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Investment Commentary

October 19, 2018

Volatility has returned to the stock market. We pared exposure to a conservative level, and are watching several items of increasing concern. Caution-with-opportunism is our approach, but we'd be remiss not to acknowledge a vastly improved economy. After years of tepid growth forecasts, more economists now peg economic growth around 4%. The official unemployment rate is now 3.7%, the lowest in 49 years. Consumer and business confidence readings are the highest in decades. Inflation has inched upward somewhat but remains near 2%. By almost any measure, the economy is running hot.

How long it will last, we don't know just yet. We continue to monitor several risks: Donald Trump's trade wars (the centerpiece of the Trump agenda), increasing geopolitical tension, the mid-term elections, and (to a lesser extent) interest rates. On trade, some uncertainty has been lifted with recent deals with Canada and Mexico. The Trump administration now pivots to Asia to rework the defunct Trans-Pacific Partnership trade pact and to press a final trade showdown with China.

Perhaps no country has suffered more from Trump's trade wars than China. So far, the U.S. has levied three rounds of tariffs on China for $250 billion worth of goods while China has retaliated with tariffs on $110 billion worth of U.S. goods. The results have been stark: China's economic growth is slowing, the yuan is weakening, and Chinese stocks are down some 25% from January. Meanwhile, U.S. stocks and the dollar have risen.

Despite the pain, it is unlikely China will roll over and give in to U.S. demands anytime soon. The possible outcomes and contingencies regarding trade are numerous, as are the risks. However, the victims of trade war so far seem to be mostly abroad, especially among "emerging" economies that are also looking at larger financial risks with a rising dollar. Much of the debt in emerging economies is dollar-based, and a rising dollar makes servicing debt more expensive.

Limiting international exposure has helped a great deal as U.S.-based assets and the dollar have far outperformed the rest of the world. We think the U.S. still offers relative safety and opportunity even though it is the cause of a lot of uncertainty on the international stage.

Treasury bills

You may have noticed the increased use of Treasury bills ("T-bills") in portfolios this year. T-bills are Treasurys issued with shorter term maturities of a few days to 52 weeks. They are issued without a coupon, but at a discount to par. For example, a current 90-day T-bill could be bought for $99.41 per $100 of par value, and the investor would receive $100 par value upon maturity.

T-bills play two major roles. One, as shorter-term, high-quality debt instruments, they are beneficiaries of a rising interest rate environment: As the Federal Reserve raises rates, investors get to reinvest and earn higher yields. Contrast this to longer-term Treasury rates which typically pay a higher interest rate but are sensitive to longer term interest rate movements. If longer-term rates move up as they have done recently, the price investors are willing to pay for those Treasurys goes *down*. The 10-year Treasury rate was as low as 1.36% in the summer of 2016 and recently traded at seven-year highs around 3.25%. Thus, investors in longer-term Treasurys and other bonds have lost value recently.

We have been happily *light* in overall bond allocation (in favor of stocks), and *short* in average maturity. Light and short means higher interest rates have both not hurt us much, and we have retained the ability to invest at higher and higher interest rates.

Today, investors get an annualized yield of 2.30% for 90-day T-bills, compared to virtually zero percent just three years ago. T-bills should continue rising in the near term and perhaps even longer with solid economic growth. As interest rates rise and stocks get pricier, or if we see deflationary risks on the horizon, we may add more bonds and lengthen maturities somewhat and "lock in" acceptable yields.

The second role for T-bills is a "no-brainer" cash substitute. T-bills are the most liquid debt instruments in the world and perhaps the safest: T-bills, like other Treasurys, are constitutionally guaranteed. Generally speaking, a money market fund's level of safety is proportional to its allocation to T-bills (it still surprises us how many "prime" money market funds invest disproportionately in lesser-credit securities, including obligations from foreign banks).

Furthering the "no-brainer" argument is yield: T-bills generally have yields higher than money market funds or bank cash vehicles. (In fact, it's hard to find a shorter-term bank Certificate of Deposit (CD)—for example a 6-month or 12-month CD—offering a yield greater than that offered by a T-bill of equal maturity.) And T-bills are *not* subject to state income taxes.

Safety and yield are nice, but the real value of these "cash" investments should be remembered: As a means to seize opportunities *tomorrow* or whenever they present themselves. Investors need not be fully invested and restricted only to today's opportunity set.

<u>Notable Trades</u>

The following summarizes major buys and sells placed during the past quarter and subsequently 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.

New Buys:

<u>3M, Inc. (Ticker: MMM)</u>

Concerns over margins and foreign sales (in the context of trade war) have made 3M the worst performer among the Dow Jones's 30 companies this year. The reduction in share price creates a buying opportunity. 3M is a well-run company with hard-to-replicate products. With the market's pessimism on trade, we think any good news could result in outsized gains. Dividend yield: 2.7%.

<u>Stryker, Inc. (Ticker: SYK)</u>

Stryker is a leader in medical implants (including hip and knee-replacements) and surgical tools. An aging population should ensure robust demand going forward. Though not a screaming bargain at 24 times this year's earnings and 22 times 2019 earnings, we think Stryker is a high-quality company and a good addition to a diversified portfolio. Dividend yield: 1.1%.

We added investment in **Microsoft Corp. (Ticker: MSFT)** and the parent company of Google, **Alphabet, Inc. (Ticker: GOOGL)**, during the third quarter. We also purchased **The Boeing Company (Ticker: BA)**, **Caterpillar Inc. (Ticker: CAT)**, and **Kansas City Southern, Inc. (Ticker: KSU)** but subsequently sold all three in October as we reduced overall stock exposure.

Sells:

We sold **Bristol-Myers Squibb Co. (Ticker: BMY)**, **iShares MSCI Emerging Markets (Ticker: IEMG)**, and **Intel Corp. (Ticker: INTC)** during the third quarter.

Since September 30, we have made additional sells, including: **Apple Inc. (Ticker: AAPL)**, **General Dynamics Corp. (Ticker: GD)**, **Lockheed Martin Corporation (Ticker: LMT)**, and **SPDR S&P Bank ETF (Ticker: KBE)**. We also reduced investment in **Hubbell Inc. (Ticker: HUBB)**.

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