Q1 **MARKET REVIEW AND ECONOMIC OUTLOOK** 2018

"Both American corporations and private investors are today awash in funds looking to be sensibly deployed. I'm not aware of any enticing project that in recent years has died for lack of capital. Call us if you have a candidate." – Warren Buffet on the use of cash for stock buybacks

After a tumultuous quarter the major indices finished relatively flat for the year through March 31st, with the Russell 1000 large cap index declining 0.69% and the Russell 2000 small cap index dropping 0.08%. The trend of growth stocks outperforming continued into 2018, with the Russell 1000 growth index besting its value counterpart by 4.25% for the first quarter. Despite this, our Large Cap Equity composite was able to slightly outperform its benchmark (net of all fees and expenses), and our Small Cap Equity lagged its benchmark by only 4 basis points (.04%) over the first 3 months of the year.

The S&P 500 experienced an official "correction" in the quarter, which is defined as a drop of 10% or more. It was the first correction in almost 2 years, although it was the fifth occurrence in the current bull market that began in 2009 (in addition to 2 other instances that came just shy of a 10% drop). There have been 16 stock market drops of 10% or more since the beginning of 1987, a time period during which you would have made more than 21 times on your money through the end of the first quarter (a return of 2,103% for the S&P 500)! The good news is that the correction in the first quarter came on the heels of very strong stock market gains at the beginning of 2018, and as of the writing of this letter both the Russell 1000 index (large cap stocks) and the Russell 2000 index (small cap stocks) are back in positive territory for the year.

Long-time readers know that we have no short-term market predictions, but rather believe in staying invested over the long term while allowing the benefits of capitalism to accrue to your account. However, the majority of full-out bear markets (defined as a drop of 20% or more) have coincided with recessions, and it doesn't appear that a recession would be anywhere in the realm of possibility this year given the tax cuts enacted at the end of 2017. Forecasts are generally calling for 17-20% S&P 500 earnings growth in 2018 (with the total growth split fairly evenly between organic growth and the impact of the recently passed corporate tax cuts). Combined with the tax cuts for individuals, it would be almost inconceivable that we would experience a recession in the next 12 months.

The first quarter of 2018 saw a return of stock market volatility, with the Chicago Board Options Exchange Volatility Index (VIX) hitting a 5 year high. In reality though, the level of volatility we have seen in 2018 is actually fairly normal compared to history, with the VIX fairly close to its 25-year average. The past 5 years of ultra-low volatility has been the anomaly, and like all good things we knew it wouldn't last forever. Stock market volatility is simply the price that must be paid for higher long-term returns.

One of the topics du jour that has had an impact on stock market volatility as of late is the potential for a trade war with China. In a perfect world, each country would produce the goods and services that it's most efficient at, countries would trade freely with one another, each country's imports and exports would balance out, and we would all have more stuff. However, this only works if each country plays by the rules and is committed to balanced trade. History has shown that shutting down one's borders (when it comes to trade) ends up being bad for all parties, and in fact the Smoot-Harley Tariff Act of 1930 is believed to have contributed to the Great Depression. However, in our view there is virtually no chance for this to turn into an all-out trade war amongst many countries, simply because it is no country's financial interest for that to happen (which is the same reason why the Financial Crisis did not lead to the end of our financial system and Greece did not end up taking down the entire European Union).

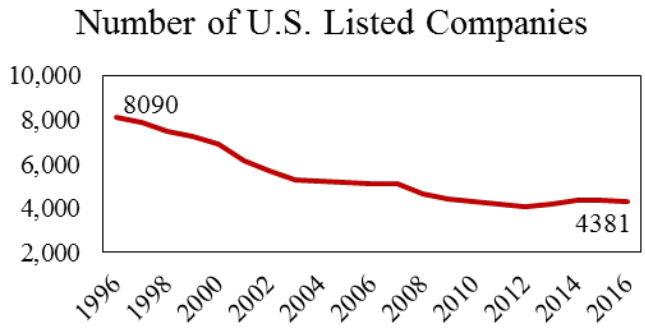
The primary emphasis of the proposed tariffs we heard about in the first quarter is the trade imbalance we have with China, and quite honestly the U.S. has all the leverage in this situation. In 2017, China purchased $130 billion in goods from the U.S. While this may sound like a large number, in reality it is approximately one half of one percent of the U.S. economy. The U.S., on the other hand, purchased $505 billion from China in 2017 (almost 4 times as much). This is why in recent days China has appeared to be more conciliatory toward trade with the U.S., and the financial markets have responded positively.

We have seen much discussion in the media about stock market valuations, in particular the price/earnings ratio of the major benchmarks such as the S&P 500. In our opinion the 17% gain in the S&P 500 over the last 12 months is a rational response to the recent tax law changes (and like most things, the stock market figured it out before the talking heads did). The index is now trading at about 17 times estimated 2018 earnings. If the S&P 500 finished out 2018 near its current levels, its trailing P/E ratio would be lower than 22 of the 26 year-end observations seen since 1992. Based on Thomson Reuters 2018 earnings estimates, at quarter end Bowling's Large Cap Equity portfolio was trading at 12.5 times earnings, our Small Cap Equity portfolio was trading at 13.4 times earnings, and our Small Cap Value portfolio was trading at 12.8 times earnings. All of these are relatively low numbers and show that value can be found in today's stock market across the market capitalization spectrum. As we write this letter, first quarter earnings are starting to roll in and are confirming analysts' estimates of an 18% rise in profits in the S&P 500 this year.

When it comes to things like valuations, we believe that the changing nature of the U.S. economy over the last 30 years is very under-appreciated and under-reported by the financial media. In 1990 Utilities, Materials and Telecommunication companies made up more than 22% of the S&P 500, while today that number is 7.6%. These 3 industries are low growth industries with enormous capital requirements (imagine building a new power plant or cell phone network to support more customers) and have very low profit margins. Meanwhile, the Technology sector has grown from 7% of the S&P 500 in 1990 to approximately 25% today. Technology companies like Google, Apple, and Microsoft are based primarily on intellectual capital and thus have massive amounts of cash that can be returned to shareholders, rather than being spent on plants and equipment. Below we will discuss how these companies are using their massive cash positions.

The Great Vanishing Act

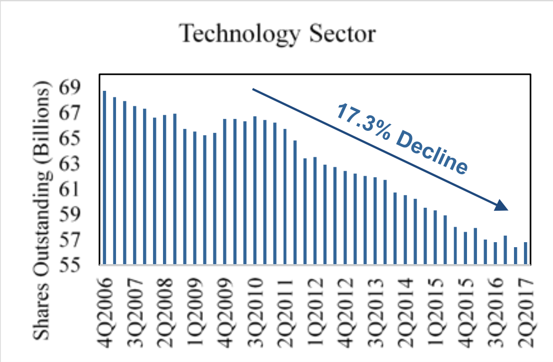
In our last letter, we briefly discussed the shrinking number of listed shares available to investors. We believe that this is a development with profound long-term consequences for investors. The reality is that there is an increasing supply of well-to-do investors worldwide and a dwindling number of opportunities in the stock market to participate in the growth of the U.S. economy. For starters, consider this chart of the total number of listed companies on U.S. stock exchanges.

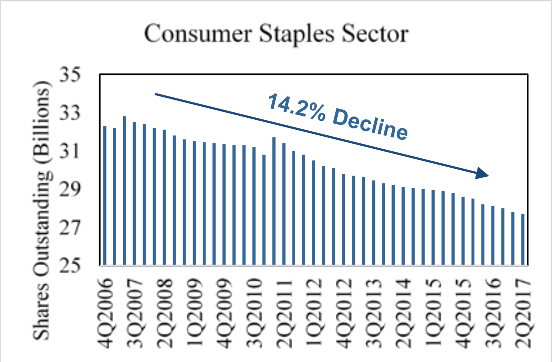


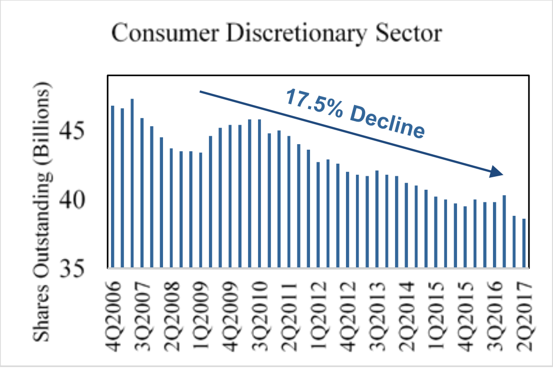
Source: Thomson Reuters

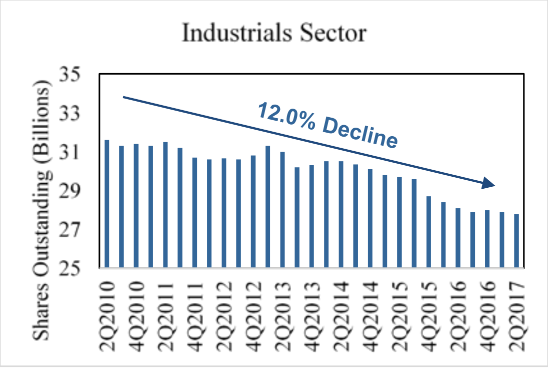
The decline of listed shares from 8,090 to 4,381 over the last 20 years is a decline (-46%) not seen before in modern history. The current number of listed companies remains near the 40-year low set a few years ago (which is as far back as we can find data). Fewer opportunities available to a growing supply of investors will inherently put upward pressure on stock prices.

What's equally interesting is the massive share reductions among some of fastest growing sectors of the economy. The Technology, Health Care, Industrials, Consumer Discretionary, and Consumer Staples sectors have seen significant reductions in shares outstanding due to stock buyback activities. The total number of shares outstanding in four of these S&P 500 sectors is shown in the following charts.









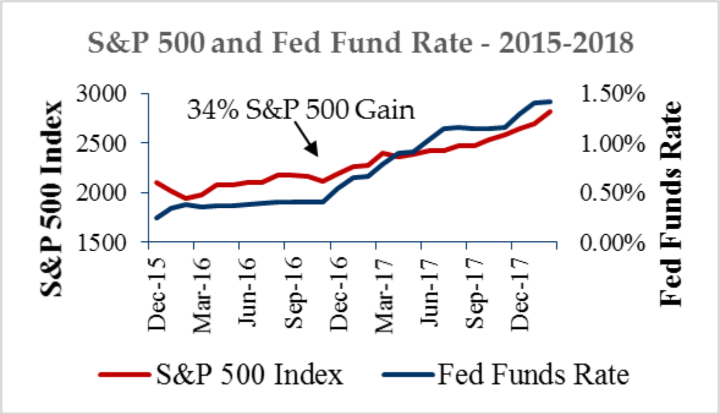
Source: Thomson Reuters

The four sectors above have all seen double digit declines in share outstanding over the last 7-10 years, with the Technology sector reducing its share count by over 17%! The Consumer Discretionary sector has reduced its share count by 17.5% since 2006, with Consumer Staples seeing a 14.2% decline over that same time period. In addition, the Healthcare sector (which we didn't have room for above) has also seen an 8.8% decline over the last 7 years. J.P. Morgan estimates that companies in the S&P 500 will buy back $842 billion in stock in 2018 due to the recently passed tax law changes. This would represent an increase of more than 50% over the levels of buybacks seen in 2017, and would be an all-time high by more than 30%! This buyback boon is due to the unprecedented profitability and cash position of U.S. companies, and is likely to be standard operating procedure for the foreseeable future. Stock buybacks, along with the reduction in the number of U.S. listed companies, puts upward pressure on stock prices.

Furthermore, the five sectors that have repurchased significant amounts of stock (Technology, Consumer Discretionary, Consumer Staples, Industrials, and Healthcare) have seen their combined sector weighting in the S&P 500 increase from 59% to 69% since 2007. This trend is likely to continue as several of the capital intensive sectors of the economy like Materials, Telecoms, and Utilities see their importance in the economy dwindle (a trend that has been in place since the late 1980s).

Interest Rate Update

In our first quarter 2015 newsletter, we spent considerable time discussing the correlation between rising federal funds rates and stock market performance. At the time, we noted that there were 4 instances since 1954 during which the federal funds rate was raised from below 2%, and all 4 times these increases resulted in higher stock prices 2 years later. We now have a fifth instance from the most recent Federal Reserve interest rate increase campaign. The chart below shows the S&P 500 versus the federal funds rate since the first increase in December of 2015.



Source: Federal Reserve

This recent data point correlates with the other 4 instances and confirms our belief that rising rates due to a strengthening economy is generally good for stocks. Since the first increase in late 2015, the S&P 500 gained 34% through the end of the first quarter. In late March the Federal Reserve raised rates for a fifth time in this most recent campaign, leading to some consternation and market gyrations due to concern that higher interest rates will hamper growth. However the current effective Federal Funds Rate (1.65%) is below 80% of the monthly observations observed since 1954, thus is not even remotely prohibitive to growth.

One other topic that has received some attention lately is the flattening interest rate yield curve. In the fixed income markets investors would normally require higher levels of compensation (interest) as the term of a bond is increased (10-year bonds will normally pay a higher rate of interest than a 2-year bond of the same quality because your money is tied up longer). However, on rare occasion this situation gets reversed and you have situations where short-term bonds (and even money market funds) will pay higher interest rates than 10-year bonds of the same quality. This is called an inverted yield curve. During the Fed's recent campaign of interest rate increases, we have seen short-term rates rise faster than long-term rates, which has led to a flattening of the yield curve. This in turn has led to some recent concern that the yield curve may become inverted, which is considered to be a bad omen for economic growth.

Bloomberg recently conducted a study looking at the relative slope of the yield curve, and the correlation with both future economic growth (GDP) and stock market performance. What they found is that an inverted yield curve (short-term interest rates higher than long-term rates) was in fact very good at predicting an economic slowdown. However, barring an inverted yield curve, there was no correlation at all between economic growth and the relative steepness or flatness of the curve. In fact, some of the best economic growth since 1979 has come with a relatively flat yield curve.

When it comes to stock market performance, an inverted yield curve was again very good at predicting below average stock market performance. However, even with an inverted yield curve, the average 12-month stock market performance was still positive at 4.6%. And as with GDP, the best stock market performance since 1979 has come with a relatively flat yield curve, similar to what we have today.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

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The Large Cap Equity Composite includes all discretionary, tax-exempt accounts investing primarily in large cap value equities, with account market values above $50,000. Effective January 1, 2006, closed end funds are no longer utilized in the strategy. Effective January 1, 2012, taxable accounts are no longer included in the composite. The benchmark for the firm's Large Cap Equity strategy is the Russell 1000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Equity Composite includes all discretionary accounts investing primarily in small cap equities. The benchmark for the firm's Small Cap Equity strategy is the Russell 2000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Value Composite includes all discretionary accounts investing primarily in small cap value equities. The benchmark for the firm's Small Cap Value strategy is the Russell 2000 Value Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

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