First Quarter 2018
Quarterly Letter to Clients
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The world can change in a moment. Take for instance, this past quarter. The first quarter of 2018 was ushered in with great fanfare. Experts excitedly proclaimed that the economic momentum from the end of 2017 would carry us throughout the New Year, supported by the reduction in income taxes provided by the highly anticipated passing of the 2018 Tax Act. Investment gurus warned of the possibility of seeing a stock market "melt-up" that would overshadow the expected interest rate increases by the Federal Reserve. Nothing was expected to stunt the continued elation of the stock market, which throughout almost all of 2017 had not seen so much as a 5% correction. Then, in what seemed like an instant, investors took on a more apprehensive mindset. Their crystal balls got cloudy as the euphoria of reduced corporate tax rates gave way to the fear of inflation heating up due to wage pressures and the possibility of higher tariffs implemented by the Administration.

The market's sudden reaction appears to be more of a focus on the possibility that the tariff squabble will escalate into a full-fledged trade war. However, despite the rhetoric, positioning, and apparent brinkmanship on both sides of the tariff equation, the current amounts being thrown back and forth would have minimal impact to trade and the U.S. Economy. Sure, an all-out trade war could cause supply disruptions and spark much higher inflation than expected, but the timing and magnitude of this type of event is difficult to assess at this juncture.

The more noteworthy issue confronting the potential prosperity of the U.S. Economy lies in one of the primary drivers of economic growth – employment. The potential output of the nation is really just a function of how many folks have jobs and how productive they are in those jobs. People cannot consume goods and services without being employed. The economy cannot continue to grow without more people spending more of their disposable income on more "stuff". Since consumer-related activities have historically provided over two-thirds (2/3) of the growth in the Gross Domestic Product, the consumer remains a critical component in determining the longevity of the current expansion.

During the 4th Quarter of 2017, the consumer went above and beyond, providing nearly 90% of the growth in GDP. Most investors would not expect this to be sustainable. Thus, it should not be a surprise to see estimates of 1st Quarter GDP growth reduced to the 1.5 to 2% range. The preliminary reports support this expectation. Consumer sentiment, while remaining at high levels, has still not translated into the robust consumption that most economists expected. Retail sales have softened somewhat from the pace set in the prior quarter, and the consumer has accumulated record levels of non-mortgage debt (think credit cards, auto loans, etc.) in their quest to buy "stuff", while simultaneously reducing their rate of saving. In fact, according to the Wall Street Journal, "For four-straight years, consumer spending has risen faster than GDP, causing the personal-savings rate to drop to 2.4% – nearly the lowest on record".[1] With savings rates at near record lows and debt at near record highs, the question confronting policymakers and investors is how can the consumer continue to drive consumption? From the macro point of view, the answer is relatively straightforward. Either more people need to be hired and employed in the workforce, or the existing workforce has to see significant wage increases so they can spend more on goods and services.

With unemployment at 4.1%, the labor participation rate still hovering around 62%, and the number of job openings being greater than the 6.5 million people that are unemployed, there is a possibility that further job growth can occur. However, the hurdles to higher employment are well documented. Business owners continually report that jobs go unfilled due to the mismatch between the skills required for a job and those applying for the position. Additionally, many applicants do not have the resources to relocate to areas where suitable jobs are being offered. Likewise, many companies are not paying for relocation, which hinders the ability to match people with good jobs.

Another headwind to consumer spending is related to the consumers' ability to borrow today to buy what they really cannot pay for until tomorrow. The estimates of Household Net Worth, adjusted for inflation, show Household Net Worth at near record highs, mostly due to higher real estate and stock prices. However, households are also holding record levels of debt. Data from the Federal Reserve Bank of New York shows that aggregate household debt balances have increased for 14 quarters in a row, to a new all-time high of $473 Billion. This surpassed the prior peak set in 2008, just prior to the sub-prime crisis and the Great Recession.[2] Lenders have responded to the rising levels of delinquencies and defaults by increasing lending restrictions on borrowers.

It is reasonable to assume that with such low savings rates and a consumer that is fairly highly leveraged already, some or all of any future increases in disposable income (from either wage increases or the reduction in income taxes) would be diverted from consumption to paying down existing debt.

Consumers are not the only group with deteriorating credit and record levels of debt. A quick perusal around the globe reveals that the easy money policies of the major Central Banks have left the world oversupplied with debt, with the U.S. leading the charge. United States consumers have record amounts of debt. Federal, State, and local governments have record amounts of debt. U.S. corporations are near record levels of debt, with outstanding corporate debt as a percentage of GDP hitting a new, all-time high. In addition, almost half of all Investment-Grade Debt is rated triple-B – at 48% – which is also at a new record high. Likewise, corporate bond investors have seen creditor protections in new issues deteriorate. Many new issues have less covenants or collateral pledged, even though their credit rating is at or below investment grade. This would imply that overall, corporate balance sheets have deteriorated when compared to just a few years ago. Yet, corporate credit spreads continue to tighten, as fixed income investors accept lower compensation for the risks of bankruptcy, recession, and volatility.

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[1] *As Boomers Go Gray, Even 2% Growth Will Be Hard to Sustain* by Jason Furman, The Wall Street Journal, February 14, 2018.
[2] *Why Consumer Spending Growth Is Slowing* by Aaron Back, The Wall Street Journal, April 3, 2018.

Finally, the cost of borrowing is increasing, placing another drag on future economic spending. Rates have climbed, both in response to the Federal Reserve's increase in the Fed Funds Rate, and their announcement to slowly continue reducing their Quantitative Easing (QE) program. In addition, there is an increasing expectation that some inflation could be seen from the previously mentioned wage increases, tariffs, and higher commodity input prices. These factors have combined with supply and demand changes to result in a further flattening of the yield curve, as demonstrated by the 2-year to 10-year U.S. Treasury spread narrowing to 47 basis points, down from 113 basis points a year ago.

Bonds

During the quarter just past, the bond market recorded mixed results, with longer-dated and riskier corporate bonds underperforming short-maturity, high-quality credits. The U.S. Government Treasury 10-year Bond ended the 1st quarter yielding 2.74%, up 34 basis points from the 2.40% yield at the end of the prior quarter. The prospect of further rate hikes, and the aforementioned reduction in the QE program, have both combined to keep U.S. interest rates attractive relative to other global sovereign bonds. Federal Reserve Fed Funds increases have put upward pressure on short rates, causing the two-year U.S. Treasury Note to end the quarter at 2.27%, up 38 basis points from last quarter, and near the highest level in almost a decade.

Morningstar Bond Indexes *As of 3-31-2018*

Style	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	(1.3)	0.6	1.3	1.9
US Shrt Core Bd TR Bond	**(0.4)**	**0.2**	**0.8**	**0.9**
US Inter Corp Bd TR Bond	(1.7)	1.3	2.1	2.6
US Shrt Corp Bd TR Bond	**(0.6)**	**0.8**	**1.5**	**1.6**
US Inter Gov Bd TR Bond	(1.1)	(0.3)	0.6	0.9
US Shrt Gov Bd TR Bond	**(0.3)**	**(0.1)**	**0.4**	**0.6**

Stocks

Stock market valuations continue to be stretched, while performance is being driven by a narrow group of stocks. Enthusiasm for the top performers carried over from last year into mid-March, with Facebook, Amazon, Apple, Microsoft and Alphabet accounting for 45% of the S&P 500's year-to-date advance.[3] Overall, the technology sector continues to be the largest weighting in the S&P 500 Index, making up almost 27% of the index. This outpaces the second place financial sector, whose components make up 17% of the index. With clearly over two-fifths of the index returns coming from these two

[3] *Tech Stocks Are Dominating Global Markets Like Never Before* by Seven Russolillo, The Wall Street Journal, March 28, 2018.

econcomically sensitive sectors, investors should take note on just how much reported returns are dominated by an ever smaller number of companies.

The Lipper Performance table on the next page displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 5-year, and 10-year time periods. For the first quarter of 2018, the table illustrates that smaller capitalization stocks underperformed again when compared to larger capitalization stocks. In addition, for the fifth quarter in a row, lower-quality stocks outperformed their higher-quality counterparts. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) decreased -2.5%, while the S&P 500 was down -0.9%. The tech-heavy NASDAQ posted a gain of +2.4%. The average mutual fund, represented as General Equity in the table, saw a small decline of -0.3% for the quarter. The average stock, represented by the NYSE Composite Index, was down -10.7%, providing additional evidence of the wide dispersion of returns over this past quarter.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, APRIL 16, 2018

	Qtr	1 year	5 year	10 year
S&P 500	(0.9)	13.5	12.7	8.9
Dow Jones Ind. Average P	(2.5)	16.7	10.6	7.0
NYSE Composite P	(10.7)	8.4	6.5	3.5
General Equity	(0.3)	12.6	10.8	8.2
Equity Income	(2.5)	8.5	9.4	7.7
Large-Cap Core	(1.1)	12.9	11.7	8.4
Large-Cap Growth	3.1	22.1	14.4	10.0
Large-Cap Value	(2.5)	9.1	10.4	7.4
Mid-Cap Core	(1.2)	9.8	10.3	8.7
Mid-Cap Growth	2.8	19.0	12.2	9.4
Mid-Cap Value	(2.2)	6.8	9.9	8.8

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

Even with the recent pullback, stocks are overvalued. Our strategy remains focused on doing the hard work of understanding the factors that make a stock a good, long-term investment that can be purchased at attractive prices relative to our estimate of the company's fair value. We will then use those investments to custom-tailor your portfolio in order to meet your long-term goals, while minimizing the risks of permanent capital loss. While we may go through periods like this past year, in which our patience and discipline made it more challenging to identify specific investment opportunities that meet our criteria, we are confident that valuations matter in the long run – even though they may appear less useful in the near term.

One final thought: market disconnects can last for extended periods, lulling investors into a false sense of securitiy as they anchor their behavior to their most recent experience, i.e. expecting things to continue as they have. As Stephanie Pomboy recently stated in Barron's, "We just celebrated the ninth year of the bull market. In that stretch, total market cap increased about $25 trillion. That's five times the growth we saw in the gross domestic product over the same stretch, and 25 times the increase in profits."[4] History shows us that these disconnects are eventually corrected. History also shows us that the world can change in a moment.

[4] *Stephanie Pomboy: How the Fed Will Trigger the Next Crash* by Leslie P. Norton, Barron's, March 22, 2018.