January 15, 2018

Dear Clients and Friends,

The first newsletter of the year is probably my favorite one, as I give in to the temptation to make some predictions about the future, ignoring for a moment that the future is unknown and unknowable. I got a few things right last year, but what I certainly didn't predict is that investors would ignore all geopolitical risks and charge ahead full-steam, pushing up prices of already expensive stocks, real estate, cryptocurrencies, and other collectibles.

Perhaps a reminder that market timing is a futile effort and that the market will do what it will do. The implication is that time is better spent building a portfolio that supports your future financial needs than trying to win a few laps against the market. You win when you can meet your financial goals, not when you have a good lap split.

I have had several conversations with clients as to whether they are better off holding on to cash and waiting for prices to come down before investing. I think the answer is "no." That's not the say you should invest your cash all at once, but waiting for a downturn can be a dangerous proposition. The return of cash is zero. If you earn zero for too long, it can be quite damaging to your ability to meet the financial goals you have set out to accomplish. 2017 was a textbook example of that risk.

So rather than thinking of cash vs. stocks, it is better to think about lower risk vs. higher risk assets and what percentage you should have in each bucket. That split- imagine a risk dial that goes from 0 to 100 – is driven by how you handle risk and what your goals are. I am somewhere around 80. A substantial number of clients are around 60-70 and then there are those who are below 50 and close to 100. Knowing where you set the dial, you can make some forecasts about what your portfolio might do in a good year and a bad year. It's better to figure that out than to try to figure out if next year is going to be a good year or a bad year.

My 2017 predictions included a positive outlook for the future of renewable energy, despite the current administration's fossil fuel focus. This one I am most excited about for having guessed right. Coal is on its way out, renewables keep growing in scale and falling in price, and politicians in red states have joined blue states in their support for renewable energy production. Betting on the industries that have growing employment is a winning political proposition. The Wilderhill Clean Energy Index was up 38% in 2017 and First Solar, with a return of

110% was the 3rd best performer in the S&P 500 Index. It is important to note, however, that it is the coming of age of these industries in terms of their business models and production discipline, rather than the political dimension that has buoyed investment returns. If lack of discipline on the supply side were to reemerge, it could be harmful for sector profitability.

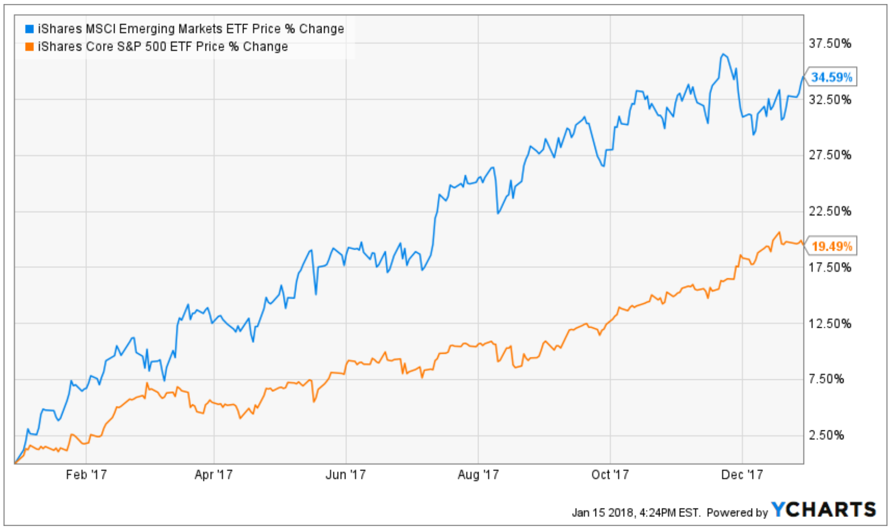
My 2018 outlook does not include a prediction of the end of the long bull market in US stocks. The more I think about it, the more I realize I have no idea as to when it will end. My guess will not be better than a coin toss. While I have a 50% chance of getting it right, it would be just luck or the broken watch being right once every 12 hours.

Inflation will increase. For years, the official inflation number has been very low; often dipping below 2%. To many people this seems odd, or perhaps even untrue. For example, if you have to buy medical services, bay area real estate, or an education I don't think you would agree that inflation is low. But recently, even the official inflation number has been ticking up a bit. A few months don't make a trend but increased deficits from the tax law and improved wage growth (finally!) might portend further increases. Also, inflation might be showing up in unexpected places, where it is not counted as inflation. For example, a bitcoin valued at $14,000 or Da Vinci's Salvator Mundi going for $450 million could be interpreted as inflation.

The 30-year mortgage rate will be higher at the end of 2018. This will be an important one to watch, in my opinion. What has driven real estate values in pricy coastal markets has been a combination of job growth, very tight supply, and low interest rates. Most real estate experts seem to agree that supply constraints are the biggest driver of price appreciation. What will be interesting to see, is if higher mortgage rates will affect demand. Even if the 30-year mortgage rate doesn't budge, the cost of ownership for homeowners in high tax states will increase due to a cap on the deductibility of property taxes and mortgage interest on new jumbo loans.

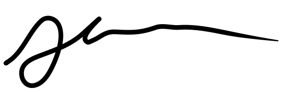
If supply remains as tight as it is, less demand might not equate to a price softening. However, one has to wonder when the supply of new homes, net migration to more affordable markets, and a slowdown in hiring & wage growth for high earners, will start to take a toll. It's hard to say. Homeowners in pricy markets are generally of the opinion that real estate values can only go up and any correction is likely to be shallow. That sentiment does not entice people to list their homes and move to more reasonably priced locales; especially considering that home is often where the heart is.

Diversification, left for dead in recent years will continue to make a comeback. Diversification is not rocket science. Because only one asset class can be the best performer, it makes sense to own multiple asset classes to have a better chance of capturing some of the returns of the best performer and avoiding 100% exposure to the worst performer. While the logic is indisputable, the US market kept winning first place, which reduced the appetite for diversification. Last year, the crown was passed to emerging markets. The streak has been broken, and I believe the race for the gold medal will remain competitive.



Bull markets don't die of old age: my final prediction – and not a very bold one – is that the stock market rally will not end because it has been going on for too long, but due to some exogeneous factor. It could be a credit event – for example the $0.7 trillion of crypto currencies evaporating – a geopolitical event that finally unnerves investors, the Federal Reserve increasing interest rates faster than expected to fend off some perceived bubble, or changing consumer & business sentiment in the real economy. Is 2018 the year? I still don't know. Market corrections notwithstanding, I am optimistic about the future: our economy continues to grow faster than the population, increasing overall wealth. Undoubtedly, we need the rising tide to lift more boats and urgently so, but at least the tide is rising.

Kindly,



Jan Schalkwijk, CFA

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