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INVESTMENTS

Investment Letter, Q3 2018
July 14th, 2018

Investing in a Two-Tier Market

It has been an interesting, headline-filled six months to start 2018. Note that while the S&P 500 Total Return was a positive 2.65%, the other two indices were slightly negative. These metrics reveal a market which was characterized by two tiers of equities in regard to performance: high beta/tech/momentum and "everything else." Please see below for a recap of the first-half performance of the markets:

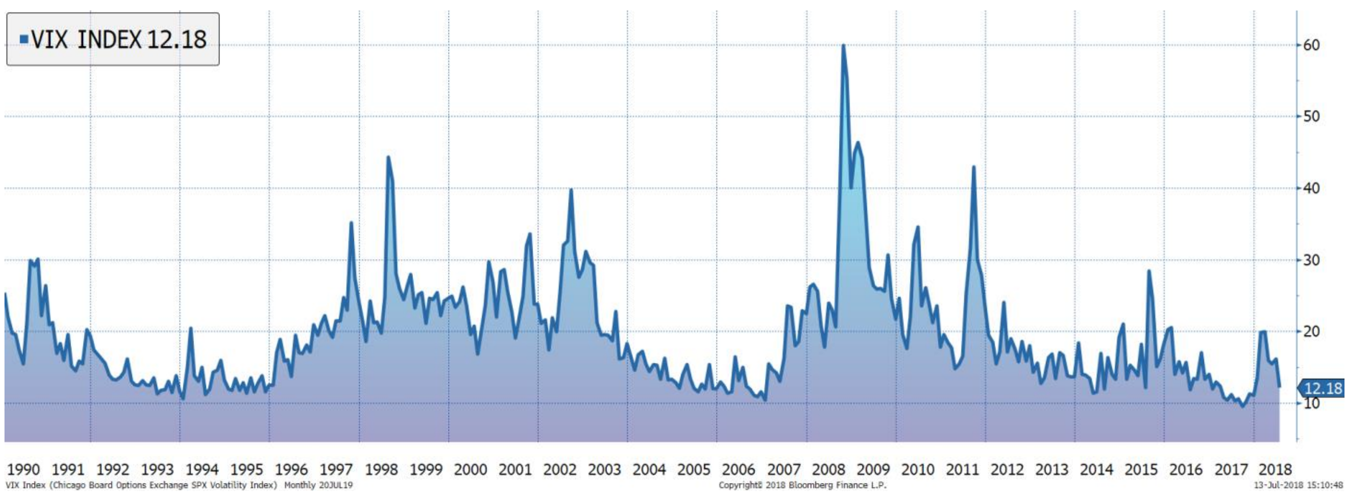
	2018 (through 6/30)		6/30/2018
S&P 500 Total Return	2.65%	U.S. 2017 GDP (Actual)	2.3%
NYSE Composite Total Return	-1.10%	U.S. 2018 GDP (Estimate)	2.9%
Barclays Aggregate Bond Index	-1.62%	S&P 500 P/E (Current)	21.35
		S&P 500 P/E (12-Mo. Forward)	16.71

Source: Bloomberg

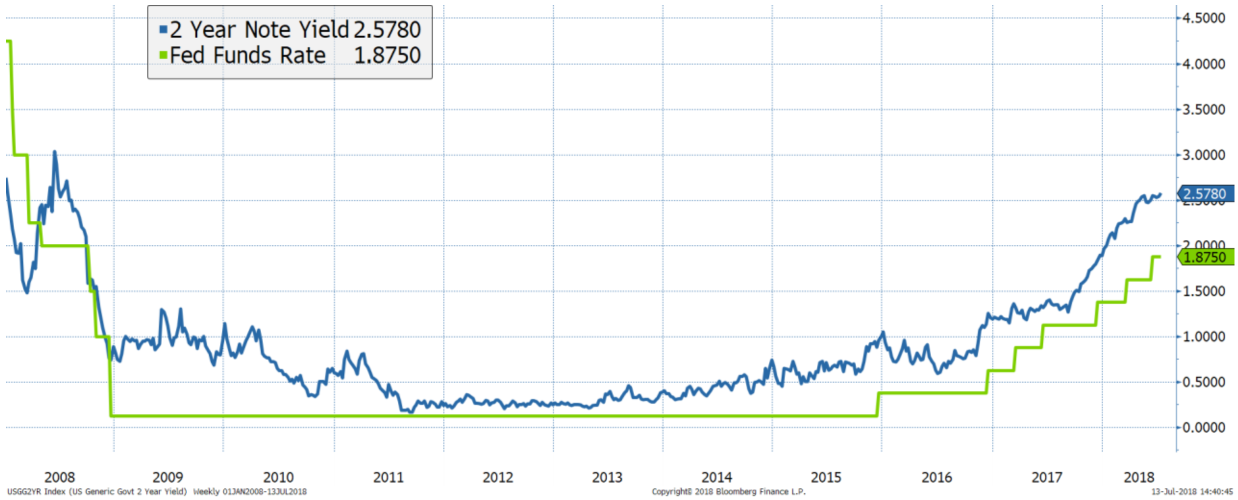
This quarter saw these indices buoyed by an extremely small number of higher-beta constituents—mostly the FAANG stocks, the "first tier." The top 5 stocks contributing to S&P 500 returns for the first six months of the year (and their respective contributions) were AMZN (**+0.91%**), MSFT (**+0.47%**), AAPL (**+0.42%**), NFLX (**+0.37%**), and FB (**+0.19%**). Together, these stocks have contributed about 90%(!) of the entire S&P 500 index's return so far this year, which, in addition to skewing expectations, gives us some cause for concern about the breadth of the overall market. In other words, if you didn't focus on *just* these five stocks, returns were probably lower. The "second tier" of stock was really everything else. While we do have exposure to these "first tier" names at the firm, they tend to represent stocks that would normally fit a growth or aggressive growth account profile. We favor a more balanced approach to long-term investing.

This two-tier phenomenon is reminiscent of a period characterized by what was called the "Nifty Fifty." Wikipedia describes the phenomenon as follows: "In the United States, the term "Nifty Fifty" was an informal designation for fifty popular large-cap stocks on the New York Stock exchange in the 1960s and 1970s that were widely regarded as solid buy and hold growth stocks, or "Blue-chip" stocks. These fifty stocks are credited by historians with propelling the bull market of the early 1970s, while their subsequent crash and underperformance through the early 1980s are an example of what may occur following a period during which many investors, influenced by a positive market sentiment, ignore fundamental stock valuation metrics. Most have since recovered and are solid performers, although a few are now defunct or otherwise worthless." These historical eras of exuberance are always good to keep in mind as we allocate capital today.

2018 may ultimately be known as the *year of the trade wars*, and there have already been numerous headlines buffeting the markets in recent months. In the early 1990s, H. Ross Perot warned about “the giant sucking sound” that would be made by American manufacturing jobs flowing out of the country as a result of various trade agreements, specifically NAFTA. The United States has the world’s largest trade deficit, which was $566 billion in 2017. Hundreds of thousands of jobs have been exported from this country as many feared. Part of the problem is the unfair trade practices of other countries in which our exports to them are taxed at a much higher rate than our imports from them. The current trade negotiations are an attempt to correct this imbalance, but the process is messy to say the least. The first round of the China tariffs has taken effect, and China has imposed retaliatory tariffs of an equal amount on imports from the U.S. There doesn’t appear be a resolution yet to this back-and-forth process, so it wouldn’t be a stretch for us to get to round 2 or even 3 of additional tariffs. These could certainly have a widespread impact and lead to higher volatility. For now, the markets seem to be assuming that resolution in the highest case probability (i.e. “cooler heads will prevail”). Every time the market has dropped on news of new tariffs or retaliation, it has bounced back quickly - for now. The chart below illustrates that volatility, as measured by the VIX, is still relatively low compared to different crises over the last 30 years:



In addition to the tariff talks, we have the Federal Reserve continuing on their path to raising rates, additional tapering activities, and telegraphing that they intend to raise rates even higher in the months ahead. The market is expecting the third hike of the year at the September meeting and then another at the December meeting which would put the Fed funds target in a range of 2.25-2.5%. This has fueled the beginnings of a return to the traditional competition for capital between stocks and bonds and could pressure equity returns at some point as it historically has. Investors might be tempted to choose certificates of deposits again in lieu of dividend-paying stocks for the first time in a decade. See the chart below which illustrates the recent increase in the 2-year Treasury note and the Fed Funds rate.



On a positive note, 2018 consensus earnings estimates for the S&P 500 continue to rise and currently stand at 21.78% and GDP estimates have been raised to 2.9%. These are both strong numbers that have been supportive of a generally stable stock market and rising interest rates. If growth were to slow marginally while rates continue to normalize back to pre-financial crisis levels, this could be another cause of volatility down the road.

Over the decades the market has spent years ranging between being “overvalued” for long periods of time and then becoming “undervalued” very rapidly. Investors tend to get lulled into complacency during the good times (like the “nifty-fifty” era) and get caught short when the seasons change and valuations drop. Things are good right now, and we take a long-term view of the investing process; therefore, we believe that having a margin of safety for our clients’ long-term investment allocations, including cash, bonds, or more conservative investments, will prove to be a wise course over the long run. Most of our programs have some margin of safety built in at the present time as we have mentioned in earlier Investment Letters. We will continue on the course of generally adding companies that we believe to have relatively better valuations and/or dividend characteristics while maintaining a margin of safety, depending on the specific mandate of each client. Of course, every account is different, and it is important discuss any changes in your goals or risk tolerance with your advisor to ensure your accounts are allocated properly.

We hope you and your family are having a great summer, and we look forward to touching base with you personally very soon!

Sincerely,

Todd Walsh	**Norman Lehrer**	**Glendon Trullinger**
CEO	Chairman Emeritus of the	Director of Trading
Portfolio Manager	Investment Committee	Portfolio Manager