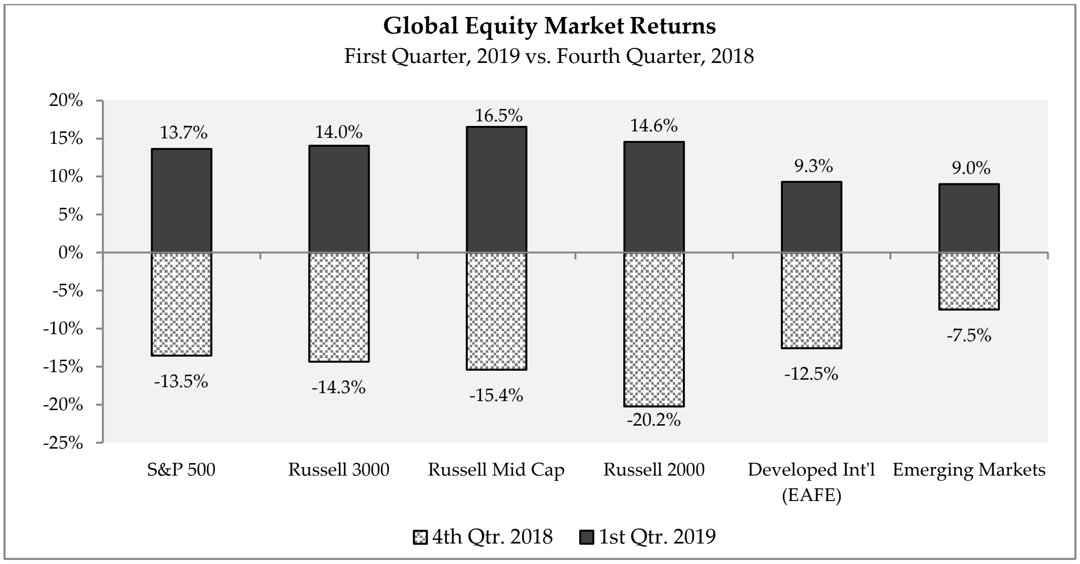
Investment Review and Outlook
March 31, 2019

"Flying too low was necessary, and our gauges didn't help much. When you felt the jungle trees scraping the bottom of your aircraft you knew it was time to gain some altitude." **- John McCain, Air Force Captain and U.S. Senator (1936 – 2018).**

Investors entered 2019 believing markets were "scraping" the economic treetops perilously heading towards disaster. Stocks had been pummeled by a fourth quarter bear collapse that drove equities down over 20% from record highs set in late September. Investor sentiment was dominated by concerns over slowing global growth, trade tensions with China, and an indecisive Fed. Political anxiety in the U.S. and abroad was boiling over as the government was bogged down in a partial shutdown and the Brexit debate raged in the British parliament. In the early weeks of the new year fears of global recession were rampant.

However, before economic doomsday arrived, investors were given much needed clarity about the economic path ahead. At the Federal Reserve's January meeting, Chairman Powell delivered the message that the Fed will "pause" interest rate hikes until there is more economic certainty. This change in monetary direction was followed by news that the protracted government shutdown would come to an end and fourth quarter earnings reports in late January came in modestly above expectations. Even concerns over China trade negotiations receded as the Trump administration dangled the prospects of a favorable outcome.

These positive developments in rapid succession signaled the "all clear" for investors to return to risk-oriented assets. As a result equity markets reversed course and soared higher. In fact, after the fourth quarter's collapse, equity markets surged to their largest first quarter gain since 1998. This dramatic market reversal is shown in the chart below.



Source:FactSet

After trailing in the fourth quarter, mid and small cap stocks outperformed their large cap counterparts in the first quarter. International markets experienced a solid bounce back; however, they trailed the sharp rise in U.S. stocks. Lingering worries over the U.K.'s failure to execute on Brexit, negative interest rates in key economies such as Germany, and slowing emerging market growth served as a drag on international markets.

Although the surge in stocks dominated financial news, dramatic moves also occurred in global bond markets. Interest rates declined around the world as many central banks pushed rates lower to avoid economic contraction. In the U.S., interest rates dropped across the maturity spectrum, forcing the yield curve to flirt with inversion. The 10-year versus 2-year Treasury yield spread finished at a razor thin 16 basis points, after dropping to a low of 10 basis points in early March. The 10-year Treasury yield dropped significantly from 2.72% in early January to 2.39% in late March. Consistent with rising investor appetite for risk, spreads between the "BBB" corporate bond yield and 10-year Treasuries contracted from 188 basis points to 158. With sharp declines in interest rates, bond prices moved higher as the Bloomberg-Barclays Government/Corporate Index gained 2.32%, and the 1-10 year Municipal Index rose by 2.21%.

Economic and geopolitical uncertainty caused commodity markets to experience dramatic volatility in the quarter. After declining 24.5% in the final months of last year, oil prices surged 32.4% in the first quarter. Despite the sharp rise in this key commodity, crude prices remain over 10% below year ago levels.

Although not nearly as heroic as John McCain's missions in Vietnam, investors felt the fear of approaching economic danger early in the year. However, with a wave of positive news delivered in January markets were able to quickly "gain some altitude." Despite the strong start to the year, the path forward remains uncertain.

The Economy: The Risk of Pessimism

"Don't be so pessimistic. The glass is always half full, it's up to you to fill it up". **Charles Schulz, Creator of "Peanuts" Comic Strips (1922 – 2000).**

The start to a new year usually brings optimism and anticipation of good things to come. It is a time to focus on new opportunities that lie ahead. Traditionally, investors follow a pattern of starting each new year with lofty expectations, believing that an improving economy lies ahead. Most often, investors' early enthusiasm is eventually derailed by the realities of the volatile global economy. This annual ritual of investor optimism, followed by economic disappointment, plays out each year. It's a process of starting with high expectations and then ratcheting your outlook lower to meet the realities of the economy as it unfolds.

Typically, investors faithfully follow this annual pattern. However, the sequence of market emotions were reversed in the first quarter as investors began the year under a cloud of extreme pessimism. As 2018 came to a close, economic expectations for the new year were sinking. After raising interest rates five consecutive quarters, the Fed was signaling 2-3 additional hikes in the new year. The synchronized global growth theme that had buoyed markets earlier in year was over, and fears of a dramatic slowdown in the Eurozone and emerging markets were escalating. Brexit resolution was caught in a U.K. political quagmire, and trade negotiations with China were showing little signs of progress.

Against this dark economic backdrop, talk of recession was being woven into every market discussion. Economists, policymakers, and strategists joined forces confidently warning of impending economic doom. The case for recession quickly moved from a fringe forecast to mainstream economic reality. An early January Wall Street Journal headline declared *"Calls for Recession in the New Year Grow Louder."*

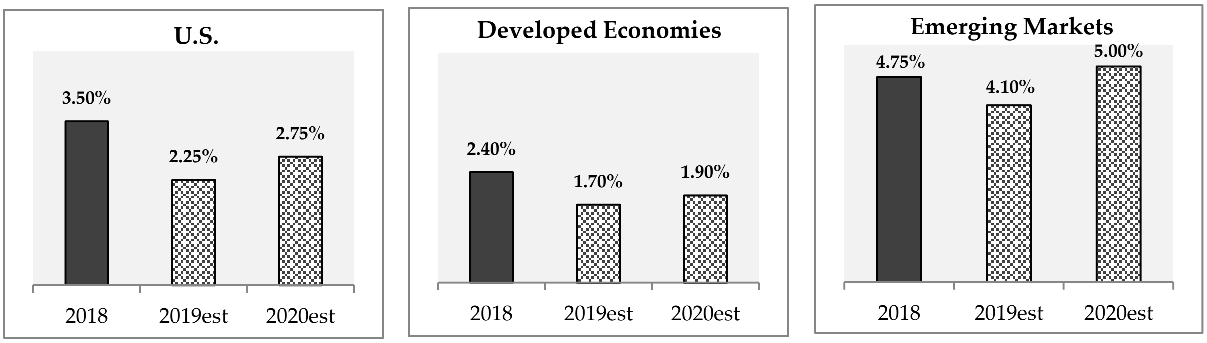
Just as investors were bracing for global recession, multiple economic events surfaced that unraveled the doomsday scenario. Chairman Powell took the stage at his news conference following the Fed's January meeting and declared that "the case for raising interest rates has weakened in recent months." His commitment to be "patient until there is better economic clarity" crushed investors' fears of recession. As a result, the market pendulum abruptly swung from doom to euphoria. The weight of tightening monetary policy was lifted, allowing equity markets to soar. Investors that had altered their long-term strategy by attempting to time the market and detour around an economic collapse that never occurred were caught on the sidelines as markets surged.

We have long warned against becoming too pessimistic. Our view is that investment risk exists at both ends of the economic spectrum. Investors assume undue risk when they are *overly negative* on markets just as they do when being *overly positive*. In fact, we warned against the risk of extreme pessimism in our year end commentary when we advised "don't confuse an economic slowdown with a recession." The negativity trap was set in early January, and most investors found themselves caught. We acknowledge that we are still early in the year, and considerable risks remain in the market. However, we believe the recession scare has passed for now. We are pleased we avoided the recession mania and adhered to our core philosophy of maintaining a long term perspective with an emphasis on broad diversification.

Although the year is far from over and economic threats are always looming in the future, we believe the global economy will continue to show positive growth, albeit at a slower pace than last year. Final U.S. GDP growth for 2018 is expected to be 3.5%, with our expectations for 2019 declining to 2.0-2.5%. Similarly, developed economies in the Eurozone and the Far East are also expected to slow. Emerging markets should sustain higher growth rates, but a similar path of decline is expected.

The charts below demonstrate our expectations for global growth.

<u>Global GDP Growth</u>
(2018 – 2020)



Source for all charts: International Monetary Fund (IMF)

Our view is that the global slowdown will continue to be positive for markets. When economic growth is running "hot" monetary policymakers become anxious to slow the expansion by raising interest rates, which most often leads to unintended contractions. This is what occurred in the fourth quarter of last year. In the current environment, the Fed's decision to step aside is encouraging. As a result, we don't foresee any indication they will become monetary "hawks" in the near future. Monetary stability should allow investors to continue to feed their appetite for risk-oriented assets.

We remain optimistic that a trade deal with China will materialize by mid-year. An agreement that demonstrates even marginal progress will be welcomed by global investors. The combined forces of global monetary accommodation and a favorable trade outcome should help bolster international growth. The beaten down emerging markets should benefit most directly. However, this is a segment of the global markets that carries the most uncertainty and volatility risk.

Despite our favorable view of financial markets, we are keeping our optimism in check. There are several risk factors that we are watching that keep us cautious. The global economy remains extremely fragile with a Chinese trade agreement yet to be resolved, and the execution of Brexit still stumbling through its political process. The news over Brexit is likely to get worse before it eventually gets better. The U.K. is expected to violate the April 12 deadline to exit the European Union without a confirmed deal in place, which will further destabilize economic agreements between the U.K. and the E.U. As the world's largest economic block, failure to resolve this complex situation will have meaningful consequences throughout most global economies.

Within the U.S., investors are keeping a close watch on corporate profits. Although year-over-year profit comparisons become easier as we approach 2020, second and third quarter revenue and earnings could be at risk of disappointing. In addition, guidance offered by company managements following earnings releases has become more significant than reported results. In the event the tone of company management commentaries turns cautious, markets will likely react negatively.

Our view over the near term is that the positive forces of a slow growth economy in the U.S., unimpeded by Fed policy, will be in constant battle with fears of global economic uncertainty. Navigating this narrow passage between maintaining positive growth and tipping back into a pessimistic environment will be a challenge for investors throughout the remainder of the year.

Investment Strategy: Don't Abandon the Strategy

"Stick to your investment plan – don't turn temporary declines into permanent losses" **Warren Buffett, Investor and Philanthropist (1930 – Present)**

Our investment strategy has not materially changed since the beginning of the year. Portfolios benefited greatly from avoiding being pulled into the recession camp that dominated markets in early January. Our outlook continues to be based on the belief that the global economy is following a slow growth path, with little risk of recession. Slow growth combined with low interest rates, manageable inflation, and a deliberate Fed is a positive recipe for financial markets.

As a result, we are maintaining our current exposure to the U.S. and international equity markets. We fully expect extreme volatility is ahead, especially following the record equity gains experienced in the first quarter. However, our strategy continues to emphasize diversification across capitalization, investment style, and discipline – to include both active and passive strategies. This approach to equity investing allows volatility risk to be managed within the portfolio, and not through attempts to time market movements.

Our interest rate outlook calls for rates to eventually rise across the maturity spectrum as the economy regains its footing. The Fed's pause in raising short rates is likely to "anchor" the short end of the curve and allow the long end to move higher as the economy slowly improves. This move has not yet materialized as long rates have actually fallen in recent months over concerns of continued global slowdown. This environment makes portfolio decisions regarding duration, credit selection, and yield curve positioning extremely important when managing bond portfolios.

Our view is that the best approach to managing bond portfolios in the current environment is to emphasize corporate securities over Treasuries and agency bonds in taxable portfolios. Without concerns about a recession in the near term, exposure to corporate bonds is more attractive than government debt securities. We are transitioning portfolios from short of their benchmark's duration towards neutral in order to better manage price risk and continue to allow for reinvestment as rates eventually rise.

We are pleased with how markets behaved in the rapidly changing environment of the first quarter. We know that we have a long year still ahead. However, we are confident that maintaining discipline in our investment process and adhering to our investment philosophy will allow us to achieve your long-term investment objectives.