First Quarter 2019
Quarterly Letter to Clients
By Scott A. Wendt, CFA
April 23, 2019

Let's all just face it. The dismal science, the pseudonym for the practice of economics, has lived up to this 1966 Nobel Prize winner's famous quote:

"The stock market has predicted nine out of the last five recessions!" - Paul A. Samuelson, 1966

It's not any easier to forecast a change in economic activity today than it was in 1966, despite all the advances in economic theory. In fact, given the speed and global scope of most of today's business activity, the ability to model and predict future economic relationships has only grown more complicated. It's no wonder that investors around the world are befuddled, vexed, and otherwise confused as stocks continue their upward ascent while global growth continues to show signs of slowing. This is even more confusing given that most equities have rebounded near their record highs after experiencing a severe downdraft in the fourth quarter of last year, which many participants thought might be the prelude to a business slowdown or maybe even a recession.

From the capital market's perspective, it sometimes appears that economic fundamentals which drive interest rates, inflation, and asset prices are much less important than the next fiscal or monetary stimulus that can be used to encourage additional economic activity. Historically, the five major indicators of an impending recession were an inverted yield curve, rising unemployment, a drop in housing starts, declining corporate profits, and a decline in the leading economic index. However, ten years of aggressive easy money policies, characterized by extraordinary actions like Quantitative Easing (QE) and pushing short interest rates to zero (remember Zero Interest Rate Policy – ZIRP) or negative levels by the world's major central banks, has left investors conditioned to focus on monetary policy changes almost to the exclusion of all else. Thus, it may not seem unusual to read something like the following in the financial press: "Global stocks are rising at the fastest pace in decades as growth around the world slows, leaving many investors questioning how much longer the market can defy the gravity of the underlying economics…Fund managers also have increasingly questioned whether the Federal Reserve's pivot from raising rates to holding them steady reflects economic weakness that will ultimately derail the market's rally."[1] This brief statement may

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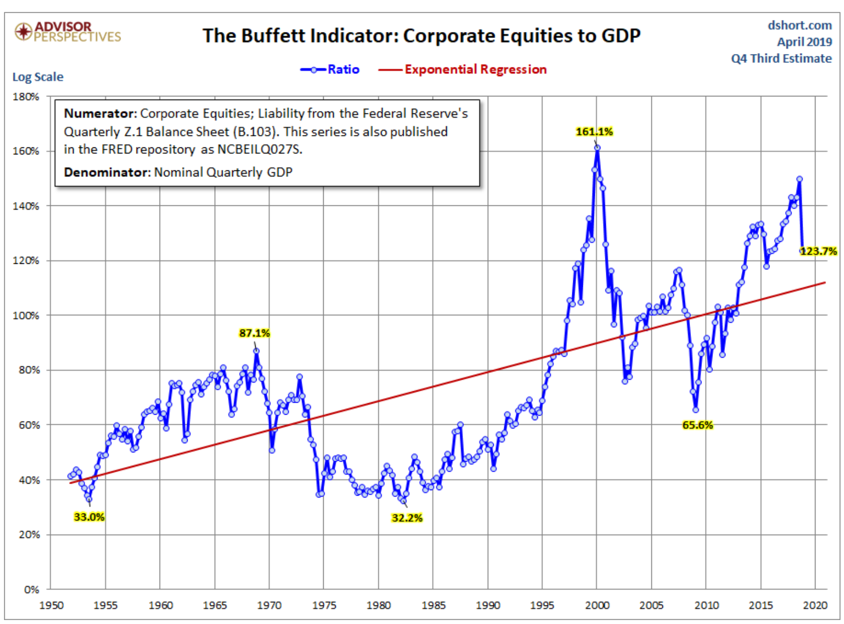
[1] Global Stock Rally Defies Dimming Economic Outlook, by Akane Otani, The Wall Street Journal, April 14, 2019.

well sum up the current tenor of the markets – and the almost perpetual focus on central bank actions.

Certainly, the signs of slowing growth are abundant. Asian growth is fading, driven mostly from a reported slowdown in Chinese GDP. European growth is softer and complicated by Great Britain's proposed departure from the European Union, now infamously known as BREXIT. Additionally, growth patterns in the U.S. have been muddled by the one-time impact of reduced taxes accompanied by increased government spending, which produced a short-lived increase in economic growth and much higher levels of Treasury Debt to fund the budget deficit. Finally, tariffs and trade talks have provided an extra measure of uncertainty, as many retailers accelerated purchases of goods from China in 2018, anticipating the potential impact of tariffs in 2019.

Corporate America continues to plan for a variety of possible outcomes to offset the potential impacts of tariffs and trade to their current supply chains and distribution routes to meet customer demands. Despite all the noise, top-line revenue growth has remained healthy, with low single-digit growth expected for 2019. Profit growth has waned somewhat, with margin pressure from higher transport costs and higher compensation costs translating into slower year-over-year growth. Analysts' estimates for Q1 2019 earnings growth have turned negative at -4.3% in a recent FactSet forecast, the first quarterly decline since the second quarter of 2016. However, net profit margins remain at near record high levels.

With historically low interest rates, moderate inflation expectations, and high but declining earnings expectations, the stock market's rise has been driven almost entirely from multiple expansion. From a longer-term view, the Buffett Indicator shown below, provides some perspective as to where valuations stand currently.



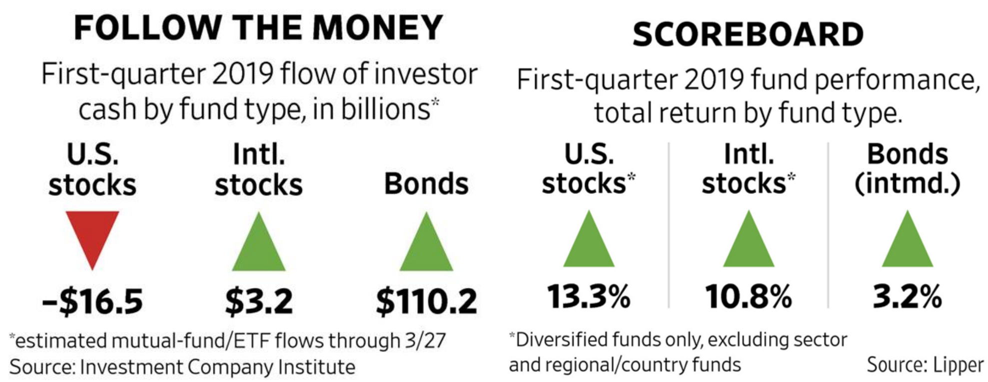
The pertinent question for investors at this point is will high valuations be sustained going forward? The answer may well depend on the belief that extreme valuations can either be supported by fundamentals or sentiment. Fundamentals are weakening, with profits peaking in late 2018 and record high profit margins beginning to decline. For sentiment to support high valuations, investors must believe that profit margins will stay at their current levels for the foreseeable future. As the economy moves into its late cycle phase, the risks to maintaining profit margins at this high level will most likely increase. This makes it increasingly probable that valuations will decline toward their long-term secular trend.

The Bond Market clearly responded to the Fed decision to hold rates steady and pause on its balance sheet normalization process. The return to a more dovish stance reversed the concerns of rising rates for many bond market participants. As a result, since the first of the year, interest rates have fallen and credit spreads have tightened across most lending categories. 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 2.39% and 2.79%, posting a yield of 2.41% at the end of March. As the table below shows, lower quality bonds outperformed higher-quality credits, as spreads tightened on corporate debt and risk-aversion decreased. This translated into mostly positive returns for U.S. Government issues, with corporate credits showing some major gains.

Morningstar Bond Indexes *As of 3-31-2019*

	Quarter	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	2.4	4.7	1.9	2.8
US Shrt Core Bd TR Bond	**1.5**	**3.4**	**1.4**	**1.4**
Corporate				
US Corp Bd TR Bond	5.1	5.1	3.6	3.7
US Inter Corp Bd TR Bond	4.6	5.9	3.3	3.4
US Shrt Corp Bd TR Bond	**2.3**	**4.2**	**2.3**	**2.1**
Government				
US Gov Bd TR Bond	2.2	4.3	1.1	2.2
US Inter Gov Bd TR Bond	2.0	4.6	1.0	2.2
US Lng Gov Bd TR Bond	4.1	6.3	1.4	4.6
US Shrt Gov Bd TR Bond	**1.1**	**3.0**	**1.0**	**1.1**

The Stock Market responded in a similar manner to the Fed change in posture. Stocks rebounded strongly from the December depths and ended the quarter near their former highs. This quick recovery allowed the bull market that began in March 2009 to continue its unbroken record as the longest bull market ever. Despite the market rally, equity flows for the first quarter were significantly negative, as shown in the graphic below.[2] In fact, the outflows were at the worst levels seen since 2008. This could be an indication of diminishing confidence in stocks as investors reassess their risk positions.



The Morningstar Performance table below displays the range of returns earned by mutual fund managers by style category during both this past quarter, 1-year, 3-year, and 5-year time periods. For the first quarter of 2019, the table shows that all major indices rebounded, with smaller capitalization stocks outperforming compared to larger capitalization stocks. On a total return basis for the quarter, the Dow Jones Industrial Average (DJIA) increased 11.8%, while the S&P 500 was up 13.7%. The tech-heavy NASDAQ posted a gain of 16.5%, outpacing most other major indices. The average equity mutual fund saw an increase of 13.3% for the quarter. International funds also saw improvement, increasing 10.8% for the quarter.

Morningstar Stock Indexes *As of 3-31-2019*

Style	Quarter	1-Year	3-Year	5-Year
US Large Growth	15.8	14.6	17.6	14.4
US Large Val	10.5	7.8	11.2	8.5
US Mid Growth	21.4	14.2	17.0	11.0
US Mid Val	13.0	3.4	11.0	8.5
DJ Industrial Average TR	**11.8**	**10.1**	**16.4**	**12.2**
NASDAQ Composite PR	**16.5**	**9.4**	**16.7**	**13.0**
NYSE Composite PR	**11.6**	**2.0**	**7.6**	**3.8**
Russell 2000 TR	**14.6**	**2.1**	**12.9**	**7.1**
S&P 500 TR	**13.7**	**9.5**	**13.5**	**10.9**

[2] **Source: https://www.wsj.com/articles/u-s-stock-funds-rose-13-but-bonds-draw-cash-11554689460?mod=searchresults&page=1&pos=1**

While the quick rebound in stock prices may give folks relief from the heartburn they experienced at the end of last year, it only makes finding genuine bargain stocks that more difficult. Our search for good companies that meet our investment criteria is a continuous process. We currently have a backlog of companies we would like to own when the offered price in the stock market is attractive relative to our estimate of the company's intrinsic value. Our disciplined process will continue to focus on finding value, without sacrificing quality. Finally, we will sell those stocks that exceed our estimate of fair value, regardless of the vagaries of the broad markets.