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Quarterly Review and Outlook

As the initial quarter of 2018 weaves to its end, it seems likely that most investors are feeling a bit nostalgic about 2017. As we noted in our year-end review, 2017 was an undeniably tumultuous year. But, despite the controversies and political whirlwinds of a year ago, the stock and bond markets behaved in a very benign manner. The new year started in a similar way, with stocks posting a broad advance and fixed income securities holding stable.

The final two months of the quarter have been very different. The securities markets have been buffeted by a sharp rise in volatility as sentiment about trade, wage inflation and Federal Reserve policy became suddenly foremost. Rising interest rates pressured bonds, and unusual swings in stock market movements were amplified by a return of "fast money" algorithmic traders. The results have been an upward shift in fixed income rates and a shrinking of confidence in equity potential returns.

For many investors, the markets now are feeling like a long day at the amusement park after too many rides. The stomach-churning of the roller coasters, the whirling and repetitiveness of the carousels, and the feeling of lost control in the bumper cars have combined to give many the desire to stop the carnival and get out!

Such feelings of exhaustion and desires to drop out are understandable given the shock of sharp swings in equity volatility and declining bond prices. In addition, while investors are challenged by the changes in tax policy, a new Fed chairman, and the uncertain trade framework, there is the incessant noise from Washington as new controversies arise almost daily accompanied by key personnel changes. So, while we can understand, and even appreciate the current concerns, we are maintaining a positive posture on equities and a non-alarmist view on Fed policy and its likely impact on fixed income securities.

Over the years, we have often witnessed volatile emotions, which overwhelmed fundamentals for limited periods. Such occurrences have the salutary effects of prompting a review of economic and corporate fundamentals and providing the opportunity to increase exposure to areas of highest conviction. At this point, we are watching closely the measures of consumer and business confidence and the impact of the recent tax changes to consumer spending and corporate capital expenditure planning. While these gauges are currently providing strong readings, hard evidence of sustainable follow-on real gains will be necessary to instill renewed and wide-spread confidence in broadly based investment opportunities.

Some observers are expressing concerns about recent economic reports that were slightly below earlier expectations and projections. Consumer spending, inventory outlays, and capital equipment investment are cited as worrisome harbingers of a slowing domestic environment. Our view is that weather is an important and unpredictable variable, and that the winter quarter is always notably weaker than the forecasters expect. We expect that inventory and equipment spending is poised to respond to tax reform and liberalized depreciation rules, corporate optimism, and continued incentives contained in new government fiscal spending on infrastructure. Industrial production is expanding which leads to new investments in capacity. Additionally, the prospective repatriation of cash, now held overseas, will spur the managements of many corporations to increase dividends, undertake share repurchase programs and initiate or expand capital equipment investments.

All of the foregoing items are supportive of a positive backdrop for equities and are not likely to cause the Fed to alter its policy of normalizing interest rates gradually. The big worry and the attendant unknowns relate to the Trump administration's trade policies. The selective application of tariffs seem to be useful as bargaining chips with certain trading nations, but on a larger scale would act as tax increases on many U.S. industries. In our mind, "free trade" is a misnomer, because some parties are always disadvantaged. A different and very complex issue is "fair trade" and its pertinence to China on various levels. Even "neutral" observers agree that many of China's trade, market access and currency policies are unfair and supportive of intellectual property theft. China will likely retaliate against the imposition of tariffs. While the imbalance of trade in currency terms clearly favors China, that nation is an important customer for many U.S. enterprises and also is a major holder of U.S. debt issues. A trade skirmish that expands into a trade war and spreads could negate all the potential gains resulting from the tax cuts and deregulations in many domestic sectors. As we said, it is complicated!

In our previous letter, we opined our doubts about 2018 being as placid as 2017 in market terms. We also promised to be alert to the proverbial "Black Swan" and to maintain a prudent level of cash reserves for protection against prolonged uncertainty and undue volatility. After the extended placid period for equities and steadiness in bond markets, a correction is not unusual.

While the recent volatility has been uncomfortable, we are not revising our constructive outlook for the U.S. economy and the broad equity framework. Despite the recent increase in negative chatter from many commentators and pundits, we believe that the positive tenor of upcoming corporate earnings reports, greater clarity on trade frictions, and growing appreciation of the future impact of tax and regulatory changes and fiscal stimulus measures could reverse the reservations of investors. An additional positive support should be the stated moderate Fed policies and intentions. Our feared "Black Swan" would be a raging and widening trade war in which no country wins and currencies and relationships are in shambles. Not likely, but requires close attention.

At the present time, we are closely reviewing our current equity holdings, rather than making broad changes. Our focus and analyses are on the strength of corporate balance sheets, trends in free cash flow generation, secure market positions, and trajectories of sales and earnings. On a sector basis, we continue to believe that the diverse technology products and applications are growing strongly. A more restrained and reasonable regulatory environment should be beneficial to an array of financial institutions. As we strive to develop conviction in the stability of energy prices, the sector could offer attractive opportunities.

In the fixed income securities sector, we maintain our view that the gradual increasing of Fed Funds rates will keep much of the interest rates spectrum under modest upward pressure during 2018 and 2019. We expect inflation to be held in check by the combined forces of demographics, global competition, and the increasing presence of technology applications and systems. A properly structured portfolio of maturities and high quality corporate and government issues is preferred to deliver reasonable current income and reduced volatility.

As we look ahead, there is a surfeit of issues and changes which could prove dynamic and unpredictable. The combined strengths of the expanding domestic and global economies and the positive incentives facing U.S. corporations provide a formidable wall for worriers to scale. We pledge not to be sanguine, but rather to be constantly wary of the unpredictable and unforeseen and to make portfolio adjustments as deemed prudent and necessary.