**Q2 2019 Quarterly Commentary – July 1, 2019 Economic Cycles and Market Signals**

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The U.S. stock market, as measured by the S&P 500, finished the second quarter of 2019 at near-record levels. The S&P 500 rose by 4.3% in the quarter and by 18.5% for the year to date through June 30th, including dividends. On the same basis, the Dow Jones Industrials and NASDAQ Composite were up by 3.2% and 3.9%, respectively, in the most recent quarter, and by 15.4% and 21.3% for the year to date. Bonds also rose, with the Barclay's Aggregate Bond Index up by 3.1% and 6.1% for the quarter and year, as long-term bond yields declined. The yield on the benchmark 10-year Treasury fell from 2.69% at year-end 2018, to 2.01% at June 30, 2019. Equity markets rose in spite of fairly downbeat investor sentiment fueled by some hints of weaker economic data, continued uncertainty over our nation's global trading relationships and the inversion of portions of the U.S. Treasury yield curve, which have increased concerns about the potential for a recession over the coming months or years. The State Street Investor Confidence Index, which measures the risk appetite of institutional investors by analyzing their trading behavior, reached the lowest level since the Index's 2012 inception in January, and has only partially recovered since (interestingly, this suggests that many of the "most sophisticated" investors were shifting allocations away from stocks just as they were about to rise). If investors are pessimistic, should we also be concerned? One of legendary investor John Templeton's most quoted maxims is that "Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria." Where's the euphoria? Where's even the optimism?

The current economic recovery is now officially the longest on record in the United States, but this milestone isn't particularly important. There is no rule that dictates how long a recovery should last, and this expansion may have a long way to go. For example, Australia's economy has enjoyed 28 years of uninterrupted growth. Recessions typically are the result of excesses caused by reckless spending and the over-extension of credit, or by exogenous shocks (like the 1973 Saudi oil embargo, at a time when our economy was highly dependent on imported crude from OPEC nations). We have seen little profligacy in corporate America, which is keeping fairly tight reins on spending. . Nevertheless, with some major global economies weakening, we should not assume the U.S. is immune.

Since 1968, a yield curve inversion, in which yields on short-term instruments are higher than on long-term instruments, has been a reliable indicator that a recession will arrive in the not-too-distant future (there is little discernable relationship in the data prior to 1968). An inversion is created when the capital markets react to expectations of economic weakness, sending yields on longer-term bonds lower, before the Federal Reserve can react and cut short-term interest rates. While each instance since 1968 was somewhat different, on average a recession occurred 14 months after the Treasury curve inverted. The recession that followed these inversions lasted anywhere from six to eighteen months. There is of course no rule that says that a recession will necessarily follow the current inversion, but we recall another of John Templeton's observations, "The four most expensive words in the English language are, 'This time it's different.'"

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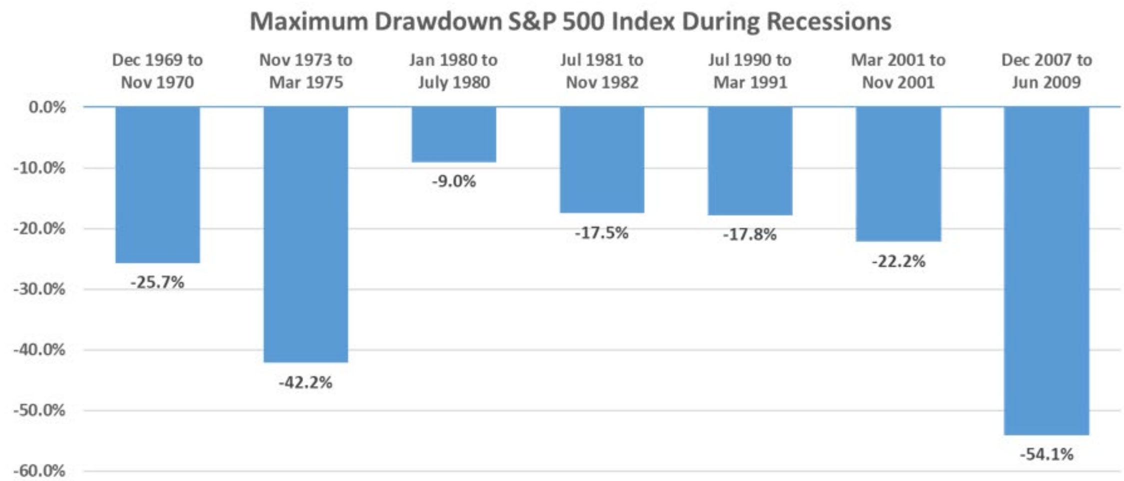
Table 1: Historical Yield Curve Inversions and Subsequent Recessions

| **Date of Treasury Yield Curve Inversion Prior to Recession** | **Time to Recession** | **Length of Recession** |
|---|---|---|
| April, 1968 | 19 months | 11 months |
| March, 1973 | 7 months | 16 months |
| August, 1978 | 16 months | 6 months |
| September, 1980 | 9 months | 16 months |
| December, 1988 | 18 months | 8 months |
| February, 2000 | 12 months | 8 months |
| June, 2006 | 17 months | 18 months |
| Average | 14 months | 12 months |

*Source: National Bureau of Economic Research is the acknowledged "official" arbiter of the timing of economic cycles https://nber.org/cycles/cyclesmain.html*

Of course we want to know how the stock market performed following yield curve inversions as well as during the subsequent recessions. In the immediate aftermath of the seven inversions and prior to the inception of the subsequent recessions, the stock market actually rose by an average of 5%, plus dividends.

Recessions, on the other hand, nearly always offered up a stock market correction or Bear market. When measured from the inception of the recession to the lowest S&P 500 Index level during the recession—the "maximum drawdown"— the markets experienced a price decline ranging from -9% in the relatively mild 1980 recession, to -54% in the Great Recession, with some addback due to dividends received. Note that in five of the seven recessions, the peak-to-trough decline was something akin to what we recently experienced at the end of 2018 (something distressing but hardly lethal, as the equity markets recovered after only a few months). The remaining two experiences, in 1973-75 and 2007-09, were far more unpleasant.




*Source: Bloomberg*

It is fairly clear that if one could correctly time the beginning of a recession, it would be a good idea to avoid equities when one commenced. This is a big if, since: (a) we usually don't know that we are in a recession until months after it begins; and (b) because to make this strategy most profitable, one would also need to buy shares back when they're down. Timing the bottoms is just as difficult as timing the tops, and recoveries tend to be swift, as we experienced this year. We do not profess to be good market timers, and are frankly not aware of anyone who has this gift.

Instead of measuring from peak to trough, it's more useful to take a longer view and consider the historical performance of markets before, during and after these recessions.

<u>Table 2: Recessions and Market Performance</u>

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| Recession Period | 1 Year Prior | Recession | +1 Year | +3 Years | +5 Years |
|---|---|---|---|---|---|
| Dec 1969 to Nov 1970 | -10.7% | -3.4% | 11.3% | 20.4% | 24.8% |
| Nov 1973 to Mar 1975 | -0.1% | -18.2% | 28.3% | 21.6% | 54.8% |
| Jan 1980 to July 1980 | 18.5% | 16.4% | 13.0% | 56.0% | 100.0% |
| Jul 1981 to Nov 1982 | 20.7% | 14.4% | 25.5% | 66.4% | 102.4% |
| Jul 1990 to Mar 1991 | 16.5% | 7.6% | 11.1% | 29.9% | 98.3% |
| Mar 2001 to Nov 2001 | -8.2% | -7.2% | -16.5% | 8.4% | 34.2% |
| Dec 2007 to Jun 2009 | 7.7% | -35.5% | 14.4% | 57.7% | 136.9% |
| Averages | 6.3% | -3.7% | 12.4% | 37.2% | 78.8% |

*Source: Ben Carlson, Ritholtz Wealth Management:* [http://awealthofcommonsense.com/2015/03/stock-performance-before-during-after-recessions/](http://awealthofcommonsense.com/2015/03/stock-performance-before-during-after-recessions/)

The column labeled "Recession" presents the performance of the markets over the entire period of the recessions. While the large "maximum drawdowns" illustrated in the previous chart occurred within these date ranges, the markets all staged dramatic recoveries even while the recessions were still underway. On average, patient investors fared reasonably well even in periods when GDP was in decline. Once the recessions were in the rear-view mirror, market recoveries tended to be quite strong.

We are patient investors, but we're not stubborn. We are taking seriously the warning signs of an inverted yield curve, plus the softer economic data we have recently seen, and accept that the risks of a recession are elevated.

The way we will execute in client accounts is not to abandon stocks altogether or try to time market tops and bottoms, but rather to ensure that we factor in the effects of a recession when evaluating the individual companies we own in our portfolios. Some companies are more economically sensitive than others, so we will insist on only owning cyclical companies that have the financial strength to carry them comfortably through downturns, and that trade at a valuation that already reflects the impact of recession on the business. Further, we will be prepared to act if the markets offer us extraordinary bargains at times of volatility that may accompany recessions. We maintain a “Focus List” of companies that meet all of our criteria for stocks we would want to own except that they currently trade at premium prices. Stock prices could change quickly in our favor, and we will act accordingly.

**Q2 Portfolio Changes**

***Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component.****

During the quarter we initiated a new position in Fox Corp and exited our positions in Alcon and Novartis.

**Fox Corporation**

Fox Corporation is a leading media company that focuses on producing live video content such as sports, local news, and national news.

The media landscape has undergone a dramatic transformation in recent years. The rise of Internet streaming has allowed companies like Netflix to bypass traditional distributors and establish direct relationships with subscribers. As a result, cable subscriptions are now declining by roughly 2% annually.

Our view of this new landscape is that unique and desirable content will continue to drive value. Viewers will continue to pay to watch the content they want and advertisers will pay up for whoever can aggregate the most viewers.

One approach that we think will be successful in this new model is Disney, which has unmatched quality in scripted content and is the only company with leading assets across cable, broadcasting, motion pictures, and streaming. Another approach we believe will succeed is Fox, which is squarely focused on must-watch live programming.

For a sense of just how valuable Fox content is, consider that Fox News is the most watched network on cable, Fox Business has more viewers than CNBC, and just as many people have viewed live sports on Fox and FS1 over the past 2 years as on ESPN and ABC. Fox owns the rights for Thursday night football, the 2020 and 2023 Super Bowls, world cup soccer through 2026, and the Major League Baseball World Series for at least 10 years.

This content is largely unavailable on competing streaming services, so cable distributors such as Comcast and Charter, are compelled to carry Fox channels in order to meet subscriber demand and differentiate their offering from emerging competition. We think this dynamic will enable Fox to raise prices for its cable channels, more than offsetting any decline in the number of cable subscribers in the U.S.

The stock came under pressure in recent months after the company completed the sale of its scripted-media assets to The Walt Disney Company. We think the decline in the stock price is unwarranted and the market is underestimating the quality of this business and its earnings power.

While Fox sometimes produces controversial content that evokes strong emotions among parts of the population, our goal is to put emotions aside and focus on the underlying business. Regardless of how one feels about the commentators on Fox News, our dispassionate analysis of the business led us to conclude that the stock presents an attractive investment opportunity for discipline long term-oriented investors.

**Alcon**

Alcon is a global medical company focused on eye care. The company is a leader in surgical and vision care products sold to physicians and individuals around the world. Alcon was a unit of Novartis and became an independent company earlier this year after Novartis spun off Alcon to its shareholders. Since we owned Novartis shares at the time of the spin-off, we received some Alcon from the transaction. After taking a closer look at Alcon's business model and future growth prospects, we concluded that the current stock price isn't attractive enough for us to maintain a position in this name.

**Novartis**

Novartis is one of the largest pharmaceutical companies in the world with annual sales of $50 billion. The company is based in Switzerland and operates a traditional pharmaceuticals business and a sizable generics operation called Sandoz.

We bought the stock in 2017 because we thought it was significantly undervalued. Our thesis was that Novartis was in the process of improving efficiency across all business segments and was on track to simplify the business by spinning off noncore assets. Since our thesis largely played out and the stock appreciated to our fair value estimate, we decided to exit the position.

In general, we prefer to hold on to positions for very long periods of time so that we can benefit from the growth of the business. But in the case of Novartis we thought the company's future growth plans and the inherent risks associated with any pharmaceutical business warranted exiting the position at fair value.

Golub Group

***The securities identified do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.


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