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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Volatility has tormented investors for much of the year. Indeed, this is our third newsletter article to discuss volatility in 2018. At the risk of repeating ourselves, there are a few major points we would note in order to provide perspective.

First, volatility is two-edged; it is used to describe rapid, short term changes in asset prices, both up and down. Sometimes investors interpret upside moves as somehow different from downside moves, perhaps because the upside is more welcome than the downside. Nevertheless, volatility includes both, and this is necessary to our understanding of the role of volatility in the financial markets.

In the opening paragraph of last year's first quarter newsletter, we stated:

"Stock market volatility is a reliable indicator of uncertainty concerning the future direction of the economy. There is nothing unusual about volatility. Markets are simply clearing mechanisms; for each purchase, there is a seller and for each sale, there is a buyer. **Prices are set by discovery between buyers and sellers, and sometimes this leads to volatility until equilibrium is attained."**

We then went on to describe why it seems volatility is on the rise, even though it is simply a return to normal levels. It is obvious to us that if the low volatility environment of the recovery from the "Great Recession" was a function of accommodative monetary policy and regulatory intervention, then as we approach a balance between stimulative and restrictive monetary and fiscal policy, the mechanism for determining the value of financial assets will again accrue to market forces. **We tend to see the process of price discovery in a market economy as akin to democracy; it is messy and imprecise, but it is an effective system for allocating resources.**

This past year, as Fed policy approached neutrality, we experienced a transition from a controlled price structure to a market priced economy. In the short term markets tend to react, or overreact, to news, and there was no shortage of headlines to disrupt the market in 2018. As the longevity of the current economic expansion surpassed all prior post-war recoveries without a recession, various market strategists began to step up speculation about when the next recession would likely occur. Rest assured, these individuals have no better evidence of recession than anyone else. **Indeed, there is no evidence of recession in the foreseeable or investable future.** When a recession does finally occur, it will most likely begin from a higher level of economic activity; or if not, it would be brought about by a near term surprise disruption to market equilibrium. Certainly markets will have adjusted prices lower long before a recession is apparent, making the exercise of trying to anticipate recession by adjusting asset allocation a challenge at best. **Most of the worry about recession is a function of the concern that years of easing by global central banks will be coming to an end. What this analysis has not considered is the amount of liquidity remaining in the system; without restrictive tightening this liquidity assures economic expansion for years to come.** If we experience a recession sooner, it will likely be short lived and shallow, much like the corporate profits recession of 2015. **It is usually futile to attempt to exploit these shallow economic dips by selling at a higher price, then trying to buy back shares lower.**

Still, fear of recession continues to weigh on the financial markets. Throughout the last quarter, the stock market responded out of proportion to news headlines which had little fundamental impact beyond the specific companies and sectors which produced the headline. **True, there are plenty of such headlines, but individually, and even collectively, these events had little fundamental impact on the aggregate economy.**

While we are not concerned about a recession lurking beyond the horizon, it does not mean we are worry free. Although we expect to see continued growth in the US economy, US companies rely on foreign sales for almost half their revenues. Political pressure, as well as some regulatory change, has caused reported economic data in the ten largest industrialized countries to come in below forecast in recent months. Adding to our concern, with the impact from the windfall of lower corporate taxes on corporate profits behind us, earnings growth comparisons will become more difficult in the coming year. **We think investors have begun to move toward the reality of lower returns due to slower anticipated economic and earnings growth, although the recent sell-off is probably overdone.**

Early in the year we spoke about volatility affecting individual stocks and sectors, while leaving index prices largely unaffected. This changed in the fourth quarter as the selling of index ETFs seemed to affect markets over individual securities. **We are concerned about this new phenomenon, the impact on the markets and volatility, the amount of money which has been invested in these vehicles in recent years, and the available liquidity should investors decide to sell en masse.**

In recent months, the decline in stock prices combined with lower expectations for continued earnings growth, as well as low inflation expectations, has produced favorable equity valuations. Looking into the new year, we expect stocks to appreciate in line with their expected earnings growth with continued higher volatility; not spectacular performance, but sustainable. **With investor sentiment at such a low level, we see a greater potential for upside surprise in 2019.**

Fixed Income

Volatility in the equity markets coincided with large movements in interest rates during the quarter. In the first few days of October, the 10-year Treasury yield surged +18 bps and reached a peak of 3.24% shortly after the mid-term elections. The yield subsequently fell 50bps from its peak to end the year at a yield of 2.69%, 29 bps higher for the year. The initial surge in yields prompted fears that higher interest rates would undermine economic growth. Yields moved lower despite the widely anticipated 25 bps interest rate hike in December amid further selling pressure on equities. **Ironically, rising interest rates at the start of the quarter were blamed for the sell-off in equities, while the collapse in rates at the end of the quarter also corresponded with a decline in equity performance.**

We continue to urge caution about divining a forecast from the change in yields at this time. The most recent decline in rates caused the yield curve to partially invert, with the 5-year Treasury yield falling below the 2-year yield for the first time since 2007. The more meaningful spread between 10-year and 2-year yields is still slightly positive, although the entire yield curve flattened sharply over the quarter. While this partial inversion has fueled fears that a recession is on the horizon, a large part of the flattening in the curve since the crisis reflects a range of factors which are quite different from past recessions. Even if the yield curve inverts further, the economy is likely to continue performing well in the short-term. **With economic growth still well above trend and core inflation close to target, the Fed is expected to continue to raise interest rates in the first half of 2019. The key to what the Fed will actually do in the new year is dependent on the economy, not the current behavior of the stock market.**

However, there is always the risk that the Fed may tighten policy too far. Since 2012, Fed officials have been publishing estimates of where they think the fed funds rate will be “in the longer run.” The theoretical concept of a neutral real interest rate refers to the rate at which inflation is stable and the economy is operating at full capacity. Estimates of a true neutral rate are highly uncertain due to the assumptions and data which are difficult to measure or predict. If policymakers overestimate the neutral rate, they may unnecessarily tighten monetary policy, causing the economy to slow. While monetary policy has been one of the larger contributing factors to prior downturns in the economy, numerous other factors have also played a role. **The next potential slowdown will likely be a function of many factors, combined with restrictive monetary policy.**

International Market

Political uncertainties, rather than economic fundamentals, rattled global financial markets throughout 2018. The overhaul of US trade policies championed by President Trump no doubt contributed to most of the market volatility. Whether Britain will be able to leave the European Union (EU) smoothly also has investors on edge. “Mouvement des gilets jaunes,” the yellow vests movement of France, added to worries as televised images looked as if Paris was under siege.

The euro-zone economy has lost momentum; admittedly, much of the fall was due to a sharp drop in the French PMI (Purchasing Managers’ Index), which could likely be attributed to the temporary disruption caused by the yellow vests movement. Triggered by protest over France’s planned fuel tax hike, the protest soon turned into a populist, grassroots movement channeling working and middle class frustration over economic inequality.

The protesters have demanded lower fuel taxes, higher minimum wage, reinstatement of a direct wealth tax, and Macron’s resignation as President of France. In response to the movement, Macron held a televised address on December 10th, agreeing to some of the demands of the protesters. The government response has eased the situation and subsequent demonstrations have decreased. **However, the issues are not fully resolved, and concerns remain that intensifying populist movements could lead to further polarization and political instability.**

Brexit serves as a prime example of a populist movement leading a country into a state of uncertainty. Following the vote to leave the EU in the referendum of 2016, the British government invoked Article 50 of the Treaty on European Union on March 29, 2017 to officially begin the withdrawal process. **Leaving the EU is essentially withdrawing from all the treaties associated with the trading bloc, both internally and externally, which means that Britain would have to renegotiate all necessary treaties within two years to ensure a smooth exit.** Otherwise, Britain will face major trade disruption on March 29, 2019.

A deal was reached in November, but the day before its ratification by the British Parliament, Theresa May announced a delay since there were not enough votes to ensure passage of the deal. With the deadline three months away, the UK is still in limbo; whether Theresa May will be able to gather enough votes to ratify the deal is anyone’s guess. In anticipation of a hard Brexit, the British government announced on December 18th that preparations for a no-deal exit would be an operational priority. **A hard Brexit would likely bring temporary disruption into the markets, but it certainly would not be a “black swan” event. With a long anticipation for the arrival of Brexit, markets have already placed a probability to it and discounted it accordingly; therefore, investors should not overreact.**

Renegotiation of US trade treaties with its major trading partners, or “trade war” as the media has labeled it, has cleared some major hurdles. With mutual understanding reached between President Trump and EU President Jean-Claude Juncker, and the United States-Mexico-Canada Agreement (USMCA) signed to replace North American Free Trade Agreement (NAFTA), the last remaining piece of the puzzle is for an agreement to be reached with China. The temporary ceasefire brokered between President Trump and Chairman Xi is a new start to stalled progress. What should follow is a new round of negotiations scheduled to take place in the new year. Whether the US can prompt a shift in Chinese policy sufficient to reach a lasting deal remains to be seen.

Even though we foresee several rounds of difficult negotiations before a deal can be reached with China, it would require a significant escalation from the current situation to trigger the next global downturn. Even in the worst case scenario of every country imposing tariffs of 25% on all imports, the impact on global gross domestic product (GDP) growth would be a decline of only 0.1 to 0.2%.

Partially due to the impact of tariffs, the Chinese economy is likely to lose steam in the first half of 2019 as its property markets cool and the lagged effect of past policy tightening takes effect. However, by mid-year, we expect growth to resume as a function of the combined fiscal and monetary stimulus currently being deployed. **China’s structural slowdown should not be a surprise; it is part of the normal progression from a rapidly expanding emerging economy to a more stable mature economy.**

In a year characterized by volatility, the Markit’s global composite Purchasing Managers’ Index (PMI) remains expansionary, indicating continued global growth. Household spending has held up well as employment and wages have continued to grow at a decent pace; consumer sentiment continues to be stable at a high level. The fall in oil price should provide a further boost to global growth as it transfers income from oil producing economies, which have high marginal savings rates, to oil-consuming economies, which have low marginal savings rates.