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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Economic activity doesn't get much better than what we experienced in the second quarter. All evidence indicates GDP growth, in advanced economies, rebounded in the quarter and is expected to rise to about a 3% annualized rate. With renewed support from global growth, the US economy strengthened significantly in the quarter. Additionally, with real disposable income boosted by tax cuts and a strong labor market, consumption growth probably improved and we expect US GDP grew slightly in excess of 4% annualized.

The best news is that this stronger growth does not seem to be generating major imbalances. Economic expansion does not appear to be accompanied by a sharp rise in private sector debt. Rising household wealth is prompting families to save less and spend more of their income. At the same time, companies have additional resources to fund investment, due to tax reform and increased profitability. Although the surge in federal debt poses a longer term threat, the magnitude of the recent surge can be partially explained by the suspension of the debt ceiling.

While there are signs of rising input price inflation in the US, we remember Milton Freidman's excellent observation, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." **In other words, we shouldn't confuse price fluctuations in essential feedstocks with inflation. There has been little evidence of unacceptably higher inflation so far.** Indeed, our view continues to see inflation trending towards 2% in major advanced economies over the next couple of years. In the US, we expect core inflation to rise to around 2.5% next year, but retreat in 2020 as a result of the monetary tightening now underway.

Recently, I listened to a presentation entitled "Chaos, Order, & What Lies Between." Although the presentation applied to personal opportunities and behaviors, the structure of the presentation equally lends itself to the art and science of investing. Order is what we know and includes the systems and processes we control and employ. It is predictable and repeatable. Chaos is the opposite; there is no way to anticipate or predict it. We should note that while the word *chaos* has a negative connotation in the English language, it can equally represent opportunity and chance. With investing, it is "what lies between," this intersection between chaos and order, which defines the experience. Without structure, systems, and processes, we have no way to identify an opportunity or to avoid a loss when the appropriate occasion presents itself. **A disciplined working process, combined with a reasonable understanding of the prevailing macro environment, allows us to exploit opportunities and minimize losses as they arise.**

With the current economy producing such stellar performance, we think it is imperative to review what we know and what we don't know. The current economic strength is the product of several years of easing on the part of the central banks. However, a decade of monetary stimulus has begun to reverse in the US and will also begin to reverse in Europe towards year end. Even with this reversal in policy, the economy will continue to benefit from the availability of easy credit for years to come. So, the likely economic and investing environment will see gradually rising interest rates slowly tempering, but not stopping, economic growth. The central banks have been very transparent in pronouncing their policies, so much so that investors have been forced to look beyond the foreseeable future. When we hear someone suggest a recession lurking more than two years in the future, we wonder at the basis for such a long range forecast. **There is simply no evidence of recession at this time. Therefore, along with a shift in monetary policy and higher interest rates, investors will need to adjust their thinking to a much extended, albeit slower economic growth cycle.** In such an environment, undiscovered, sustained, and superior earnings growth will become increasingly difficult to identify. Our investment process, which allows us to sort through vast quantities of relevant data, will continue to help us identify attractive investments in this orderly and efficiently priced opportunity set.

But, what about chaos; what can we do about those events which suddenly introduce a new order to our investment assumptions? In the past few years, there have been several occurences that completely defied the probabilities which investors had previously assigned. Some recent examples have been Brexit, the election of President Trump, and the passage and magnitude of corporate tax reform. Of course, none of these events had as much impact as the unforeseen meltdown of the global financial institutions which produced the Great Recession a decade ago. Each of these events very quickly altered the previous order underpinning our investment assumptions. **While surprises such as these are unavoidable, our investment process allows us to adapt to the subsequent new order.**

Once again, we are faced with an event of potentially chaotic proportions. **If we are to believe the media, we are already in the midst of a global trade war; but the posturing and conclusions are far from over.** First, it helps to put this discussion in context. Global trade, as we know it, was the product of eight years of contentious negotiations concluding in 1994. World trade was very different 24 years ago; the treaties advantaged some countries at the time and disadvantaged others. Naturally, the advantaged countries do not want to give up their protections and the disadvantaged countries would prefer a more level playing field. In the meantime, there is much rhetoric and posturing by global leaders which, amplified by the media, is weighing on the markets. Clearly, the issue of global trade can be characterized as a chaotic variable, with an unknown outcome. In spite of media hype, we have no idea how this will unfold, whether trade will be stifled by protective tariffs or increased by freer trade, which economies/countries will benefit, and which industries/companies will be affected. *(continued)*

It is impossible to quantify this unknown outcome at this time. However, our models will continuously reflect new information and details of a new world order. **In this way, the order of our investment approach allows us to organize real world chaos to our advantage.**

Fixed Income

Rising levels in U.S. corporate, government and household debt may begin to cause investor concern, if perceived as a trend toward an economic downturn. While absolute measures of debt are interesting data points, they are unreliable for predicting inflection points in economic cycles. **Further, when viewed in the context of the broader economy, current debt levels remain manageable and are not indicative of overstretched economic conditions in the U.S.**

Since the 2008 financial crisis, U.S. companies have taken advantage of low interest rates to borrow and refinance debt. Leverage has increased steadily, with a concern that companies may need to refinance this debt at higher rates in the future, as the Fed continues to normalize monetary policy. However, parallel to this increased corporate leverage, companies have accumulated a substantial amount of cash on their balance sheets, which could be utilized to reduce debt should higher rates make refinancing less attractive. Additionally, U.S. tax reform has not only been positive for company earnings but it has also further increased cash levels. For now, as corporate debt matures in a rising rate environment, companies are still able to refinance at historically low long-term rates. **As a result, rising U.S. corporate debt levels are not a near term risk to U.S. economic growth as companies remain well positioned to service current debt levels, even as interest rates continue to gradually increase due to monetary policy normalization.**

Consumer debt levels are also continuing to rise as the total amount of revolving consumer debt outstanding has returned to levels last seen in 2008. A higher consumer debt level alone does not indicate that consumers are experiencing financial stress or signal a potential downturn in the economy. Consumers' total debt relative to income earned and the amount of disposable income used to make payments on loan obligations provide a better indication of the consumer's ability to manage debt. **Compared to 2008 metrics, households are currently using a smaller percentage of their income to pay back loans and total household debt as a percentage of income remains at levels below the peak of the financial crisis. These higher levels of debt are even further justified when compared to household net worth.**

As discussed in previous newsletters, a flattening of the yield curve does not imply an inverted yield curve, which has sometimes been the indicator of a future recession. Interest rates have steadily increased with 2-year and 10-year Treasury yields ending the quarter at 2.52% and 2.85%, respectively. The higher move in short-term yields versus long-term yields has resulted in a "flatter" curve, which reflects the Federal Reserve's gradual increase of the fed funds rate to a target range of 1.75% to 2.00%. At the same time, long-term rates continue to be bound by lower long term inflation expectations. Current trends in Fed policy and inflation are not yet consistent with the factors which have led to an inverted yield curve in the past. **Given this outlook, we continue to believe there are favorable opportunities in high quality credit on the shorter end of the yield curve.**

International Market

It was quite an eventful quarter as far as international markets are concerned. **Political turmoil in Europe, especially the elections which resulted in temporary political deadlock in Italy, rattled the markets for a short time.** However, investor concern quickly dissipated once a new government was formed. Then, after months of strident headlines implying the U.S. was on the brink of war with North Korea, President Trump held a historical summit with Kim Jong-un in Singapore. Although what may have been accomplished from the meeting remains inconclusive and open to debate, the numerous "nuclear holocaust" media headlines have disappeared.

As the nuclear threat from North Korea abated, attention returned to international trade with the view that President Trump would redirect his efforts to trade negotiation. Indeed, towards the end of the quarter, after earlier announced tariffs on steel and aluminum were implemented, new threats emerged of additional layers of tariffs on Chinese imports. As expected, alarming "trade war" headlines overwhelmed investor attention, casting doubt on the viability of continued global growth. Nonetheless, our current view remains consistent with the view expressed in our last newsletter, "we see the current trade proposals as a less-than-subtle attempt at negotiating new treaties." **It is important to realize that during the renegotiation of any treaty, rigid postures and harsh rhetoric are merely tactics used to obtain the best possible deal acceptable to all parties. We continue to view the escalating trade tensions as a means to accomplishing a goal, not the goal itself.**

To put the tariffs already implemented into perspective, the $50 billion worth of Chinese exports to the U.S. that are subject to tariffs is equivalent to less than 0.5% of China's GDP, while the tariffs on steel and aluminum imports apply to less than 2% of world trade. **Those tariffs in aggregate will not have a major macroeconomic impact on global growth.** That said, however, further tariff threats, and potential retaliation, raise the risk that global trade will begin to slow. Given that trade makes up more than 50% of world GDP, a scenario where all countries impose significant retaliatory tariffs could potentially cause a disruption to the global supply chain. If this were to occur, not only would it have a negative impact on business and investor sentiment, it could, indeed, cause a global recession. **We continue to view this risk a worst case scenario and an extremely remote possibility at this stage of the trade discussion.**

The low probability of protectionist threats escalating into a global recession is complicated by election campaigns, with politicians and their supporters clamoring for attention. **Politicians know they will have to answer to their constituents or face the possibility of being voted out of office in the next election; simultaneously, governments of advanced economies face substantial pressure from companies to avoid disruption to the global supply chain.** Harley Davidson's recent announcement that it will shift some of its production abroad due to retaliatory tariffs imposed by the European Union may be an example of companies behaving both rationally and strategically to circumvent the impact on earnings of retaliatory government policies.

The risks to successful trade negotiations would increase if this government retaliation develops into more aggressive responses. However, the worst case scenario of dismantling the global supply chain remains unlikely. Although investors may react to each new trade threat with greater fear, it is in every country's best interest for a rules-based trading system to remain functional. **Therefore, even though fear of protectionism is on the rise, there's a greater probability that trade renegotiations will begin to advance and global economic growth will continue.**

When inundated with worrisome "trade war" headlines, it is human nature to begin to believe we are actually in a trade war and to consider portfolio adjustments. Yet, investment decisions should be based on fact, not fear. In the absence of fundamental information which changes the investment landscape, it is prudent to maintain the status quo. We do not see current events evolving into a full blown trade war. We will continue to monitor future developments and make necessary adjustments when warranted. In closing, we ask you to consider whether, in a few months, we will regard those who react to the "trade war" hysteria in the same way we now regard those who reacted to the "nuclear holocaust" scenario? If so, what do you think will be the next hysteria to dominate the headlines?