2nd Quarter 2018

Volatility and investor angst, both of which were largely absent during all of 2017, returned in the second quarter and for much of 2018 to date. Equity returns have diverged widely so far this year with U.S. markets outperforming international; small cap returns beating larger cap indices; and growth stocks outperforming value stocks.

The Dow Jones Industrial Average rose 0.64% in the second quarter and remains down 1.87 year to date. The S&P 500 Index rose 2.89% for the quarter and is up 1.63% year to date. Technology stocks had a strong quarter with the NASDAQ up 6.33% and 8.7% higher for the year. International stocks as measured by the MSCI EAFE Index and Emerging Markets Index declined 3.3% and 10.6% on the quarter respectively. The price of the Barclays Aggregate Bond Index of investment grade bonds was down 0.87% for the quarter and is off by 2.75% year to date.

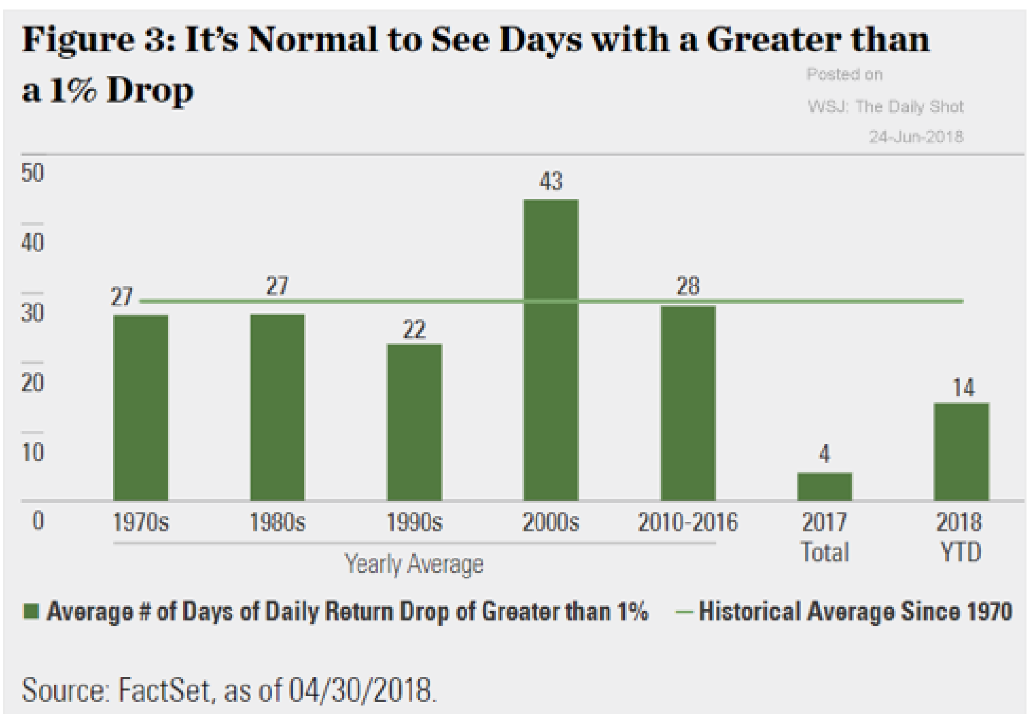
The current economic expansion is 9 years old, and the second longest in modern history. A key question for investors is how much longer this can go on. Current economic data supports the continuation of the economic expansion in the U.S. First quarter real GDP in the U.S. came in at 2% and the second quarter data is tracking in excess of 3.5%. The rub in all of this for investors is that this economic backdrop co-exists in a market environment characterized by high valuations for asset prices (which should limit future return potential). Another backdrop for markets that we think will lead to higher levels of volatility is the tightening of financial conditions from the reversal of the extraordinary monetary policy programs by central banks around the world led by the U.S. Federal Reserve. Both the level of interest rates and inflation are off of their extreme lows that coincided with much of the economic recovery and the climb in asset prices. The Fed, for the time being, seems content to continue hiking interest rates.

Markets also have to contend with the growing prospects of restrictive trade policies and the ripple effect these can have on global growth, currency volatility, inflation, and further on corporate profits, supply chain disruptions, corporate investment spending, etc. Market volatility related to trade tariffs seems to surface routinely in an on gain/off again manner based on the negotiation tactics of the parties involved. Most of this has centered on U.S. trade relations and intellectual property laws with China, but more recently has expanded to other trading regions such as the Eurozone. With respect to China, it is a bit more complex than simply trade tariffs levied on each other. According to the geopolitical strategists at BCA Research, for China to have a proportional response to large scale tariffs, they could potentially retaliate in other ways (since they are limited by the lower amount of U.S. imports) such as with their currency or strategic interests that they want to advance in The South China Sea or other parts of Asia where their interests may not align with the U.S. and other allies. Such actions would add to the complexity of outcomes if an escalation in trade tensions were to reach this level.

So far the emergent trends in interest rates and inflation have been slow to develop and remain below levels that have historically posed a threat to risk assets. Things can change more quickly, and markets are forward-looking, and we are on alert for this especially given the heightened uncertainty surrounding trade wars. The risk as we progress further into this late cycle period is the balancing act of high valuations in asset prices operating in an environment of accelerating economic growth coupled with low rates and low inflation. They don't typically exist together for too long before one of them begins to give out. Investors should be prepared for higher volatility across asset classes as these forces play out.

As risks build and sentiment shifts from political, economic, and market forces, the risk/reward proposition for assets in a portfolio can change. While it is difficult to invest successfully by making macro predictions on politics, policy or turns in the economy or stock market, it is practical (and quite prudent) to use time-tested valuation methods to guide portfolio decisions in the context of long term planning needs. As long term investors with an eye on valuation, we remain diligent in managing risks while seeking returns. With the rise in valuations, asymmetric risks can develop in crowded assets where limited upside remains with significant downside. We avoid these risks and go where the rewards are greater than the risks even if that means it may take a while for the rewards to be realized. Sidestepping large declines based on overvaluation is an important component to compounding returns.

As the late cycle plays itself out we expect volatility across assets to increase. In stocks, we are just starting to see this and as illustrated in the chart below, there is likely more to come just to get to "normal" levels of volatility. Awareness allows us to pick our spots selectively and filter out the noise, leaving us to focus on business fundamentals.



In the bond market, the flattening of the yield curve has resulted in a very small differential between the yields offered at the short end of the maturity curve related to the yield further out in maturity. This dynamic has had us favoring shorter term bonds in fixed income portfolios as well as active and more tactical strategies.

As we've said before, volatility can create opportunity for those who are prepared for it. We have sources of liquidity and dry powder incorporated into portfolios as well as strategies that can take advantage of higher volatility and greater dispersion in markets. We also focus our equity exposure in areas where the valuation metrics and business prospects put the odds in our favor that we will be adequately compensated for the risks we take as equity stakeholders in outstanding businesses.

As always we appreciate the trust and confidence you place in us to guide you on your financial journey.

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