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Portfolio Comments
For the Quarter Ending March 31, 2018

It was bound to happen sometime, although this fact did not make it any more palatable. After the largely relentless climb of the U.S. equity markets since the final quarter of 2016, the S&P 500 officially entered correction territory at the beginning of 2018. This was defined by the drop of over 10% experienced by the benchmark index in the span of a few short days of trading between January 27th and February 9th. The dramatic slide following a bright start to the year was short-lived, and the aftermath witnessed a choppy recovery that was then followed by another slump to see out the quarter.

With investors now reminded of corrections that had come to feel a safe distance in the past, and currently on edge about what might be to come, Marty McFly from the classic 1985 movie Back To The Future makes an astute observation during a crucial scene: "Since when can weathermen predict the weather, let alone the future?" While it's understandable to get caught up in the barometer of the markets day-to-day, near-term prediction is often foiled by the unanticipated, while over the long-term the U.S. equity market has always proved a profitable place to invest so far. We remain in it for the long haul.

In terms of aggregate results, the S&P 500 ended the first quarter of 2018 at 2,641, delivering a return of -0.76% for the year to date. Similarly, the Dow Jones Industrial Average (DJIA) ended March at 24,103 for a first quarter return of -1.96%. Preceding the first drop, both the S&P 500 and the Dow Jones achieved record closing highs on January 26th of 2,873 and 26,617 respectively, each up close to 7% since the beginning of the year at that point.

At the 'peak' of its dip the correction in the S&P resulted in an almost negative 12% slide. This is the tenth correction in the index (defined as a drop of 10% or more) over the past twenty years, with the preceding one spanning November 2015 to February 2016. Even for those who eschew market timing, it's not comfortable investor territory. However, some solace can be gleaned from the fact that only two of these corrections degenerated into bear markets (drops of 20% or more). The rally following the correction saw the S&P 500 rise over 9.5% from its February 9th low, but the recovery was not sustained. In naming culprits responsible for the turbulent, but ultimately underwhelming, first quarter for U.S. equities, fingers are most commonly being pointed at the trio of central bank tightening, trade war threats, and tech worries.

A lesser-mentioned factor is that changes in volatility can trigger sell-offs based on the algorithms of high-frequency trading programs independently of economic or fundamental data.

The gradual unwinding and reversal of economic stimulus by the Central Bank is neither new news, nor unanticipated. Nevertheless, each concrete move in that direction can take the edge off investor appetite for riskier assets such as stocks, as the cost of leverage rises and high-quality fixed income products regain more appeal. This is coupled with the fear of a tightening labor market resulting in higher wages, which in turn can cause potentially rising inflation. Greater personnel costs also eat into corporate earnings (a key multiplier in equity valuation), although the recent tax cuts provide some offset.

February 5th marked the official baton handover from Janet Yellen to Jerome Powell as Chair of the Federal Reserve. Mr. Powell's subsequent monetary policy testimony to Congress brought no surprises. He underlined that the economy is strong, the labor market is experiencing full employment and that further increases in the federal funds rate are to be expected, with the pace of such increases to be determined by economic data. Mr. Powell lost little time with the first hike of 0.25% announced towards the end of March bringing the federal funds rate up to 1.75%. At present, the market expects at least two more to follow before year-end. There is a sense that central bank policy makers all around the rich world yearn for an ultimate return to 'normal', but maybe we are not that far off from a 'new normal' where low interest rates reflect economic growth that is substantially slower than the post-war era, coupled with low and stable inflation, and an overabundance of capital looking for an investment home.

A largely unanticipated impact on the markets was wrought by President Trump flexing his protectionist muscles and following through on March 8th with the imposition of import tariffs on steel and aluminum of 10% and 25% respectively (although certain nations, including Canada and Mexico were later exempted). Given the relatively small size of these industries in the U.S. the domestic economic impact is minor, but it marked a definitive 'shots fired' moment in a potentially looming larger trade war and was enough to send equity indices scurrying backwards again. The slide was exacerbated by the resignation of Gary Cohn (a vocal free trade advocate) as Mr. Trump's economic advisor. Irrespective on an individual's leanings on the subject of barriers to global free trade, uncertainties in the area are generally not good news for stock prices whose value depends on modeling future corporate profits with a reasonable level of confidence. The shorter that confidence horizon, the more near-sighted investors are in their decision making.

Many construed the underlying agenda of the steel and aluminum tariffs as a move designed to show the President's real target – China – that he is prepared to back up rhetoric with action. China's exports of these metals to America make up a mere 0.03% of its GDP. Of more weighty concern in Beijing is Mr. Trump's insistence that the country works to cut up to $100 billion off its $375 billion trade surplus, coupled with the U.S. President's vow to punish the Eastern superpower for allegedly stealing American corporate intellectual property. On March 22nd, Mr. Trump brought the hatchet down on Chinese imports into U.S. in the form of tariffs of 25% on up to $60 billion of goods. A follow-up move intends to curtail Chinese investment in American companies to provide greater protection for domestic trade secrets. The Chinese government and markets did not react favorably.

Of concern, if a tit-for-tat retaliation escalates, both sides think the other has more to lose. For his part, President Trump is eying China's bigger surplus and interpreting it as a greater dependence on exports. The reality is that its exports to the U.S. make up less than 3% of China's GDP – not insignificant, but not dependence level. The flow of goods is also not all one-way; both the American agricultural and aerospace industries could be hurt by trade cut-offs by China. There is also the question of whether U.S. manufacturers and consumers alike will welcome paying high prices for the vast number of parts and consumables that currently flood in from China and are so integrated in our day-to-day Western lifestyle. Much of this production, especially for cheap goods, could probably be migrated to other developing countries, although that hardly achieves any net gains at home. President Trump sees himself as a master negotiator, and for him this may be just the opening foray of a negotiation for which he has a clear end-objective in mind where America emerges in a more favorable, but not antagonistic position, with its major trading partners. Given the important role countries like China and Japan play in buying Treasuries, presumably he also knows there are risks in pushing too far.

President Trump hasn't shied away from clashes at home either. In addition to the aforementioned departure of Gary Cohn, who was replaced by television pundit and ex-banker Larry Kudlow, this quarter saw the sacking of Rex Tillerson as Secretary of State. The role is to be taken over by Mike Pompeo, a former Republican congressman from Kansas who is currently serving as Director of the Central Intelligence Agency (CIA). In turn, Gina Haspel, deputy Director of the CIA, will be the first woman to step into the top role at the Agency.

By all accounts Mr. Tillerson was not forewarned, but the ex-chief executive of **Exxon Mobil Corporation (XOM-NYSE)** had openly disagreed with his boss over a number of major foreign policy matters and, these differences aside, hardly shone in his diplomatic efforts or as the state department's staff leader. On an interpersonal level, the Secretary of State had pointedly failed to exonerate himself over 'morongate' – an incident that involved an alleged direct slur against the President. National Security Advisor H.R. McMaster is also out, with John Bolton, a former United Nations Ambassador, taking over. In a White House that had the highest first-year turnover rate out of the past five, a resounding lesson learned is that Mr. Trump values loyalty, perhaps above all else. A sign that loyalty may be slipping among those that put him in power – the American electorate – recently came with the victory of Conor Lamb, a young Democratic candidate, in a Special House Race in Pennsylvania. President Trump took the same district by nearly 20 percentage points in 2016.

One world leader who has little reason to question the fidelity of those that keep him in power is President Vladimir Putin who cruised into his fourth term (the previous being from 2000-2008 and 2012 onwards) on March 18th following Russia's presidential elections. His victory was resounding, having secured over 76% of the votes (his record high and more than ten points up from 2012), although Mr. Putin's numbers were presumably bolstered by the barring of his main opponent from the ballot following a fraud conviction that said rival insists was fabricated. It may be assumed that Mr. Putin will interpret his win as further endorsement of his current course that includes a measure of confrontation with the West. In an incident that could have been plucked from the pages of a John le Carré novel, a few weeks previously an ex-spy, Sergei Skripal, and his daughter were found poisoned on a park bench in an English town.

Britain was quick to point the finger at Russia, who practically laughed it off.

For Teresa May, the British Prime Minister, alongside other Western allies, the incident was no laughing matter. Mrs. May went on to announce the expulsion of 23 Russian diplomats called out as intelligence operatives. Within two weeks, in a sign of solidarity, President Trump expelled 60 Russians from America. Expulsions are also underway in fourteen European Union member nations including Germany and France. Earlier in March, the U.S. President, by way of Treasury Secretary Steven Mnuchin's team at the Office of Foreign Assets Control (OFAC), imposed sanctions on a number of Russian individuals and organizations over meddling in the 2016 Presidential election as well as "malicious cyberattacks".

Things haven't been entirely smooth sailing between Britain and its other European neighbors as tense negotiations continue over the terms of Brexit. At the beginning of March, Teresa May set forth her country's desired outcome for future trade negotiations, which Donald Tusk, president of the European Council quickly dismissed for its overt sector-by-sector cherry picking demands. A transition deal was later announced on March 19th in which Britain agreed to a 'status quo' period in terms of upholding most of its obligations to the EU while not being a voting member. In return, the U.K has until the end of 2020 to hash out a new comprehensive trade deal with its erstwhile European cohorts. Many view this as an overly ambitious timetable.

Over in Germany it took an unheard of six months after elections for parties to form a coalition, but after the Social Democrats (SPD) came back around to re-forming its alliance with Angela Merkels' Christian Democrats (CDU) and the Christian Social Union (CSU), Ms. Merkel was reappointed Chancellor for a fourth term on March 14th. Olaf Scholz of the SPD was appointed as the new finance minister and vice-chancellor. Italy has also been to the polls, but the inconclusive results of the election, with neither a center-right bloc nor the anti-establishment Five Star Movement (M5S) garnering enough votes to form a government, mean alliance negotiations continue.

Back at home, questions of safety and security have been at the forefront. In the wake of the tragedy of one of the deadliest school shootings in American history that took place in Florida in February, there are renewed calls for stricter gun controls in the form of more stringent background checks, "red flag" laws surrounding concerning behavior of individuals, and tightened rules on gun storage. Congress seems unlikely to act any time soon, but a number of city governments and state assemblies have enacted their own measures. In the online world, shares of **Facebook Inc. (FB-Nasdaq)** have been in near free-fall since mid-March following revelations concerning the unsanctioned use of members' data by third parties. Facebook's tepid response hasn't helped the eighth-most valuable publicly traded firm, and the rallying cry of #DeleteFacebook is gathering momentum. This, coupled with disappointing results from a number of big tech companies has definitely contributed to the cloud dampening equity performance of late.

We entered 2018 with the positive winds of broad-based strength across sectors, followed by a better than expected earnings season (the few big techs aside), but quickly encountered the stormy waters described above. This was far from being the first correction encountered in our investment lifetime, and we can predict with a high degree of confidence that it won't be our last. That is why we don't focus our efforts on trying to time the market, but rather diligently scrutinizing the right price to pay for individual stocks that meet our criteria of demonstrating a competitive advantage, competent and shareholder-friendly management, and reasonably predictable cash flows. We can't predict the weather or the future, but we can examine a single company from a value perspective right here and now.

May Spring bring us sunshine and growth in all areas, including the markets, and in the meantime we remain at your service and grateful for the continued trust you place in us as your financial adviser.