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Fourth Quarter 2017

Enclosed are your Portfolio Statement, showing your portfolio's holdings and asset allocation, Performance Analysis, displaying investment returns for your portfolio, and Statement of Management Fees for the first quarter of 2018.

Fig. 1 – S&P 500

Fig. 2 – iShares Emerging Markets Index

Stocks finished the fourth quarter of 2017 with strong gains across most major indices. The large cap S&P 500 index (**Figure 1**) posted a total return of +6.6%, ending 2017 up 21.8%. Small cap stocks lagged again, with the Russell 2000 Small Cap index gaining 3.3%. International stocks also had a strong quarter. MSCI's emerging market index rose 7.1%, and developed countries outside the U.S. were up 4.3%.

S&P 500 third quarter earnings grew 6.4%, after rising 11.1% in the second quarter. It is worth noting that at the start of the past earnings season, forecasts called for only a 3.1% increase. In addition, according to Factset**,** 74% of companies beat analyst earnings projections, and 67% surpassed revenue expectations, results in keeping with recent quarters. These better than expected earnings reports suggest improving and strengthening corporate profitability and sales, key drivers of higher stock prices.

For the 4th quarter, S&P 500 earnings are forecast to rise 10.5%, a significant acceleration over last quarter's 6.4% rise. All 11 sectors are expected to report earnings growth. Analysts expect double-digit increases in 2018 as well. Some market watchers have expressed concerns over stock valuations. For example, the current market price to earnings ratio is now 18.3, vs. 15.8 for its 5-year average. However, stocks are likely to move higher if companies continue to generate solid earnings growth.

Economic news in the third quarter was generally positive, and appeared to improve as the year ended. Manufacturing and services surveys were very strong, as new orders rebounded after lower hurricane-related production in August and September. Consumer spending also appeared to accelerate. Holiday retail sales were much stronger than in 2016, and consumer confidence reached a 17-year high. In addition, new and existing home sales were strong, as more buyers entered the housing market. Finally, solid hiring resumed after a rare loss of jobs in September. Taken together, these readings indicate a solid and improving economic picture, that seems likely to continue in 2018.

Index returns taken from Morningstar.com

U.S. economic strength has been matched by developments overseas. European export economies, especially Germany, have benefited from growing U.S. and emerging market demand. German business confidence reached an all-time high, while industrial output there saw its largest increase in six years. Brazil, which has suffered from a two year recession, logged its third consecutive quarter of growth, and has raised estimates for gross domestic product growth in 2018. After trailing U.S. stocks significantly for most of the past five years, emerging markets (**Figure 2**) appear likely to post another solid year in 2018.

Global economic strength bodes well for stock investors. However, the prospect of improving economies may lead to more inflation pressures, which could force central banks to reduce their financial stimulus plans and increase interest rates. Treasury yields in the fourth quarter rose in anticipation of those changes (**Figure 3**). Further increases would pressure bond prices, which generally produced solid returns in 2016 and 2017. Also, some stock sectors, including real estate investment trusts (REITs) and utilities, are often bought for their yields. These stocks are likely to underperform in a rising rate scenario.

On the other hand, other sectors are likely to benefit from rising interest rates. Financials (**Figure** 4) may be able to grow earnings faster. Banks enjoy higher loan margins, and insurers earn more from their investment portfolios. In addition, domestic banks are a prime beneficiary of the recently passed tax act, which lowers the corporate tax rate significantly. Finally, financial institutions may receive regulatory relief under the current administration, including loosening of some of the Dodd-Frank rules passed after the last financial crisis.

Fig. 3 – U.S. 10-Year Treasury Yield

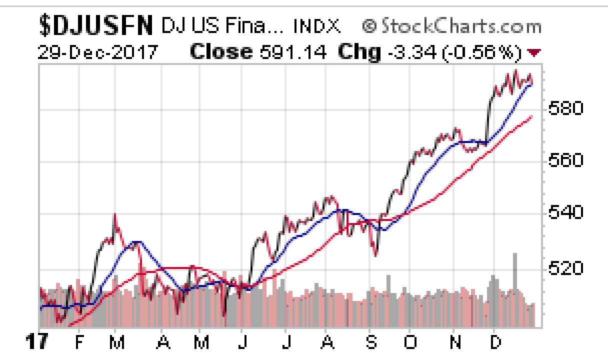

Fig. 4 – Dow Jones Financial Sector

This past year was also marked by excitement over Bitcoin and other cryptocurrencies. Investors have bid up the price of many of these digital assets, often with little or no understanding of the actual investment value or risk. The technology used to generate and track cryptocurrencies, blockchain, may become an important part of our financial system. However, the dramatic rise in Bitcoin's price appears to be primarily a result of investor "animal spirits", and is somewhat reminiscent of the dot-com bubble that ended badly in the bear market of 2000-2002. Our responsibility in managing client assets is to look beyond the short-term excitement, and we will continue to pursue investments supported by cash flows and solid fundamentals.

We hope your new year is beginning well, and look forward to speaking with you soon.

Sincerely,

Kenneth M. Bernard, CFA