HALLMARK CAPITAL MANAGEMENT, INC.

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A FOND FAREWELL TO 2017

We suspect that every investor has a secret, deep-seated fantasy of living in a world where stock prices only go up. For many, 2017 came about as close as possible to realizing this dream; it seemed as if almost everything went up. The Dow-Jones Industrials registered seventy-one record highs in 2017, the most ever for a calendar year and the Standard and Poor's 500 Index chalked up gains each month. The last time that happened was in 1959. Not only were the gains consistent, but they also occurred with extraordinarily low volatility. There were only eight trading days when the S&P 500 Index was up or down by more than 1% and the average daily change for the Index was the smallest absolute number since 1964. Stock markets beyond the U.S. also did well, with many of the overseas Indexes showing even better returns than ours.

Stocks were helped by better-than-expected U.S. economic performance, driving corporate earnings growth to the fastest pace since 2011. Real GDP growth finally broke above 3% in the second and third quarters, after far too long a period stuck around 2%. Even with higher GDP growth, inflation remained well controlled, keeping the inflation-adjusted Consumer Price Index below the Federal Reserve's 2% target. The U.S. labor market set a record of seventy-four consecutive months of higher employment, pushing the unemployment rate down to only 4.1%. There also were many positive economic surprises globally. For the first time in eight years, all forty-five of the Organization for Economic Co-operation Development (OECD) countries had inflation-adjusted GDP growth. This sets up the potential for a synchronized global expansion, where each country's growth enhances its trading partners' economies as well.

Low rates of inflation helped keep most bond investors reassured. Although tightening by the Federal Reserve moved yields up noticeably in the shorter end of the curve, intermediate and longer-term Treasury yields were far more stable. In fact, the yield on 10-year U.S. Treasury notes ended the year virtually unchanged from its level on January 1. Trading in the bond market mirrored the extraordinary calm seen in the stock market, with 10-year Treasury notes recording the lowest price volatility in forty years.

The lack of significant downside for stock prices in 2017 probably kept many investors in the market who might have left. Normally, corrections spur some selling from those who may be on-the-fence about the outlook, helping to curb excessive enthusiasm and help reduce overvaluation. Without such a break in prices, P/E ratios rose to above-average levels. With valuation appearing to offer less support to stock prices, continued low levels of volatility may be necessary to sustain the stock-market rally over the course of the New Year. Unfortunately, there is no agreement as to why volatility has been so low.

THE MYSTERIES OF LOW VOLATILITY

Several theories have been posited to explain the abnormally low financial volatility, some serious and others frivolous. Some academics have suggested that stock markets are more stable now because economic and corporate news gets distributed so quickly, often within seconds. More timely information leads to fewer surprises, allowing traders to more accurately set security prices. Another idea is that the widespread use of passive investment products, like Index funds and ETFs, lower market variability. As money poured into passive investments, fund managers have been forced to continually buy stocks, almost regardless of price levels. Since the list of stocks in the Index is fixed, fund managers cannot sell a position in response to bad news. ETFs essentially lock up a large amount of the available shares, which helps lessen selling pressure in a declining market.

On the other hand, some economists believe the financial markets have been relatively stable only because economic growth has been so consistent. Since the end of the Financial Crisis, real economic growth in the U.S. has held to a narrow range between 2.0% and 2.5%. Slow, steady growth has allowed corporations to plan their expenditures better and avoid the "boom and bust" cycle that has driven so much price volatility in the past. Monetary economists point to the vast amount of Quantitative Easing from the major Central Banks as the reason behind the markets' stability. By reducing short-term rates to almost zero, Central Banks forced savers out of relatively safe deposit accounts into riskier assets, like stocks and bonds.

One explanation, made with tongue-in-cheek, was that volatility has dropped because all the speculators left the stock and bond markets to trade Bitcoins. Who knows? Maybe they are right.

After deeper examination, however, we believe that volatility hasn't gone away, but it was hidden underneath the apparent calm of the aggregate numbers. It may seem self-contradictory, but one of the reasons that overall Indexes were so quiet was because so many individual stocks were not. Even though the entire S&P Index had a total return of over 20% in 2017, almost a quarter of the stocks in the S&P were down last year. The divergent performance of both individual stocks and larger sectors of the market tended to offset each other. The statistical correlation between individual stocks in the S&P 500 Index was only 0.1, well below the long-term average of 0.34.

Although both the Russell 1000 Growth and the Russell Value Index were up double-digits last year, their monthly performance were often quite different; in five months last year, one of the two indexes dropped while the other one rose. Our sense was that investors were unclear if the "new normal" of subpar economic growth would remain in place or not. Investors shifted between Growth and Value stocks, based upon their changing outlooks, but, once again, the divergent performance of the two investment styles tended to cancel out much of their individual volatility.

IRONICALLY, A BETTER ECONOMY MAY MEAN MORE MARKET VOLATILITY

With the major global economies finally moving together, 2018 could finally be the year when the vestiges of the Financial Crisis are finally shaken off. Economists may differ on the long-term effect of the recently passed tax cuts, the consensus expectation is that it will be stimulative this year. Europe is growing at 2% for the first time in a very long while. In Asia, Japan appears to have escaped its deflationary pressures and growth in China continues unabated.

In the past, stronger economic growth tended to push the relative performance of Growth and Value stocks closer together. Many of the so-called Value stocks are in cyclical businesses that receive an outsized sales and earnings boost from an economic expansion, especially companies with highly leveraged balance sheets. For a time, Value companies can experience extraordinary rates of earnings growth … even better than the established Growth companies. As the relative earnings growth rate between Growth and Value stocks narrows, stock price movements in both groups tend to move more in synch. Both move up when investors are optimistic, but both are vulnerable to downturns whenever news appears to put the economy at risk. If the rosy economic outlook for 2018 comes true, we anticipate that stock-price correlations will move closer to normal levels.

EARNINGS IMPACT OF THE NEW TAX LAW

While investors seem pleased with the latest changes in the tax laws, it has been a challenge for us to determine what the law's impact will be on upcoming quarterly earnings announcements. Ultimately, many corporations will benefit from significantly lower tax payments, but some corporations are expected to take large one-time charges to write off deferred tax assets on their balance sheets. Digging through the accounting will make analysis this earnings season messier than most.

Even over the long run, the tax laws impact on earnings is uncertain. Corporate managers will have to choose what to do with their tax windfall. They could opt to expand their businesses, either by mergers or capital spending, or they could use the money to pay down debt, or reward the shareholders by increasing dividends or buying back shares. With the jobless rate hovering around full employment, the money may finally go toward boosting wages. This would be good for the country, but perhaps less exciting for shareholders. We should get some guidance on these issues during first quarter conference calls, but until then, estimates vary widely as to the tax law's effect on next year's earnings. Most estimates from Wall Street strategists suggest that the tax law, by itself, will increase 2018 S&P earnings by about 5%-7%, but few have strong convictions on what the final number will be.

LOTS OF UNCERTAINTY ABOUT BONDS

Normally, arriving at an outlook for the stock market is challenging enough, but this year we find forecasting the bond market equally challenging. Somehow, the bond market overcame a series of obstacles last year that normally would have knocked it back. Short-term rates moved up with tighter monetary policies from the Fed. Sharp increases in energy prices and many other commodities could have led to higher rates of inflation. Import prices rose due to dollar weakness. After several years of strength, the U.S. dollar posted its worst year in a decade against some major foreign currencies. This was in the face of tighter U.S. monetary policy, greater fiscal stimulus and the new tax bill's provision for repatriating foreign profits. Most econometric models with these inputs would have predicted a spike in inflation, but it didn't happen.

After years of worry, economists appear to have become accustomed to inflation rates below 2%. Most forecasts call for similar increases in inflation this year, with the Fed's economic staff looking for core inflation to rise 1.9%. There are signs that some investors disagree. The yield spread between 10-year U.S. Treasury notes with their Inflation-Adjusted brethren moved above 2% for the first time in nine months. Inflation has been low for so long that any sign of acceleration could change investor psychology quickly. In the first few trading days of 2018, a rise in the 10-year Treasury yield from 2.40% to 2.60% was enough to spark a flurry of articles announcing that a bear market in bonds has begun.

Even if inflation remains quiet, supply and demand factors are likely to keep some pressure on bond prices. The effects of a higher government deficit, combined with the Fed shrinking its balance sheet, will cause the U.S. Treasury to raise issuance by about 60% this year. The Treasury Department has historically used short-term T-Bills for most of their funding needs. This should pressure short-term yields more than long-term ones, but we are concerned that there seems to be an overwhelming consensus for continued flattening of the yield curve. If the Treasury decides to change the term structure on U.S. debt, it could raise its monthly five-year auctions by as much as $15 or $16 billion. A steeper yield curve would probably result.

OUR OUTLOOK

Thanks to stronger economic growth and the effects of the tax bill, we anticipate correlations between stocks to rise, causing greater volatility than we saw in 2017. Due to supply and demand issues and the risks of higher inflation, we remain slightly negative on the bond market.

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