January 20th, 2018

Dear Turtle Creek Client,

2017 was a remarkable year for global securities markets. While there have been better individual market years in terms of performance, 2017 stood out for the unified manner in which global markets and traditionally uncorrelated asset classes marched in lockstep. Bond markets that normally zig when equity markets zag posted strong results. International markets normally beholden to different economic factors than here at home surged notably. Most striking was the nearly rhythmic, daily positive trend for global stock markets, which posted gains each month of the year for the first time in history. In the face of market bug-bears such as geopolitical concerns, presidential election finger-biting, and central bank angst; global markets methodically advanced higher with only limited volatility.

<u>Elements of 2017 Stock Market Performance</u>

The equity market trends we have highlighted in recent letters – "late-cycle" stock movement, the premium of growth over value, and relative underperformance of defensive business models – accelerated through the last quarter of the year. Technology shares advanced an amazing 39% through the year while economically sensitive companies in the Industrial, Financial Services, and Basic Materials sectors posted market beating results. Energy companies were the only exception to this trend, as prices stagnated after a strong 2016 performance.

In contrast, all-weather companies in the Consumer Staple, Telecommunications, and Utilities sectors trailed the market significantly despite posting healthy profit growth and returns on shareholder capital. The S&P 500 Value Index, capturing companies trading at below market valuations, returned a respectable 13% on the year yet trailed the aggregate market return by a large degree.

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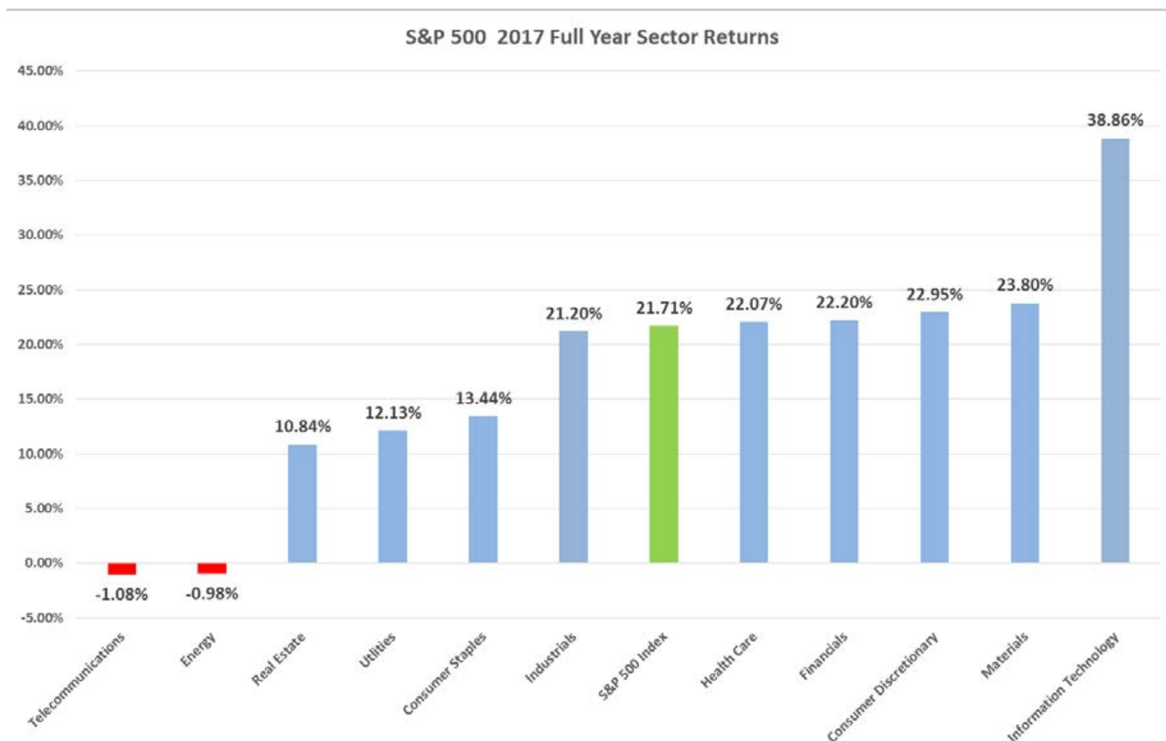
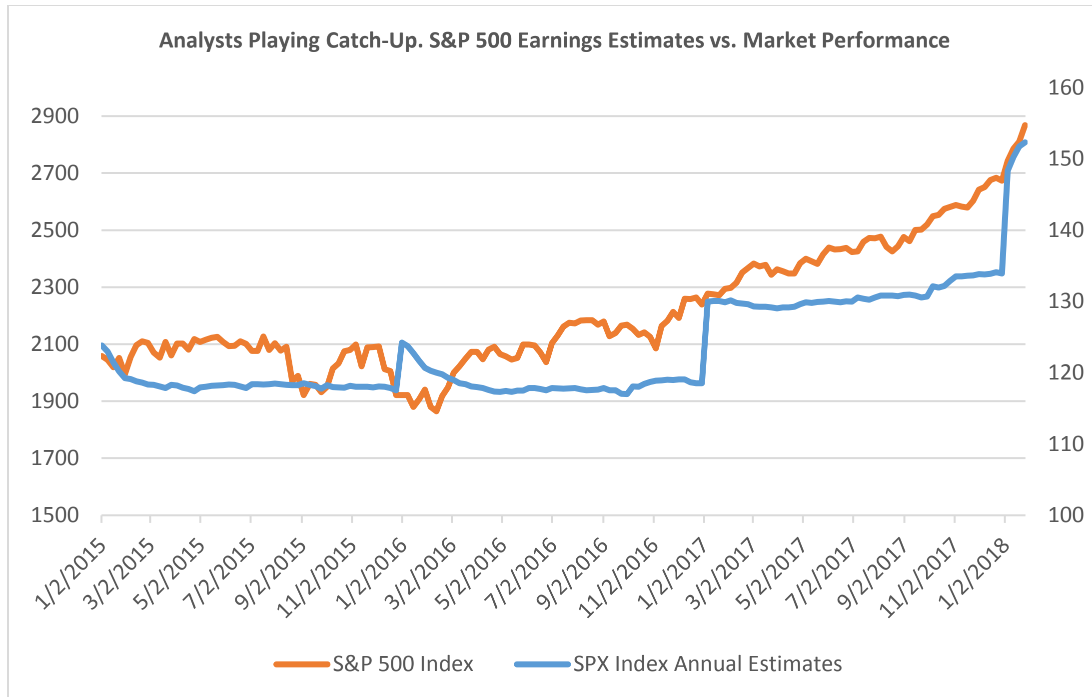


<u>Short-Term Rational Exuberance</u>

Investors have shown a healthy degree of skepticism regarding the sustainability of recent stock market gains. As index values climb ever higher, terms such as “Bubble” and “Mania” have crept back into many market discussions. While current market valuations do from our perspective ignore longer-run risks; we don’t think that the current stock market should be grouped with periods of irrational stock market mania.

The hallmarks of historical stock market bubbles are jarring disconnects between market valuations and the true fundamental value of corporations. The prime example was the Dot.com period, in which companies were given billion dollar valuations despite hazy business models and a lack of profits. A more recent example is the housing bubble of 2007-2008, during which investors extrapolated out highly improbable growth in real estate values which resulted in wild speculation and then a painful collapse in prices.

By contrast, the current bull market reflects the ongoing and robust improvement in the global economy. Corporate performance continue to improve and at much faster pace than assumed by investment analysts. Profit growth exceeded 20% during the year and the U.S. Economy as measured by GDP posted several quarters of growth in excess of 3%. Every strong market month during 2017 represented an increasingly optimistic prediction of economic acceleration and this trends shows no signs of slowing down as we enter 2018.



Long-Term Risks Remain

Despite the encouraging near-term fundamental backdrop, investors should not lose sight of longer-term risks embedded in today's stock market. Specifically, they should consider the price they are currently paying for this strong fundamental performance and the sustainability of growth and profits over the longer-haul.

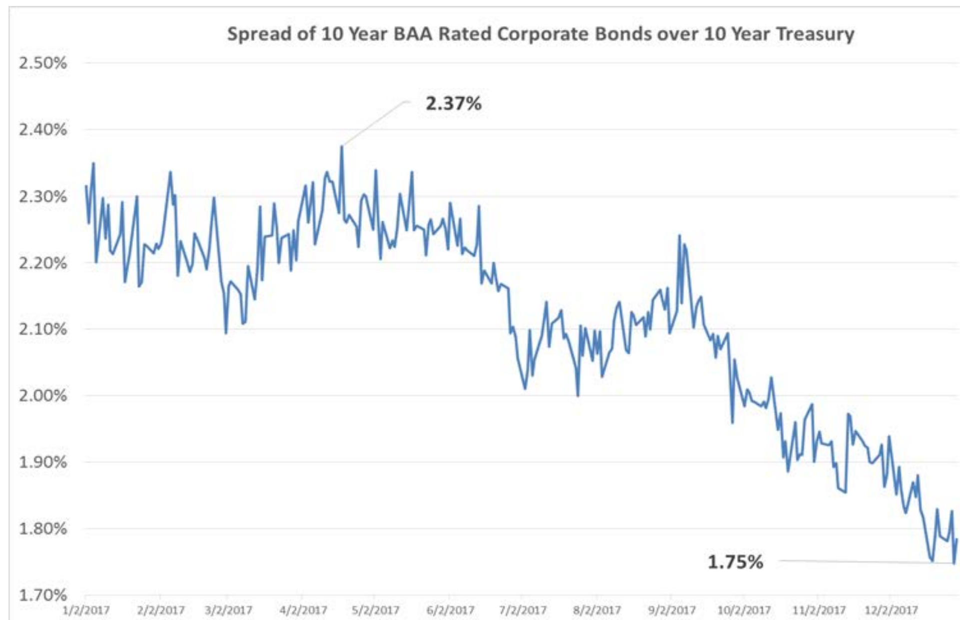
Equity valuations are influenced by many factors, but the key consideration of the moment is the role of interest rates in supporting the current historically high price/earnings ratios for the stock market. Low rates beget high-stock market multiples and vice-versa, so any sustained increase in the interest rate environment has negative connotations for stock market returns. As the Federal Reserve and other global Central Banks plow forward with clearly signaled rate hikes in 2018, valuations could be pressured.

It is also important to recognize that "late-cycle" economic performance historically reverts to longer-run averages so the robust growth of today should not be extrapolated out over the longer-term. The current historically high profit margins should also not be considered permanent for all companies in your portfolio.

Bond Yields – Another Lost Year

The 10 Year Treasury bond, our preferred proxy for the bond market as a whole, finished the year roughly where it started while oscillating considerably in-between. The macro-economic data-points that influence bond yields sent conflicting signals throughout the 2017 market year but turned uniformly positive in the first weeks of 2018, a trend that has sent rates materially higher. The great bond bull market which started all the way back in 1981 is now likely over. The unemployment rate is currently at a historic low and GDP has advanced at a slow but steady pace, trends that should result in further Federal Reserve Bank rate hikes throughout 2018. Inflation, however, remains muted and concerns remain about the impact of higher Federal Reserve rates on the economy persist.

The additional yield offered to bond investors for taking additional risk (spread) compressed during 2017. In theory, when an investor buys a bond with some risk of default he or she will be compensated through additional yield. At the beginning of the year, the investor that purchased a 10 Year Corporate Bond with Moderate Credit Risk would have earned nearly 2.4% spread over the risk-free 10 Year Treasury Bond. That spread shrunk to just 1.7% by year end.



Portfolio Positioning in the Current Environment

With no discernable storm clouds on the horizon and forecasts of several years of robust growth ahead, there is little rationale for dramatic portfolio adjustment. The typical conditions that have historically resulted in market sell-offs – rampant inflation, an overheating economy, extreme Central Bank tightening, irresponsible credit extension, etc. – are currently nowhere to be found. Of course the potential for unseen events, geo-political or other, are difficult to anticipate. As prudent managers of portfolio risk, we are conscious of this fact and will continue to keep your assets well-diversified among multiple asset classes. While this approach can limit returns when markets underweight long term-risk, it is substantial component of capital preservation during more difficult market periods.

Given the very low margin of error implied by current stock and bond market prices, investors should be exercising caution. The bond market's current mix of historically low credit spreads and rising yields reinforces our existing strategy of short maturity bonds of very high credit quality. A time will come when yields stabilize and adequate compensation is offered for credit risk. Until then, our conservative approach will be emphasized in your bond holdings. For your equities, we will continue managing to our long-term equity allocations and pare back holdings whose valuations we believe are not sustainable over the longer term while emphasizing companies with attractive valuations and superior business quality.

We appreciate the support from our clients, and will continue to work diligently in managing your assets for the long-term.

TURTLE CREEK MANAGEMENT, LLC
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