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PORTFOLIO UPDATE – AUGUST 2, 2019

The last couple months have afforded us relative calm in the capital markets, with the S&P 500 climbing from an adjustment down to under 2,750 points to more than 3,000 by the time July was coming to a close. We seem to have adjusted to an environment where major political, economic and trade figures walk around with war paint applied, and after brief interruptions markets seem to shrug off the chest thumping and return to business. Our concern right now is that this time is different.

A convergence of three significant forces seem like a recipe for volatility if not an outright correction.

The first is the situation with the Federal Reserve. On the whole, we actually think the Fed's language coming out of the last meeting was reassuring. No more rate hikes means the risks associated with rising rates recede for a while more, and a single reduction Chairman Powell characterized as a mid-course correction tells us any concerns about the economy slowing are minor and addressable. All in all, the Fed is telling us things are pretty good and that staying mostly out of the way of the markets and the economy is the right course of action.

Our stock market thought otherwise. Many investors were banking three rate cuts this year, and bidding up the US market on that hope/assumption. We have written numerous times before about "monetary methadone" and investors continue to be hooked. But, this alone was not enough to darken our outlook. Our assumption was that the longer-term good news from the Fed position would take hold and the short-term pouting about no more rate cuts would go away.

Then President Trump happened. Again. For the most part, the markets have shrugged off his Twitter-jawboning about everything from the Fed to China to free trade. It has introduced some extra episodes of volatility in the very short term, but markets now seem conditioned to keep on going, actually separating the news from the headline. This time, President Trump reintroduced the rhetoric of tariffs in the trade negotiations with China, including a new 10% tariff imposed on another $300 billion in imports to the US beginning on the 1st of September. Our view is that the haphazard approach to a tariff regime is not productive — While the goal of balancing trade with China is necessary, it is potentially beyond reach without a disciplined approach. The market has previously reacted to and then subsequently shrugged off prior rhetoric and the actual implementation of tariffs. As of right now, we are only seeing the immediate reaction on the announcement, but no visibility on the follow-through. We view this is an aggravating factor but also nothing that would break the market loose on its own.

For us, the more consequential concern is the rapidly deteriorating civil rights situation in Hong Kong. What started as protests against a botched policy move by the China-friendly HK government over extradition to the mainland has expanded to more widespread political unrest and protests over economic equality and right to vote among other issues. Some protesters have gone beyond demonstrating and have begun vandalizing infrastructure and property, and the interface between the protests and law enforcement have gotten increasingly violent. Our specific concern as of Friday morning is that the rhetoric from Chinese authorities and the military presence has gotten increasingly bellicose in their determination to restore order and also enforce Chinese (anti-democratic) policy. The potential for an event multiples the

size and consequence of Tienanmen Square, particularly in Hong Kong which is the West's gateway to capital and markets in China, could throw markets into chaos.

Any of these on their own would give us pause, but taken together in the same week we view the risks as immediate. For that reason, we have reduced our equity exposure across all portfolios and models, primarily from emerging markets, but also selectively from small cap equity and in a few cases from corporate credit in order to buffer the portfolio from this concentration of event risk. If any two of these issues move toward resolution that will raise our confidence that staying constructively exposed to equity risk is ok. However, retaliatory tariffs, bullets fired at protesters, or yet another problem in from the wings could motivate us to further trim market risk for a period of time.

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