The Federal Reserve increased interest rates 3 times last year. They've indicated they will do it 3 more times this year. However, the yield curve has been flattening. **The spread between the yields on 2-year and 10-year Treasuries narrowed to a half a percent (54 basis points). It's the tightest spread in nearly 10 years.** Most of the move has come at the front end of the curve in response to the Fed rate hikes. The 10-Year Treasury yield has been basically flat for a year. But the 30-Year Treasury yield has been falling of late, a bit of an ominous sign that trouble could be brewing. Ultra-low rates overseas are certainly contributing to the low 30-Year rate, which stands at 2.75%. Global institutions have been borrowing in Japanese Yen and putting the money in higher yielding Treasuries and getting a return. It's called a Yen carry trade. You may recall, interest rates in Japan were negative at one point last year.

It's our sense that the Bond Market, which is the smartest of Markets, doesn't believe in the sustainability of this economic growth. It has our attention to say the least. We do see interest rates going higher in 2018, but not materially so. It's still a tough place for Bond investors.

Financial liquidity, which supports economic activity, has been contracting recently. The Federal Reserve has been withdrawing liquidity with interest rate hikes and is in the beginning stages of reducing its bloated balance sheet built up from the Financial Crisis. There will be a changing of the guard at the Fed with Jerome Powell succeeding Janet Yellen. Though their policies are quite similar, transitions always come with a few bumps in the road. **It's been 35 years since we've been in a rising rate environment.** We expect some bumps ahead with interest rates.

GEOPOLITICS – EVER-PRESENT & ALWAYS A CONCERN

The Market largely ignored geopolitical developments last year, but we think it changes this year. It can't be ignored for long. The global landscape has changed so much. Gone is the Cold War era with defined lines and zero-sum games. Traditional institutions are being questioned. It's the case in the United States, Europe and around the world. Political parties, government and the media are disliked and distrusted. Economic interdependence, mutual distrust, and unreliable security guarantees are the new norm.

GEOPOLITICS CONTINUED...

The role of the lone Super Power has taken a toll on the US. Traditional alliances and global norms have frayed. The West has moved towards protectionism. China has become a global player under President Xi, its most powerful leader since Mao. Vladimir Putin has seized every opportunity to enhance Russian influence, and he's succeeded. Russia and China have formed some alliances in trade and diplomacy. China seems to be taking the lead on economic and trade issues while Russia takes the lead on Geopolitics and Global Security. They don't necessarily trust each other. But they have common ground in not trusting the United States and enjoying the American political and social disruptions.

The nuclear threat from North Korea and Iran is not new, but it's our sense that the Market will start paying closer attention to it. The Russian investigation continues into the new year with findings not exactly clear. Tensions are white hot in the Middle East with a standoff between Iran and the Saudi's very possible. 2018 is going to be an important year for the future of Iran. The Winter Olympics will be in South Korea in February which presents many risks as well as opportunity. The world will be watching. Geopolitics are amongst the greatest risks for investors in 2018, but they're not new. The Market didn't care last year. We think it will this year.

2018 - GOLD'S YEAR TO SHINE AGAIN

Gold and all precious metals have gone through a healthy basing pattern the past 2 years. They hit bottom in December 2015 after a 4-year Bear market that began in 2011. As an uncorrelated asset to equities, Gold performed quite well the past 2 years, returning over 22% against the S&P 500's 31%. We believe this is only the beginning.

Gold has quietly been "accumulated" over the 2 year base formation. Each price pull-back continues to be accompanied by stronger internal buying. We call this "accumulation" and a strengthening internal signal. It's characteristic of some of the strongest Bull market moves we've seen. The most impressive part is that it has been such a stealth move. There aren't many Gold Bulls out there now, the complete opposite from 2011. Inflation has been absent. Global stock markets have been soaring. Gold is boring. We find this very compelling.

Using Technical Analysis Verbiage, Gold has gone through a 2-year Inverse Head and Shoulder pattern (very Bullish) and is about 50-75 points away from confirming a multi-year breakout. Our price targets reside in the $1,600+ area for the initial part of the move, and ultimately $1800+ before the move is complete. Inflation has started picking up. We believe it's going to return in 2018 in conjunction with higher interest rates, which could provide the positive "catalyst" to finally break Gold out. We believe the precious metals market will outperform stocks the next 2 years. We are very comfortable having an allocation to this precious asset class.