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ASSET MANAGEMENT

Q2 2018 Investment Review

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"Creativity can only be anarchic, capitalist, Darwinian."
Umberto Eco: *Wired* magazine (1997)

Most major global stock markets were falling in June and ended the second quarter in the red. The U.S., however, regained its footing following Q1 and registered a +3.4% advance (as measured by the S&P 500) – which helped the All Country World Index notch a +0.5% increase for the period. Reversing the trend from last quarter, the U.S. Dollar gained +5.0% against a basket of foreign currencies and dented U.S. investors' returns on foreign investments. This somewhat surprising move can be partially attributed to the Federal Reserve's persistence in raising short-term interest rates and the comparatively strong U.S. economy.

Benchmark Index Returns

	S&P 500	MSCI All Country World	MSCI Emerging Markets	MSCI EAFE	Bloomberg-Barclays Aggregate Bond	Gold $/Troy Oz.	Crude Oil $/bbl.
Q2 2018	**3.4%**	**0.5%**	**-8.0%**	**-1.2%**	**-0.2%**	**-5.4%**	**14.2%**
Q1 2018	-0.8%	-1.0%	1.4%	-1.5%	-1.5%	1.3%	7.5%
Q4 2017	6.6%	5.7%	7.4%	4.2%	0.4%	1.9%	16.9%
Q3 2017	4.5%	5.2%	7.9%	5.4%	0.8%	3.3%	12.2%
1 Year	**14.4%**	**10.7%**	**8.2%**	**6.8%**	**-0.4%**	**0.9%**	**61.1%**

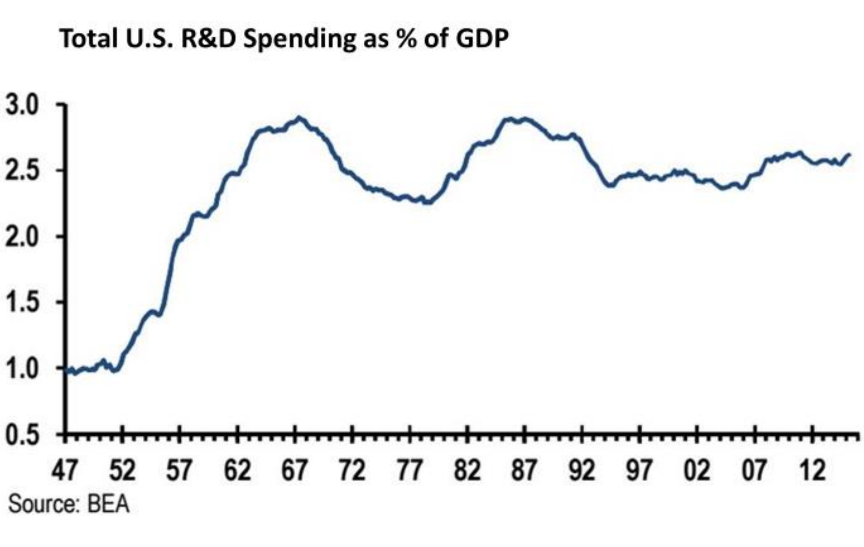
The Fed raised short-term rates for the second time this year on June 13th to a range between 1.75% and 2.00%. At his press conference following the move, Chairman Powell said: "The decision you see today is another sign that the U.S. economy is in great shape." Inflation measures, both market-based and those calculated by government agencies, remain subdued and in the range of 2%. Unemployment statistics point toward very healthy levels of total employment, so the Fed does have reasonable cause to be upbeat. Both long-term and short-term U.S. Government bonds gained in value for the quarter, but the broader bond market index, the Bloomberg Barclays Aggregate Bond Index, posted a small -0.2% decline. The widely followed 10-year U.S. Treasury yield was 2.9% at the end of June, up three quarters of one percent from 2.3% this time last year.

Given these somewhat positive datapoints, it is worth mentioning that West Texas Intermediate (WTI) crude oil prices hit a three-and-a-half year high and ended the quarter at $74 per barrel. Among other supply and demand concerns, the U.S. State Department was actively applying pressure on the global community to eliminate imports from Iran by November of 2018 by threatening the use of punitive economic sanctions. These proclamations of executive action against our trading partners joined the chorus of tariff announcements that plagued the markets all quarter long. Though how these trade tensions ultimately play out is highly uncertain, we will be listening to corporations' Q2 earnings discussions very closely for evidence of cracks in the otherwise positive sentiment among consumers and business leaders in the U.S.

The geopolitical atmosphere has figured prominently in investors' minds this year and the list of eyebrow-raising developments keeps growing. To add some stock market perspective to this sense of unease and uncertainty, however, is the fact that since July of 2008 until now – a span of ten full years that included plenty of serious geopolitical upheavals – the S&P 500 has gained +10.2% *per year* on a total return basis. If one was to extract only the five best performing days of that ten-year period, the annualized total return would drop over four percentage points to +5.8%. Ups and downs will come but enduring investment results, in our view, are best achieved with a healthy dose of patience coupled with careful analysis.

Circumstances change and people change with the circumstances. No matter how hard we as investors may seek to anticipate changes using software and financial theory, a simple mathematical equilibrium cannot, and will not, explain the complicated, reflexive world around us. Making correct judgments about the path of potential changes, however, can provide important inputs for the investment process. An important, related topic at hand in American discourse is the role of manufacturing in our post-industrial economy. From the agrarian era, through industrialization, and now into what some call the service economy, manufacturing has held a key role during this progression as both a propellant for innovation – stimulating change - and as the creator of a rich tapestry of sustainable employment.

As an example of profound, evolutionary change in our macroeconomy, consider the movement away from the agrarian-based phase. The U.S. was a largely agrarian economy through the middle of the nineteenth century until inventions and feedback loops slowly disrupted this model. Innovations in petrochemical science spurred advancements in fertilizers and pesticides that made row crop harvests more bountiful. Developments in mechanization led to bigger and more powerful tractors, combines, and irrigation systems that allowed farmers to plant and harvest crops more effectively. Trains and



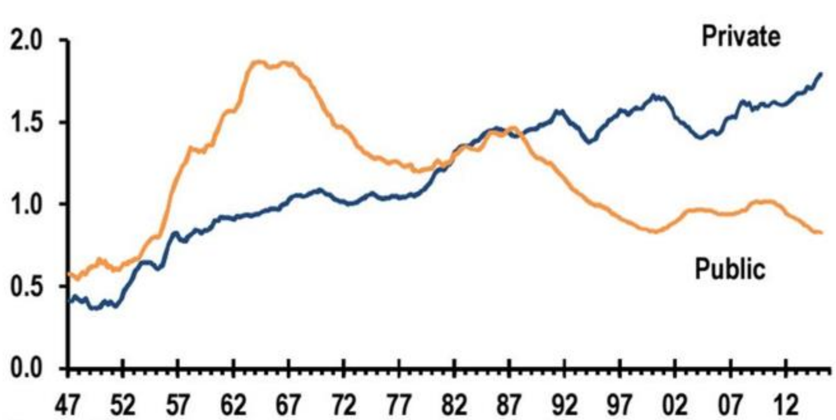
ships with increasingly more powerful gas turbine engines allowed materials and foodstuffs to be shipped to and from distant markets. This incremental, virtual innovation spiral ultimately allowed labor to migrate off the farm and to areas where it could earn a higher standard of living. All of this would have been difficult, perhaps impossible, to forecast in the mid 1800's.

At a more micro-level, the aerospace industry highlights the role manufacturing and innovation play in the employment picture. The aviation business includes the design, manufacture, and assembly of parts into highly complex finished products. In this process, engineers, materials specialists, laborers, maintenance and repair specialists, sales agents, executives, trade consultants, legal and tax specialists, test pilots, banking and financial representatives, to name a few, combine to create a web of sustainable and rewarding jobs. This employment ecosystem is broader, deeper, and more resilient than that of many elements of the service economy.

Technical innovation has been pushed by manufacturing operations and also, reflexively, has become the lifeblood of manufacturing. As knowledge about processes grows, the need and desire to push for "better" inevitably takes over in a state of competition to survive and thrive, similar to the way Darwin outlined. Invention, in this sense, is simply the growth and transference of beneficial information.

Measuring research & development spending is one way to judge how the U.S. is protecting and cultivating its base of helpful creativity. Total R&D spending post WWII exploded as a portion of U.S. GDP but has leveled off since the collapse of the Soviet Union (see chart above). Early on, R&D expenditures were dominated by the Federal government – largely a function of Cold War military budgets and the space race during the 1960s. Following NASA's heyday, with the stagnating economy of the 1970s, and then the fall of communism in the early 1990s, the Federal portion of overall R&D expenses registered a steady decline in relation to total GDP (see the chart below). On the other hand, business spending increased steadily. Parsed a bit more finely, the Private portion of the R&D outlay has consistently favored software and IT equipment – whereas the Public portion is considered more heavily skewed toward basic research. Even though the advancements from the semiconductor, telecommunications technology, and software industries have been enormous, much of the

U.S. Public and Private R&D Spending as % of GDP



Source: BEA

follow-on manufacturing that had one time been focused in these areas have since migrated to lower labor-cost nations (e.g. semiconductors in Japan and Taiwan, phones and PCs in China).

Though many factors can be selected as the potential underpinnings to growth in per capita standards of living, the role of capital spending on research & development, and by extension manufacturing, should not be ignored. Technical innovation, however disruptive and seemingly anarchistic to current eyes, has been a fundamental engine for sustained national income growth.

How the global economy evolves and who influences that evolution the most are pressing questions for investors because our view is that nearly all of the current value of an investment is a function of that investment's future expected earnings. A process of analytical thought that emphasizes flexibility and openness, in our mind, is more resilient and likely to produce positive returns than one characterized by hardened rules and anchored in rear-view mirror analysis. Our study leads us to believe that a future that features machine learning, the dematerialization of industries, increasing automation, and the sharing economy are likely to pressure total employment in the manufacturing sector. With care, however, a vibrant creative culture stemming from manufacturing can still thrive and support growing per capita standards of living. This will be increasingly important in a world of expanding federal budget deficits, longer expected lifespans, and fewer younger workers participating in the workforce.

Surveying the investment landscape, we see low interest rates (here and abroad), growing operating earnings for the S&P 500, stable global inflationary trends, and reasonable equity valuations. The list of worries that could work to upset these three basic phenomena are long. But, we continue to believe the weight of the evidence supports a case to be confident in relatively full exposures to stock investments and cautious on fixed income investments. These views, essentially, have not deviated for some time now.

We very much appreciate your continued support and hope that you and your family are enjoying these summer months.
