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CAPITAL MANAGEMENT, LLC

First Quarter Market Outlook 2018

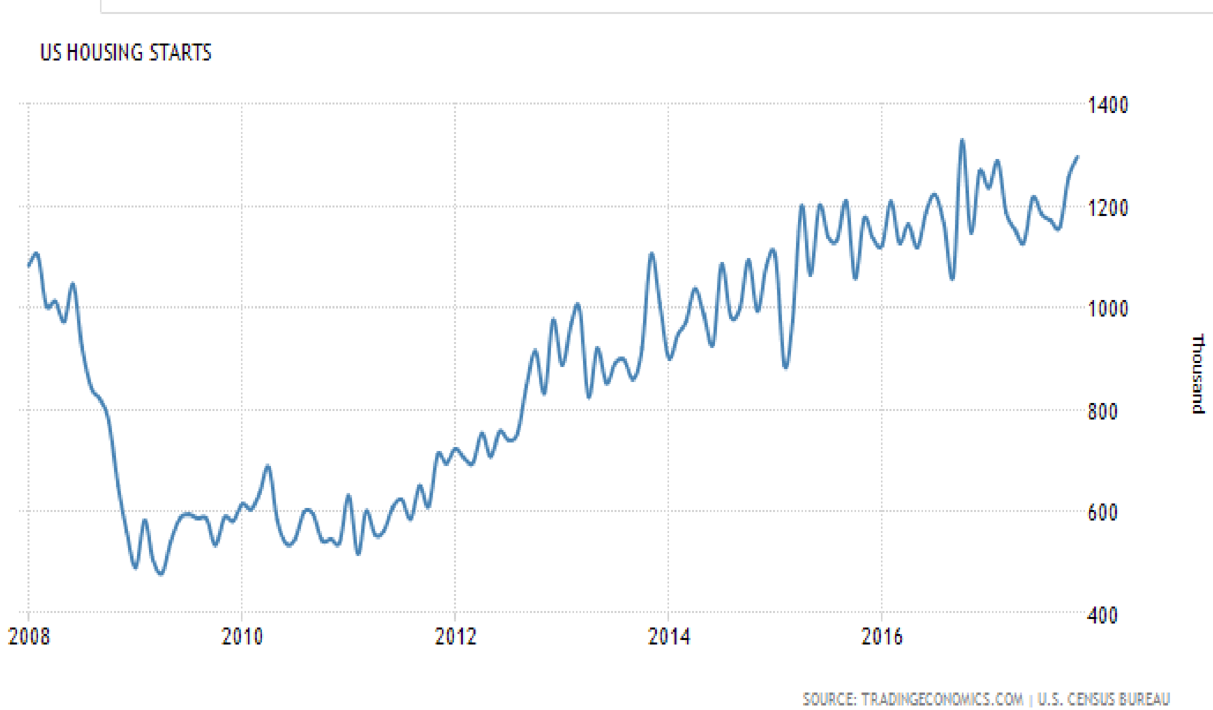
2017 was a solid year for both the market and the economy. Moreover, 2018 is starting out positive as well. In this commentary, we will talk about why the market has been strong as well as what could derail it. In addition, we will address questions we have been receiving on what is Bitcoin, and why it has had so much written about it.

Why the market has been strong and what could derail it?

Stronger than expected corporate earnings and an improving global economy have provided the fuel for solid market returns. Moreover, the recent tax cuts will further increase corporate earnings, which will have the effect of lowering valuations and will help near term to extend the current rally in the stock market.

Our concern at this point is what can happen that will cause the market to fall, and what are the probabilities of that happening. Indeed, we do expect to see some sell off this year, which would be normal. Historically the market has one 10% correction, and two 5% corrections every year. Last year the market went all year without even a 3% correction, which is highly unusual. Historically, it is recessions that have caused most bull markets to end. Indeed, since the end of World War II, recessions or anticipation of recessions have caused two thirds of bull markets to end according to CFRA Research. Currently, however, the country is experiencing solid growth in many sectors, and looks poised to continue if current economic data continues.

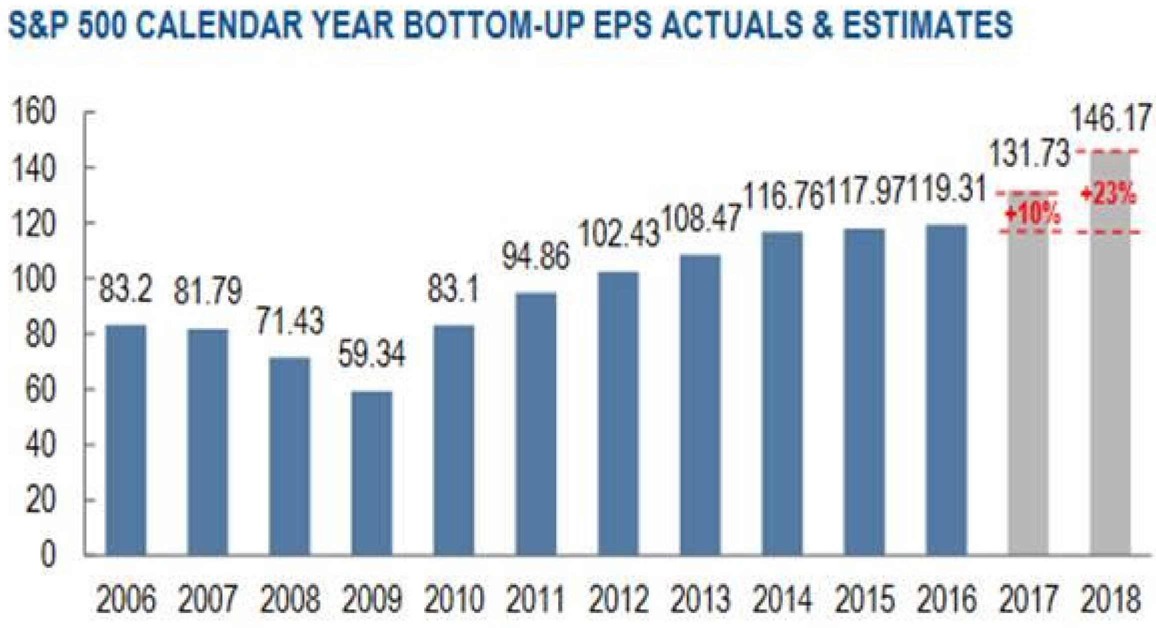
One of the best ways to foretell economic contractions is to watch housing starts. Since 1960, every recession in the United States has been preceded by a double digit decline in housing starts. (CFRA Research) Housing is one of the largest industries in the United States, it is also one of the largest industry multipliers because it affects so many other industries (finance, construction, employment, furnishings, plumbing, wood, glass, appliance, materials, flooring, insulation, etc.) and it is most consumers largest asset. Thus, housing is a key industry to watch. Fortunately, housing starts were up 5.5% last year, so home builders appear confident for the future (National Association of Home builders).



Global Growth

Global Growth also appears to be strong going into 2018. Payden & Rygel, an investment research company, estimates that the fewest countries on record (data goes back to 1980) expect to be in recession this year. Only 3% of the worldôs countries expect recession this year, and those countries account for only a tiny 0.4% of world economic output. For comparison purposes in 2009, nearly 50% of the economies on earth contracted in the Great Recession. Or, compare 2018 to an average year in the 1990s, when in any given year around 20% of the worldôs economies were shrinking. So part of the growth we are seeing in our markets is the fact the whole world is now starting to grow at the same time.

The World Bank is now estimating that global GDP will grow 3.1% in 2018, which breaks down to 2.2% growth in developed economies and 4.5% growth in emerging markets. Specifically, emerging economies will be aided by a continued commodity recovery. Keep in mind, that the average company in the S&P 500 gets almost 50% of its earnings overseas so having the whole world grow at the same time is a nice tailwind to corporate earnings.



Taxes

As 2017 draws to a close, Congress passed a tax reform bill designed to propel the economy upward, with the prospect of most middle income Americans (with incomes ranging from $35,000 - $40,000 on the low end to $75,000 - $80,000 on the high end) expected to receive tax cuts between $1,000 - $2,000 a piece, beginning with February paychecks. That should help drive the economy higher; as various studies historically show a high correlation between rising income and rising consumption.

Everybodyȇs tax situation is different, and individual taxpayers benefits will vary. The big beneficiaries, however, are corporations. The corporate tax, now at 35%, is being lowered to 21%, in the most dramatic change (tax wise) in 30 years.

We believe this will have a positive near term impact on the economy (longer term higher growth will be needed to offset lower taxes); both in terms of new jobs, and new investment in plant and equipment, as corporations will also be allowed to expense 100% of capital projects in the year expended.

Although growth and market momentum appears to be strong for now, the Federal Reserve could spoil the party. By increasing interest rates too fast the Fed could derail the economic recovery. By raising rates, the cost of big ticket items increases and consumers delay purchases of big ticket items likes homes and autos. Autos this year contracted for the first time since 2009. Housing and interest rates are also highly correlated historically. In addition, the Fed is reversing its quantitative easing programs and is actually starting to contract their balance sheet and money supply to undo the stimulus they provided during the Great Recession. So there is a real chance of miscalculation. The market is a forward looking indicator which means movements in the market tend to precede recessions or recoveries. In fact, the average bear market (market correction of -20% or more) preceded recessions by an average of 7 and half months according to CFRA Research. So, just because things look good now, does not mean they cannot change. Valuations are no longer cheap, and are actually above average. So there is more risk in the market than a few years ago. This is not to say that valuations are extreme, because they are not, but they are not cheap either.

Fed Balance Sheet

While the reality of higher interest rates could weigh down the (bond) market ï (recall that bond and mortgage prices are inversely correlated with interest rates), the degree that interest rates move up too much will be a big factor in 2018. What is more concerning to the Fed at this point is the size of the Fedôs balance sheet, which is now nominally the largest it has ever been.

The net effect of all the previous Fed programs to create money over the past several years have left the Fed with over $4 trillion dollars on its balance sheet. The Fed has announced that it will begin to unwind these holdings during 2018 and beyond. The Fed presently is selling $10 billion per month of its Treasuryôs and corporate obligations, the impact of which will be to put downward pressure on prices, and correspondingly put upward pressure on rates. The Fed has also issued a statement that it will increase the size of the monthly sales by adding an extra $10 billion every month on a quarterly basis as the year progresses. So, after the end of the year, $50 billion dollars of assets will be taken out of the money supply every month going forward, and $300 billion in total will have been reduced from the Fedôs balance sheet in 2018. There is $4.2 trillion on the Fedôs balance sheets which is roughly 17.5% of the value of the stocks in the S&P 500. So this is a factor we will be watching closely as the year progresses.

What is Bitcoin and why is it Popular?

Bitcoin was invented in 2009 by a person (or group) who called itself, Satoshi Nakamoto. The stated goal was to create "a new electronic cash system" that was "completely decentralized with no server or central authority." Bitcoin has gained in popularity for two reasons. First, many see it as a way to hedge against government debasing paper currency. As governments print more money, the value of existing currency goes down. One does not have to look far into the history books to see how far the value of all currencies have fallen. The maximum number of Bitcoins will be 21 million. The Bitcoin generation algorithm defines, in advance, how currency will be created and at what rate. Any Bitcoin that is generated by a malicious user that does not follow the rules will be rejected by the network and thus is worthless. Thus, backers see Bitcoin as a type of digital gold that cannot be debased by central banks. Second, Bitcoin lives on the internet and can thus be accessed anywhere in the world. Moreover, in theory, Bitcoin can be used to buy, sell, or transfer funds cheaper than existing methods. Bitcoin has exploded in value in 2017 driven largely from Asian demand, particularly Japan. In April, Japan even passed a law that accepted Bitcoin as legal tender. This is important because once you convert Bitcoin to Yen, you can use Yen to buy any currency you want.

No matter what happens to Bitcoin, the technology that makes Bitcoin work, blockchain, is poised for widespread adoption. Blockchain technology can be used by anyone. Virtually every bank is testing, planning or researching ways to use blockchain technology to reduce cost. Meanwhile, technology companies such as Microsoft (MSFT), Intel (INTC), and International Business Machines (IBM) are developing blockchain technologies. Another example is Kodak, which on January 10th announced that it would create a cyber currency, using blockchain, which will allow photographers to track their artwork and allow photographers to get paid royalties going forward for whomever uses their pictures. Thus, there are many uses of blockchain, not all of which will affect the price of Bitcoin.

At its core, blockchain is a list of transactionsð a ledgerð maintained by a community of users, rather than a central authority (peer to peer network). Itôs called a blockchain because new transactions are bundled into ñblocksò of data and written onto the end of a ñchainò of existing blocks describing all prior transactions.

That process of chaining blocks together provides the security that has made Bitcoin hack-proof. In addition to security, blockchain has the potential to reduce transaction cost (peer to peer transactions can be completed without the need for a third party), and improve settlement times (blockchain technologies work 24 hours, 7 days a week).

What could go wrong with Bitcoin?

While we believe blockchain technology is here to stay, the outcome for Bitcoin is harder to determine. Despite its huge rise in 2017, on CNBC, Warren Buffett said ñstay away from it,ò and that ñitõs basically a mirage.ò On the other hand, well regarded fund managers such as Bill Miller have over 40% of their assets invested in cryptocurrency.

We believe the biggest wildcard for Bitcoin going forward will be how the U.S. government reacts to it. Does the Federal Reserve issue their own cryptocurrency? Does the U.S. government try to ban Bitcoin? We do not know.

To Warren Buffettõs point, some of the biggest users of Bitcoin are unsavory individuals and organizations that use Bitcoin because the coins are untraceable. Traditional money transfer vehicles, banks, and credit cards are heavily monitored. This has made Bitcoin a favorite way to transfer assets for not only organized crime and criminals, but also nation states such as North Korea and Venezuela who are trying to avoid U.S. sanctions. Moreover, these same organizations are actively trying to increase their share of Bitcoin. The CIA has reported that the terrible computer virus named ñWanna Cryò because it made its victims want to cry, was created in North Korea. Furthermore, North Korea was using the virus as ransom to gain more bitcoin. Thus, pressure is being put on the U.S. government to better control or limit Bitcoin.

Despite this, the market for Bitcoin could be huge. The WSJ reports that the global money supply as measured by M2 was at $79.5 trillion at the end of 2016. Bitcoin bulls argue that if 1% of that supply was held in bitcoin, dividing that by 21 million (maximum amount of Bitcoins allowed) then the price of Bitcoin would be $38,000 per coin, up from roughly $18,500 currently. If 2% were held in Bitcoin, the price would be $76,000, and so on.

The problem with this is that the Bitcoin network can only handle a limited amount of transactions per second, and is already being overwhelmed by traffic. Moreover, Bitcoin transactions require a tremendous amount of energy (due to the encryption involved). Motherboard estimates that a single Bitcoin transactions uses approximately 5,000 times more energy than a credit card swipe.   In addition, while Bitcoin has limited the number of coins to be mined (thus the perceived value due to limited supply), other block chain Cryptocurrencies (they are called altcoins because they are alternatives to bitcoin), are not limited, and are taking some of Bitcoins market share. This has put price pressure on the ultimate price of Bitcoin (a research site called coinmarketcap.com list over 1,000 altcoins which have measureable value).

Lastly, because Bitcoin is completely digital, you could lose your password or get hacked, and lose everything. If you lose your account password, thereǒs no bank to call to reset. Last month, Elon Musk tweeted he had misplaced part of his bitcoin password, and could not access his Bitcoin. Buyers beware.

In conclusion, 2017 was a solid year and 2018 has started out strong as well. Both the U.S. and global economy are improving, corporate earnings are expected to be strong, and the unemployment rate is declining.   To keep the markets going, the Federal Reserve will have to be correct in their monetary policy of unwinding the Fed balance sheet while also controlling inflation and not stomping out growth at the same time. This will be a difficult task. In the meantime, we believe the best risk adjusted returns for investors will be to focus on large capitalization, brand name companies who are returning cash back to investors through both dividends and stock buy backs, and provide goods and services that consumers need to use on a daily basis. Thank you for your continued support.

Sincerely,

Bill	Jim	John
William H. Schnieders Principal	James F. Schnieders, CFA Principal	John C. Schnieders, CFA, CFP® Principal