Market and Portfolio Update

For the six months ending June 30, 2019, global equity markets posted exceptionally strong returns as central bankers around the world expressed a willingness to provide more accommodative monetary policy. Notwithstanding these strong returns, the roller-coaster ride experienced in 2018 continued throughout 2019, as investors remained concerned over softness in the economy and an ongoing trade war with China. U.S. large-cap equities were the best performers during this period, returning 18.5% and reaching record highs in late June. While not as strong, global equities provided investors with positive double-digit returns. Fixed income benefited as bond prices rose in response to the decline in U.S. Treasury rates from a high of 3.2% in October 2019 to 2.0% at the end of the second quarter. All in all, Brown Brothers Harriman's (BBH) policy portfolios performed well, and we are pleased with the results as markets continued to rise.

In discussions with clients, we have received questions regarding topics such as increased market volatility, the reversal of Jerome Powell's hawkish stance on monetary policy, the impact of an inverted yield curve and uncertainty surrounding an ongoing trade war with China. *InvestorView* sat down with Scott Clemons, chief investment strategist, and Suzanne Brenner, chief investment officer, to explore how these developments affect our clients' portfolios.

***InvestorView:* The equity market appears to be on a roller coaster. The fourth quarter of 2018 had massive declines, and the first quarter of 2019 the market rebounded. May returns were weak, but June was positive, with U.S. equities reaching record highs. How should investors think about allocating assets in such a volatile environment? Why are we seeing more volatility in the markets?**

Scott Clemons: It may seem like we have been experiencing more volatility in the markets, but in fact, the price volatility is consistent with history. Data on S&P 500 returns shows that there were 20 days in 2018 where the market moved by more than 2%, which was in line with an average of 21 days per year over the past 20 years. So far in 2019, there have been four days of 2% movements, so a bit lower than 2018, but we

Investment Returns as of June 30, 2019

Asset Class	3 Months	YTD	1 Year*	3 Years*	5 Years*	10 Years*
Fixed Income						
1-3 Year Treasury Bonds	1.5%	2.5%	4.0%	1.3%	1.2%	1.2%
U.S. Aggregate Bonds	3.1%	6.1%	7.9%	2.3%	2.9%	3.9%
Global Aggregate Bonds (USD – Unhedged)	3.4%	5.7%	6.0%	1.6%	1.4%	3.0%
U.S. Municipal Bonds	2.1%	5.1%	6.7%	2.6%	3.6%	4.7%
U.S. High-Yield Bonds	2.6%	10.1%	7.6%	7.5%	4.7%	9.2%
U.S. Leveraged Loans	1.7%	5.7%	3.9%	5.2%	3.7%	6.2%
U.S. Inflation-Linked Bonds	3.0%	6.4%	4.9%	2.1%	1.8%	3.7%
Equity						
Global Equity (ACWI)	3.8%	16.6%	6.3%	12.2%	6.7%	10.7%
U.S. Large-Cap Equity	4.3%	18.5%	10.4%	14.2%	10.7%	14.7%
U.S. Small-Cap Equity	2.1%	17.0%	-3.3%	12.3%	7.1%	13.4%
Non-U.S. Developed Equity (USD)	4.0%	14.5%	1.6%	9.7%	2.7%	7.4%
Emerging Markets Equity (USD)	0.7%	10.8%	1.6%	9.7%	2.7%	7.4%
Non-U.S. Developed Equity (Local)	3.1%	14.1%	2.7%	10.3%	6.4%	8.8%
Emerging Markets Equity (Local)	0.3%	10.2%	2.2%	11.5%	6.5%	8.2%
Long/Short Equity Hedge Funds	1.7%	9.4%	0.5%	6.8%	3.5%	5.4%
REITs	1.3%	17.8%	11.1%	4.2%	7.9%	15.5%
Commodities						
Gold	9.1%	9.9%	12.5%	2.2%	1.2%	4.3%
Silver	1.3%	-1.2%	-5.0%	-6.5%	-6.1%	1.2%
Crude Oil	-2.8%	28.8%	-21.1%	6.6%	-11.1	-1.8%

**Annualized return figures.*
Past performance does not guarantee future results.

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still have a half a year to go! In general, investors need to adjust to a market that continues to be volatile – and that is not necessarily a bad thing. More volatility provides active managers with greater opportunities to buy high-quality securities at prices that trade below their intrinsic value.

Suzanne Brenner: The question I get often is whether investors should sell equities given the recent highs in the market. The answer is a resounding no. However, I would caveat this answer by saying that there are times in a market cycle to take more risk and other times to be more cautious. After a long bull market, we are encouraging our clients to reduce risk by taking opportunities to rebalance portfolios back to targets. By rebalancing, our clients are better able to align their asset allocations with their tolerance for drawdowns and increase equities at a later date by buying into weakness in the market.

SC: The most important thing that investors can do in down markets is to stay the course. And it is perhaps the hardest thing to do. When you see the market value of your portfolio declining, your natural reaction is to exit. However, the price of that decision is that you have locked in realized losses and now must determine when to get back into the market. In essence, you must be right on two decisions – when to exit the markets and when to return. It's almost impossible to do consistently. At the end of the day, it's not just price that determines portfolio activity. It's price vs. value, and our managers continue to find that appealing trade-off on a bottom-up basis.

SB: Scott, I agree with that statement. I would add that because our managers have a strict valuation discipline and can hold cash when valuations are not attractive, BBH's portfolios have been able to protect capital in down markets, making it easier to stomach downturns. As an example, during 2018, when equity markets experienced significant declines globally, our portfolios outperformed nicely. We were very pleased with our ability to protect clients' capital during this period.

***IV:* It's interesting that the Federal Reserve reversed course on its hawkish stance in early 2019, which was a large reason that the equity markets rebounded in the first quarter. What is your expectation for the Fed to lower rates? How do lower rates influence how you invest at BBH?**

SC: The Fed met market expectations and cut rates by 25 basis points (bps)[1] at its late-July meeting, citing global economic conditions. In reality, the Fed had painted itself into somewhat of a corner by allowing the market to conclude with almost certainty that a rate cut was coming. Domestic economic conditions do not warrant lower rates: Unemployment is low, wages are rising, and financial markets are close to all-time highs. We view this as an "insurance" cut, or a nod to global conditions. The interesting thing is that the market expects more rate cuts to follow, and we're not sure the Fed is inclined to make this the beginning of a new easing trend.

SB: As we have noted in past updates, given the low level of interest rates, our fixed income portfolios have been skewed toward short-duration bonds. However, we try to be opportunistic, and in that spirit, we took advantage of the higher interest rate environment in the middle of 2018 to increase the allocation to longer-duration fixed income for both taxable and tax-exempt clients. If you recall, the 10-year U.S. Treasury bond increased to over 3.2%; it is back down to 2.0% currently.

As we were able to invest in the middle of 2018, our clients' fixed income portfolios now stand at a roughly 50-50 balance of short- and longer-duration bonds, and as interest rates declined since we made that investment, our clients' portfolios benefited. As always, our municipal bond team invests opportunistically. I recently was talking with Greg Steier, who manages our tax-exempt bond group, and he noted that with general market valuations becoming more expensive, patience and selectivity are critical. He added that today, the best opportunities can be found in smaller market niches. Household investors own approximately two-thirds of outstanding municipals and prefer maturities of less than 10 years. The team reliably finds opportunities in bonds with maturities modestly longer than this. As with everything in investing, you must be patient and opportunistic.

10-Year U.S. Treasury Yields

Source: Bloomberg.
Data as of June 28, 2019.

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***IV:* You talked about the impact of lower rates on fixed income. How do lower rates affect equities?**

SB: There are several ways to think about interest rates and equities. First, it is important to note that long-term interest rates, such as the 10-year Treasury, matter more than overnight rates such as the federal funds rate. From a fundamental perspective, lower long-term interest rates are generally positive for stocks in that they generally allow companies to decrease their cost of borrowing over time. In addition, lower interest rates should theoretically increase the value of a company's stock because lower interest rates decrease the discount rate that investors use to determine the present value of a company's cash flows. A lower rate can increase the P/E multiple of a stock all else equal, increasing its value. Scott has done some research on the relationship between interest rates and equity valuations over time, and in general, the lower rates get, the higher the earnings multiple that the market has tended to pay for stocks, and vice versa.

SC: Yes, that's right. Lower interest rates mean higher present values, and that's what the P/E ratio captures.

SB: Looking at past data during periods in which the Federal Reserve reduced interest rates is also interesting. For example, from 1980 to 2000, the Fed cut rates as inflationary pressures in the economy gradually subsided, and the equity markets tended to do extremely well during this period. In contrast, the last two rate cut cycles that occurred in 2001 and 2007 had little to do with inflation, but instead were in response to a deterioration in the economy. These cuts were large and abrupt, with the Fed initially cutting rates 50 bps both times, and while markets ultimately recovered, the rate cuts did not immediately result in higher equity prices. It is also interesting to note that the Federal Reserve's forward guidance (which it started issuing in 1999) has begun to move markets more than actual rate cuts. Thus, we believe that assessing the impact of rate cuts on equity markets is difficult and not necessarily predictable, especially in the short term.

***IV:* Another topic that has gotten a lot of attention is the recent inversion of the yield curve, with the three-month U.S. Treasury rate recently yielding 2.06% and the 10-year yielding 1.86%.[2] What is the impact? Does this inversion mean we will have a recession?**

SC: It is true that every previous recession was preceded by an inverted yield curve, but that is different from saying that every inverted yield curve led to a recession. The important thing is not that the yield curve is flattening, but why. In previous cycles, aggressive Fed tightening pushed up the short end of the curve, while diminishing fears of inflation brought down the long end. Aggressive Fed tightening can cause a recession, but that is not the current environment.

***IV:* A top-of-mind risk for investors relates to an outright trade war with China. Negotiations continue without resolution, and China continues to meet U.S. tariff hikes with higher tariffs of its own. What risk does this pose for the economy or financial markets? How are clients' portfolios affected?**

SC: We're worried about it, too, hence the feature article in this issue of *InvestorView*! The first-order risks are small, simply because trade accounts for such a small part of the U.S. economy. Second-order risks, while more difficult to analyze, pose a greater risk. If American businesses rein in investment and spending, or if they decide to pass on the costs of tariffs to their end customers, the benign economic environment we're currently in may evaporate. We think that cooler heads will prevail, particularly as we get closer to the U.S. election, but the risk of an economic accident is certainly rising.

SB: We are talking to our managers all the time about the companies in which they invest. Our portfolios, for the most part, are not affected directly by tariffs because we don't have significant investments in sectors such as industrials, automobile manufacturers and metals and mining. It is interesting to see how companies that are affected by tariffs are reacting, though. They basically have two choices – either to pass on price increases (if they have pricing power) or to live with temporary margin declines and seek to adjust their operations to lower costs by changing their sourcing and supply chains. We are watching closely to see how this situation evolves. However, absent an escalation of the trade war, we believe our asset-light portfolios are relatively insulated. Even if we have a trade war, we believe that the resilience of demand for the products and services offered by the companies in our portfolios should mitigate the negative impact on our portfolios, especially over long-term periods.

***IV:* Given the risks you just discussed, is there a case to be made to continue investing in China?**

SC: Yes, although the trade dispute highlights the fact that emerging markets always come with exogenous risk and require a great deal of patience from investors. Remember that the very reason for the current trade war is China's economic development – rising national and household income means that China should compete on a more level playing field, but also stands as evidence that the long-term bet on Chinese growth is paying off.

SB: As Scott mentioned, we believe investors should have an allocation to emerging market equities, including China, in their portfolios. Because we take the long view, our managers can look past short-term noise to buy attractively valued companies that are positioned to capitalize on the growth of the domestic economies in which they operate. In all markets, our managers sort through thousands of companies to identify high-quality cash-generating businesses that are managed by talented and well-aligned management teams. China is an important global market, and while there are many companies that we would never own, we believe a bottom-up fundamental investment will lead us to invest in the best Chinese businesses, which will benefit client portfolios over time.

***IV:* Our final question! We know that summertime is a great time for relaxing and reading. What books are you reading now? What's interesting?**

SB: That's a great question. Our team, the Investment Research Group, has established an informal book club. As with investing, we believe that the compounding effect of reading is powerful. The more you read, the more you know. The more you know, the better you are at recognizing patterns, allowing for more informed decision-making. Our team regularly reads financial and investing books, including those that are written by great investors that we respect. In the second quarter of this year, we read Christopher Mayer's "100 Baggers: Stocks that Return 100-to-1 and How to Find Them." The book incorporates some important insights – the idea that exceptional investments only occur rarely, and when they do, investors should hold them for the long term, allowing them to compound and become "home runs."

We also read books that are not directly related to the financial markets. In fact, we are currently reading "The Power of Habit: Why We Do What We Do in Life and Business" by Charles Duhigg. This book helps the reader understand just how much of our behavior is habit-driven, how habits form via the "habit loop" and how they can be changed. The insights from Duhigg's research enable us to challenge our own behaviors, both as individuals and as a group. Whether implicitly or explicitly, this book has provided some important lessons that help inform how we evaluate managers and management teams – important data points that help us make informed investment decisions.

The best part of the book club, though, is the lively dialogue that our team has once we've finished a book. I love being able to share diverse opinions on interesting, thought-provoking topics. I would encourage everyone to join a book club!

SC: I've read Duhigg's book on habits as well and concur with Suzanne's recommendation. I've also just finished reading "Scale: The Universal Laws of Life, Growth, and Death in Organisms, Cities, and Companies" by the theoretical physicist Geoffrey West. West investigates the importance of scaling in nature and finds the same laws at work in manufactured organisms such as cities and businesses. It helps to explain why some cities and companies thrive and others struggle. I'm fascinated by the insights that one branch of science such as physics has for other branches such as economics.

***IV:* Thank you both for your insights.** ■

[1] *One "basis point" is 1/100th of a percent (0.01%). Past performance does not guarantee future results.*

[2] *Yields as of August 2, 2019.*

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