Strong Finish for 2017, but Politics is Messy

Global equities continued to rally during the fourth quarter to finish the year with handsome gains amid persistently low volatility. It was the first year ever that the S&P 500 registered positive returns in every calendar month.[1] There were plenty of other records: new highs for the Dow, the S&P 500 and the Nasdaq, and $450 million paid for da Vinci's *Salvator Mundi*, now the world's most expensive painting. For the quarter, the S&P 500 Index rose 6.6%, the MSCI All Country World Index (ex U.S.) gained 5.0%, and the MSCI Emerging Markets Index jumped 7.4%. For 2017, these three indexes increased 21.8%, 27.2% and 37.3%, respectively. From a style perspective, growth dramatically outperformed value — by 12% among U.S. Large Caps and by 14% among U.S. Small Caps — and Technology was the lead sector globally by a wide margin. Considering the strong performance of stocks in 2017, most bonds also did well. On a global basis, both credit and long-term treasuries returned between 6% to 10%, while U.S. Municipal and short-term bonds rose modestly, between 1% to 5%, as short-term interest rates climbed more rapidly than long-term rates to "flatten" the U.S. yield curve.

Let's call 2017 a "Green Swan," a performance outlier that almost no one predicted.

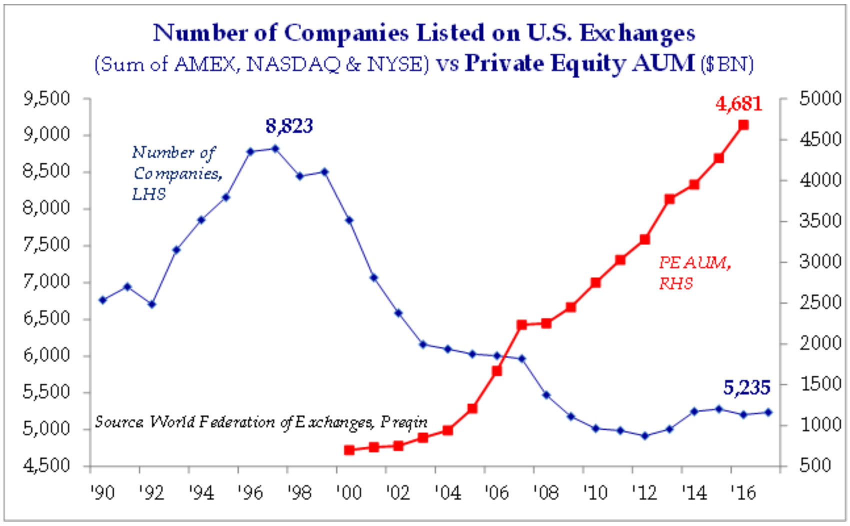
While equities displayed historically low volatility, the volatility of U.S. politics in 2017 was off the charts. On bad days it can feel like the country is coming apart at the seams. We take a measure of comfort, and caution, from reading Bhu Srinivasan's brilliant new book, *Americana: A 400-Year History of American Capitalism.* In his chapter on Computing, he summarizes the 1960s:

> *In a decade filled with dramatic moments - the Bay of Pigs invasion, Martin Luther King Jr.'s "I have a dream" speech, the Cuban missile crisis, Kennedy's assassination, civil rights legislation, and the protests against the Vietnam War—it is easy to imagine an unsettled country on the verge of some revolution. A look at the business pages, however, shows a country in the midst of one of its great economic booms. Given the dominant historical narrative, reviewing the economics of the sixties seems like an investigation into a parallel universe. Yet it also exposes the central paradoxes of the time and the pitfalls of blind faith in modernity.*[2]

Politics and the stock market are often distant cousins at best.

While there is arguably equal disruption and division today, investors again seem to ignore it. The business pages of this recovery to date have been describing a "disinflationary boom" with stable to declining costs raising corporate profit margins, but the rest of the newspaper is busy documenting and editorializing about the social effects of inequality, stagnant wages, civil unrest and populism. The fact is, taken to extremes, both inflation and deflation are destabilizing and harmful to living standards in any country. We have actually witnessed relatively mild disinflation (remember what happened to Greece) considering the dramatic advancements in technology and globalized supply chains built on cheap labor. The effects are very real and painful, however, when the cost of necessities like healthcare and housing rise much faster than inflation and flatlining wages.

Chart of the Year: *Going Public, Going Private, Gone*[3]



Private equity investment has displaced a significant portion of the public U.S. stock market in the past decade.

Inflation: The Long and Short of It

Inflation has both cyclical and longer-term secular drivers, and for many years after 2007 (the credit crisis and, coincidentally, the introduction of the iPhone) both drivers were pushing prices down. While world GDP contracted after the Lehman bankruptcy, an investment boom in new cost-saving technologies (think of robotics, artificial intelligence, fracking and digital logistics) only added to the pressures globalization and adverse demographics have placed on American workers. Many of these new investments were designed to wring efficiencies out of labor markets and take market share, not necessarily to add to global output of goods and services with new factories or equipment.

Inflation expectations have been crushed since the Great Recession.

In addition, some have argued that ultra-low interest rates are themselves disinflationary because they keep default rates abnormally low. The logic is simple: more companies stay in business under easy credit terms which eases pressure on margins and enables more price competition. At the same time, low rates compel investors seeking higher yields to forsake current cash flow for the potential price return of riskier, less liquid investments (see total global non-public investments topping $4.5 trillion in the chart above). As mentioned, a lot of that money ended up funding highly disruptive and disinflationary business plans. For example, why does an Uber X cost $6 less than a traditional cab for the 3.5 mile trip from Logan Airport to our offices in downtown Boston, and why does an Uber Black (a $50,000 Lexus or sometimes a $75,000 SUV if you're lucky) cost only $7.50 more? Not only does the "independent contractor" driving for Uber make less than the cabbie, but the Uber shareholder has also sacrificed current earnings, dividends and liquidity in hopes of gaining market share. One day, in order to transform itself from "the most lossmaking private company in tech history"[4] to one that makes a profit, Uber will have to raise prices. Or, if shareholders can find better yields with less risk, Uber will be forced to retreat and allow cabs to raise their prices. There is no single catalyst for a sea change of inflation expectations to occur; we think a combination of higher interest rates, inflation and central banks draining liquidity over the next few years may begin to change investor behavior, and we need to be vigilant.

When conditions change, investors can be complacent and/or suspicious. Many aren't old enough to remember a different narrative.

Strategy Trades We Made in Q4

We sold an industrial company across our strategies after attending the company's analyst day. We came away disappointed by poor earnings guidance and a lack of visibility into revenue prospects beyond 2019. Ongoing secular issues affecting the company's energy-related businesses were also a concern. The stock is now trading well below where we sold it, and proposed restructurings at this writing have failed to excite investors. For replacements, where applicable, we bought a U.S. large cap ETF in our growth strategies and added to a dividend growth ETF in our income strategies.

We sold an industrial company across our strategies due to secular concerns about energy, and more immediate concerns with management.

We made no changes during the quarter to our portfolio of fund managers.

Outlook: More Stimulus, Inflation is More Likely to Accelerate

On December 22nd the Tax Cuts and Jobs Act of 2017 was signed into law, adding further momentum to the receding tides of regulation and fiscal austerity. It has been almost 32 years since major tax reforms were implemented in the U.S.[5] In 1986, dramatically lower tax rates for individuals were the centerpiece, with the highest marginal rate dropping from 50% to 28%. This new legislation, on the other hand, lowers the top marginal rate from 39.6% to 37% and eliminates enough deductions so that many high earners in high-tax states will pay more. The vast majority of individuals will nonetheless receive a tax cut, and it will be larger than most expect (see our latest Financial Planning Note). The real focus and the biggest cuts are on the corporate side, however, where tax rates drop from 35% to 21% and certain small business pass-through entities, "S-Corps," get similar benefits. Most analysts estimate S&P 500 earnings will increase meaningfully, by about 7% to 10%, as a result of the tax changes.

It is not unusual for fiscal policy cycles to last ten to twenty years or longer.

In our view, the U.S. is undergoing numerous fiscal reforms that will modify behavior and raise the economy's growth potential. Consumer spending, savings rates, wages, capital expenditures, repatriation of profits, the attractiveness of debt versus equity, the marginal cost of a barrel of oil and risk appetite among banks are all affected by this tax bill and by concomitant efforts to deregulate the economy. Taken together, the reforms create a positive feedback loop that is powerful but difficult to quantify. While investor response and appetite for global equity risk is obvious, the long-term bond market has been slower to discount higher growth and inflation. Who is asleep at the switch and who is less alert to the downside risks of higher prices for goods and services? Perhaps there is some complacency on both sides, though we have begun to see significant moves in 10 year interest rates globally year-to-date in 2018. For now, a synchronized global expansion and U.S. tax cuts are pushing growth and price expectations up, a welcome development from the Fed's perspective. It allows them some cover to raise short-term interest rates and stockpile dry powder for the next recession.

In December 2016 we sold one half of our position in an ETF that provides exposure to long duration U.S. Treasuries. Our concern was partially inflation and also excess leverage among long duration investors here and in Europe. Lately our asset allocation committee has been analyzing *all* of our fixed income holdings to ensure that credit quality and interest rate exposure are consistent with our expectations. Finally, the committee has discussed adding incrementally to international stocks to benefit further from less mature economic cycles and more attractive valuations. Any changes will be communicated in detail next quarter.

We are emphasizing quality and looking overseas for better valuations.

Robert G. Scott
Chairman & CEO

Fraser J. McLean
Chief Investment Officer

New ESG Strategies are Coming

For clients who seek to balance their personal values, financial goals and investment strategy through impact investing, we are finalizing the launch of our new ESG strategies in Q1 2018. ESG is a set of integrated environmental, social, and governance criteria that investment managers seek to incorporate into their processes to better manage risk while delivering competitive long-term performance. The diversified ESG portfolios will be invested by seasoned professional managers who target companies committed to a wide variety of ESG initiatives and who advocate for shareholders through a positive influence on company boards.

We are excited to announce the launch of sustainable investing strategies at North American Management.

Special Note to Clients: Herbert P. Hess Retires From NAM

It is with the utmost respect and affection that we announce the retirement of Herb Hess, a former President and Board Member of North American Management Corp. Since 2001, when his firm Berents & Hess merged with NAM, Herb has offered a steady guiding hand to all of us. We believe it is safe to say that, as a mentor, no one cared more about the personal wellbeing of everyone at North American Management than Herb. Herb was a staunch champion of our culture, gave freely and generously of his time and talents to his fellow employees, and personified in word and deed the ideals and standards of loyalty, selflessness and service that we all strive to emulate.

Herb has had a long and distinguished career in the investment business, and we and our clients have been beneficiaries of his experience. Before forming Berents & Hess, Herb served as President of State Street Research & Management. He is also active in philanthropic circles, as a Trustee of Gordon-Conwell Theological Seminary, a Director of the Billy Graham Evangelistic Association, a Director of Opportunity Bank Serbia, and an Advisory Board Member of Olive Tree. Herb earned a Bachelors degree in Mechanical Engineering at Cornell University and an MBA from Boston University.

Herb and his wife, BJ, have 10 wonderful grandchildren, whose lives keep them completely engaged and well traveled. Please join us in wishing Herb and BJ the best as they enter the next phase of their lives. (If you'd like to send Herb a note, but don't have his address, please send your note in care of the office and we'll be sure to get it to him.)

Endnotes

[1] Vlastelica, Ryan. "Global stocks just made history by rising in every month of 2017." *MarketWatch.* December 29, 2017.
[2] Srinivasan, Bhu. *Americana: A 400-Year History of American Capitalism.* Chapter 30.
[3] Strategas Research Partners. January 22, 2018.
[4] Hook, Leslie. "Can Uber ever make money?" *Financial Times*. June 23, 2017.
[5] Hunt, Albert. "It's Been 31 Years Since the Last Tax Overhaul. Here's Why." *Bloomberg*. February 21, 2017.

Source of data not specifically cited: BlackRock, FactSet.
All return data through December 31, 2017, in U.S. Dollars. All equity returns include dividends.

Disclaimer

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If you have any questions regarding the content of this letter, or would like to discuss your investment strategy, please contact your wealth advisor/relationship manager.

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