July 2018

> ***"Real liberty is neither found in despotism or the extremes of democracy, but in moderate governments."*** *-Alexander Hamilton*

Interesting Times

Dear Investor,

I was recently reminded of the purported Chinese curse: "May you live in interesting times" and the first thought that came to mind was that I could happily live in less *interesting times* than today's tumultuous environment.

It was only two years ago that Brexit shocked those who assumed that the Euro skeptics were a fringe minority. Following the elections in the U.S., Germany, Italy, Austria, France, Hungary, Spain and Poland, it is evident that there is discontent in much of the developed world.

The global recovery over the past decade benefitted the investor class and those with the right skills for the new economy. However, a wide swath of the electorate has experienced stagnant incomes, while many governments have reduced social spending due to weak finances, thus squeezing the middle class.

Politicians could usually count on a strong economy to assure re-election. However, at present, voters seem more attracted to a new wave of populist leaders who offer simple solutions to complex problems, rather than those whose goal is incremental improvement. The result has been a number of policy decisions aimed at satisfying a frustrated constituency, regardless of the economic impact.

Two such examples are the decisions by the U.S. to pull out of the Iran nuclear accord and to implement import tariffs. These moves will result in increased prices for gasoline and other goods, thus causing economic harm to the middle class and a reduced level of economic activity. Thus far, Europe, Canada and China are responding cautiously with carefully targeted tariffs of their own. In terms of the global impact, so far this is more of a trade skirmish than a war. Nonetheless, the decades-long trend of increasing free trade is, at minimum, taking a pause, which suggests that government policy may become less friendly to investors than in the recent past.

Bull markets and bond spreads

As can be seen in the chart below, the current bull market has lasted nine years, and is the 2nd longest in the post-WWll period.

A Long Goodbye

The S&P 500's bull market from its 2009 lows is already the second-longest on record.

Trough	Peak	Gain	Number of Days
10/9/46	6/15/48	20.8%	615
6/13/49	8/2/56	267.1	2607
10/22/57	12/12/61	86.4	1512
6/26/62	2/9/66	79.8	1324
10/7/66	11/29/68	48.0	784
5/26/70	1/11/73	73.5	961
10/3/74	11/28/80	125.6	2248
8/12/82	8/25/87	228.8	1839
12/4/87	3/24/00	582.1	4494
10/9/02	10/9/07	101.5	1826
Average		161.4	1821
3/9/09	**?**	**301.8**	**3400***

Number of days includes weekends and holidays. *Through 6/29/18
Sources: Yardeni Research; Bloomberg

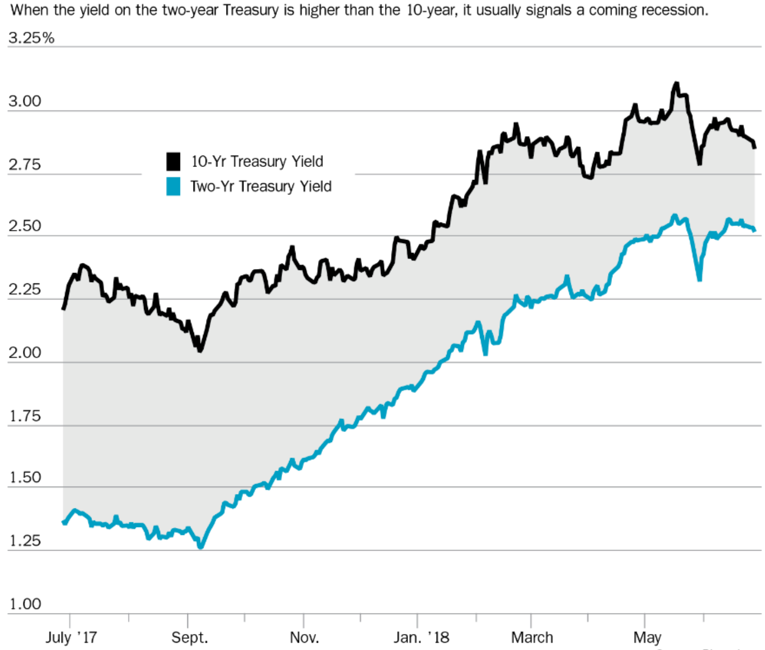
Source: Barron's
https://www.barrons.com/articles/why-the-bull-market-could-end-in-2020-1530317447

It is not the length of the current bull market that causes us some concern, but the fact that the fundamentals are less supportive of a rising stock market than at any time in the past number of years. After the financial crisis, the Fed and other central banks lowered interest rates and longer-term bond yields to levels not seen before. This "cheap money policy" encouraged consumers and businesses to borrow, while basically forcing investors to shift capital into riskier assets in search of higher yields.

The era of zero interest rates is now over and bond yields are on the rise. Rates at the short-end of the yield curve are rising at a faster rate than the long-end, as can be seen in the following graph, which tracks the difference between the yields on the 2-year and 10-year U.S. Treasury bonds.

The Big Squeeze

When the yield on the two-year Treasury is higher than the 10-year, it usually signals a coming recession.



Source: Barron's

Over the past year, the spread has narrowed to only 0.32%, the tightest level since the financial crisis. The yield curve is not yet inverted (a situation when short-term yields are higher than long-term yields), but it may be headed in that direction. Typically a flat or inverted yield curve is an indicator of an impending recession, as banks have no incentive to lend. Banks normally borrow short-term money at lower rates, and lend at higher long-term rates. When the yield curve is inverted, economic activity tends to decline.[1]

Opportunities

The performance of most markets in the first half of this year have been relatively flat; however, we note that two sectors have performed especially poorly thus far in 2018: financials and consumer staples. The performance of the financial sector can be explained by the flattening yield curve, as well as the aforementioned trade issues. The flatter yield curve has reduced lending margins, so bank lending is less profitable.

Consumer staples - companies such as Proctor and Gamble, Kimberly-Clark and Kraft Heinz - have been suffering from slowing sales growth and margin pressure, as the balance of power has been shifting from these large global brand names to retail powerhouses, such as Amazon and Costco, who are steering customers to their own "house" brands. Valuations in this sector became elevated over the past number of years, as investors bought these stocks for their attractive yield, regardless of fundamentals. These companies will probably not achieve the level of earnings growth that investors are used to, but as share prices have declined, we are starting to see value in the sector for the first time in many years.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: **High Yield Quarterly**.

Final thoughts - where do we go from here?

While there have been countless *"interesting times"* throughout history, most of us born in the West after World War II have probably not experienced the level of global disruption that we are witnessing today. For fifty years, until the financial crisis, the global economy expanded, and the standard of living improved in most of the developed world. Economic gains led to political stability, and the electorate was comfortable maintaining the status quo. However, the ongoing acceleration of both globalization and technological advances, in addition to a number of other factors[2], has led to a large segment of society being left behind. The situation worsened in the aftermath of the financial crisis, and the result has been a populist revolt.

None of this is good news for investors. Stability is a necessary ingredient for economic growth, and at present, the world seems to be heading in the opposite direction.

Alexander Hamilton is perhaps better known today as the subject of a hit Broadway musical than for serving as the first U.S. Treasury Secretary under George Washington. His quote at the beginning of this letter is simply a reminder that the risks of political extremism and populism are nothing new.

All of this suggests that investors remember the lessons of history, and remain conservatively positioned.

Sincerely,

Lorne Steinberg
President

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[1] Levisohn, Ben 2018, 'Why the Bull Market Could End in 2020', Barron's <https://www.barrons.com/articles/why-the-bull-market-could-end-in-2020-1530317447>.
[2] Thomas Piketty's book "Capital in the Twenty-First Century" (Harvard University Press, 2014) presents an excellent discussion on the history of income inequality.