Fourth Quarter 2018

Quarterly Letter to Clients

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The past quarter was one for the record books. It capped off a year that may best be characterized as one of taxes, tariffs, and turmoil. We began 2018 with the pundits proclaiming calm seas and clear skies ahead, pinning their forecasts on the December 22, 2017 passage of the Tax Cuts and Jobs Act, which lowered tax rates for most taxpayers beginning in 2018, and provided a chance for increased prosperity for all. The stock market rallied – that is, until the talk of tariffs picked up steam at the end of January 2018 and the market realized that the benefits of the Tax Act could be offset by the uncertainty of tariffs, which could shift the cost of goods and prices charged by an indeterminate amount. The stock market then dropped by almost 10 percent, not quite enough to be considered an official correction, but enough to bring the tired bulls back into the market to allow stocks to recover by the end of the 2nd quarter.

Even with the realization that the trade talks may take months or years to accomplish, the stock market traded its focus between rising interest rates and tariffs throughout most of the rest of the year. Domestic economic activity, as measured by Real GDP, hovered around 3 percent, providing cover for the steadily increasing level of interest rates that were beginning to challenge borrowers with the prospect of higher monthly payments for shelter and transportation. Finally, the turmoil peaked near the end of September. Tariff talks progressing poorly with China, combined with the uncertainty of BREXIT impact on the already slower growth in Europe, provided the real possibility of global economic activity slowing to a snail's pace and the realization that the almost 10-year long expansion might come to an end.

The capital markets spent most of 2018 dominated by a handful of high-flying stocks, whose stratospheric rise pushed the major stock indices to their peak in September. However, the lack of participation by the broader market, combined with increased uncertainty regarding tariffs and trade, resulted in a 4th quarter downdraft that caused most stock benchmarks to end in the red for the year. In fact, all three major indices registered their first negative total return year since 2008. The S&P 500 completed the year with a loss of 6.2 percent, while the Dow Jones Industrial Average declined 5.6 percent, and the NASDAQ composite was off by 3.7 percent. The average diversified U.S. Stock fund fared worse, declining 7.7 percent, while the

average international stock fund declined 15.5 percent. Fixed income funds did somewhat better, but still ended in the red, with the average bond fund falling 0.7 percent.

The dizzying market volatility in the year's final quarter was only exacerbated by the game of chicken taking place between Congress and the President regarding final funding items in the annual fiscal year budget appropriations. The result – a partial government shutdown that is not yet resolved as of this point in time. In addition, friction between the Administration and the Federal Reserve's increasingly less accommodative policy stance came to a crescendo when the Fed voted to increase the Fed Funds rate another quarter point in mid-December, placing the current federal funds rate at 2.5 percent. Ironically, almost to the day one year after the Tax Act was signed, the stock market's wobble turned into a fall, with the stock market logging its worst-ever Christmas Eve selloff. But in the spirit of Dr. Seuss's How the Grinch Stole Christmas, the market rebounded, posting the largest one-day point change in history the day after Christmas.

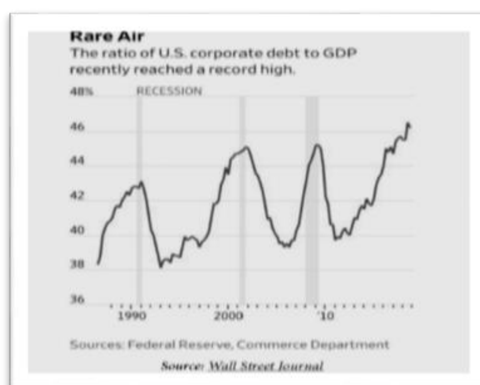
Economic activity in the 4th quarter of 2018 had its bright spots. Consumer confidence remained near peak levels for this cycle and was reinforced by continued spending into the holiday season. Job creation in December surprised economists, with nonfarm payrolls rising by 312,000 jobs. This level was significantly greater than the monthly average rate of 220,000 jobs seen throughout 2018. In addition, 419,000 more workers entered the workforce during December, increasing the labor force participation rate to 63.1%, up 0.2% from November and 0.4% when compared with last year's levels. Unemployment rose to 3.9%, up from the prior month's 3.7%, mostly due to the influx of labor entering the workforce. Finally, wages increased 0.4% in December, putting wage growth solidly over 3% and recording the highest rate of growth since April 2009.

While the sustainability of U.S. Real GDP growth will continue to be dependent on consumers' ability to keep spending, *how* that spending is funded is becoming more and more of a concern. Consumer debt, generally defined as credit cards, auto loans, student loans, and personal loans, is on track to exceed $4 trillion in 2019. In addition, mortgage debt at the end of the 3rd Quarter of 2018 was $10.3 trillion, up 2.8% year over year and just shy of the record level of $10.7 trillion, set in the first part of 2008. The average consumer at the end of September 2018 had a credit card balance of $6,826, an increase of 1.9% year over year. In addition, the average new car loan is just shy of $31,000, with an average payment of $530 per month.

While low interest rates have allowed consumers to keep their total debt payments, including mortgages, around 10 percent of disposable income, there are some warning flags of which investors should be aware. First, credit card losses are climbing, despite the strong job creation and the historically low unemployment rate. Write-offs by credit card issuers are

gradually increasing, with the most recent figures showing a 3.16% level versus 2.59% a year ago. Secondly, the student loan burden has continued to rise, with loans outstanding approaching $1.5 trillion (92% of the total owed to the Federal government) and an increasing number of borrowers paying late or becoming delinquent on their loans. As John Anglim, a credit analyst at S&P Global Ratings recently wrote, "If borrowers can't pay down their student loan debt in a time of relative economic prosperity, what will happen during the next economic downturn?" [1]

The world is awash in debt. In fact, the consumer isn't the only one that has taken advantage of the extraordinarily low interest rate environment. Governments and corporations around the world have participated in a like manner. According to the Citigroup Institute of International Finance, the latest estimate of worldwide debt is approaching $250 Trillion, with the largest borrowers being "the U.S., China, the Eurozone, and Japan, which have more than two-thirds of the world's household debt, three-quarters of the corporate debt, and nearly 80% of government debt."[2] As the graph below shows, the ratio of U.S. corporate debt, when compared to U.S. GDP, is almost 46%, the highest level on record.



With global central banks at various stages of transitioning their monetary policies from "super accommodation" (through their Quantitative Easing (QE) and Zero Interest Rate (ZIRP) programs) to something less accommodating, the cost of borrowing will likely be higher in the near future. As financial conditions continue to tighten, those firms, people, or governments that have gone overboard on debt will feel the dual impact of slower economic growth combined with higher interest rates as they try to finance expansion in operations, buy homes or cars, or just try to refinance existing debt. In a nutshell: Those with liability heavy balance sheets are highly dependent on the continuation of the existing economic expansion to grow company revenues, wages, and tax receipts.

[1] "US Economy Fuels Boom in Consumer Debt" by AnnaMaria Andriotis, The Wall Street Journal, 12-31-2018.
[2] "Taking Stock of the World's Debt" by Aaron Kuriloff, The Wall Street Journal, 1-2-2019.

As the capital markets try to divine the future and what drivers will dominate in maintaining an economic status quo, two things become obvious. First, the world is too complicated to be modeled and to take into account all the factors that will drive global and domestic economic growth, the proverbial "what we don't know." Second, in the camp of "what we do know" is the fact that a Federal Reserve policy mistake, a tariff war, or increased barriers to business growth (i.e. increased regulatory hurdles) could be detrimental in shifting the delicate balance within the economy from expansion towards contraction. All of this breeds the type of uncertainty that the bond and stock markets abhor, implying that a higher level volatility in stocks and bonds will return to the capital markets.

The **Bond Market**, historically the leader in the divination process, appears confused at this point in time. After 10 years of extraordinary monetary policy which masked the risk and pricing mechanisms of interest rates, the credit markets seem to be saying what has happened in the past is not going to happen again. Credit spreads have remained historically tight, despite the unprecedented growth in corporate debt and the meager level of high-quality credits for fixed income investors to purchase. Confidence, always a fragile thing, appears to be misplaced and focused on the Fed instead of on the borrower's ability to repay the debt, including the agreed upon interest rate.

In the midst of this apparent confusion, the yield curve has spent the last year flattening, driven on the short end of the curve by rising Federal Fund rate increases. The 90-day Treasury bill increased a full 100 basis points (1 percent) during 2018, while the 10-year increased almost 30 basis points. The 2 year – 10 year spread, which historically has indicated a slowdown in the economy if it turns negative, has continued in a downward trend and ended the year at 21 basis points, down from the prior year's 51 basis points.

Finally, it appears that the bond market's focus is on whether or not there will be 1 or 2 more rate increases in 2019 and whether that will be 1 or 2 too many, which might be a catalyst for the next recession. Historically, the Fed tightens too far in trying to slow inflationary forces. At the current time, inflation as measured by the Fed is hovering right around their target level of 2 percent. The second Fed mandate, employment, continues to show favorable progress. The tug-of-war continues between the part of the market focused on slowing global growth and increasing probabilities of recession, and the other side asking, "If growth is so good, why is there any concern about raising the Fed Funds rate a quarter point?" In the middle, Federal Reserve Chair Jerome Powell sits with the FOMC members, which currently forecast at least two rate increases and about $600 Billion in Quantitative Tightening (QT) in 2019 – which sounds suspiciously like a less accommodative policy. Yet, Mr. Powell's reaction to market turmoil was to crack the door open and provide the hope that the Fed will at least maintain the status quo. The path and the destination of the Fed's policy is increasingly becoming more uncertain.

This increased uncertainty had a direct impact on interest rates and the performance of various credits during the past quarter. Yields on treasury bonds continue to vacillate within a trading range. During the past 91 days, the 10-year Treasury bond traded to yield between 2.69% and 3.24%, posting a yield of 2.69% at the end of December. As the table below shows, lower quality bonds underperformed higher-quality credits, as spreads widened on corporate debt and risk-aversion increased. This translated into mostly positive returns for U.S. Government issues, with corporate credits showing some minor losses.

Morningstar Bond Indexes *As of 12-31-2018*

	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	2.1	0.9	1.9	2.7
US Lng Core Bd TR Bond	1.3	(3.2)	3.3	4.6
Corporate				
US Corp Bd TR Bond	**(0.1)**	**(2.3)**	**3.2**	**3.3**
US Inter Corp Bd TR Bond	0.7	(0.4)	2.9	2.9
US Lng Corp Bd TR Bond	(1.2)	(5.5)	4.3	4.4
Government				
US Gov Bd TR Bond	**2.6**	**0.9**	**1.4**	**2.0**
US Inter Gov Bd TR Bond	2.9	1.4	1.4	2.0
US Lng Gov Bd TR Bond	4.1	(0.7)	2.2	4.9
US Shrt Gov Bd TR Bond	1.5	1.5	1.0	0.9

The **Stock Market** in this past quarter woke up to the reality that the earnings comparisons from corporate tax reductions might be offset by reduced global growth and the increasing possibility of an extended trade dispute with China, or worse, a tariff war that could put a dent in earnings forecast for the next few years. Combine tariffs with higher interest rates that might slow the domestic economy, add slower global growth to the mix, and one has the recipe for additional uncertainty and volatility. In response, investors did some year-end tax selling and capital gain capture that morphed into a sharp drawdown causing the stock market to close out the year with the worst decline since the 2008 financial crisis.

The Lipper Performance table below displays the range of returns earned by mutual fund managers during both this past quarter and the 1-year, 3-year, and 5-year time periods. For the fourth quarter of 2018, the table shows that all major indices sank, with smaller capitalization stocks underperforming when compared to larger capitalization stocks. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) decreased -11.3%, while the S&P 500 was down -13.5%. The tech-heavy NASDAQ posted a loss of -17.4%, outpacing most other major indices. The average mutual fund, represented as Equity Income Fund in the table, saw a decline of -11.3% for the quarter. International funds did not fare

much better, decreasing -12.5% for the quarter, providing additional evidence of the wide downdraft of returns over this past quarter. Most of those losses occurred during the last month of the year, making it the worst December since 1931 for the S&P 500 and DJIA. All three indexes dropped by at least 8.7% during December.

LIPPER MUTUAL FUND INVESTMENT

Performance Averages

Friday, January 4, 2019

Investment Objective	4th qtr	1-year	3-year	5-year
S&P 500 Daily Reinv IX	(13.5)	(4.4)	9.3	8.5
DJ Ind Dly Reinv Avg IX	(11.3)	(3.5)	12.9	9.7
Multi-Cap Value Funds	(14.5)	(11.4)	5.6	4.2
Equity Income Funds	(11.3)	(7.2)	6.9	5.4
Large-Cap Core Funds	(13.5)	(5.6)	7.9	6.9
Large-Cap Growth Funds	(15.5)	(0.8)	9.4	8.9
Large-Cap Value Funds	(12.8)	(8.7)	6.6	5.3
Mid-Cap Core Funds	(16.2)	(11.7)	5.2	3.8
Mid-Cap Growth Funds	(17.6)	(5.4)	7.7	6.1
Mid-Cap Value Funds	(16.8)	(14.8)	4.2	3.2
International Stock Funds	(13.5)	(15.5)	2.5	0.1

Sources: Lipper; WSJ Market Data Group

It is apparent that the weak finish to 2018 is challenging investor confidence in the stock market. It is never fun to watch account balances decline – especially when we've gone so long without any major market corrections. Exuberance has faded for the time being and many investors may believe a more cautious approach to deploying funds is probably in order. However, the risk profile of the market has changed, as lofty multiples experienced over the past few years have now been replaced with more reasonable valuations and a better risk to return tradeoff. This is not to imply that the market cannot see a further drawdown. However, as prices fall, the expected returns for long-term investors improve dramatically. This can be capsulized in the old saw attributed to Warren Buffett, "Be fearful when others are greedy, and be greedy when others are fearful."

Irrespective of the market's turmoil, our focus remains on achieving your long-term goals by custom-tailoring your portfolio to minimize the risks of experiencing a permanent loss of capital. We will continue to concentrate on the long-term prospects of those companies that meet our investment criteria. Through our disciplined process, our emphasis will continue to be on finding value, without sacrificing quality. In addition, we will purchase those stocks that can be bought at prices that meet our standards, while providing an adequate margin-of-safety. Finally, we will sell those stocks that exceed our estimate of fair value, regardless of the gyrations of the broad markets.