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Performa Market Perspective

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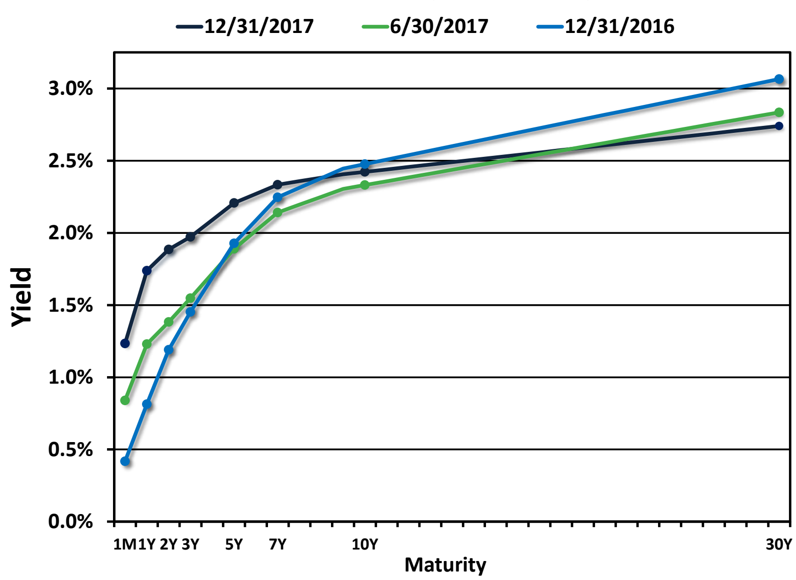
The Year In Review. The Year Ahead. And Bitcoin, Why Not?

As we move through the first few days of 2018, we would like to take a moment to reflect on the year gone by and provide some thoughts on the 12 months ahead. We hope 2017 was a good one for you and yours, and we wish you a happy, healthy, and successful 2018.

The Year In Review

2017 was a year of synchronized global growth coupled with continued accommodative global monetary policy. With a backdrop of dismissed political/geo-political uncertainty and diminishing volatility, asset returns across the board were impressive. Equity markets marched higher and high yield bonds posted solid returns. The yield on benchmark 10-year U.S. Treasury remained largely unchanged for the year, as the yield curve flattened in dramatic fashion (see chart 1). Investor complacency took over as volatility in all asset classes collapsed. Meanwhile, the Federal Reserve stayed true to their message from a year ago delivering three interest rate hikes along with starting the process of reducing

Chart 1: U.S. Treasury Curve Comparison



Source: Bloomberg, Performa Limited (US)

the size of their balance sheet (quantitative tightening) by decreasing the amount of principal reinvested each month.

2017 Asset Class Performance

Index	Month to Date	Quarter to Date	Year to Date
Barclays Intermediate Gov/Credit	0.11%	-0.20%	2.14%
BofA ML US High Yield Cash Pay	0.29%	0.38%	7.48%
S&P 500	1.11%	6.64%	21.83%
MSCI World	1.39%	5.62%	23.10%

Source: Bloomberg, Performa Limited (US), LLC

On the fiscal side, the Trump administration managed to deliver on one of the cornerstones of his election promises – getting a tax bill done. In the short-run, we expect that the tax cuts will provide a modest boost to economic growth, but at the expense of an already dismal outlook for the U.S. deficit. The cuts are driven by a significant increase in deficit financing, so if substantially higher growth rates do not materialize as estimated (less than likely), then difficult political discussions will surely follow. Additionally, with wealth disparity continuing to swell, and the increasing polarization of red/blue states due to the new limit on state tax deductions, this tax bill ensures that these conversations have little chance to turn towards moderation. Lastly, from a growth perspective, we are puzzled by the timing of this tax bill. Traditionally, these types of fiscal moves are saved for times of economic hardship instead of periods of economic expansion. With the unemployment rate at 17-year lows and solid underlying momentum in the economy, it begs the question: what is the rationale for spending fiscal bullets now as opposed to saving them for a time when the economy is truly in need of fiscal stimulus?

The Year Ahead

Monetary Policy

We expect an uneventful leadership transition at the Federal Reserve. New FOMC Chairman Jerome Powell is a noted consensus builder who has never voted against the majority during his tenure on the Federal Reserve Board of Governors. We expect him to continue the FOMC's message of gradual rate hikes in 2018 while allowing for flexibility (should incoming data warrant a change in policy stance). With that said, Chair Powell's job will not be easy as turnover within the Committee brings new faces and new egos to deliberations. The deeper into the current hiking cycle, the higher the stakes and costs associated with any potential policy miscommunication will be.

Despite the Fed's best efforts (three rate hikes and quantitative tightening), financial conditions continued easing in 2017. Equity markets and home prices increased, and corporate credit spreads tightened. Yields, aside from short maturities, have barely moved as term premium appears to be a thing of the past. Said differently, the tightening of monetary policy in 2017 has been more about removing accommodation rather than tightening financial conditions. This dynamic can't, and won't, last forever.

The Fed forecasts three more interest rate hikes in 2018, while the markets are priced for less. At this point, our tendency is to take the Fed at its word, understanding that a significant drop in economic activity or a large increase in inflation will cause the Fed to shift its course. However, we are less concerned about the absolute number of rates hikes and more focused on the point at which rates hikes switch from being a removal of accommodation to actual tightening. Once there is more clarity on the latter, we would expect to see a dramatically different reaction in financial markets then seen thus far in the current hiking cycle.

Fiscal Policy

President Trump campaigned on a pro-growth platform promising tax cuts, infrastructure spending, and the rollback of Obamacare and overly burdensome regulations. While executive orders rolling back regulations seemed to flow pretty frequently from President Trump's desk over the past year, there were no large legislative gains until the fourth quarter. Just days before Christmas, the new administration got its first victory, passing the Tax Cuts and Jobs Act. The bill was marketed as a tax cut for the middle class, but seems to provide the most benefits to companies and those that can take advantage of pass-through entities. Starting in 2018, most American families will see the government taking less out of each paycheck, but those cuts are temporary, and a subtle change to the inflation measure buried within the tax code will slowly erode individual gains before the cuts eventually sunset at the end of 2025. There will continue to be arguments over the scenarios in which middle class families pay less; however, there is no arguing that the spoils of this bill will go to the wealthy and corporations.

While the tax cuts look to be a short-term tailwind for the U.S. economy, the potential longer-run growth implications are less friendly. Most importantly, the bill increases the federal deficit by an estimated $1.5 trillion over 10-years. Legislators' use of "Dynamic Scoring" to prove the bill's worth is a red flag for potential suffocation of future long-term expansion. Using potential increased velocity of economic growth to pay for an outsized increase in deficits is pretty much a non-starter in most rational circles.

Secondarily, we are not convinced that companies will suddenly increase wages and hiring while engaging in new capital expenditure plans – a key component that the tax cut proponents hark upon. Frankly, if U.S. corporations had projects and expenses that would materially and positively affect their bottom lines, a tax cut is not the propellant - they would have acted already!

Finally, the trillions of dollars held by U.S. companies in overseas subsidiaries only pertains to a relatively small number of firms and the technology sector represents the lion's share. We are not convinced that big tech companies with newly repatriated cash is a stimulant for sustained, higher long-run growth.

What having more cash – either via a tax cut or repatriation – does allow companies to do is continue with their shareholder friendly activity. Firms like Apple that issued large bond deals to finance higher dividends and buybacks can now retire some of that debt early and tighten up their balance sheets. With that said, deleveraging in response to policy changes usually takes place over long periods of time and any changes will likely be on the margin and depend heavily on corporate expectations for Trump's re-election.

With the tax bill passed, the administration will likely turn its attention to infrastructure spending and trade deals. We suspect that any movement on the infrastructure front will be difficult given current and expected future deficit levels. There is no arguing that American infrastructure is in need of attention, but given U.S. debt dynamics and the fact that brinkmanship remains the default political strategy in D.C., we are not placing high odds on the passage of a large infrastructure package for 2018. On the trade front, the administration has a clearer ability to more easily influence trade deals. We'll be following the handling of NAFTA re-negotiations as a blue print for the new 'America First' stance on trade.

Economic Activity

In our view, the probability of a recession in the next 12 months remains low. This is the 9th year of the current expansion (long in the tooth by any historical comparison), yet global growth looks robust and synchronized. All of the world's top 45 economies grew in 2017 and are expected to do the same this year according the Organization for Economic Cooperation and Development (OECD). For much of the current expansion, the story has been one of the U.S. economy leading the global pack. That narrative has now shifted to one of global strength, which should help to prolong the current U.S. expansion.

Looking at leading economic indicators, the U.S. economy is on solid footing. Manufacturing and non-manufacturing surveys remain elevated and measures of both consumer and business confidence are at, or near, cycle highs. The labor market, our preferred gauge of underlying economic trends, remains solid with steady month-over-month job creation. The unemployment rate sits at 17-year lows and new unemployment claims are historically low. The only piece missing is growth in wages as the average worker continues to see their purchasing power erode year after year. It is worth noting that some of the year-over-year wage measures are being skewed somewhat lower as result of structural changes.

Our long standing, accordion-like business cycle thesis remains intact. The unprecedented amount of monetary accommodation arising from the 2008 financial crisis stretched the typical business cycle from 4-6 years to an elongated 8-12. While the tax cuts are shrouded with uncertainty and only time will reveal the true unintended consequences, there are a few scenarios that we believe to be highly likely. The tax bill will help corporations the most, providing them the latitude for another round of financial engineering. This could propel stock markets even higher as their earnings ratios suddenly end up looking more attractive – even without top line growth. Secondly, the tax cuts should be a short-term consumption booster over the next year, maybe two. Lastly, the tax bill will spark a further polarization in U.S. politics as income inequality gaps grow wider, and Republicans use blunt swords to punish states that typically vote blue. None of these outcomes are beneficial to long-term growth and stability.

In short, once this economic cycle ends, there is a probability of a deeper trough due to the end of year 2017 legislation than before.

Risks to the Outlook

We continue to be amazed by the lack of volatility across all asset classes. The market seems willing to shrug off any negative geopolitical news. Whether it is the threat of nuclear war with North Korea, mass shootings or terrorist bombings, the markets hardly react negatively anymore. When they do, it's short-lived as both Brexit and Trump's election inspired initial selloffs only to spur a rebound to fresh highs. The complacency that has penetrated all corners of the market leaves asset prices susceptible to an abrubt reversal. However, unlike in 2007 and 2008, there is no big leveraged housing-type bubble hanging precariously over investors' heads. Sure, an event that had previously been shrugged off by market participants may spark the beginning of the down-trade, but most likely it is something no one anticipates, save for a few *"seers"* who will live off that call for the next decade.

Ahh, But Isn't Bitcoin a Bubble?

Before diving into the weeds, let us be clear about how we view Bitcoin from an asset allocation perspective. We would never consider allocating any client capital to crypto currencies such as Bitcoin or funds that invest in the like. Digital currencies have yet to show fundamental value as an accepted medium of exchange for legitimate goods and services. With that said, just because we would never consider allocating capital to Bitcoin or other crypto currencies doesn't mean the story isn't interesting.

Bitcoin is an open sourced digital currency powered completely by its users. Transactions are anonymous and irreversible, helping to create a level of perceived security that has increased the popularity of the cryptocurrency. While the unregulated and decentralized characteristics of Bitcoin have contributed to its success, these have also become some of Bitcoin's (and others) biggest weaknesses. For Bitcoin, the amount of energy and computing power to mine an additional coin is now close to $6,000/coin and must rise in accordance with the algorithm. The number of available Bitcoins is only 21 million. Together, these problems characterize Bitcoin as more similar to Beenie Babies than Benjamins. If that is not enough, the increasing number of hacks (not unlike bank robberies) have highlighted the lack of ability to act as a store of value. There are no authorities to either protect against or assist in reclaiming stolen Bitcoins. Additionally, there is almost no chance of reversing fraudulent transactions to recover stolen coins. So much for deposit insurance.

Bitcoin and its brethren remain extremely risky and bubble-like behavior should be enough to cause pause for any potential investor. Whether it was the South Sea Company, Dutch Tulip Mania, the Dot Coms, or the U.S. housing market last decade, Bitcoin's chart looks pretty similar.

Digital currencies are in their infancy and platforms like Venmo, PayPal, and others have infinitely more penetration with consumers. We expect subsequent iterations to address some of the shortcomings which could increase the probability of digital currency acceptance. While the future of Bitcoin is unknown, the Blockchain technology behind the digital currency appears to have broader implications. While its notoriety came from the rise of Bitcoin, Blockchain is not a currency-only problem solver. At its core, Blockchain is a public ledger containing every transaction ever processed for the asset in question. This verifies the validity of every transaction. Although originally designed for Bitcoin, Blockchain technology has greater uses elsewhere, far beyond the murky, uncertain world of Bitcoin.

Within the financial markets, trades and settlements could become almost simultaneous through Blockchain, eliminating the need for intermediaries. Errors would be eliminated and security would be strengthened by using encryption technology rather than a standard username/password process. Smart contracts and stronger identity management are also potential applications. Blockchain can be programmed to automatically execute once certain conditions are met without a third party involved. Client verification can cross multiple markets and institutions, potentially reducing the duplication of customers' due diligence requirements from increased regulations.

All of this is to say that while get-rich stories associated with Bitcoin dominate today's headlines, the more interesting story to us is the potential long-run implications of the technology across industries.

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ABOUT PERFORMA

Combining our extensive knowledge of the insurance industry with the institutional expertise of our investment team, Performa has been managing assets on behalf of captive and other insurance clients for 25 years.

Our capabilities include asset allocation, active fixed income and equity management through diversified mutual funds or separate account portfolios. With offices in the world's largest captive domiciles, including Bermuda, Vermont and South Carolina, we are focused on delivering customized solutions to meet the unique investment objectives and liquidity requirements of our investors.

We are 100% employee-owned and currently manage $4.1 billion in captive assets worldwide as of November 30, 2017. Our investment philosophy is value driven and long-term in nature. Whether approaching asset allocation, fixed income or equities, our ability to be nimble, contrarian and decisive sets us apart from our peers and promotes capital preservation.

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