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INVESTMENT REVIEW AND OUTLOOK

A 180 Degree Turn

The first quarter of 2019 witnessed a strong rally in global stock markets and an important move in interest rates. The broad U.S. stock market, as measured by the S&P 500, had a total return of 13.6% and the Barclays Aggregate Bond Index had a return of 2.5%. The yield on the 10-year U.S. Treasury Bond declined from 2.7% to 2.4% during the quarter. Short-term stock market movements are notoriously difficult to predict and often challenging to explain without the passage of time. However, the strength in global stocks since late December can be largely attributed to a change in both the tone and substance of U.S. Federal Reserve policy. In contrast to mid-December, when the Fed communicated its intention to increase interest rates during 2019, the Fed has more recently tempered its language in its official and unofficial communications; the federal funds rate has held steady since December and consensus expectations now call for no additional increases in the federal funds rate during 2019.

Changes in Federal Reserve policy are not uncommon. The central bank has a "dual mandate" to promote full employment and keep inflation in check. Fed policy shifts with the changing economic picture. During 2017-2018, in response to a strong U.S. economy, the central bank pursued a generally tighter policy of gradually increasing the federal funds rate. In early 2019 however, the Fed altered its interest rate policy and this development was unusual because it occurred within weeks of the December interest rate increase. What changed?

During the second half of 2018 the "synchronized global growth" narrative of the past few years began to shift. The Chinese and European economies demonstrated notable signs of deceleration in their industrial and export sectors. In contrast, the U.S. economy performed strongly during 2018 with real GDP averaging over 3% for the first 9 months of the year. It was this backdrop of strong domestic economic growth that influenced Fed policy through the end of 2018. During the 4th quarter of 2018, several domestic economic indicators, such as payroll growth and factory orders, showed signs of slowing. This slowing occurred at the same time as the prolonged federal government shutdown which further dampened economic activity. Also coinciding with these signals was a deceleration in the Consumer Price Index reported for November-December. Short-term economic indicators can be fickle and are subject to revision, however the combination of a deceleration in economic growth *and* the rate of inflation caught the attention of the Federal Reserve and resulted in a literal "about-face" in the Fed's interest rate policy. The stock market rally was largely in response to the Fed's "pause"; the move in stock prices also reflected confidence that the softer economic data was more transitory in nature.

Cross Currents

Economic and geopolitical conditions are rarely uniform. Even in the best of economic times, such as the global economy experienced from 2016-2018, there are almost always areas of concern. As an example, South America (specifically Brazil and Argentina) has been a notable exception to the current global expansion. Similarly, the global geopolitical picture usually contains trouble spots beset by heightened tensions or outright conflict. These cross currents are part and parcel of navigating the investment landscape.

By the standards of recent history, the cross currents today are stronger than average. We have touched on a number of these challenges in recent letters:

- Slowing economic growth in China, Japan and Europe.
- A deceleration in the growth rate of global trade due in part to trade tensions and the implementation of tariffs in the U.S., China and Europe.
- A global rise in populism, the consequences of which span the Brexit impasse, prolonged street protests in France, and deteriorating fiscal conditions in Italy. The impact of growing populism has manifested itself in more extreme policy positions on both the left and the right ends of the political spectrum.
- An increase in "Great Power" tensions between the U.S., China and Russia. Enhanced rivalries have played out in the political (U.S. election meddling by Russia), economic (China's "Belt and Road" infrastructure initiative) and military realms (the establishment of China's first overseas naval base on the Horn of Africa).

To a certain degree, the developments above are intertwined. Great Power rivalries have an impact on trade policies which in turn can affect economic growth rates. We view the challenges above in three categories: short, medium and long-term. In the short-term, we are encouraged by the robust trade negotiations between China and the U.S. These negotiations have been accompanied by a delay in any additional tariffs. While there is no firm timeline for concluding these talks, the participation of high-level officials from both countries is an encouraging sign. Another short-term development relates to the less restrictive monetary policy of the U.S. Federal Reserve. As noted earlier, interest rates have fallen since the Fed's "180 degree turn." While it is too early to gauge the impact of the lower interest rates, recent economic data, such as existing home sales for February and the employment report for March, are encouraging.

The rise of populism is more of a medium-term issue. The root causes of populism are deep-seated and are not likely to be quickly remedied. Developments that have led to the rise in populism include the disruptive impact of technological change, the unintended consequences of global trade, an increase in economic inequality and a backlash against transnational sovereignty on issues such as trade, immigration and regulation. As the prolonged Brexit negotiations demonstrate, revisions to the status quo are not easily attainable. We do not know what course global populism will take in the future. However, we are reminded of the phrase "If we want things to stay the same, things are going to have to change."

Great Power rivalries have been a constant throughout history. In recent decades, China has been a rising economic force and, more recently, a diplomatic and military power. By virtue of its geographic size and population, Russia has been a Great Power for over 100 years. However, Russia's economic and diplomatic standing declined following the fall of the Berlin Wall and the dissolution of the Soviet Union. The greater assertiveness of China in the diplomatic and economic realm in recent years is emblematic of the country's enhanced role on the world stage. In the case of Russia, the country remains a diminished economic power, yet it retains considerable influence in the world. Russia's historical prominence juxtaposed to its lessened economic and geographic position helps to explain its sometimes antagonistic behavior.

The challenges of managing our relationships with China and Russia are a balancing act and are longer term in nature. The tensions of today are concerning, but they are at a much lower level than experienced during the Cold War. In the same vein, economic ties are vastly stronger.

Change is the Constant

It has been said that "change is the only constant." Those words are true as ever today. While we cannot predict the future, we can make inferences based on the conditions described above. Regarding the slowing in economic growth, we feel that the recent changes in monetary policy by the Federal Reserve will serve as a tonic for both domestic and international growth in the months to come. Trade tensions are elevated, but so is the level of engagement among our trading partners in Asia, Europe and North America. While rhetoric (and headlines) can become heated, there is a general recognition among all parties that the trade regimes of the late 20th century will need updating for the 21st century.

The surge in populism in recent years has caught many observers off-guard. The results of the Brexit vote in 2016 and the U.S. elections in the fall of 2016 were both unexpected and represented a challenge to the existing order. Looking ahead, signs of populist sentiment continue to be evident, particularly in Europe and in some of the early rhetoric leading up to the 2020 U.S. elections. It is only in hindsight that we can truly measure the strength of populism and its ultimate impact on legislation and government policies. However, it is reasonable to expect a change in the status quo in areas such as trade, fiscal, tax and immigration policy in the years ahead.

Investment returns in the first quarter of 2019 were among the strongest quarterly results of the last decade. In many respects, economic conditions were similar to the pattern of recent years: inflation and interest rates remain low against a backdrop of modest economic growth. Equity valuations are reasonable, neither cheap nor expensive. Looking to the remainder of the year, key factors we are watching include: signs of a reacceleration of economic growth in response to lower interest rates; tangible progress on trade negotiations and pragmatic responses to populist economic concerns.

The stock market decline during the fourth quarter provided an opportunity to increase our equity weightings. Our stock selection continues to emphasize financial strength and free cash flow generation. We have increased our allocation to non-U.S. markets with a focus on companies that benefit from the global rise in middle class consumers. We are maintaining modest cash reserves in the form of short term U.S. Treasury securities. Where appropriate, we are also holding a modest position in the Gold iShares.

As always, we welcome your comments and questions.