WOODSTOCK

QUARTERLY NEWSLETTER

In This Issue:

An Uncoiling Spring
-
Tax Update

Winter, 2018

Woodstock sits both in the larger financial industry of banks, insurance companies, broker dealers and investment management firms, and amongst our competitors in the investment management world. In the larger financial industry, who gets to keep the difference between a historic 8% return on equities, an "equity-like return", and a historic 4% return on "risk free" investments, such as government bonds? Currently government bonds are at 2% while stocks have kept up their 8% average return, so the question is even more important now. Also, as interest rates rise above 2%, a bond originally bought yielding 2% will lose market value.[1]

Various simple and complex investment products from banks, insurance companies and broker dealers try to take advantage of the public's fear of "risk" by "guaranteeing" a 4%, or currently 2%, return in exchange for the investor not caring who reaps the benefit of the difference between 8% and 4%, or even 2%.

The historic New Yorker cartoon, the "Customers' Yachts" seeks to capture this squalid, but still humorous situation and is currently rendered on the back page of this newsletter.

We don't have to go back to 1929 to illustrate our point. Since 1999 the US financial world has had two 30%+ drops in the stock market (the "risk") and for those who did not panic and sell, a subsequent market recovery has generated an 8% annualized return on equities even including the two spectacular drops. While we have to say, and we actually believe, that past performance is no guarantee of future returns, we believe that Woodstock represents our clients' best opportunity to capture that equity-like return into their own accounts rather than negotiate it away in purchasing an investment product, because we believe we have done it.

Amongst our competitors in investment management, what differentiates Woodstock? We like to review SEC Form 13Fs. This form is filed by investment managers over a certain size and lists recent investment holdings. While we and others can tout our skill and investment processes, the 13F reveals what we, and they, hold for our clients. Look for up and coming names in the industries that will drive US growth: information technology and healthcare biotech. And look for the names connoting stability and irreplaceability in energy and consumer staples, all the time keeping "quality" in mind. We believe our 13F shows those priorities.

Our conclusions? First, you should be invested with an investment management firm and try for an equity-like return. And second, pick an investment management firm with an emphasis on investment advice and counseling (see Form 13F), who can also provide other financial services.

We illustrated in a year ago's newsletter,[2] the US economy is a powerful engine for both domestic and world-wide economic growth. The US economy has recently received the stimulus of a growth-oriented revision to the US tax code. While Woodstock may not match the more speculative returns that will appear over the next few years in certain areas, our goal is to capture an equity-like return for our clients. We hope that you are as proud of your choice of Woodstock as we are of our service to you. The next few years should be multi-generational, economic fun for us all.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow. We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling, Chairman & President *Adrian G. Davies, Executive Vice President*

[1] Of course, bonds held to maturity return their face value; [2] Winter 2017

An Uncoiling Spring

Adrian G. Davies

2017 was a phenomenal year for stocks, with the S&P 500 Index returning 21.8%. The NASDAQ Composite Index returned 29.6%, and the Dow Jones Industrial Average returned 25.1%. Internet stocks drove the market, but the Dow's cyclical stocks also performed well. Many international markets had strong double-digit gains in US Dollars as well, helped by a 10% decline in the currency over the year. The S&P 500 Index has generated positive returns for fourteen months in a row, the longest such stretch since 1959.[1] Stock market volatility also has fallen to the lowest level we have seen in years. This strong, consistent performance has buoyed sentiment and fostered some level of speculative interest.

Investors' fears dissipated through 2017 as they gained confidence in the economic outlook. The contentious political environment in the US did not affect the broader economy. In Europe, there was no fallout from Brexit, and there was no further spread of anti-Euro sentiment. Inflation and interest rates remained subdued, while S&P 500 Index earnings grew approximately 10%. President Trump's policy agenda has also been an important factor in market returns. Initial optimism about the prospects for tax reform gave way to doubt as the new administration flailed through several attempts to repeal Obamacare. Even with the market steadily rising, stocks which benefited from the initial Trump rally in 2016 underperformed for much of 2017. Then as corporate tax reform became more likely and was ultimately passed into law, stocks likely to benefit rallied once again. They have continued to rally into 2018.

What is the reward potential and what are the risks for stocks as we enter 2018? Almost nine years old, both the stock market rally and the US economic growth cycle ought to be mature, but the bull market may have the dynamism to carry prices higher still. We are entering 2018 with a tremendous amount of economic momentum, driven by a synchronized global economic acceleration as depicted by the charts on page 3 and the Trump tax cuts.

The US unemployment rate has remained at low levels for much of 2017. The current rate of 4.1% is lower today than it has been 86% of the time over the past 70 years.[2] Although the rate could continue to trend down in the near term, it shows that the US workforce is fairly well utilized. Economists arguing the US has additional unused capacity cite the country's participation rate, which is its total workforce divided by total population. The participation rate remains low by historical standards, both because baby boomers have been retiring and discouraged job seekers aren't included in headline unemployment rate. Participation suggests the economy has more capacity for non-inflationary growth than the unemployment rate indicates, even if the unemployment rate is cyclically low relative to its own history. Consumer confidence and high yield bond spreads corroborate the unemployment rate in suggesting that we are in the mature stages of the current business cycle. However, wage growth and inflation, which usually appear in the latter stages of an economic cycle, have so far remained dormant. With few indications of overheating, the economic expansion and bull market may have further to run.

US GDP growth itself has shown modest gains in the 2% range, suggesting one of the reasons for the economic expansion's duration relates to its moderate pace. Furthermore, the economic expansion hasn't been without setbacks. Despite steady economic growth, the US stock market suffered through five quarters of earnings recession, in which S&P 500 earnings fell year-on-year due to falling oil prices and a strong US Dollar, returning to growth in the third quarter of 2016. Other countries have experienced recessions since 2009, holding back the global recovery.

At the end of a bull market, signs of excess are typically obvious for those willing to see them -- a flurry of initial public stock offerings rising 100% on their first day trading, or no-income, no-asset mortgages to home buyers. Then again, having experienced two epic market bubbles in the past 17 years, it is possible that the current economic expansion might not reach the same level of euphoria. We might consider the speculative nature of Bitcoin and other cryptocurrencies to be a sign of excess, and in the fullness of time, stock investors may find themselves relieved that speculative fervor was

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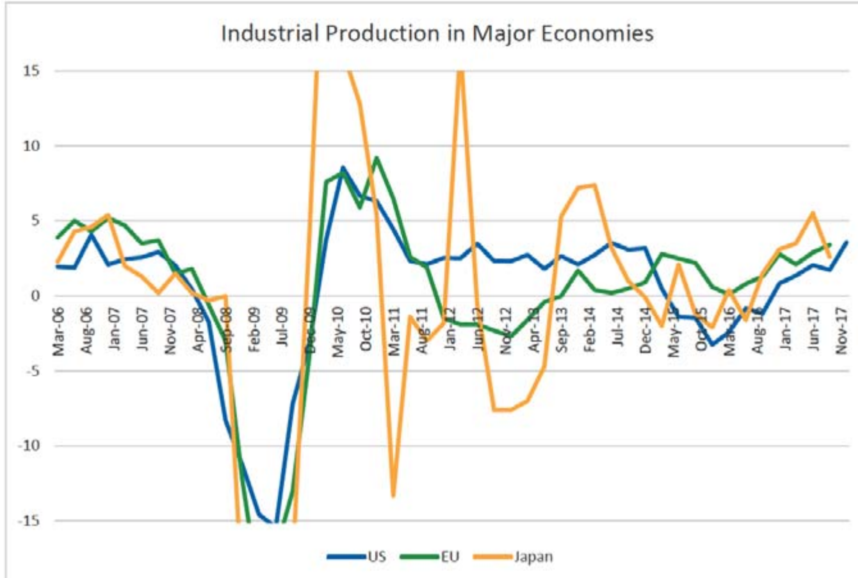
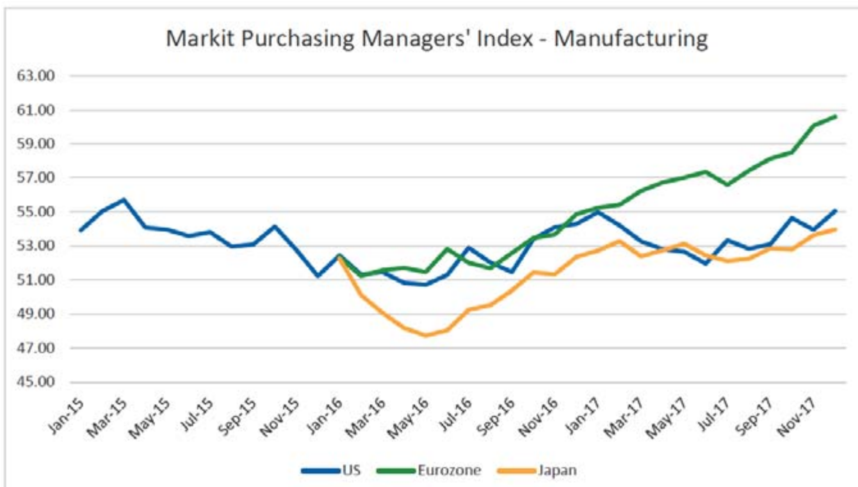


Source: Bloomberg



Source: FactSet

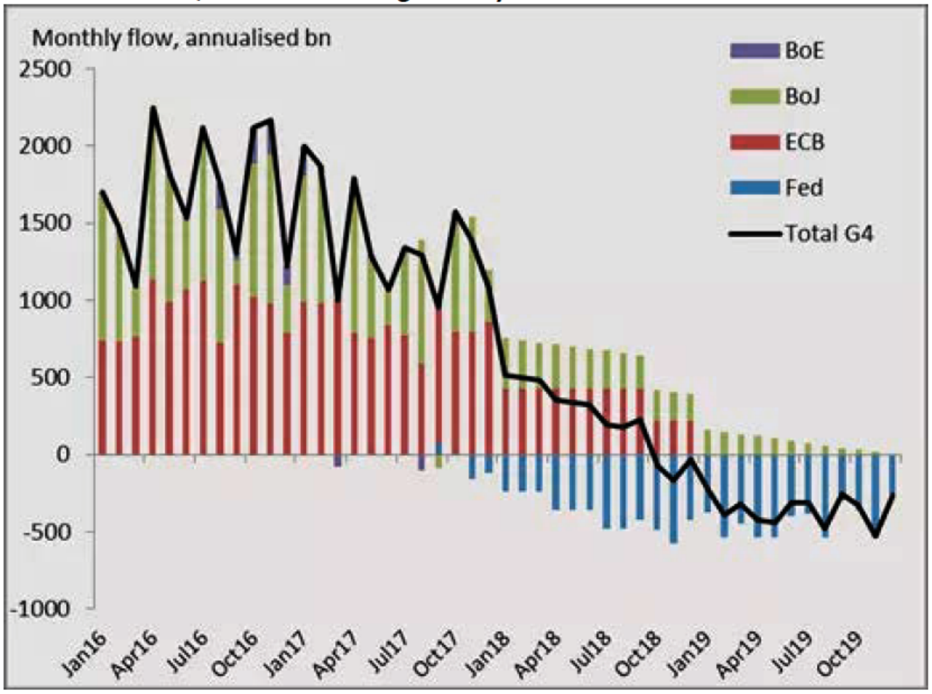
channeled into Bitcoin rather than stocks. Although the nominal value of cryptocurrencies is about $500 billion spread across the globe,[3] we don't believe cryptocurrencies are big enough to impact developed economies significantly.

A more important indication of excess, though not "animal spirits," might be negative interest rates on European sovereign and corporate bonds. The Financial Times reports that $11 trillion worth of bonds trade at negative interest rates.[4] Negative interest rates are hardly justifiable – investors would likely be better off storing their cash in vaults than paying others to borrow it. Many bonds trade at negative yields because the European Central Bank (ECB) and the Bank of Japan (BOJ) continue to buy bonds as part of their management of monetary policy. Negative bond yields make even less sense in the context of accelerating economic growth spurring greater demand for capital. Without central bank intervention, the current level of interest rates would most certainly correct, but central banks change course slowly.

In October 2017, the ECB announced plans to begin scaling its bond purchases down to €30 billion per month from €60 billion per month. The Bank of Japan has made modest adjustments to its quantitative easing

Continued on Page 4

Central Banks' Quantitative Easing Activity



Source: Financial Times

program, although it has yet to change its policy guidelines. The US Federal Reserve is ahead of other central banks in normalizing monetary conditions. The Federal Reserve stopped its bond buying program in October 2014, and raised interest rates for the first time this cycle in December 2015. The Fed then decided to start letting bonds on its balance sheet mature without replacing them in September 2017. The Fed is currently allowing $20 billion worth of bonds to mature per month, a manageable amount for the markets to absorb at present. However, the Fed's plan is to increase this amount by $10 billion per quarter, such that the Fed will be rolling off $50 billion of bonds per month by the fourth quarter of 2018. In all, the Fed expects to shed $420 billion of bonds this year, approximately 9% of its balance sheet. Furthermore, the Fed should exit the year with bonds maturing at a $600 billion annualized rate, a significant supply for the markets to absorb calmly. The recently passed tax cuts could increase the Federal deficit by around $200 billion this year, adding to the supply of bonds.

The Fed may modify its plan up or down as conditions warrant, but interest rate hikes can take up to two years to impact the economy. FOMC Committee members don't know how the cumulative effect of five rate hikes to date will play out in the markets or the economy. The Fed has been raising rates in anticipation of higher inflation, and there are reasons to believe inflationary pressures are building, even though we have seen little of it.

Eight and a half years on since the Fed began its quantitative easing program, it's hard to argue the Fed has effectively used monetary policy to raise inflation. The last two business cycles had more to do with asset price bubbles, while perhaps the central bank was keeping a watchful eye on inflation. Asset prices are in fact much more sensitive to monetary policy than either the economy or inflation are, with the incumbent risk of fueling market bubbles. A better understanding of the risks may be a major reason why the Fed has been reversing course lately.

Are stocks overpriced? Back in early November, S&P 500 Index earnings forecasts probably should not have factored in the Trump tax cuts. The probability of tax cuts existed, but the outcome and particulars were far from

Continued on Page 5

certain. Even so, analysts were expecting aggregate earnings to grow 11% in 2018, reflecting an unusually sunny outlook. As this article goes to print, sell-side analysts are still in the process of revising their 2018 and 2019 earnings estimates higher to account for lower tax rates. 2018 earnings estimates for the S&P 500 Index have moved from $146 to $150 with the passage of the law,[5] and could easily move up another 2%-5%.[6] Even though the tax cuts generally weren't in Wall Street's 2018 earnings forecasts last year, prospects for tax cuts probably were an important driver of 2017's stock market returns. Price-to-earnings (P/E) ratios seemed high because companies' earnings power was understated.

If changing a company's forecast tax rate from 35% to 21% is a first order effect on earnings, what remains to be appreciated are the second order effects: the effects of the tax cuts on corporate and consumer behavior. These second order effects may well play out throughout 2018. Fiscal expansion is typically stimulative and the tax cuts are estimated to expand the US Federal deficit by $1.5 trillion over ten years, with much of the stimulus coming in the early years. Offsetting potentially faster GDP growth, some of the earnings power may be competed away via pricing strategies, investment programs, and higher wage expenses. Additionally, repatriation of corporate capital overseas could very well fuel share buybacks and a wave of acquisitions.

The market hangs delicately in the balance between strong economic momentum and higher interest rates. Trading at 18.1 times $154 in 2018 earnings, assuming the upward estimate revisions continue, the S&P 500 remains at a P/E above its historical averages, just perhaps not as high as it looked previously. Higher P/E multiples make sense in the context of low interest rates, but if the Fed is changing its interest rate policy, stock prices will eventually respond. This interest rate cycle arguably looks to be more gradual than the last one when the Fed raised rates 4.25 percentage points via 17 rate hikes over two years. In addition to removing more than $420 billion of bonds from its balance sheet this cycle, the Fed has communicated intentions to raise interest rates three times this year and two next year, on the back of five completed rate hikes. Last cycle, the stock market didn't peak until 16 months after the Fed finished raising rates. So the battle between monetary and economic forces plays out over years, not months. Being in a more mature phase of an economic expansion currently, however, the next market peak might come sooner than it did last cycle. While a modest market correction might persuade the Fed to scale back on monetary tightening, there's further upside to the markets if monetary policy doesn't prove to be as restrictive as expected, or if the global economic momentum and tax cuts are more stimulative than expected. The US midterm elections and new personalities on the Federal Reserve Board may also introduce interesting contours to the investment landscape of 2018.

As is usually the case, the market is full of stocks with attractive reward/risk profiles and others with unattractive reward/risk profiles. Current market conditions make finding unexploited investment opportunities harder to find, but not impossible. As you know, we look for high quality growth stocks with strong cash flow. We believe these stocks will outperform over the course of a market cycle even if they are not in vogue at the moment. To the extent that these stocks have been underperforming, they are all the more attractive against more speculative and more cyclical stocks. We will continue to look for stocks which have the best reward/risk trade-offs, while being mindful of the tax consequences where appropriate.

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[1] Haghani, Victor and James White, "The Message in the S&P 500's 12-Month Winning Streak," 11/14/2017, Bloomberg View.

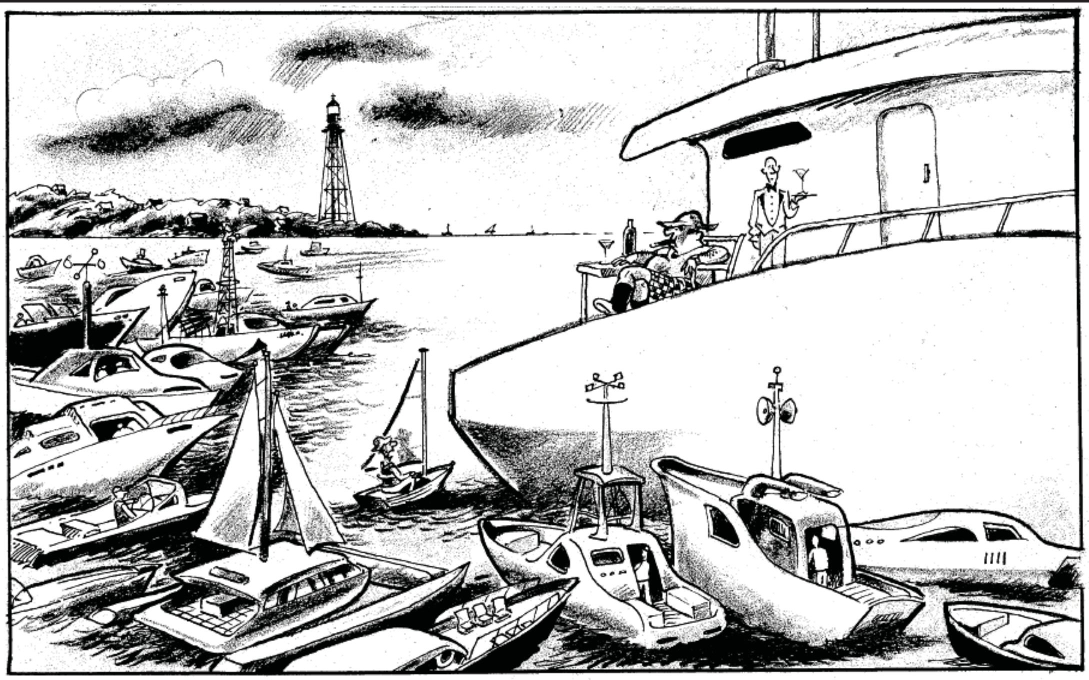
[2] St. Louis Federal Reserve Civilian Unemployment data, dating back to 1/1/1948.

[3] Coinmarketcap.com

[4] Financial Times, 12/13/17.

[5] FactSet Earnings Insight, 11/3/17 and 1/12/18.

[6] Corrie Driebusch, Corrie, Michael Wursthorn and Chris Dieterich,"'Melt-Up' Rally Propels Dow Above 26000 as Fear Turns to Greed," 1/18/18, Wall Street Journal.



...YES, BUT WHERE ARE THE CUSTOMERS' YACHTS ?

Once in the dear, dead days beyond recall, an out-of-town visitor was being shown the wonders of the New York financial district. When the party arrived at the Battery, one of his guides indicated some handsome ships riding at anchor. He said, "Look, those are the bankers' and brokers' yachts."

"Where are the customers' yachts?" asked the naïve visitor.[1]

[1] Where are the Customers' Yachts? Fred Schwed, Jr. New York, 1940 & 2006.

Tax Update

Over the next few months, analyses of the new tax law, the Tax Cuts and Jobs Act of 2017 which is generally effective starting January 1, 2018 will be forthcoming. Most of the tax return preparation for the year 2017 will be under the old law and planning for 2018 and beyond will be under the new law, a dual mandate for tax departments this year.

Generally there are reduced income tax rates, and thereby tax due, for almost all taxpayers. There are initial indications that certain tax benefited plans such as 529 plans and health savings accounts may have enhanced future usefulness. Also, the higher thresholds for the Alternative Minimum Tax ("AMT") mean that many taxpayers who had to add back deductions for state and local taxes to determine their tax due may not have to pay the AMT, but the new law "caps" those deductions so the end result may be a small change for those taxpayers.

There are substantial changes to estate and generation skipping tax ("GST") rules with implications for the gift tax. The planning opportunities have opened very wide, especially in a state like Massachusetts which does not have a gift tax but does have a rather low threshold for the estate tax. From wondering in 2012 whether the federal estate and GST thresholds would drop to $1 million or be compromised at something higher (the compromise was $3.5 million) to now be at approximately $11.2 million per individual is dramatic change in a relatively short period of time. Elections have consequences, so 2018 should be a time for planning and change. While the tax free gift per individual per donee of $15,000 per year (inflation adjusted from $14,000 from 2013-2017) seems less important now, one of its chief benefits was that it could be structured to generate no paperwork. We will still have elections and the tried and true methods used for intergenerational planning should still have a place even within these dramatic changes.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

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