FLAGSTONE

FINANCIAL ADVISORS, INC.

MARKET REVIEW
CALENDAR YEAR 2017

What Happened:

2017 was a terrific year for stocks, with large gains across the board. Accelerating global growth combined with low interest rates, low inflation and a falling dollar translated to an almost perfect environment for corporate earnings growth, driving stock prices higher, both here and abroad. The stock market was also characterized by very low volatility. In fact, 2017 had only eight days in which the market closed up or down by 1% or more. This compares to the long-term average of about 50 such days per year.

What is most remarkable about the 2017 stock rally is that nobody saw it coming. Looking back at forecasts from a year ago, most analysts were predicting very modest gains at best, and very high volatility. Of course, these predictions missed the mark by a wide margin. This is confirmation of how unpredictable the market is, even to investment professionals. This inherent unpredictability is exactly why we advocate sensible asset allocation and diversification strategies, rather than trying to anticipate market moves or time the market.

Annual Performance for 2017:

S&P 500 Index (large stocks)	21.83%
Russell 2000 Index (small stocks)	14.65%
MSCI EAFE Index (international stocks)	25.03%
Barclays U.S. Aggregate Bond Index (bonds)	3.54%

Prognosis:

Where do we go from here? History tells us that very good years like 2017 are generally followed by good, but not great, years. According to *Barron's*, since 1943, the market has returned 20% or more 26 times. Twenty of those years—76% of the time—the subsequent year also had market advances, averaging 12%.

Expectations of future earnings growth may help extend the market rally in 2018. S&P Global forecasts earnings growth ranging from 11% for large cap companies to 21% for small caps. What's more, sentiment/optimism among businesses and consumers is very high, a strong signal for economic growth and activity.

In spite of all the positives, we realize that market rallies do not go on forever. A market correction will eventually become a reality. The good news, however, is that any correction is likely to be relatively insignificant and short-lived. Severe market drops—bear markets—are generally accompanied by recession and falling sentiment/optimism. Neither of those conditions are in sight.

A Note About the Bitcoin Phenomenon:
Bitcoin and various other cryptocurrencies made headlines in 2017 with eye-popping returns not seen since the tulip mania of the 1630s. Bitcoin was created at the time of the financial crisis of 2008-09 as a global digital currency that is market driven and works independently of any central banks. There are now dozens of cryptocurrencies in addition to Bitcoin with new ones being created almost daily.

Unlike traditional investments like stocks and bonds, cryptocurrencies have no intrinsic value, no future cash flows or other future streams of income. Rather, they are simply worth what the next buyer is willing to pay. This isn’t investing; it is pure speculation. There will likely be a future role for cryptocurrencies, but it is too soon to know exactly what role that may be or which cryptocurrencies will survive in the long-run. In the meantime, the rabid enthusiasm that has driven cryptocurrency prices up this far and this fast is probably a signal that the party will end soon.

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