A Pyrrhic Victory

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WE WERE RIGHT—WHAT NEXT?

A Pyrrhic victory is a victory that is offset by staggering losses. As in stocks during February– a correction that we called for on CNBC on January 29th, but one that has moderated fairly quickly. We first suggested a healthy correction would be welcome last July. Enthusiasm over economic growth and regulatory relief and finally, tax reform, catalyzed stocks prices during Q4 of 2017 and through January of 2018 pushing all the indices to new highs. And then, inflation and wage pressure concerns sent investors to the exits. Since then, the Fed, trade tariffs and a potential trade war with China, the Mueller investigation, Facebook's faceplant and bombs in Syria have given investors pause and the volatility (sometimes intraday) has increased dramatically over 2017 levels.

Increased volatility is a good thing. It weeds out the complacent, focuses investors on company fundamentals and rewards disciplined investors over the long-term. Current levels of volatility are in line with historical averages.

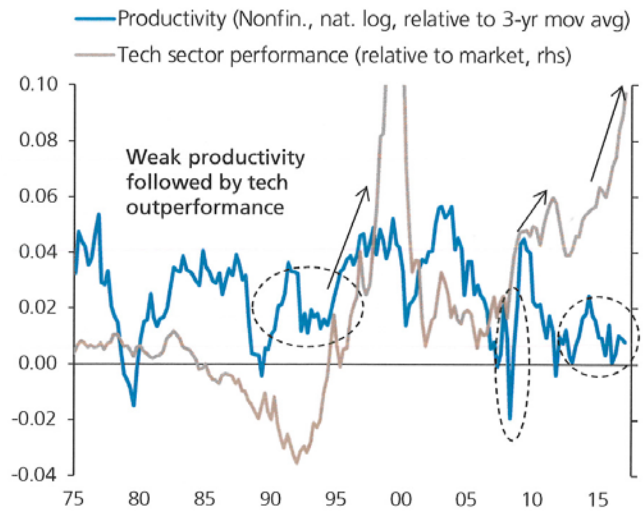
By the end of Q1, stocks as measured by the S&P 500, were down only 0.76% after entering official correction territory (down more than 10%) in February and retesting those lows into early March. As expected, stocks recovered because the underlying fundamentals are better than they've been in a long time. As I write, stocks have gone positive for the year. Volatility will continue, but we expect the trend to be positive this year overall.

We wrote to you in February 6 ***Times Like These—Redux*** that we would welcome what we perceived to be a long overdue correction. "*The global stock market has not experienced a correction for 16 months. That is unsustainable. If markets only went up (think Bitcoin) everyone would be an investor.*"

And here is what we said in January: "*In year nine of the second longest running bull market in history and in the face of rising interest rates, we determined it was a good time to introduce our Diversifiers Portfolio. On January 2nd, we implemented a* *portfolio funded by taking 5% from stocks and 5% from bonds. The move reflects our pessimism over the interest rate environment (rising) and a desire to take some of our overweight in U.S. equities off the table (outperformance). We still remain overweight stocks—both domestic and international—and believe after our Hawaiian Time Correction (late but inevitable) stocks will continue to rally for the foreseeable future."* This remains our view and we will be adding modestly to our Diversifier portfolio in the coming weeks.

Earnings are expected to rise 19% this quarter. This is driven largely by energy but earnings growth is strong overall. So far during this reporting season companies have generally exceeded expectations and raised future guidance. More important to us is the top-line guidance (recall we look at sales relative to the market and relative to a stock's own history as one of our primary buy/sell metrics) which is as healthy as we've seen it for some time. Expectations for the quarter are up 7.3%.

One chart to contemplate. Many have been predicting the end to technology growth. This was sparked by Facebook's woes and as is often the case with Wall Street, recent events were extrapolated out to infinity. Real technology companies that increase productivity are the stocks we believe will drive future growth. This chart emphasizes the outperformance of technology equipment and software companies after periods of sustained low productivity. Social media companies will be moved into the newly designated Communications Services sector in September in the S&P 500 which is where they belong. Technology cap-ex is rising as we outlined in our Q4 commentary and the old-tech stocks we own will benefit.



Source: Haver, Website of Professor Kenneth R. French (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french), UBS

Below are comments I published in our twice monthly Research Bulletin (see your Wealth Advisor if you'd like to be on our distribution) and provided to both CNBC and Fox News for interviews.

By hiding behind a blog post, and refusing to speak to any anchor who would listen, by shunning Parliament, by being The Zuck, Zuckerberg created a vacuum. He handed over the headlines to the politicians and the media. He swept the barn door wide open after the collective hand wringers had already been on their own for days and a weekend. PR nightmare created by a media scion.

So the politicians galloped through the barn door, four abreast on their high horses. The Zuck might as well have rolled out the red carpet. Come on in! Look behind the kimono! The Great OZ has spoken!!!! There is nothing to see here behind this curtain!! The Great Oz has spoken! And there went billions in market cap. Right into the manure pile.

We still own the stock but we had trimmed prior to the crisis and acquired the stock at much lower levels. We think the company will continue to grow but will be less profitable as management struggles to protect user data that is critical to the business model. That said, Facebook is not tech—it is a social media platform. And the stocks we like in the technology space generate productivity enhancing technology. Productivity is the key to sustainability of this business cycle because productivity keeps wage pressures and inflation at bay.

Stocks are always volatile during mid-term election years but have a long history of positive returns once the result is known. We believe this bull - and this economy - has more room to run. But we are prudently diversifying your assets via the Diversifiers and Paul Dickson has been incredibly adept at navigating this rising interest rate environment in our bond portfolios. Tom Peckosh is focused on producing steady, stable income in our High Income strategy and our equity strategies are focused on growing income and quality holdings for the long-term.

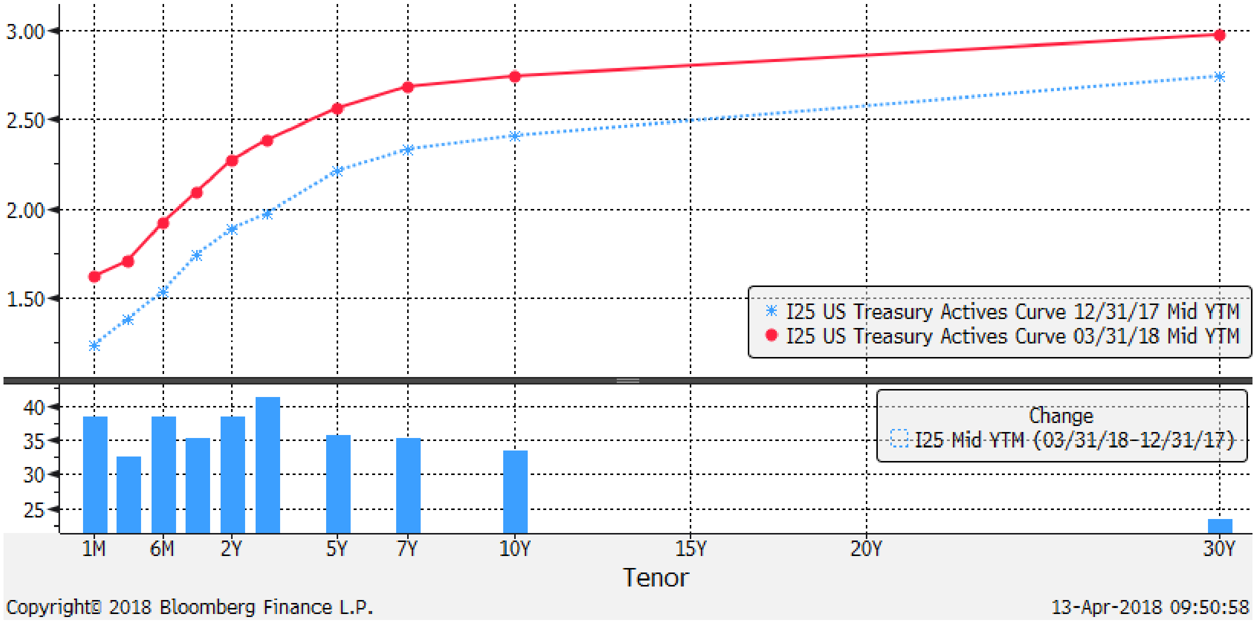
FIXED INCOME REVIEW Q1 2018

"If we are right on many more market calls we shall all be ruined".

To ruin a nice quote from Plutarch about the victories of Pyrrhus; if we continue to be right about the bond market, 2018 won't be remembered very fondly. The first quarter of 2018 saw general weakness in the bond markets and a bias towards higher rates. Equity volatility did, at times, cause bonds to rally on signs of potential trouble in the real economy and threats to the growth outlook due to economic policy changes, but the overall trend for the month was softer prices and higher interest rates. The Federal Reserve also played a role in the rates increase by hiking the short-rates that the Fed explicitly controls (Fed Funds) and maintaining the policy of reducing its balance sheet, which is expected to add net bond supply to the market. Finally, the dramatic increase in the projected US government budget deficit after the tax cut package and the more recent spending bill has raised concerns that future net new issuance from the US Treasury will be heavy and prompt even more pressure on the bond market.

While rates overall rose, the US Treasury yield curve flattened during the quarter with the one-month T Bill rising almost 40bps but longer rates much less. The 10-year rose 33bps and the 30-year rose less than 20bps. This appears to reflect market expectations that inflation remains under control and doubts over the Fed's own forecasts. A continually flattening yield curve raises concerns that the bond market sees economic troubles, possibly including a recession, in the foreseeable future.

U.S. TREASURY YIELD CURVE

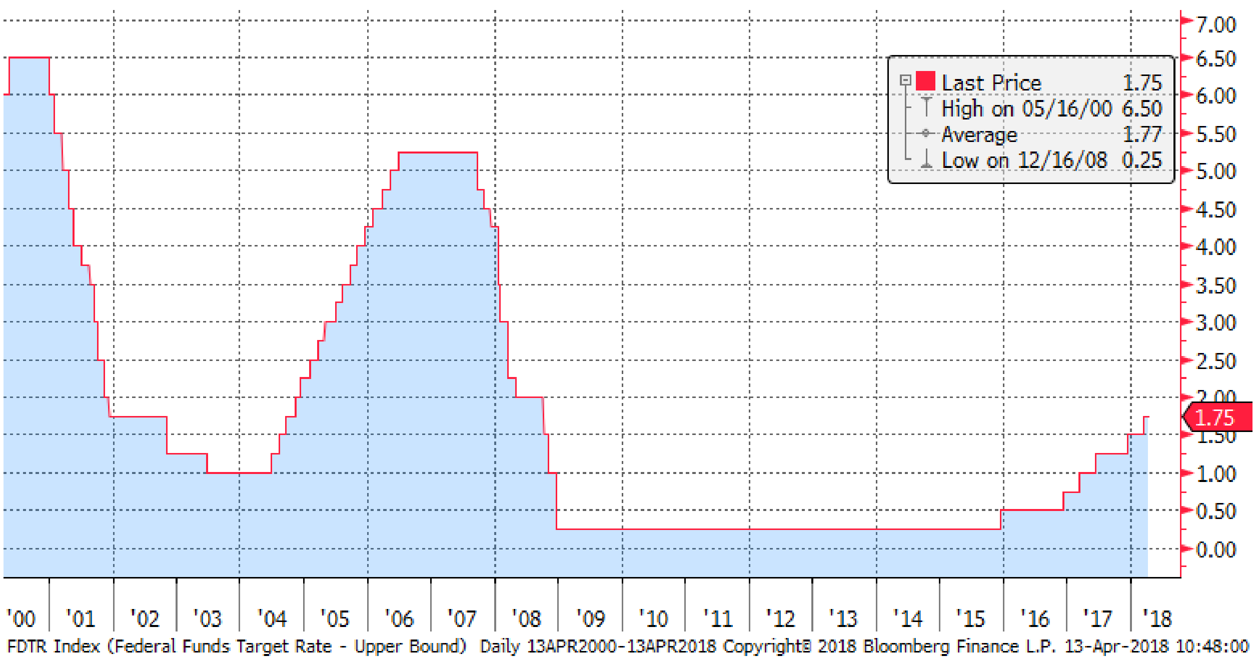


The benchmark Barclay's Intermediate Aggregate Bond Index faced a total return loss during the quarter. The index had a return of -1.05%. This was led by losses in corporate bonds, which fell around 1.5%. Mortgages lost 1.2% while US Treasuries had a negative return of 0.75%. The US High Yield bond market fell 0.61%, ending a rally that had started last fall. US Dollar denominated Emerging Markets lost 1.34% during the quarter reflecting, in part, concerns over the outlook for the global economy under the shadow of a trade war. The US Municipal Bond index lost 1.11% during the period. Overall bonds performed poorly globally in the first quarter of 2018.

Our Taxable Active Fixed Income strategy outperformed the Barclay's Aggregate Index by 105 bps during the quarter with overall return of zero. The out-performance reflected, in part, our duration exposure of more than a year shorter than the index. Other contributing factors included our significant underweight to mortgages and a decision to further reduce corporates and avoid high yield. Our step coupon Agency and Bank bonds outperformed their fixed coupon peers and our less correlated holdings in consumer loans and reinsurance also helped.

The outlook remains cloudy as the Fed continues to be poised to hike rates. The Fed Open Market Committee forecasts two more increases this year and will continue to reduce its balance sheet – holdings accumulated over three periods of Quantitative Easing (bond buying). The fiscal deficit will also add significant supply to the market and rising tensions with China could potentially lead to that country wanting to hold fewer US government bonds. We will continue to take advantage of a still relatively flat yield curve to maintain our lower duration profile but be able to add to our running yield. The good news is that the overall adjustment (or normalization) of the bond market from the lows post Great Recession may well be half over, if not more so. As we see that adjustment come to a close, we will likely increase our duration exposure for better term premium.

FED FUNDS RATE (UPPER BOUND)



For the time being, our duration positioning will continue to be significantly shorter than the benchmark as we see the outlook on interest rates as asymmetrical for the time being. We are also looking at further reducing our exposure to mortgages when we find compelling opportunities.

HIGHLIGHTS | 2018 Q1 REVIEW

ECONOMY

- Volatility has increased from 2017, but is in line with historical averages.
- We experienced a long overdue correction that we first called for in July 2017.
- Volatility will continue, but we expect the trend to be positive this year overall.
- Earnings are expected to rise 19% this quarter.
  —Driven largely by energy
  —Earnings growth is strong overall and companies have generally exceeded expectations and raised future guidance.
- Top line guidance is as healthy as we've seen it for some time.
- The Fed played a role in the rates increase by hiking the short rates and maintaining a policy of reducing its balance sheet.
  —The Fed Open Market Committee forecasts two more increases this year and will continue to reduce its balance sheet.
- A continually flattening yield curve raises concerns that the bond market sees economic troubles, possibly including a recession in the foreseeable future.

BONDS

- If we continue to be right about the bond market, 2018 won't be remembered fondly.
- Q1 2018 saw general weakness in bond markets and a bias towards higher rates.
- While rates overall rose, the US Treasury yield curve flattened during the quarter.
  —This reflects market expectations that inflation remains under control and doubts over the Fed's forecasts.
- Overall bonds performed poorly globally in the first quarter of 2018.
- Our Taxable Active Fixed Income strategy outperformed the index by 105 bps during the quarter.
  —This was due, in part, to our duration exposure of more than a year shorter than the index.
  —Other factors included our underweight to mortgages and a reduction of corporates and avoidance of high yield.
- The outlook remains cloudy as the Fed continues to be poised to hike rates.

STOCKS

- By the end of Q1, stocks were down only 0.76% as measured by the S&P after entering official correction territory.
  —Stocks recovered from correction territory because of strong underlying fundamentals.
- Increased volatility weeds out the complacent, focuses investors on company fundamentals, and rewards disciplined investors over the long term.
- The stocks we like in the tech space produce productivity enhancing technology.
  —Productivity is the key to sustainability productivity keeps wage pressures and inflation at bay.
- Stocks are always volatile during mid-term election years but have a long history of positive returns once the results are known.

STRATEGIC ALLOCATION

- We generate excess total return over the long-term by employing a rigorous, time-proven investment valuation discipline that provide confidence to take appropriate action in difficult markets.
- We seek to buy companies with strong fundamentals at relatively attractive valuation levels.
- We remain overweight stocks, both domestic and international, and believe that stocks will continue to rally.
- On January 2nd we implemented a Diversifiers portfolio funded equally from stocks and bonds.
  —This move reflects our pessimism over the interest rate environment (rising) and our desire to take some of our overweight in US equities off the table (outperformance).