Armory Capital Management LLC
110 West Fayette Street, Suite 900
One Lincoln Center
Syracuse, NY 13202-1387
315.701.6452
www.armorycm.com

The Buttonwood

Our Thoughts On Investment Trends, An Informational Newsletter

4th Quarter —2017

2017 - A Year to Remember

Simply stated, there is no shortage of superlatives when one considers stock market performance in the year that just ended. For some perspective on 2017, consider the following.

- The Dow Jones Industrial Average weighed in with a return of 25.08% for the year, the 19th best return since 1921. This performance was just ahead of the 1936 return of 24.82% and just behind the 1999 return of 25.22%.
- The three major US indices, the Dow Jones Industrial Average, the Standard & Poor's 500 and the NASDAQ notched new daily highs that were at all-time records. The Dow Jones posted a record 71 new highs in 2018. The S&P and NASDAQ saw 63 new daily highs and 72 new daily highs, respectively.
- Up days vs. down days was a mark of consistency for the 3 major indices. Of the 251 trading days in 2017 the Dow Jones was up 146 days (58.17%), the S&P was up 145 days (57.77%) and the NASDAQ was up 154 Days (61.35%).
- Volatility dipped to extreme lows as the Standard & Poor's saw only 8 trading sessions with a move of 1% or more up or down. The Dow Jones saw 10 days of these 1% moves while the more volatile, technology heavy NASDAQ produced 25 such moves.
- Further evidence of extreme low volatility is the fact that according to MarketWatch, the absolute daily percentage change for the Dow Jones in 2017 was 0.31%. MarketWatch was quick to point out that the markets "haven't been this quiet since the Beatles made their debut on the Ed Sullivan Show in 1964."
- The S&P was up each month in 2017 (on a total return basis), something that has not happened before. December's gain marked the 14th straight month of gains. While the S&P has been up 12 months in a row before, it has never done so in an entire calendar year. In 1958, 1995 and 2006 the index was up in 11 of the 12 months.

History of the Buttonwood

On May 17, 1792, twenty-four merchants gathered under a Buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

- The NASDAQ posted gains (price returns) in 11 of the 12 months in 2017. This marked an unprecedented performance.
- The Dow Jones rose in 11 of 12 months in 2017—something that has happened only once before in 1958.
- The Bureau of Labor Statistics reported jobs growth in December of 2017 of 148,000. This marked the 87th consecutive month of jobs growth.
- Seasonal unemployment remained at 4.1% for the third straight month. The last time the rate had a lower 3 month run was in Q1 2000.
- The Consumer Price Index which measures the US inflation rate remained relatively benign for all of 2017.
- World markets, as measured by the MSCI AC World Index, posted a gain in December 2017 of 1.50%, its 14th consecutive monthly gain. This streak of 14 monthly gains matches the gain from April of 2003 to May of 2004. The 12 months of gain in 2017 was the first time the index was up each month of an entire calendar year.
- Interest rates in developed economies world-wide remained at or near all-time lows. Even with three rate hikes in the US the 10 year Treasury began 2017 at 2.45% and ended the year at 2.40%.

In summary, while the year was filled with its fair share of political controversy, for investors 2017 was truly better than predicted and exceeded the expectations of most Wall Street analysts. Our attention now turns to the year ahead.

2018 - Things Are Getting INTERESTING

As we look at 2018, we believe that there are four variables that could significantly influence the investment equation this year – interest rates, inflation, earnings and the tax bill. With respect to interest rates, it is interesting, to say the least, that despite three rate increases last year, the 10 year US Treasury Bond finished slightly lower at year end 2017 than the year before.

US Treasury Rates—Year end 2016, dates of March, June rate hikes, year end 2017

Date	1 mo.	3 mo.	6 mo.	1 yr.	2 yr.	3 yr.	5 yr.	7 yr.	10 yr.
12/29/2017	1.28	1.39	1.53	1.76	1.89	1.98	2.20	2.33	2.40
6/15/2017	0.86	1.02	1.13	1.21	1.35	1.49	1.76	1.98	2.16
3/15/2017	0.71	0.73	0.89	1.02	1.33	1.59	2.02	2.31	2.51
12/30/2016	0.44	0.51	0.62	0.85	1.20	1.47	1.93	2.25	2.45
Annual increase	190.9%	172.5%	146.8%	107.1%	57.5%	34.7%	14.0%	3.6%	-2.0%

Source: ACM archives

As the data above is reviewed, it helps to keep in mind that the percentage increases in the shorter-term maturities are large from an absolute perspective. However, rates are so low (near all-time lows) that any increase tends to be magnified. It is also important to remember that rates are returning to normal and are not high from a historical perspective.

What we have focused on is the fact that the 10-year Treasury rate has gone down as the Federal Reserve has raised rates. You would expect the opposite to occur. The fact that this hasn't happened, has gotten our attention, and is something that we will continue to monitor. The chart on page 3 displays the returns on 10-year Treasury bonds for 5 well developed world economies. The bonds offered by these nations offer a safe haven for institutional investors worldwide. Since US government debt is recognized as the safest investment in the world, it makes sense that there would be demand for US debt as rates rise. Remember that the Chinese ($1.147 trillion) and Japanese ($1.09 trillion) are the two largest US creditors. This demand has helped push returns down as rates rise. All of this falls very much in line with our expectations.

10 Treasury Rate for 5 Nations - Developed Economies

Nation	1/1/2013	1/1/2014	1/1/2015	1/1/2016	1/1/2017	3/31/2017	6/30/2017	9/30/2017	1/1/2018
US	1.84%	3.03%	2.17%	2.29%	2.45%	2.39%	2.30%	2.34%	2.40%
France	1.99%	2.42%	0.79%	0.98%	0.67%	0.97%	0.82%	0.75%	0.79%
Germany	1.44%	1.95%	.050%	0.63%	.019%	.033%	0.47%	0.46%	0.43%
Japan	0.83%	0.73%	0.33%	0.27%	.065%	.071%	.084%	.064%	.049%
UK	1.84%	3.04%	1.72%	1.96%	1.33%	1.14%	1.26%	1.37%	1.19%

Source: ACM archives

The surprise in the equation is that, in part, the US individual investor has also been a buyer of US debt. A Wall Street Journal article on 1/2/2018 stated that "ordinary investors are a growing force keeping longer-term bond yields low." The article suggests that much of this individual investor participation is a result of their investment in diversified bond funds or exchange traded bond funds and not necessarily "an insatiable hunger for" US debt. This was a little bit of a surprise from where we sit, but upon further review it makes sense.

What we need to monitor is the rate of return on the longer maturities vs. the shorter maturities. The relationship between short-term rates and long-term rates is known as the yield curve. If the yield curve inverts (long-term rates less that short-term rates) it could signal a recession. Although it is an inexact science (much of investing is) inverted yield curves have been a precursor of recessions in 1981, 1991, 2000 and 2008. The New York Federal Reserve provides data that looks at the relationship between 3 month and 10 year US Treasury rates and inverted yield curves. The NY Fed uses this data to predict the probability of a US recession twelve months ahead. At present the NY Fed has assigned a 4.06% percent probability of a recession based upon the 3 month and 10 year Treasury spread. We need to stress that what we are currently seeing is a flattening of the yield curve, not an inversion. A flattening yield curve, in and of itself, will not cause a recession. In addition, there are many other variables that must come into focus before the economy falls into a recession. At this point we do not see much evidence that suggests a recession is imminent, however we will continue monitor the yield curve closely.

2018 - Can the Bull Market Continue

With respect to inflation, earnings, and the tax bill, we remain very positive. Currently the Consumer Price Index (CPI) remains at or slightly below the Federal Reserve's long term inflation target of 2%. In addition, there seems to be little evidence of any significant price, commodity, or wage inflation going into 2018. The Federal Open Market Committee has forecasted inflation rates of 1.9% in 2018 and 2% in 2019 and 2020. While energy prices grew by 8% in 2017, the forecast calls for less energy price inflation in 2018. The non-energy sector, which includes housing, medical care and food, among other areas, is forecast to grow at 2.1% in 2018 vs. 1.6% in 2017.

It has long been said that there are two things, and only two things, that drive stock prices higher in the long run. Those two things are dividends and earnings. On the earnings front, the news continues to look bright. FactSet has forecast Standard & Poor's 500 earnings growth of 12.7% ($131.41) for 2018 and 10.6% ($163.73) for 2019. Two other sources that we use for earnings growth forecasts, RBC and First Trust, are very much in line with the FactSet numbers. From a valuation perspective, such as the price-earnings ratio, stocks are fairly valued given current low inflation as interest rates return to more normal levels. We are encouraged by the earnings forecasts because we need to see earnings growth for stocks to climb higher.

Another positive development for the US economy and stock prices is the recent tax legislation. Like any piece of legislation, the tax bill has its detractors and there will be some unintended consequences. Despite this, our take is that the new tax law will benefit US businesses and in so doing be a tailwind for the stock market over the longer time horizon. RBC has said that the "$1.5 trillion bill, with its substantial business tax cuts and moderate reductions in individual's tax burden will be positive for the US economy and equity markets." RBS noted several positives that include a likely boost to GDP, earnings growth as mentioned above, incentives for increased capital expenditures, and the belief that US based multinational firms that had high tax rates will be able to better compete with foreign competitors.

Warren Buffett had this to say about the tax legislation. "The tax act is a huge factor in valuation…you had this major change in the silent stock holder (the government) in American business who has been content with 35% (the old tax rate)…and now they get 21% and that makes the remaining stock more valuable…21% is not baked in (to current stock valuations)…that's a huge reduction."

As we look to 2018, we feel the odds favor a continuation of the bull market. While we are overdue for a correction, we feel it would take a recession to pull the US stock market into bear market territory. There is little evidence of a recession anytime soon. We'll be the first to acknowledge that things can change quickly, but any sudden change to such a positive economic climate on an international scale seems remote. As we mentioned above, 2017 was the 19th best year for the Dow Jones Industrial Average since 1921. Of note is that in the years immediately following, the Dow Jones was up 72.2% of the time and the average return was 19% on a price basis.

Here are some things to keep in mind as we kick off the New Year. We are not forecasting returns in 2018 like we saw in 2017. We will most likely see some sort of market pullback in 2018. There is almost certainly going to be more day-to-day volatility, and an unexpected geo-political event could jar the markets. Trying to time the markets is a fool's errand. It can't be done. So stay the course and remember what Peter Lynch once said, ***"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."***

Let's ***"GET RICH SLOW"*** in 2018. Happy New Year!

7 Key Tenets to Successful Long-Term Investing

At its core, we believe that successful investing requires a consistent investment philosophy and discipline. We believe that buying and holding quality investments over a long period of time is the foundation for a successful investment program. Here are our beliefs for successful investing:

1. **GET RICH SLOW**
2. BELIEF IN CAPITALISM, FREE ENTERPRISE, & AMERICA
3. A DISCIPLINED INVESTMENT PHILOSOPHY IS CRITICAL
4. DON'T OVERPAY FOR UNDERPERFORMANCE
5. COMPARE PERFORMANCE CORRECTLY
6. TAXES ARE IMPORTANT
7. MANAGERS MANAGE

CONTACT US

Henry J. Wildhack II
President, Investment Advisor
P 315.701.6415
hwildhack@armorycm.com

Matthew J. Abbott
Investment Advisor
P 315.701.6331
mabbott@armorycm.com

For more information about our investment philosophy and approach, please visit www.armorycm.com.

Patient Investing. Steady Returns.

Successful investing is an elusive realty for many people. It should not be that way.

Investors who are willing to embrace a long-term time horizon, adhere to a conservative investment philosophy, and seek proper guidance will be rewarded. In the short run, the markets may seem volatile, in the long run, the trend is favorable for those willing to hold quality investments over time.

At ACM we believe that the underlying principles of sound investment should not alter from decade to decade. The likelihood for success is overwhelmingly in your favor if you have the required patience and proper guidance.

Please call us, we'd like to help you ***Get Rich Slow***.

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One Lincoln Center
Syracuse, NY 13202-1387

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