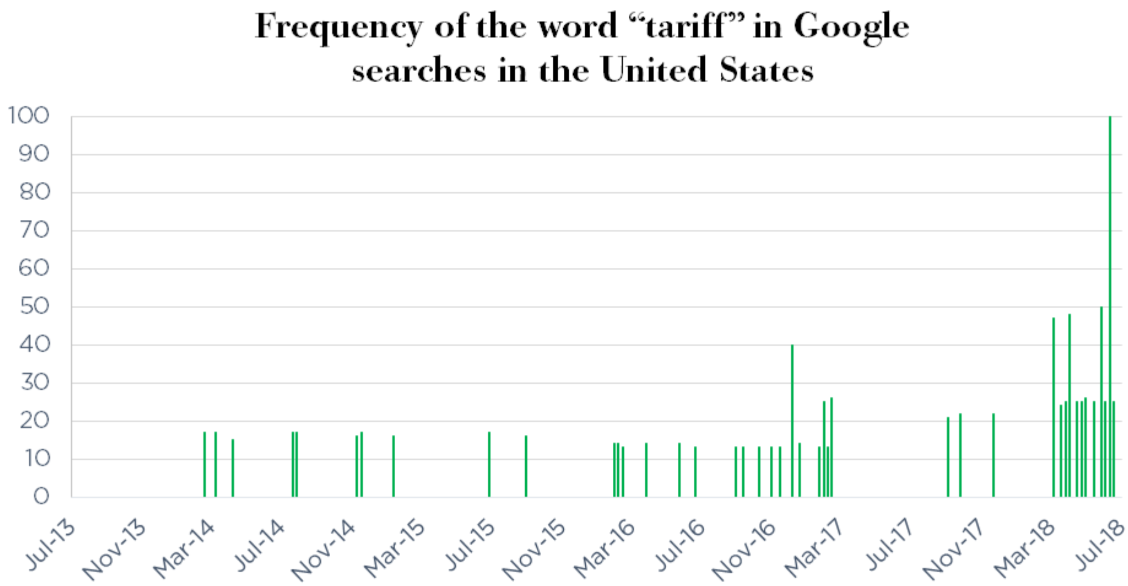
JULY 12, 2018

**The News**

As we have noted previously, it is our strong belief that interest rates have been and will continue to be a dominant force for financial markets. U.S. equities generally moved higher during the second quarter as interest rates were deceptively stable. Despite a fair amount of inflammatory rhetoric, stocks had a smoother ride than during the winter months. Daily price fluctuations returned to more normal patterns, even though trade dominated headlines. Once relegated to the study of American history, the word tariff has made a comeback. It has suddenly become a popular term for Google searches (see chart below) as investors, business leaders and consumers try to make sense of the tug of war of trade negotiations.




Source: *Google Trends*

Though escalating trade tensions have yet to produce broad market impact, as the year unfolds we feel it is important to understand how a trend toward protectionism might affect investors. So far, the consequences have been isolated and specific. Winners and losers are few in number and easily identified. U.S. producers of steel and aluminum (only a handful of companies) have been beneficiaries of the first round of tariffs. Manufactures of products that require steel, aluminum or lumber (RV's, airplanes and single-family homes) are seeing a small rise in their input costs. Retaliation from our trading partners has hurt soy bean farmers (China), Harley-Davidson (Europe) and maple syrup producers (Canada). These are not likely to be the cause of significant stock market risk.

If negotiating tactics evolve into broad protectionist policy, the effects will be more widespread. Once touted as a prime beneficiary of a strong stance on trade, Harley-Davidson is a perfect illustration of the unintended costs of protectionism (it is *not* a holding in our portfolios). It faces dual challenges. Motorcycles are largely made of steel, so their costs have already begun to rise modestly. The European Union increased the tariff on motorcycles from 6% to 31% (an average of $2200 per "Hog"). Harley feels that it will not be able to pass that along to the consumer through higher prices. The company has made no secret that it will be forced to move at least some manufacturing overseas (it sold 16% of its bikes in Europe last year). This will result in jobs lost in the U.S. There will also likely be a subtler response. Over the last five years, Harley-Davidson has used excess cash flow to reduce its shares outstanding by 25% for the benefit of existing shareholders. Moving production to Europe and laying off U.S. workers will require a meaningful capital expenditure, as well as severance costs. At the very least, this cash outlay will reduce the potential for stock buybacks.

It is not difficult to understand why broader applications of protectionist policies could have negative implications for global economies and unnerve investors.

**Equity Commentary**

In the U.S., investors seemed willing to embrace a bit more risk during the second quarter. Small stocks, as measured by the Russell 2000 Index, outperformed large stocks. Once steady consumer staples and financials lost ground, while consumer discretionary and technology built on first quarter gains. Energy, which had been a laggard throughout 2017 and the first quarter of 2018, bounced back to be the top-performing sector during the period.

As in the first quarter, investors were not rewarded for diversifying portfolios with non-U.S. equities. Developed market stocks, as measured by the MSCI EAFE Index, lagged the S&P 500 Index by more than 9%, although the UK, India and Australia were notable outperformers (perhaps a positive response to the second season of "The Crown"?). Emerging markets were weak in general in response to a rising U.S. dollar, as China, Brazil and Turkey had double-digit declines.

**Fixed Income Commentary**

Absent an unexpected shock to the economy, we generally see rates acting orderly and the yield curve flattening at a slow pace over the next 12 to 24 months. We believe supply/demand imbalances, as well as the Federal Reserve's intentions to continue to increase short rates, will allow shorter maturing bond yields to increase. This should not come as a shock, as it has been well telegraphed by the Fed. Longer rates are dampened by strong demand, especially from U.S. pension funds and foreign investors. The difference between U.S. 10-year rates and German 10-year rates is over 2.5%, while inflation expectations for the two economies are only 0.80% apart. This should lead to continued strong foreign demand for U.S. Treasuries until Eurozone rates increase.

In the longer term, as the Federal Reserve approaches the neutral rate for the Fed Funds rates, somewhere around 3.0%-3.50%, the yield curve should flatten completely. In an orderly environment, we would expect this to occur over the next two to three years. However, in the real world, the timing of this flattening is subject to global political policies as well as continued domestic growth.

**Looking Forward**

While it is always tempting to forecast change or to identify an inflection point as it is occurring, it is often more useful to recognize stability. In an environment of low interest rates and easy credit terms, corporations should continue to provide steady demand for stocks. Mergers and acquisitions, leveraged buyouts and stock buybacks show no signs of slowing down. If anything, the new tax law provides a boost to these activities.

The combination of rising earnings and relatively steady stock prices means that valuations are no longer stretched. At quarter end, the S&P 500 Index was valued at about 16.5 times estimated earnings for the next 12 months. The average valuation for the last 20 years is 16.3. We do not see signs of rampant speculation that typically signal a market peak. We do see opportunities to invest in high quality businesses at valuations that are reasonable by most any yardstick. If the trade environment worsens, which is by no means guaranteed, there will be an opportunity to take appropriate steps as necessary.

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