March 2018

A Focus on Key Fundamentals

In his most recent annual shareholder letter, Warren Buffet writes:

What investors need … is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period -- or even to look foolish -- is also essential.

The discipline and composure Buffet celebrates are core components of our investment philosophy. And while it may seem unimaginative at times, we do our best to encourage our clients to focus on investment fundamentals that will serve their time horizons and personal financial goals.

This month, we will zero in on global growth data, inflation metrics, views expressed by the Chair of the Federal Reserve, and the long-term beneficial economic entanglement of North American countries and global trading partners. While volatility has reappeared, we do not believe it means economic expansion is ending. On the contrary, we believe that the global economy, and the U.S. economy in particular, is fundamentally healthy and continues to experience balanced growth. We also expect global equity markets to right themselves from the recent correction, although there may be some periods of heightened volatility.

Overview

In February, U.S. and foreign equity prices moved sharply lower as the correction that began in January continued. Toward month-end, however, some stability seemed to reappear. On the month, the S&P 500 Index declined 3.69%, and the MSCI All Country World ex-US Index retreated 4.72%. Even core municipal and taxable bonds gave ground as yields rose. The BarCap U.S. Aggregate Bond index dropped 0.95%. Nevertheless, global economic activity generally continued to expand and remains on firm footing, despite increasing uncertainty about the U.S. approach to trade and future Federal Reserve monetary policy. In this installment of *Insights*, we discuss our take on these two matters against the backdrop of recent economic and investment developments. We continue to believe that the global economy, and that of the U.S. in particular, is healthy and continues to experience synchronous growth. In our view, economic expansion should continue, although at perhaps a more moderate pace. We also expect global equity markets to right themselves from the recent correction, although there may be some periods of heightened volatility.

Performance

U.S. equity performance finally registered a negative month after an atypically long period without one. Bond yields rose, and the prices of core bonds, which move inversely to yields, dropped. For the year through February, the S&P 500 Index is up nearly 2%, and the U.S. Aggregate Bond Index is down a tad more than 2%.

Index Name	Feb.	2018 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	-0.30	-1.47	2.57	4.66	US Muni Bonds
BarCap US Agg Bond TR USD	-0.95	-2.09	1.71	3.60	US Taxable Bonds
BoAML US High Yield Master II TR USD	-0.93	-0.30	5.35	8.13	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	-1.99	-2.03	4.49	7.00	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-1.04	3.39	-0.97	3.59	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	-1.49	1.87	3.52	-0.18	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-3.96	1.69	15.02	10.27	US Equity -- Large
S&P 500 TR	-3.69	1.83	14.73	9.73	US Equity -- Large
NASDAQ Composite TR USD	-1.74	5.54	19.56	13.60	US Equity -- Large
Russell 1000 TR USD	-3.67	1.62	14.56	9.78	US Equity -- Large
Russell Mid Cap TR USD	-4.13	-0.52	13.01	10.05	US Equity -- Mid-sized
Russell 2000 TR USD	-3.87	-1.36	12.19	9.75	US Equity -- Small
MSCI All Country World Index ex-USA NR USD	-4.72	0.59	6.31	2.65	Int'l Equity -- Comprehensive
MSCI EM NR USD	-4.61	3.34	5.02	2.65	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-1.73	0.22	-8.08	-8.26	Commodities
HFRX Global Hedge Fund USD	-2.42	-0.04	1.63	-0.39	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 02/28/2018

One additional note: In part because the U.S. dollar has weakened this year, local currency emerging market bonds are up approximately 3.4%, according to the JPMorgan GBI Emerging Market Diversified Index. Emerging market equities are up about the same amount, as measured by the MSCI Emerging Market Index.

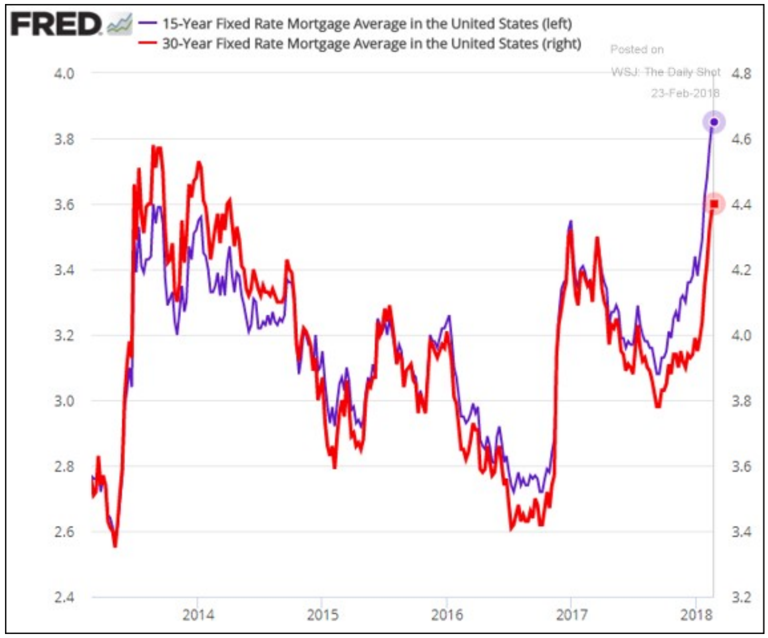
Outlook

As we have noted in recent installments of *Insights*, we continue to anticipate consistent economic growth, a moderate rate of inflation, and a largely measured and telegraphed U.S. Federal Reserve policy, with supportive global growth in Europe and emerging markets. This remains our base case outlook, despite the recent stock market correction and new attention to U.S. trade policy. It is possible that equity markets are still finding their new foundation, but on balance we believe that these factors will contribute to largely positive market conditions albeit with the potential for some additional equity price volatility.

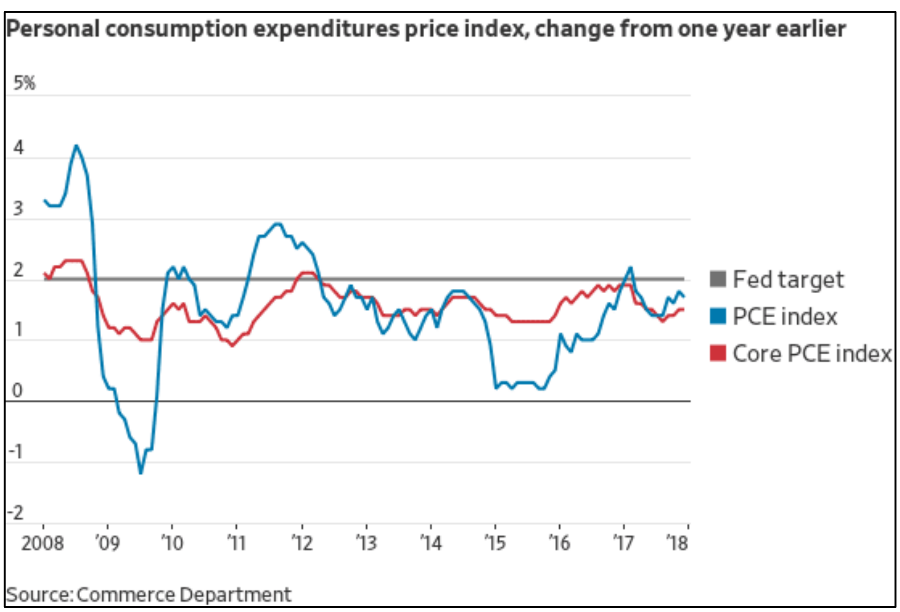
One element that coincided with and also perhaps contributed to the correction that began in January was the change of leadership at the Federal Reserve. Last month Jerome Powell succeeded Janet Yellen as Chair, and the market responded with some worry that he might alter Fed policy in a more aggressive manner that would potentially disrupt the ongoing expansion. Now that he has submitted his first Congressional testimony to Congress, markets seem to reflect a belief that some of the initial worry may have been misplaced. The central message of his February 27 report, as noted in the *Wall Street Journal*, was as follows:

> What we've seen is incoming data that suggests a strengthening in the economy. We've seen continuing strength in the labor market. We've seen some data that will, in my case, add some confidence to my view that inflation is moving up to target. We've also seen continued strength around the globe. And we've seen fiscal policy become more stimulative.

The chief concern that many investors have is that inflation may run too hot, and that bond yields might rise sharply and quickly in a way that chokes off economic activity through higher borrowing costs. For instance, although home mortgage rates remain very low by historical standards, they have increased of late, as you can see from the nearby graphic based on data from the St. Louis Federal Reserve (FRED) and published in the *WSJ* on Feb. 23. The benchmark 30-year mortgage rate (red line) has not yet returned to the levels it attained in 2014, but it has risen about four-tenths of a percentage point year-to-date. Higher borrowing costs can lead to decreased demand from buyers.



The slope of that line – that is, the speed and magnitude with which the mortgage rate has increased – is part of what has some observers concerned about inflation. However, as you can see from the inset quotation (above) from Chairman Powell, the main inflation data that he is studying suggests that inflation, especially the Fed's preferred core measurement of Personal Consumption Expenditures (PCE), remains healthy and is "moving up to target" – which means that it is still currently *below target.* As shown in the chart below, both headline and core inflation (i.e., minus food and energy components) have indeed been moving higher over the last year, but they are still underneath the Fed's 2% long-term target. Moreover, the rate of inflation has spent so much time well below that target over the last decade that Fed officials have stated previously that they may be willing to let inflation run slightly above that target for a while before tightening rates aggressively to slow the rise in inflation.



We believe that these official measures of inflation will continue to rise somewhat but also be largely benign and within the orbit of policymakers' tolerated expectations. There is a risk that price and wage data could strengthen more than the scenarios that officials are studying. Rather than leveling off after a further rise, inflation could keep rising. Exceptionally low unemployment could contribute to such a development. That is possible but, again, not our central expectation at present.

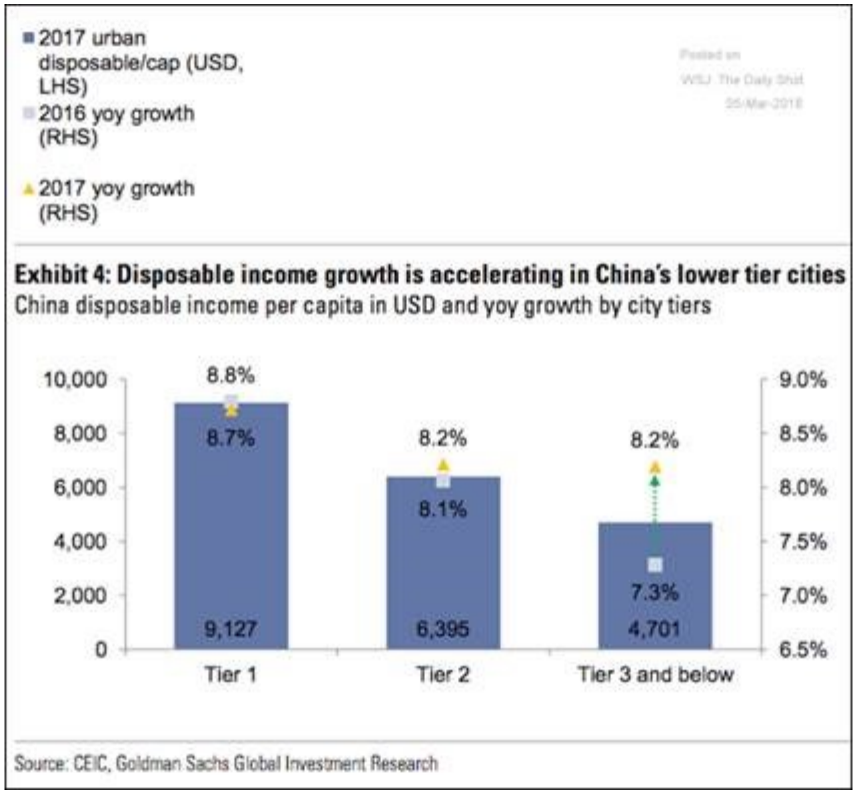
At the same time, U.S. trade policy and its effect on global economic growth has returned to the fore. This is for two reasons. First, negotiations to revise NAFTA (the North American Free Trade Agreement), which was first implemented during the Clinton administration, have continued – and have continued to trip over key issues. The Trump administration has said that it would like to wrap up negotiations by March 31, an extremely ambitious goal, that neither Canada nor Mexico (which has an imminent presidential election) has endorsed. Some revisions to provisions of the more than 20-year-old trade agreement could benefit all parties, but it is unlikely that a long-term revision of terms will be agreed to by the end of March. The key concern is that President Trump may eventually lose patience with negotiations and announce a potential exit from the deal, which would be unchartered territory economically since NAFTA does not contain exit provisions.

Second, on March 1, President Trump announced proposed tariffs (i.e., taxes on imports) on steel and aluminum. These proposals were widely criticized both abroad by key trade partners and domestically by corporations and politicians on both sides of the aisle. The worry is that such tariffs will prompt a trade war in which other countries will impose their own retaliatory trade tariffs on goods and services. Such back and forth policy measures could lead to a vicious, negative economic spiral of increased import prices, which leads to increased input costs for companies, which leads to higher inflation for consumers and lower profits for corporations, which leads to less consumer spending and less capital spending, which leads to adverse effects on job and wage growth unemployment.

In our view, the Trump administration is likely to give NAFTA more time for negotiations to proceed. We believe that the President is looking for some sort of political gift to his base supporters, even if symbolic, and that some of his advisors realize that a protectionist trade stance is both largely foreign to the party that the President joined only a few years ago and would be economically adverse heading into midterm elections this year and the next presidential election in two years. Nevertheless, the possibility of an adverse or tumultuous path for the future of NAFTA is non-trivial. The interconnectedness of the U.S., Canadian, and Mexican economies has deepened since the adoption of NAFTA, and so much is also at stake. Trilateral trade between the U.S., Mexico, and Canada under NAFTA totaled $1.1 trillion in 2016. Supply chains between the three countries are extremely enmeshed. If the President announces that negotiations have failed and triggers a 6-month notice to withdraw from the treaty, we think that portfolios and markets would stand to wade through a likely long limbo period of legal court challenges that would delay (perhaps much like current Brexit negotiations) or prevent the actual exit.

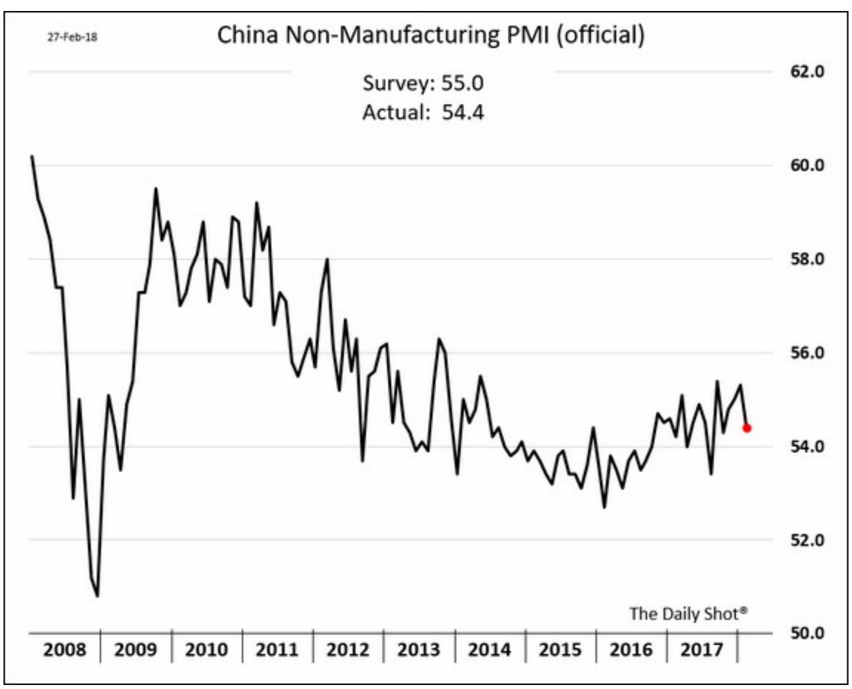
There may be policy challenges well before even such a point is reached. House Speaker Paul Ryan on March 5 stated that he and others are "extremely worried about the consequences of a trade war" and that House Republicans do not "want to jeopardize those gains" that they believe have started to flow from recent tax reform. Representatives and Senators, as well as CEOs, may pressure the White House to backtrack somewhat from the aggressive protectionist proposals to something more moderate. Capital markets will likely continue to need to muddle through the uncertainty that this has introduced.

Finally, with all of the talk of monetary and trade policy in the U.S., we would like to turn our attention briefly to China, the other major engine for global growth. Many emerging market economies, not only in greater Asia but also in commodity exporting countries in South America and Africa, pivot off of Chinese economic strength. What is the state of China's economic health then? Overall, it remains solid. The nearby chart shows that disposable income trends are accelerating in China's lower-tier cities. This is a good sign for the Chinese economy and those economies that export to China.



Moreover, manufacturing activity in China remains in expansion territory, although the most recent reading showed a deceleration, which is fairly typical for China early in the year, in part because of the Chinese lunar festival (i.e., new year) celebrations.

Chinese service sector activity also remains squarely in expansion territory, which is indicated by a reading above 50, as you can see in the graph below.



China is not without its challenges, which include an increasing (although still quite manageable) debt burden, a transition to a more service-based economy from manufacturing, and political transition from principles that have prevailed since Deng to a new set of principles advanced by Xi. All things considered, China in our view still seems to be navigating these changes well, and its growth history presents a path for others in greater East Asia to follow or join in their own economic maturity and growth.

To recap, both *leading* economic indicators globally and in the U.S. in particular (Manufacturing/Service PMI, Consumer/Business confidence) and *lagging* indicators (GDP, wage growth) remain robust. In our view, this fact will likely contribute to additional economic expansion, although we recognize the potential for uncertainty about new proposals for U.S. trade policy to be disruptive. News about inflation, Fed policy, NAFTA, and trade policy generally are likely to remain in the near-term central to much economic and political news. Worries related to each of these may induce collective concern or energized excitement.

Which brings us back to the wisdom we shared upfront from Warren Buffett's most recent annual shareholder letter:

> What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period -- or even to look foolish -- is also essential.

Staying disciplined with asset allocation decisions and not responding in knee-jerk fashion to passing developments is a central aim of ours. Focusing on a few simple fundamentals is one way to accomplish that. So in this month's commentary we have zeroed in on global growth data, inflation metrics, views of the Chair of the Federal Reserve, and long-term beneficial economic entanglement of North American countries and global trading partners. Short-term fluctuations in asset prices are typically a distraction from the big picture. What, then, is the big picture?

Bond yields and interest rates are indeed moving upwards. That increases uncertainty. But those developments are also a sign of an improving economy. Recent employment reports confirm that the economy has attained essentially full employment. Wages are starting to increase. In our view, new Chair Powell will by and large continue the measured, informed, and data-dependent approach of previous Chair Yellen. With growth and other indicators as positive as they are, we do not anticipate a recession this year. Economically, we believe that growth will continue, and, after a period of settling, investors will recognize that and return to stocks. Meanwhile, we will be cultivating our "ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals." And we encourage our clients and friends to do the same.

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