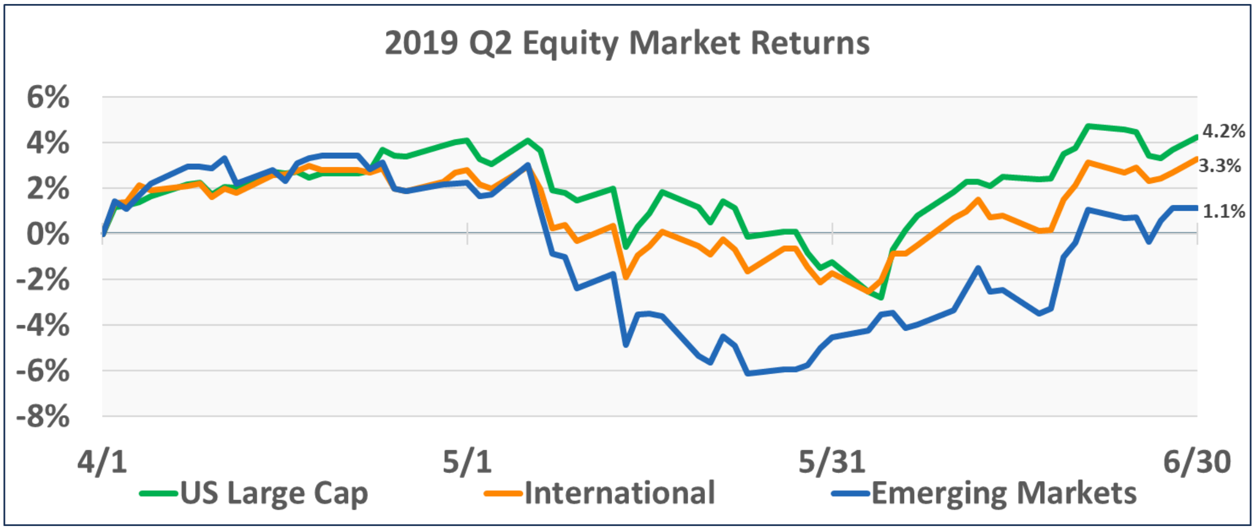
Second Quarter 2019 - Easy Money Is Back!



Despite significant equity volatility and news headwinds, global markets performed well this quarter, following a very strong first quarter. This is known as "Climbing A Wall of Worry." US equities are up 18% year-to-date and international markets generated double digit returns as well.

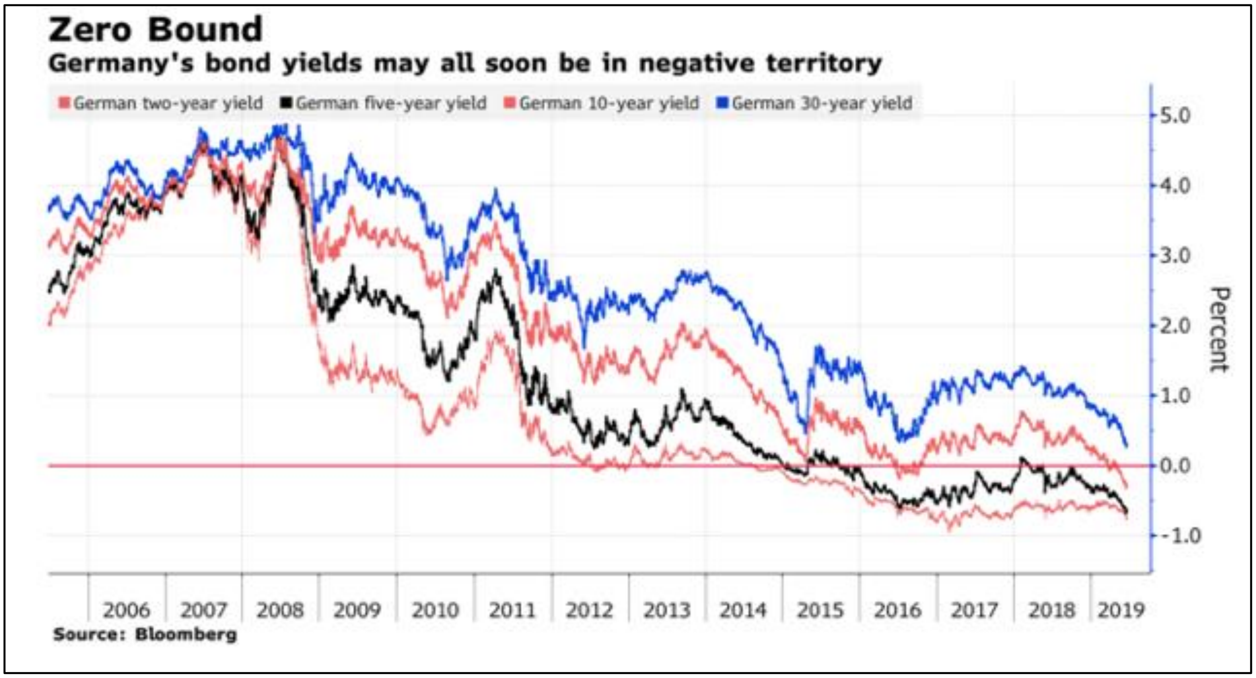
Does this make any sense given all the things we have to worry about? Isn't it about time to experience a recession? As the more experienced observers will tell you, recessions do not die of old age. Recessions have generally resulted from three causes:

1) Monetary or Fiscal tightening in response to inflation pressures.
2) A Financial Crisis.
3) An External Shock.

The above three triggers all reduce consumer confidence, causing demand to fall and the cascade begins. Meanwhile, retail investors are bailing out of equities and reallocating capital into bonds. Their fund flows out of equities are at a 15-year extreme and they are usually "wrong." That said, if this leads to a generalized consumer caution then it could lead to declining demand. The consumer is about 70% of GDP in the US so where they go the economy follows.

The volatility we saw this quarter was related to two factors: (1) Trade and Tariffs and (2) Speculation regarding the Federal Reserve getting ready to cut rates. No one can predict either dynamic, but you would have to say that so far, the tariff worries have been exaggerated or, at least, short lived. While the political and media pressures on the Fed to cut rates have mounted, it is worth noting that interest rates have already declined dramatically in the US. Usually the Fed cuts rates to force longer dated bond rates to fall in order to help increase business financing and, thus, bolster the economy. So, the Fed may cut rates in the future, but it is not necessary in a strictly economic sense. Credit is plentiful and cheap and has gotten much cheaper without any Fed help!

The rest of the world's Central Banks are already at 0.0% base rates and a substantial (and growing) portion of their bonds are delivering negative coupons. That's right - if you buy a German, Swiss or Danish bond you are paying them to take your money.



So, the rest of the world's major economies are throwing money at governments and companies at unprecedentedly low or negative rates. We do not know where this leads, but: 1) We are in uncharted territory and 2) Credit availability and stimulus is very high.

One key question all should be asking is: Are the world's central banks and bankers becoming "politicized?" If there is a drift in this direction it will make for more short-term thinking and that is never healthy in monetary policy making.

We are watching global equities valuations carefully and, while valuations seem modestly high by historic measures, uber low interest rates are supportive of these higher valuations. And reported earnings are holding up but expectations about rates and earnings can change quickly. Our equity portfolios are tilted toward less volatile and better valued asset classes and our fixed income portfolios are tilted toward higher credit quality and shorter maturities.

Thank you for your confidence in us.

Sincerely,

Donald E. Callaghan
Co-Managing Partner and Chief Investment Officer