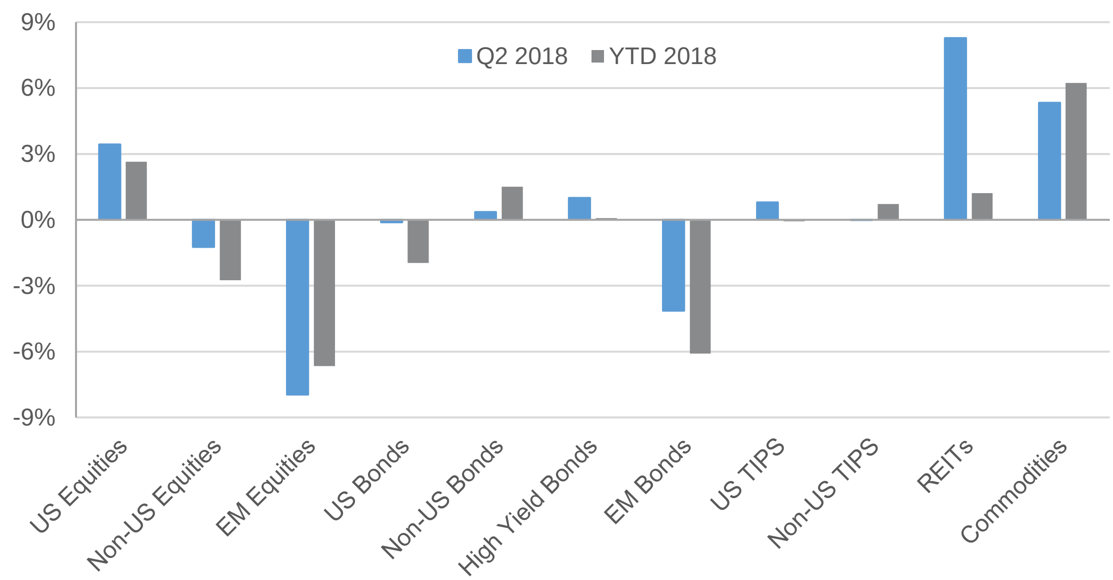
Today's Market Environment

August 10, 2018

The second quarter of this year was one in which markets diverged from one another quite significantly amidst escalating trade tensions and the U.S. Fed continuing to raise rates. These factors were broadly positive for the U.S. dollar, for real assets and for U.S. equities, but quite negative for foreign equities, especially emerging markets equities (Exhibit 1). The trade tensions also significantly hurt particular segments within the U.S. equity market.

Exhibit 1: Asset Class Returns for the Quarter and the Year-to-Date



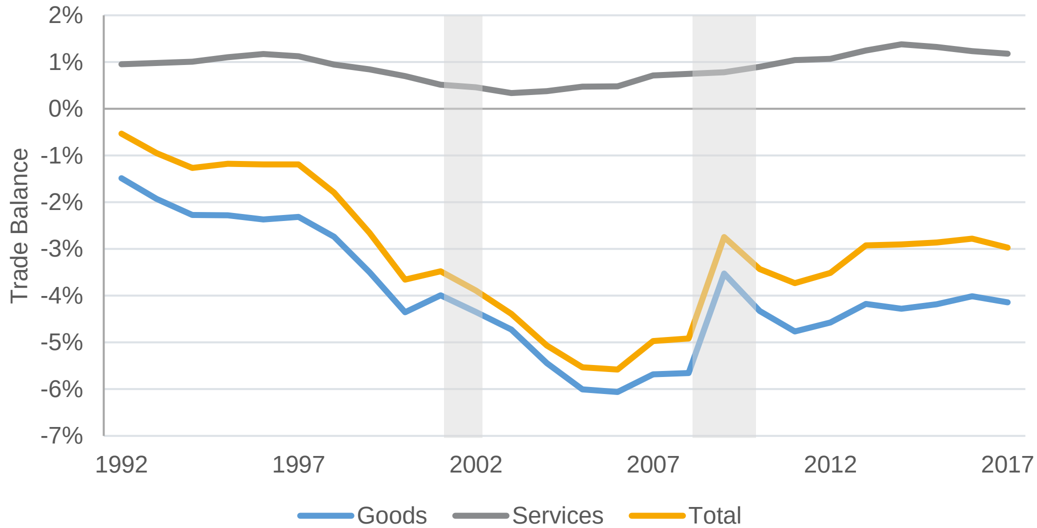
Few investments are immune to macro events and the risks posed by a trade war and an inflationary spike certainly could be in that category. Though most of our investments are selected through a “bottom up” process with a heavy reliance on fundamental analysis, a broader perspective on these risks and the market environment is important for understanding and managing overall portfolio risk.

Assessing broad economic risks, however, is always a challenge, and that is certainly the case today. It is easy to imagine things that could go wrong, but difficult to gauge the odds. The first place we look for insight is the market itself. Market prices result from the actions of a vast and competitive array of players, and their collective efforts make the market a pretty good handicapping device. We accordingly view it as a necessary exercise to try to understand the assumptions that are embedded in asset prices. Unless we have some kind of edge over the market—which is highly unlikely at the macro level—we should treat the assumptions implied in prices with a lot of respect.

Utilizing this framework, we look at systemic market risk from a number of perspectives.

Trade tensions: Trade, whether internationally or otherwise, is foundational to any economy. Estimates of the gains from trade vary but researchers put the cost to the U.S. of shutting the doors to international trade as high as 8% of U.S. GDP.[1] The present tensions are about the U.S. trade deficit—which in goods last year stood at 4% of GDP (Exhibit A1) or some $800 billion—reflecting imports of $2.3 trillion versus exports of only $1.5 trillion. The U.S. runs a trade surplus in services of around 1% of GDP so the combined deficit is 3% of GDP. Trade deficits are not inherently bad. In fact, as seen in the exhibit, the U.S. trade deficit has been a barometer of economic health, expanding in growth environments and contracting in recessionary times, as it did strongly in 2008/9.

Exhibit A1: U.S. Balance of Trade in Goods and Services (% GDP)
(Shaded areas are recessionary periods)



During Donald Trump's presidency, only some $44 billion of imports have actually become subject to new tariffs. However, the President has put in place processes that could lead to additional tariffs being imposed on imports worth hundreds of billions of dollars—primarily on autos and goods imported from China. U.S. trading partners have responded with threats of retaliatory tariffs; China also has allowed the yuan to devalue quite significantly and just recently nixed a large merger transaction. The trade tensions have added uncertainty to the economy which is making affected firms more cautious in their decision making.

Beyond currency impacts, the market has reacted to these and more dire future prospects. Stock prices have declined through June of this year in sectors such as China A Shares (-17%), U.S. steel and aluminum companies (-10%), U.S. agriculture and protein firms (-8%), and U.S. firms with a heavy involvement in Chinese imports (-5%). The A Share declines alone constitute a loss in market value of $1.1 trillion. In addition, global equities have been flat (through June) even though corporate earnings have exhibited excellent growth. There are many factors that drive equities but even if tariff concerns only partially account for these observed effects, it is clear that the markets are not unaware of these issues—in fact, a significant impact of trade tensions seems currently baked into stock prices. One implication is that there could well be significant upside in the share market should the tensions resolve in a benign way.

Equity earnings and valuations: Equity markets have performed strongly in recent years because the underlying fundamentals have done well. Earnings growth has been globally robust and more of the same

[1] See for example "The U.S. Gains from Trade: Valuation Using the Demand for Foreign Factor Services," by Arnaud Costinot and Andrés Rodriguez-Clare, NBER Working Paper No. 24407.

appears in store for 2018. Consensus forecasts of earnings growth for 2018 are strong—most notably 20% for U.S. firms—and forecasts for 2019 are also at or near double digit levels of growth (Exhibit A2, lines 1 and 2). The current earnings announcement season is a good example—some 80+% of U.S. company earnings announcements so far have exceeded analysts' expectations.

Relative to these fundamentals, stock market levels are not excessive. P/E ratios (line 3) are not much higher than long term averages, and earnings yields are well in excess of bond yields (lines 4 and 5). As long as this state of affairs continues, equity markets will continue to look relatively attractive.

Exhibit A2: Earnings Growth, Forward P/E Ratios, and Forward Earnings Yields[2]

		US Equities	Non-US Developed Equities	Emerging Market Equities
(1)	**2018 estimated EPS growth (FY 2018 versus FY 2017)**	20%	8%	10%
(2)	**2019 estimated EPS growth (FY 2019 versus FY 2018)**	10%	8%	12%
(3)	**P/E on estimated 2018 earnings**	17.3 x	14.1 x	11.9 x
(4)	**Earnings yield (based on estimated 2018 EPS)**	5.8%	7.1%	8.4%
(5)	**U.S. bond yield (10 Year)**		2.9%	

Inflation: A shock to inflation is one of the most feared risks today and rightly so. Should it occur, significant rate increases would likely follow, which would be damaging for most if not all asset classes. In a prior letter (Q4 2017), we documented how over the last century, the only major declines in U.S. equities in periods of rising bond yields were in times of high inflation. In these episodes, inflation averaged 6% and equities on average declined 22% in real terms.

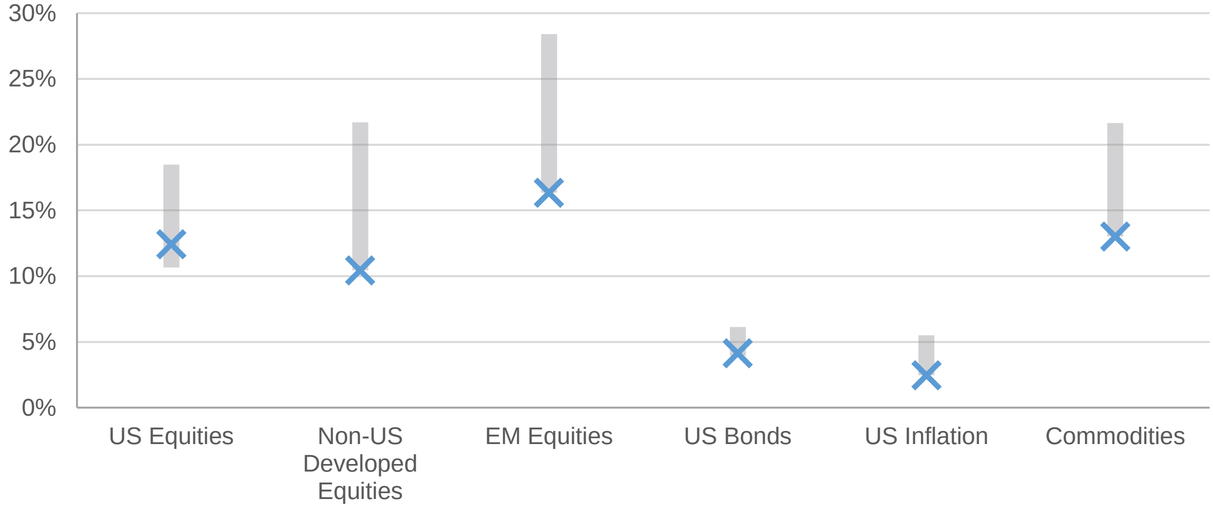
Concerns that inflationary increases may be imminent are rooted in labor market statistics. Unemployment is at near record lows in the U.S. and there are now more jobs being posted today than there are people looking for work. In addition, there are signs that hourly wages are beginning to rise. It is something of a global phenomenon given that 80% of the world's major economies are now at full employment.

However, there remain offsetting effects, such as the anti-inflationary impact of technology, and the U.S. inflation rate being discounted by the market over the next 5 years is below 2.0% p.a. (It is 2.1% per annum over the next 10 and 30 years.) These breakeven levels of inflation are only some 10 basis points per annum higher than at the beginning of the year, and they are lower than in the five years preceding and following the 2008 crisis. The market, in other words, does not yet view a major inflation shock as an imminent risk.

Market volatility and correlation: Geopolitical tensions surprisingly have had little effect on broad market volatility—other than in March when details of the first of the Trump tariffs were announced. In fact, over the last quarter volatility was below median for U.S. equities and at or below the 25th percentile for other asset categories (Exhibit A3).

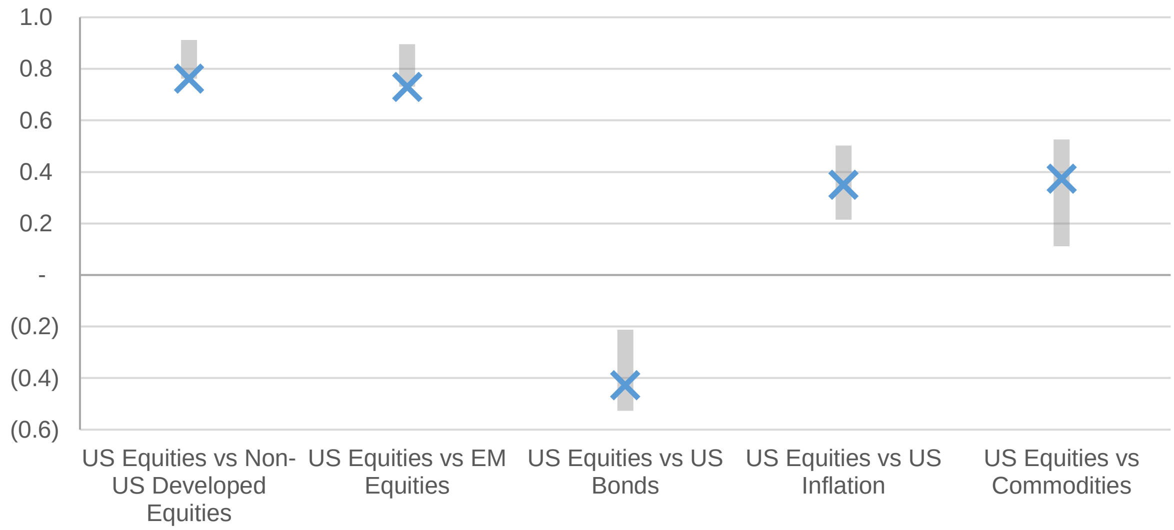
[2] Please refer to the important legal disclosures at the end of the letter.

Exhibit A3: Market Volatility in Q2, 2018 vs Historical Range Since 2005[3]
("X" indicates Q2, the bars indicate 25% to 75% percentile range since 2005)



Correlations between the asset classes also are quite favorable. For example, in Q2 U.S. equities were less correlated with other major asset categories than has been typical (Exhibit A4). These figures reflect the resumption of the pattern seen in 2017 when the linkages between markets were weaker than normal. By themselves, weaker linkages mean that global diversification is more effective as a risk mitigant. Also, as seen in the exhibit, equities and bonds continue to be negatively correlated. Bonds remain the only major asset class that should perform well when other markets do poorly.

Exhibit A4: Asset Class Correlations with U.S. Equities in Q2, 2018 vs Historical Range Since 2005[3]
("X" indicates Q2; the bars indicate 25% to 75% percentile range since 2005)



[3] Please refer to the important legal disclosures at the end of the letter.

Our overall takeaway is that the headline concerns are real and should not be minimized, but there also are many positives:

1. Markets seem to have reacted quite definitively to the tariff tensions as evidenced by the most affected sectors being down quite significantly. The overall market (through June) has also been flat in a period of strong earnings and some of that can be attributed to trade tensions. On balance, the market has been viewing the trade issue as more of a localized risk rather than a major systemic risk.
2. Corporate earnings growth has been strong and analysts' forecasts are for continued healthy earnings gains at least through 2019. Valuations are very much in line with history and are not excessive especially given globally robust corporate earnings.
3. A significant shock to inflation would trigger a strong Fed response which would be damaging to almost all asset classes. However, despite the strong economy and tight labor conditions, market expectations are for muted inflation over the near-term as well as over longer-term horizons.
4. The volatility spikes in Q1 notwithstanding, broad market volatility is low in relation to history, as are the correlations between major asset categories. These conditions are reflective of the points above and are favorable for equity exposure and asset class diversification.

In all, we see a world with less fragility than some of the headlines would suggest, but also one where this state of affairs may be quite temporary. Inherent in our approach is a constant vigilance to changes in the risk environment and the capability to adjust our broad market exposures. Most importantly, our source of greatest confidence stems from the quality of the investments we have been able to make—mostly through our managers and opportunities we have been able to source with their help. In each case, our conviction level is driven by positives that are specific to the investment rather than macro considerations.

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Terms & Definitions

Definitions for **Exhibit 1** are as follows:

Asset Class	Index
US Equities	S&P 500 Index
Non-US Equities	MSCI Daily TR Net EAFE USD Index
EM Equities	MSCI Daily TR Net Emerging Markets USD Index
US Bonds	Merrill Lynch U.S. Treasury 5-7 Year Index
Non-US Bonds	JPMorgan USD Hedged GBI Global Index
High Yield Bonds	Goldman Sachs CDX NA HY Total Return Index
EM Bonds	JPMorgan EMBI + Index
US TIPS	Barclays U.S. Inflation Linked Bonds TR Index
Non-US TIPS	Barclays World Govt Ex-U.S. Inflation Linked Bonds All Maturities TR Hedged
REITs	FTSE NAREIT Composite TR Index
Commodities	S&P GSCI Reduced Energy Official Close TR Index

Definitions for **Exhibit A2** are as follows:

Asset Class	Index
US Equities	MSCI USA Index
Non-US Equities	MSCI EAFE Index
Emerging Market Equities	MSCI Emerging Markets Index

Definitions for **Exhibit A3** and **A4** are as follows:

Asset Class	Index
US Equities	(SPY) S&P 500 Index ETF
Non-US Developed Equities	(EFA) MSCI EAFE Index ETF
Emerging Market Equities	(EEM) MSCI Emerging Markets Index ETF
US Bonds	Generic 10 Yr Treasury Futures
US Inflation	10 Yr TIPS and Nominal Treasury Bond Spread
Commodities	S&P GSCI Reduced Energy Official Close TR Index