APRIL 10, 2019

Who flipped the switch? When markets closed on December 24 for the Christmas holiday, investor gloom was palpable. At the risk of reopening old wounds, the fourth quarter of 2018 was one of the worst on record. Negative sentiment was a three-legged stool: slowing economy, simmering trade wars and, worst of all, rising interest rates courtesy of the Federal Reserve Board. However, by the first trading day of the New Year, investors began to embrace a more optimistic view, especially about future Fed policy moves. Markets turned on a dime.

Stocks posted their sharpest quarterly advance since 2009. According to mutual fund tracker Morningstar, the average investor produced returns in line with exceptionally strong broad market averages. Our portfolios performed better, thanks to robust results in virtually every sector. Investments in technology, consumer related businesses and the newly designated "communications services" were uniformly strong. Financials and healthcare were mixed, though virtually every position produced a positive return during the quarter.

While lower long-term interest rates provided a boost for stocks in general, the current environment is not considered positive for all businesses. Banks typically use low cost daily deposits to fund multi-year loans at higher rates. Insurance companies collect premiums from their customers and invest in longer dated assets. When short and long-term rates are roughly the same (a "flat yield curve"), these practices are less profitable. We believe that our holdings in the financial services sector are less exposed than average to generic spread-lending and are therefore trading at extremely attractive valuations.

As we move forward, investor sentiment should continue to be defined by the opposing forces of concern about slowing growth and enthusiasm for low rates. Forecasters are starting to call for a U.S. recession. Europe and Japan are in worse economic shape, and China clearly appears to be feeling strained. BREXIT is difficult to handicap given the range of outcomes; however businesses should be less affected than the headlines might suggest given many have already implemented contingency plans for a "hard BREXIT", which would probably be the most disruptive scenario. A successful conclusion to trade negotiations would be viewed as a positive. In the meantime, markets will keep a close eye on the release of every economic statistic. Interest rates around the world are even lower than in the U.S. Incredibly, some foreign maturities are being issued with *negative* rates:

	U.S.	**Germany**	**Japan**
2 Year	2.26%	-0.61%	-0.18%
10 Year	2.41%	-0.07%	-0.09%
30 Year	2.81%	0.57%	0.50%

As of 3/29/2019

While this environment continues, it is hard to imagine that U.S. rates will move meaningfully higher. Facing at best paltry returns in their home markets, foreign investors have been an increasingly enthusiastic source of demand for U.S. bonds. Our bond portfolios are currently positioned to take advantage of slightly better rates in the shorter end of the maturity range. Given recession fears, we continue to limit our client investments to the highest credit quality issuers.

As we have stated previously, we cannot predict the timing of the next recession, but we are confident it will be a shallow one. We recognize that this view may be at odds with more popular (and emotional) concerns about the potential for another crisis. Absent an exogenous shock (a China meltdown for instance), we believe that consumers and businesses alike are currently well positioned to withstand a period of economic retrenchment. However, we acknowledge that markets are likely to over-react and the ride may be bumpy.

We feel we are well prepared for just such an environment. We have ample cash reserves and, where appropriate, allocations to fixed-income to help cushion the ride. Our equity holdings are characterized by strong market positions, high profit margins and conservative balance sheets. Most will benefit in the long run from short-term stress by taking share from weaker competitors. We believe that our more cyclical holdings will fare significantly better than expected and will be accorded commensurately higher valuations.

Our portfolio of high-quality businesses has proven valuable in two ways. Critically, by owning strong companies, we were able to stay invested in December when markets were sending frightening signals. Just as importantly, individual stocks outperformed as investors recognized superior fundamentals. We believe this is the most appropriate way to invest in the current economic and geopolitical environment.

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