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March 31, 2018 Quarterly Report

Hope Springs Eternal

While we have yet to recognize springtime weather here in the Midwest, we are invigorated by the prospects the spring season has to offer!

Volatility in the equity markets continued throughout the quarter as we have seen VIX index increase by its largest amount since 2011. After the elation and celebration of the announced tax cuts at the end of 2017, we went from a robust increase in stock valuations to a correction in just a few weeks time.

Immunity from volatility was not afforded to the bond markets either as we note that the 10-year US Government Bond Yield increased from its nadir of 2.06% last September to 2.74% at the end of this quarter. Since bond yields and prices move in opposite directions, investors in bonds have seen substantial losses this quarter for the first time in many years.

For this letter we want to discuss further some of the more important factors that have kept our attention and which we believe will continue to influence our investment outlook:

- Interest Rate Expectations
- Return of Inflation
- Trade Wars
- US Employment Figures
- GDP expectations
- Cryptocurrency Bubble Burst

FOMC Interest Rate Expectations

On Wednesday, March 21, 2018 the FOMC approved the generally anticipated quarter-point hike that puts the new benchmark funds rate at a target of 1.75%, up from 1.50%. This is the 6th rate hike since the FOMC started raising rates from near zero in December 2015. One additional rate hike was added to the two-year forecast, with the benchmark of the expected 3 hikes for 2018 remaining the same.

The FOMC's dot plot indicated that officials expect two interest rate increases that are warranted in 2019 and 2020, which would bring the effective fed funds rate to 3.375% by the end of 2020.

The FOMC stated that "recent data suggest that growth rates of household spending and business fixed investment have moderated from their strong fourth-quarter readings" and changing their description of gains in the labor market, household spending, and business investment from "solid" to "strong".

We have been patiently waiting for the zero-interest rate policy to disappear and have yields reflect a normalized environment. We view the rise in rates, albeit with an orderly pace, as allowing us to reenter the fixed income markets at a much more attractive risk reward entry price. We finally feel that investors will be compensated appropriately for lending their money to various governments and corporations.

Inflation

A sign of strengthening US inflation pressures occurred when prices rose in February 2018 and annual inflation edged closer to the Fed target of 2%. The personal-consumption expenditures price index, which the Fed uses as its preferred inflation gauge, rose 0.2% from the prior month of January

As the chart below shows, deflation (the opposite of inflation) is anathema to our credit-based economy. The 2008-09 recession and its accompanying deflation is an excellent example of the problems the US faces in a deflation scenario.

Source: Commerce Department

University of Michigan data shows greater demand for big ticket goods might be in the context of expectation of rising inflation. While inflation expectations are still gradually moving higher, consumers that were surveyed expected an inflation rate at 2.8% within the next year, which is still well below the pace seen from 2011 to 2014. The Director of the Michigan Survey Richard Curtin stated "inflationary psychology is feared because it is a self-fulfilling prophecy; rather than diminish demand, increases in expected prices accelerate purchases."

Inflation expectations and interest rates are inextricably tied together. As with the increase in interest rates, we welcome the burgeoning rise in inflation expectations and have allocated resources with a high degree of exposure to these forces.

China Trade War

China recently increased tariffs up to nearly 25% on 128 US products ranging from frozen pork and wine, to select fruits and nuts. This is in response to the US duties on imports of aluminum and steel.

University of Michigan survey data shows that households are anxious about the effects on the prices from higher tariffs, including those on machinery and steel. However, Bloomberg Economics' chief economist Carl Riccadonna stated "the tariffs-driving-prices-higher story is way overblown, especially if we're just talking about a narrow range of products."

Historically, tariffs and protectionist policies cannot save or protect any particular industry, company, or special interest. The most infamous US tariff, the Smoot-Hawley Tariff of 1930, was applied to over 20,000 imported goods and was an unmitigated disaster that served to exacerbate the Great Depression.

We certainly would be concerned if a carte blanche tariff policy were enacted, but targeted tariffs with individual trading partners on limited goods has been in place for centuries.

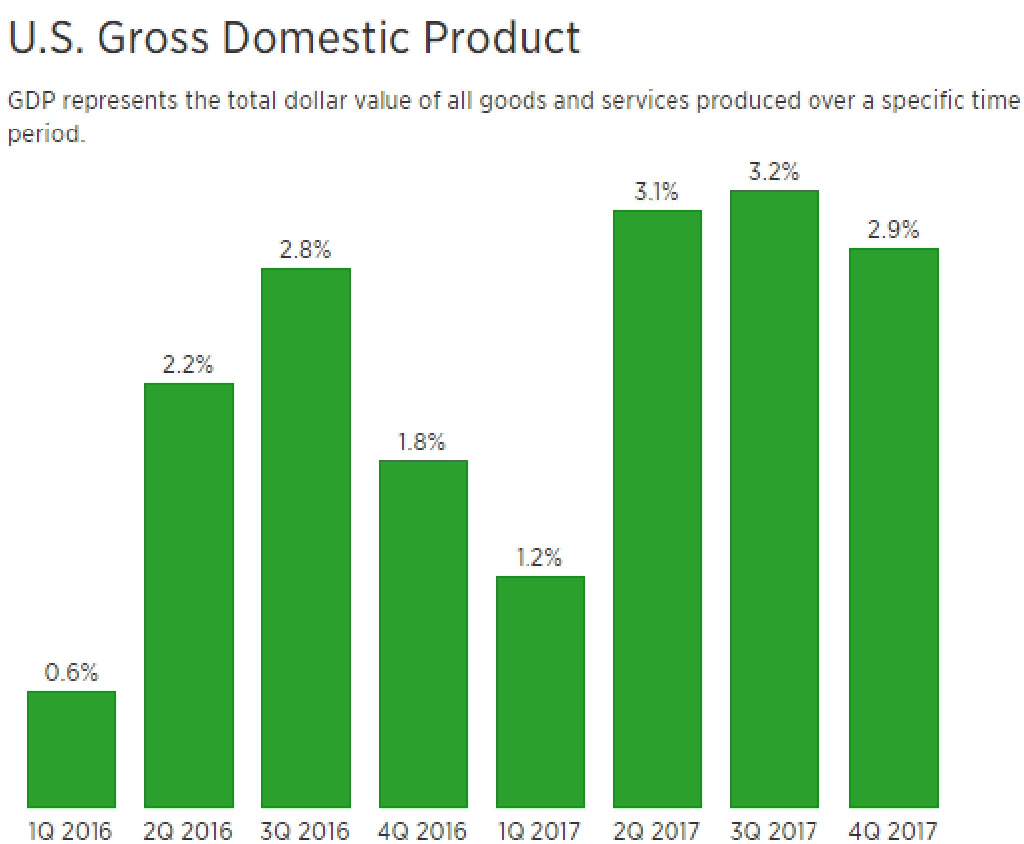
US Employment

In March, it was reported that employers added the most workers since mid-2016 and the participation rate (which is the share of working-age Americans with jobs or actively seeking one) rose by the most in nearly eight years despite downward pressure from retiring baby boomers.

The jobless rate held at 4.1%, maintaining that level for the past 5 straight months. Chicago Fed President Charles Evans said that “the state of the labor market is vibrant. An increase in the labor-force participation rate is a really good sign.” Additionally, Mr. Evans stated that the central bank should be patient and careful in raising interest rates to see if inflation picks up.

US GDP Expectations

As the chart below shows, US GDP expanded at a 2.9% annual rate in the final quarter of 2017, which is 0.4% up from the previously forecasted 2.5%.



The Fed has raised their forecast for 2018 GDP growth from 2.5% to 2.7%, as well as increasing their 2019 expectation from 2.1% to 2.4%. However, the forecast will cool as 2020 holds at 2% and 1.8% on out. Chief investment strategist Liz Ann Sonders of Charles Schwab stated "the economy still looks strong and we believe the upcoming earnings season will be solid."

Crypto Bubble Burst

As mentioned in our last quarterly comments, we were adamant that the cryptocurrency market was in a bubble stage. True to form, the bubble has burst. As of publication, Bitcoin prices have declined from a high of almost $20,000 to below $7,000. There are numerous investigations that have been announced centering on various fraudulent offerings of cryptocurrencies. While the general acceptance of cryptocurrencies has yet to be determined, we believe that the euphoria exhibited around the trading of these products serves to remind us that value investing, and the associated means of deriving value, is based on rational thoughts and expectations.

Index Returns

Index	Q1 2018	Q4 2017	Q3 2017	Q2 2017	5 Year Annualized
*MSCI ACWI ex-US	-1.76%	2.23%	5.51%	4.80%	3.25%
S&P 500	-0.76%	6.64%	4.48%	3.09%	13.47%
Russell 2000 Value	-2.64%	2.05%	5.11%	0.67%	10.53%
BBgBarc US Agg	-1.46 %	0.39%	0.85%	1.45%	2.12%

Data provided by MorningStar Office
*MSCI ACWI ex-USA PR USD is the Price Return of the Morgan Stanley Capital International Index excluding US based companies

Summary

Inflation, GDP growth, rising interest rates and employment strength has given us an optimistic outlook at the start of this spring season. Recent earnings reports and conference calls with management supports our thesis that value-oriented US based companies should see a growing level of ownership interest.

Should you have any questions please feel free to call me directly at 314-726-5500 or email at bgrunzinger@chrysalisim.com.

Sincerely,

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