Investment Commentary

June 30, 2018

Positive and negative developments of the first quarter escalated in the second quarter. Portfolios remain balanced and conservative. We added shorter term Treasurys during the quarter.

Economic data continues to improve in the U.S. Real GDP estimates continue to rise, with many now expecting over 3% growth in 2018. Corporate earnings, already growing at double-digits, are expected to accelerate throughout the year. Employment data and small business and consumer sentiment gauges are posting record highs.

There is also an escalating trend in the two principal sources for financial uncertainty and risk, the biggest being the Trump Administration's trade…what do you call it? Negotiations? Gambit? Bluff? In our investment meetings, we find ourselves debating just *what* it is. (An increasing number of Investment Committee members say "war"). If we can't clearly define it, how are we to know what happens next or what it means for stock and bond prices?

About Trade

Trade is often communicated in simplistic, one-fact sound bites. Commentators on TV blast the European Union's (EU) 10% tariff on U.S.-made cars (versus the U.S.'s 2.5% tariff on European cars). Unfair, right? On the surface, yes, but we are only considering one partner and one specific type of good. The truth is, while the EU does impose higher tariffs on cars (and many other goods), there are numerous other goods for which the U.S. has the higher tariff.

Foreign trade with any one country or political union is incredibly complex, especially for a $20 trillion economy with countless goods and services to trade, performed by countless (and many well financed and influential) stakeholders—companies, industry groups, labor unions, etc. Trade policy gets exponentially complex when you add all of our other trade deals and partners, as well as each country's fiscal, monetary, and currency policies.

We have spent a lot of time thinking about and discussing trade but have little to show for it. Maybe the president is right about some things regarding trade. Maybe the U.S. has poorly positioned itself in its trade deals. Maybe we are getting "ripped off" by Mexico, Canada, the EU, China—maybe everyone. However, we can't help but wonder: "How do you know?"

We suspect his answer is that trade deficits are bad, period, in aggregate or even bilaterally (and possibly he believes this to be true on an industry-by-industry basis). This logic is hard to follow, and not just because countries with consistent trade deficits have performed better economically. For every deficit, there is a surplus elsewhere (like capital flows). That is why the governor of New York doesn't worry about a trade deficit with Illinois.

In the meantime, the trade whatever-you-call-it has escalated, and tariffs have led to retaliation and more tariffs. How much it could escalate is a cause of concern here. Almost no one has personal experience with trade wars on Wall Street or in Washington. For your Investment Committee here, with an average investment tenure of over 28 years among its members (including one with 50 years), this is quite new. For now, we are re-reading about Smoot-Hawley and digging more deeply into trade. We'll keep you posted.

Interest Rates

Since we are light in fixed income securities and have no long-term bonds, rising interest rates continue to be a welcome development for us. Every interest rate increase by the Federal Reserve means portfolios' earning potential increases. Longer term rates (> 10 years in maturity) have gone up, too, but not much. They don't strike us as a good deal yet.

We continue to "limp in" with periodic Treasury bill and note purchases as rates rise. With the cash-like 90-day Treasury bill now yielding almost 2% annually, investors finally get some yield without sacrificing quality or liquidity. With every Fed rate increase, "cash" will pay even more.

Welcome as they are, higher rates might also place second on our list of concerns for stock prices. The Fed recently acknowledged economic acceleration as justification for two more raises of 0.25% by the end of the year, with more raises thereafter. There is some risk here as persistent interest hikes have often led to a market calamity. That said, we are not too worried at this point as rates are still historically low, and the Fed seems careful not to repeat the two most recent tightening cycles of 1999 and 2007 that helped cause subsequent carnage. We will continue our Fed watching.

Smaller Companies

We have come back to one of our first takeaways of the Trump presidency. In a new era of fiscal stimulus, lower corporate taxes, and harsher treatment toward large multinational corporations and trade, the odds favor smaller, domestic companies on the margin rather than larger, international ones. After several years of large company stocks outperforming, a period of new leadership may have already begun.

Good, investible, and reasonably-priced smaller companies are hard to find, but we are spending more of our research time there. In the meantime, we added a mid-cap ETF for immediate exposure.

Notable Trades

The following summarizes major buys and sells placed during the quarter in our Core strategies (conservative, asset allocation-driven and absolute return-focused portfolios representing a majority of our clientele). Note that not all clients or portfolios participate in every trade idea due to clients' circumstances, account size, or other factors. Some portfolios are managed primarily, or exclusively, with exchange traded funds.

We bought and sold Huntington Ingalls Industries (Ticker: HII), America's largest military shipbuilder, during the quarter for a loss. After adding to our allocation in defense stocks, the unexpected peace talks with North Korea and a technical breakdown in the stock price led us to reverse and exit the stock.

New buys:

Treasury Note due 11/30/2020. Yield to maturity: approximately 2.4%

Treasury Note due 6/30/23. Yield to maturity: approximately 2.75%.

Intel Corp. (Ticker: INTC)
After a period of stagnant growth, sales have accelerated as the company chips away at its reliance on desktop PCs and adjusts to increased competition and the increased adoption of different chip formats in the marketplace. At worst, we see Intel as a reasonably-priced, potentially low-cost producer as more chips architectures become commoditized. It is harder to lead innovation across a wider and differentiated chip landscape (e.g. graphic processor units by Nvidia are taking a larger role in current and future computing, artificial intelligence, and cypto-technology)—but first mover seldom make the most profits. Where Intel doesn't lead, it can muscle in or acquire. We paid roughly 14 times earnings and 18 times free cash flow. Dividend yield: 2.4%.

Accenture plc. (Ticker: ACN)
We increased our investment in this long-term performer. A favorite holding of ours over the years, Accenture is a leader in management consulting, technology services, and outsourcing. The company represents a rare combination of a well-managed and durable business with high returns on capital. The stock trades at 21 times free cash flow. Dividend yield: 1.7%.

iShares Core S&P Mid Cap (Ticker: IJH)
This ETF contains exposure to 400 stocks, most of which have market capitalizations of $2 billion to $10 billion.

SPDR S&P 500 Bank ETF (Ticker: KBE)
Financials still seem a "Trump" winner. Few industries have benefited more from recent tax cuts, and prices for banks remain reasonable. The ETF holds roughly 80 national and regional banks. Dividend yield: 1.4%.

Sells:

In non-taxable accounts, we reduced exposure in iShares Core MSCI Emerging Market ETF (Ticker: IEMG) on trade fears and U.S. dollar strength.

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