ICR® 3rd Quarter Newsletter – October 2018

Robust economic conditions and corporate earnings growth once again led U.S. stocks higher in the third quarter, as the S&P 500 index gained over 7%. The strong performance in Apple, Amazon, Microsoft, and Alphabet – which together comprise almost 14% of the S&P 500 index – has helped to hide the fact that (as of the middle of October), almost half of the constituents of the index are negative for the year. That is, a relatively small number of stocks have accounted for an outsized portion of the gains in the U.S. stock market this year.

Looking abroad, foreign markets once again lagged the U.S., with developed markets close to flat for the quarter, while emerging markets posted a loss of 2%. Currencies were relatively stable this quarter compared to earlier in the year, though the dollar still strengthened marginally, providing another headwind to foreign investments.

The 10-year Treasury yield rose 20 basis points (0.20%) from 2.86% to 3.06%, putting pressure on bond prices. Then, in the first week of October, the yield surged another 20 basis points, briefly touching 3.26%. The stock market reacted to this rise in interest rates by dropping almost 7% (as measured by the S&P 500) over the course of seven trading days. The Fed has signaled its desire to "normalize" rates and has projected four more rate hikes before the end of 2019.

Rising Concerns over Financial Conditions and Politics

Financial conditions are tightening. Based on the turbulence in the stock market, it appears investors are trying to come to grips with what the end of the low-interest-rate, easy-money era means to companies' bottom lines. And there may be reason to worry. The ratio of non-financial corporate debt to GDP just reached an all-time high of more than 73% and what is perhaps more worrisome is that a large amount of the new debt issued has been in the form of leveraged loans. These are adjustable rate loans where interest rates vary based on market rates. In the past six years, the size of this market has more than doubled to over $1.1 trillion on the back of the Fed's sustained low interest rate policy. The potential problem is obvious: when interest rates rise, will these companies be able to make their higher interest payments? Exacerbating the matter is that around 80% of these loans being issued are "covenant-lite," meaning they have fewer restrictions on collateral, payment terms, and levels of income. Think back to the mid-2000s when anyone with a pulse could get a mortgage. We're entering that territory with regard to corporate debt. Recent bankruptcy filings by Sears and Mattress Firm (America's largest bed retailer) show the effects of rising interest rates on companies with marginal balance sheets.

And, it's not just indebted companies that are vulnerable. Already, a number of emerging economies have succumbed to tightening financial conditions - Argentina and Turkey are the obvious examples. With high levels of U.S. dollar-denominated debt, these economies suffer when interest rates rise and/or the dollar strengthens.

Political risks such as trade issues, Brexit negotiations, and an Italian budget battle are concerns that share the common theme of populism. Rising trade tensions seem to be the primary political risk on the minds of investors, but we believe all three deserve our attention. Currently, the direct impact of tariffs on growth and sentiment seems to be minimal. And, we remain hopeful that the Trump administration will soften its rhetoric if trade concerns start impacting economic growth. However, higher tariffs and higher energy prices - related to sanctions on Iran - could lead to higher input costs, higher consumer prices, and disrupted supply chains. This, in turn, could lower business and consumer confidence.

The Good News

The good news is that steady economic expansion is expected to continue. The IMF's recent World Economic Outlook is forecasting strong economic growth, with global output growing 3.7% this year and next. Some late-cycle dynamics are emerging, but global growth is still strong enough to support modestly higher interest rates and inflation. In the U.S., tax cuts and deregulation seem to have rendered the economy temporarily immune to these late-cycle dynamics. While monetary policy is becoming less supportive, central banks are removing support cautiously, so as not to choke off growth.

Investment Implications – A Balancing Act

It would be helpful if there was an "Investor's Calendar" that showed the exact dates on which business cycles begin and when they will end. However, as you know by now, our "Investor's Calendar" only shows historical events and declares, "THE FUTURE IS ALWAYS UNCERTAIN – INVEST ACCORDINGLY." But, we can stay mindful of the lessons from economic history as we look for clues in the current data.

We believe tightening financial conditions and increased political concerns suggest lower expected returns and increased volatility. However, this needs to be balanced with the prospects for continued economic growth, as late-cycle dynamics play out.

In our portfolio construction, we emphasize caution by choosing managers who invest in companies with strong balance sheets and solid business models – quality companies that may bend but won't break. We like managers who are positioned to be providers of liquidity when the credit cycle turns, rather than forced sellers of discounted assets. We also think that investment income or "carry" is important at this point in the cycle, but we are mindful of the risks associated with many high-yielding investments. And lastly, we know that an uncertain future demands that your portfolio remains diversified, and we are committed to that.

Ours is an investment discipline that requires both patience and confidence. We are extremely grateful for your confidence in ICR's investment process, and we firmly believe your patience will be rewarded. These are challenging times for investors. Please don't hesitate to call us if you have questions or concerns.

Sincerely,

James A. Heine James L. Cobb

Market Report (as of 9/30/18)

Index	**2018 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	8.99	14.92	11.62
Dow Jones Industrial Average	7.04	17.56	11.82
U.S. Aggregate Bond Index	-1.60	1.31	2.16
MSCI EAFE (Foreign Index)	-3.76	6.27	1.65