Quarterly Commentary

3Q18

There is a wonderful quote from Joseph Heller's classic, Catch-22, which states that just because you are paranoid doesn't mean they aren't after you. While most talented investors are paranoid to some degree, the environment of this quarter seemed especially distrustful. Despite relatively strong economic activity and fundamental results, equity markets appeared to be more apprehensive about what impact trade policy and the continued normalization of interest rates by the Fed would have on future growth prospects. While there appears to be no current evidence of a foreboding recession, investors are watchful for how small changes in trends influence market risk given the strength and longevity of this cycle. Nevertheless, returns the 3rd quarter of 2018 were still favorable, with the Russell 2000 Value Index rising a modest 1.6%, producing YTD returns of 7.1%.

During the quarter we continued to see solid fundamental strength. Lower corporate taxes along with stronger corporate and consumer spending trends produced conditions advantageous to earnings growth. Broad leading indicators such as the ISM index and the regional activity indices as well as constructive employment trends and higher wages have helped sustain favorable trends for U.S. economic activity. Some of the volatility regarding trade policy in the prior quarter, which drove the U.S. dollar higher and pressured the performance of internationally-focused industrial companies, began to subside. However, the prospect of a prolonged potential "trade-war" with China and increased tariffs on foreign goods have created impediments to growth that will have to be offset by growth initiatives. Furthermore, the Fed appears ready to stay-the-course on tighter monetary policy and higher rates which could eventually hinder access to capital and slow growth.

The third quarter brought us market leadership that was cyclically mixed but broader than in the first half of the year. The Healthcare sector, driven by strength in biotech, continued its torrid pace and was once again the leading sector. Both the Utilities and Producer Durable sectors were significant outperformers as investors shopped for bargains among those industrial companies with trade-related declines from the previous quarter. Conversely, the Consumer Staples and Energy sectors were the most meaningful laggards with Staples being impacted by higher valuations while energy companies responded to slightly lower crude prices during the quarter. While we continue to maintain a slight cyclical emphasis in our portfolios as we incorporate the prospects solid U.S. and global economic activity, we have become more cognizant of emerging threats to this outlook.

Though economic trends continue to progress favorably, we think the concerns about slowing growth are not without merit. The Fed will continue to normalize interest rates and establish more restrictive monetary policy. The spread between long and short-term interest rates has narrowed considerably over the last year, which has historically been a precursor to slower growth. Trade policy has already begun to produce negative impacts on some companies (Autos and Consumer Durables) and may begin to negatively affect global growth. We are hopeful that U.S. fiscal stimulus along with easier China monetary policy will act to offset some of these headwinds. However, market results will be more reliant upon self-sustaining growth, which now is at greater risk given developments related to U.S trade policy, rising input costs, and a more hawkish Fed.

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