HARVEY, THE FED, DEBT CEILINGS, STOCK VALUATIONS AND A LITTLE DICTATOR RUN AMUCK

Nancy Tengler
SVP, CHIEF INVESTMENT OFFICER

Paul Dickson
VP, DIRECTOR OF FIXED INCOME

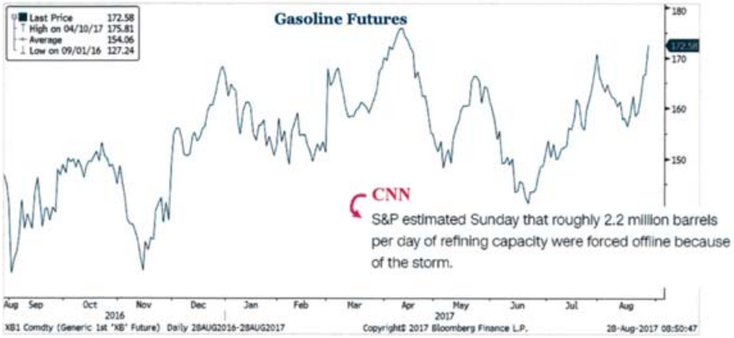
"I don't think I ever was cut out for it in the first place. Frankly, New York makes me nervous."

Richard Bissell
"Say, Darling"

There are a myriad of famous Harvey's. But none so iconic (at least in the 1950's) as Harvey the 6'3" invisible rabbit—friend to Jimmy Stewart's hard-drinking and somewhat delusional character. Would that Hurricane Harvey were so discreet and elusive. But this hurricane, now tropical storm, hit the Texas Gulf coast with a one-two punch unlike any in memory. Witness the following tweet from The National Weather Service: "This event is unprecedented & all impacts are unknown & beyond anything experienced. Follow orders from officials to ensure safety. #Harvey."

It should be noted that Texas employs almost one out of twelve workers in the U.S. That the state economy has been growing at 2.7% prior to the storm—an economy bigger than Canada, or Mexico for that matter. And the city of Houston alone produces goods and services in line with the entire economy of Sweden. Former Fed Governor Richard Fisher commented this morning on CNBC that the most important life blood during disasters such as this one is the free movement of cash. Dallas and Houston have the two biggest vaults of cash in the Fed system and both are open for business–the free flow of cash continues. That is good news for relief services and commerce.

Harvey's devastation remains incalculable at this point, to be sure. The immediate impact to crude has been negative since the supply of crude continues to hum along thanks to the shale producers. However, near-term gasoline prices at the pump are another matter since many refiners are offline. Harvey is the first storm in more than a decade to affect the Gulf Coast (the last was Ike in 2008) but it is important to note that energy stock piles are much higher this time around. That will ease some of the pressure on supply of gasoline while the refiners get back up to speed.



We expect a temporary depression to GDP growth due to displaced workers (43,000 workers were temporarily displaced during Katrina, Harvey will likely result in a much higher number) and to the inability to move products. Subsequently, we expect a strong snap back when the flooding recedes and the rebuilding begins. Our optimism is due to the robust nature of the Texas economy. Note the chart on the next page as illustrative of how markets respond during natural disasters. This chart measures the sale of automobiles. But it is the trendline we are focused on.

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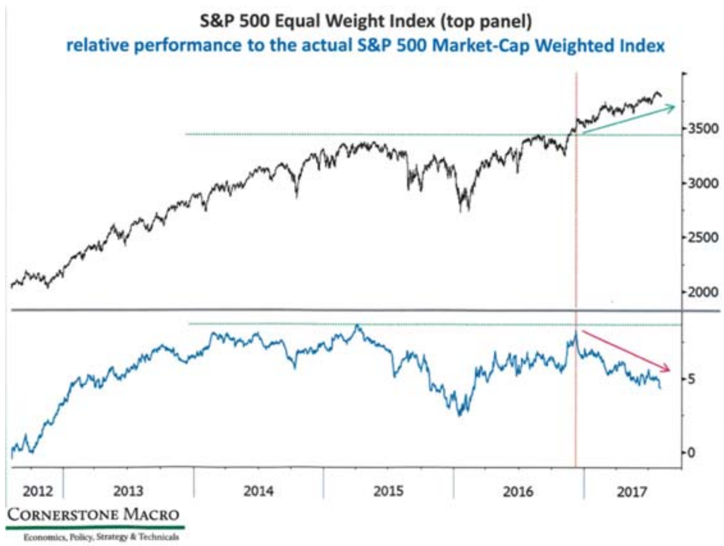
Our hearts go out to our fellow citizens. We hope and pray that the relief efforts will be rapid and effective; months of displacement and rebuilding will follow this epic storm.

However, we note: Harvey is not the reason for this morning's sell-off in the futures prior to the open. The sell-off was due to a misbehaving, little dictator in a starving and economically devastated country just north of the economically thriving South Korea. A human Harvey (of the hurricane type) who will eventually blow out one way or another. In the meantime, the unpredictable potential devastation has the markets a little goosy. Still, once stocks settled in and news of the United Technologies acquisition of Rockwell Collins (we own both stocks in Equity Growth and just UTX in Equity Income—as we frequently assert: good things happen to the cheap stocks of great companies) and both stocks rallied investors turned their attention back to the issues that impact the price of stocks. And neither Harvey nor the little dictator are expected to have a lasting effect on long-term economic growth.

Stock Valuations: Bullish or Bearish?

Let's take a quick look at current market levels. The S&P 500 is trading at a forward multiple of 18.70x. This level reflects a fully valued market. The market has gone 15 months without a correction and a pullback or pruning in U.S. equities would be a plus. Many investors are holding cash on the sidelines waiting for just that. But it is important to note that few investors have taken note of the impact of depressed energy earnings which produce higher p/e's (for the wrong reason). Energy p/e's are inflating the overall market p/e. The energy weighting in the SPX is 5.7%, but the p/e contribution to the overall index is 8.5%. Unless you think energy earnings are permanently depressed, that discrepancy should be noted. REIT stocks are just under 3% of the index but contributing over 6% to the market p/e. In other words, the SPX is not as expensive as its multiple would suggest.

Still that hasn't stopped the bears from arguing that stocks are overvalued. The equally weighted SPX is underperforming the reported index which is market-cap weighted. That, as we know, is due to a very few of the largest companies producing the lion's share (33% of the total return from the top-ten stocks in terms of market capitalization) of the index's year-to-date return. But this phenomenon also tends to precede corrections according to the technicians. As does the technical indicator that measures the number of stocks trading above their 150-day moving average—the number this year has declined significantly. Noted.



Fortunately, we own many of the stocks which have generated excess return this year. Employing a time-proven discipline that looks for relative yields above the market and compared to a stock's own history (RDY) provides valuable insight. The same holds true for our other valuation discipline: relative-price-to-sales ratio (RPSR). When we can buy a high-quality company whose stock is cheaper than its peer group and the market, and cheap relative to its past, we have found over the last 30+ years that excess long-term returns will follow. (Please

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ask your local Wealth Advisor to provide you with our peer group rankings by strategy.)

Active Management and Value Stock Performance

And then there is the passive vs. active debate. The news of active investing's death—as the saying goes, is greatly exaggerated. According to Strategas Research Partners, in 1979 *Business Week* published a cover story entitled "The Death of Equities." The same is being said of active investing now. *Investments in ETFs have grown so dramatically that their number of indexes required to track the now exceed the number of publicly traded stocks in the U.S.* Apple is held in 300 different ETFs, and the proliferation of ETFs has reached the absurd. ETFs for global millennials, obesity, organ products, wearable tech and bourbon to name a few. In 2016, 28% of active managers beat their benchmark. 80% of our strategies did so. We are enjoying the same experience in 2017—eight out of ten outperforming. We are seeing the signs of opportunity for active management to continue to add value over ETFs in the coming years.

Value investing was the subject of a comparable business magazine cover story touting the end to value investing in the early 1990s, with the picture of a value manager being buried by sand in an hourglass. The story literally marked the beginning of a ten-year bull market in value stock investing.

Value stocks have underperformed their growth stock counterparts for a decade. Year-to-date the Russell 1000 Growth Index has returned 16.8% vs. just 4.3% for the Russell 1000 Value Index. Our two value strategies are performing much better than the average value manager with returns ahead of the SPX which is up 10.6% through yesterday. The reason for the disparity between growth and value is that investors flock to growth stocks when economic growth is slow. They are willing to pay up for growth. The trend will not sustain forever. We believe that sound disciplines and focused research pay off. New York (Wall Street) makes us nervous, too. But we are staying the course.

Nancy Tengler
Chief Investment Officer

Fixed Income: The Real Eclipse was that of the Debt Ceiling overshadowing Jackson Hole

Last week the Kansas City Fed hosted its annual Economic Policy Symposium at Jackson Hole, an annual event watched closely by bond investors for clues as to how global monetary policy might be evolving. As it is attended by global policymakers as well as academics, it serves as an open forum in which to present ideas and offer insight into forward looking policies. It was at the Jackson Hole event a few years ago when findings were presented that pointed to a decline in the effectiveness of Quantitative Easing just before, and possibly leading to, the Taper of that program announced by then Chairman Bernanke. This year Chairwoman, Janet Yellen addressed the assembly and hopes ran high that she would provide additional clues as to what next steps the Fed might take.

In the final analysis, the event provided few surprises and Chair Yellen's address was considered more "dovish" than might have been expected. In the end, the Fed seems to be leaning slightly in favor of one more rate hike in December, and an announcement of the balance sheet reduction (sale of bonds acquired during QE) in September for commencement in October. Bonds traded up (yields down) in the immediate aftermath of the Symposium.

Of much greater excitement for the bond market was the growing political tension regarding the passage of an increase in the Debt Ceiling (as well as a Continuing Resolution around spending). At his rally in Phoenix, President Trump criticized the Republican Congress for

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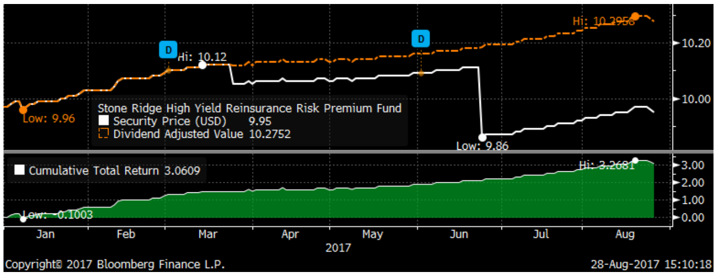
not including the debt ceiling in the veteran benefit bill before the recess, and threatened to shut down the government if he did not get his way with his proposed border wall funding. While Senate Majority Leader Mitch McConnell had been promising a clean Debt Ceiling increase, the President's words cast doubt that such will necessarily be the case. If there is no increase, the Treasury will run out of money in early October and will have to choose between default and some form of rationing of expenses. As the President warned, the government could well be shut down.

There is a chance that the Congress passes a Debt Ceiling increase that overrides the President, but talk about playing with fire. If the Debt Ceiling is not addressed it is likely that the Fed will hold off on any policy adjustments until the matter is settled.

Hurricane Harvey and the Stone Ridge Reinsurance Fund (SHRIX)

One of our best performing assets over the past four years has been our Stone Ridge Reinsurance Fund which primarily invests in Catastrophe (Cat) Bonds, which are tied to specific insurance risks, usually associated with natural disasters. Bond covenants vary and triggers for the Cat Bonds to lose value (reimburse the issuer) might not be met given a particular event, but whenever a large natural disaster strikes, we have reason to worry about the impact to our client portfolios invested in the fund.

Texas Storm as a category is just over 9% of the risk embedded in the Stone Ridge fund. Having said this, most of the targets in the Cat Bonds involve wind speed and reimbursement for wind damage rather than for flooding, which is usually covered by the National Flood Insurance Program (NFIP), a government run program. It is estimated that most homeowners do not carry supplemental flood insurance and so claims will not be as extensive as they otherwise might have been.
More of a risk to our investment in Stoneridge is commercial property damage where claims could lead to an impact on the Cat Bonds and Quota Share Insurance contracts. The event is still transpiring and Stone Ridge will be revising their assessment of the impact of the storm on the fund's NAV on a daily basis. They might overestimate and the fund will recover, or the damage could become worse and the fund takes a larger hit. The chart below shows the Price and Total Return of the Fund as of last night with some of the impact showing up. So far, the impact is modest. Surely, some of the Texas Storm is tornado-based and possibly centered on other areas such as Dallas, making the 9% contribution to the Fund's exposure significantly less.



Paul Dickson
Director of Fixed Income