"If everyone is thinking alike, then someone isn't thinking." - George Smith Patton, Jr.

Second Quarter 2018 Review and Commentary

The volatility that reemerged in the first quarter of 2018 continued unabated in the second quarter as the markets continued to react to a variety of significant news. Among the more important factors are signs of a slowdown in the synchronized global economic expansion, the growing threat of tariff wars, rising interest rates, the improving employment situation, a large and growing U.S. Government deficit as well as the prospects for continued growth in corporate profits as the U.S. economy picked up speed.

After equities witnessed negative returns in the first quarter, the S & P 500 Index, representing large-cap stocks, recovered nicely in the second quarter with a 3.4% total return. However, large-cap stocks underperformed their small-cap brethren with the Russell 2000 Index producing a 7.8% total return. For the second quarter, energy, consumer discretionary and information technology were the strongest groups returning 13.5%, 8.2% and 7.1%, respectively. Conversely, industrials, financials and consumer staples were the poorest performers, returning -

3.2%, -3.2% and -1.5%, respectively. Interestingly, emerging market stocks had a poor quarter, returning -7.8%. Lastly, the MSCI EAFE (a measure of developed non-U.S equity markets) returned a disappointing -1.2% for the quarter.

In light of the returns produced by the markets, Metis Value Partners had an exceptionally good quarter. The concentrated MVP value strategy had a total return of +12.1% for the second quarter compared to the S & P 500 total return of +3.4% and the Russell 1000 Value Index with a return of -1.7%. On the other hand, the MVP International Value strategy slightly underperformed with a total return of -2.2% compared to the EAFE Index with a -1.2% return. Lastly, the MVP Dividend Income strategy had a total return of +4.3% compared to the DJ Global Select Dividend Index with a total return of -1.2%.

With the volatility and sector rotation evident in the equity markets, many observers consider the current market to be a stock picker's market. While MVP is content to let others describe the marketplace, we have certainly had our share of winners in the value strategy. Specifically, Fossil Group had a spectacular quarter rising more than 100% while Abercrombie & Fitch and Copart, Inc. also had strong gains. Other stocks such as Sony, Suncor Energy and Encana Corp. helped the International Value strategy and the Dividend Income strategy benefited from holdings in Abercrombie & Fitch, Cisco Systems and Royal Dutch.

Supporting the positive tone in the U.S equity markets was an economy that showed encouraging signs of renewed vitality. Specifically, in the first quarter the GDP expanded at a 2.0% rate but showed added strength in the second quarter undoubtedly helped by the tax cuts enacted in late 2017. As the quarter unfolded, favorable news included rising consumers spending, a stable housing market, an improving employment picture and a pick-up in corporate spending. Some forecasters believe GDP grew in the 3.5% to 4.0% range for the full quarter. Importantly, corporate profits were strong in the first quarter and consensus expectations are for second quarter profits to expand by more than 20% when earnings season concludes in a few weeks. Overall, investors should be encouraged by these results because as profits expand smartly and the market advances modestly, the all-important price-earnings ratio gradually declines.

So, while the current environment looks promising for future stock market gains, there are clouds on the horizon that need to be recognized and discussed. To begin, while the massive tax cuts enacted late last year are having a salutary effect on the growth of GDP and corporate profits, these positive effects will gradually lessen as we move through the remainder of this year and enter 2019. With GDP growth expected to moderate, corporate profit growth will also slow down to a more modest pace. Simultaneously, the Federal Reserve is gradually raising short term interest rates, a process that is expected to continue for the remainder of 2018 and into 2019. Last fall, the Federal Reserve commenced a program to reduce its balance sheet. Currently, the monthly reduction is at a $40 billion rate that will increase to $50 billion a month beginning in October. The combination of these two actions is reducing liquidity in the financial system and gradually tightening credit market conditions. When the Federal Reserve was lowering interest rates and engaged in massive amounts of bond buying for its own account, this action had a positive impact on all financial assets. Now, with the Federal Reserve withdrawing stimulus it remains to be seen if these Fed actions negatively impact the financial markets. Based upon a long history of the markets, many observers believe that when the Fed removes the “punchbowl”, it is time to become cautious on the capital markets.

It is noteworthy that the Federal Reserve has raised short term rates seven times in its current tightening cycle. While the Fed raises its overnight Fed Funds rate, the two-year U.S. Treasury has also been climbing and, as this report is being written, presently stands at 2.59 %. The other important Treasury issue is the ten-year Treasury that currently yields 2.84%. Investors are watching the spread between the two-year and ten-year Treasuries (now only 25 basis points) in the belief that when the spread inverts, the inversion is usually a precursor to a recession. As a matter of fact, since 1975, every time the two-year Treasury yielded more than the ten-year Treasury, a recession followed in a relatively short period of time. Those who pride themselves on the "two-ten" spread also carefully watch the spread between the ten-year Treasury and the thirty-year Treasury as this spread usually inverts *before* the two-ten year spread and is a warning sign to those in-the-know. Currently the spread between the ten and thirty-year Treasuries is a mere 10 basis points (10/100 of one percent). Assuming the Federal Reserve raises overnight rates two more times this year, once in September and once more in December, there is an increasing chance an inverted two-ten yield spread will occur by year-end 2018. This raises the possibility that a recession could be in the offing sometime in 2019. Of course, there could be many other events that influence the course of the economy and Federal Reserve actions but it is good practice to keep an eye on these factors.

As we review the various components of the current equity market, it is also important to keep a watchful eye on the CAPE ratio – the "cyclically adjusted price-earnings" ratio as developed by Robert Shiller of Yale University. This indicator attempts to smooth out the ups and down of corporate earnings by using a ten-year average of corporate earnings. In the past, this ratio has been helpful in identifying overvalued markets and it is currently at an elevated level not seen since the dot-com bubble in early 2000. While this high level does not, in and of itself, suggest the market is about to collapse, it does indicate that the equity markets are extended and that thoughtful investors should exercise caution when considering equity exposure.

Yet another factor to consider is the effect of rising rates on those investors who, for several years, have been unable to earn a reasonable return on their cash reserves. With the near zero rate environment engineered by the Fed following the 2008-09 financial crisis, these risk averse investors were forced to invest in higher risk equities. This phenomenon gave rise to the acronym TINA which "translated" stands for *"There Is No Alternative"* (to investing in equities). Now, however, short term interest rates are rising and risk averse investors have reasonably attractive returns available in short term Treasuries, money market accounts and bank CDs. As these funds migrate from riskier equities to more traditional short term investments, this will reduce the buying power that contributed to the huge market advance of the past nine years. Frankly, no one knows how much this outflow of assets may affect the equity markets but, again, it is wise to remain alert.

Another feature of this market that is particularly disturbing is the record setting pace of corporate buybacks of their common stocks. With corporations repatriating large quantities of corporate cash from abroad as a result of the 2017 tax cut legislation, corporations have the option of using the cash for dividends, share repurchases, acquisitions, capital expenditures to expand capacity and improve efficiency or the reduction of corporate debt. It is telling that with all these opportunities to wisely employ their cash, managements as a whole embarked on a spree of share repurchases at the very time most stocks are trading at or close to all-time highs. To say that this does not appear to be the best use of their corporate assets is a gross understatement. In fact, managements seems to have forgotten the age old adage to "buy low and sell high" as they appear to be doing the exact opposite.

Earlier in this commentary, there was mention that the synchronized global expansion that characterized the 2017 economic environment has given way to signs the expansion is getting long in the tooth. Specifically, China has been witnessing a noticeable economic slowdown, Japan is also showing signs of weakness along with Germany, Italy and France. Many emerging markets are also seeing slower growth and are struggling with their economies very dependent on global growth and international trade. The recent imposition of tariffs on Chinese goods as well as on goods from our European trading partners is an added chill to the current economic environment. While it is too early to judge whether or not U.S. tariffs are a part of a negotiating strategy to obtain a more favorable treatment vis-à-vis our major trading partners, the prospect of an extended tariff war would only serve as an added headwind to further economic growth.

Lastly, a recent report on the composition of index funds deserves some additional comment. In May, our discussion of index funds focused on the folly of the S & P 500 Index fund with purchases of that index being allocated according to the capitalization of the companies in the index, regardless of their investment merits. Interestingly, there are also bond index funds that have an unusual way of allocating capital within the index. Instead of reflecting the market's evaluation of the asset, the entities are weighted by the size of their debt. In particular, the iShares Core U.S. Aggregate Bond ETF (AGG) tracks the principal taxable bond benchmark, the Bloomberg Barclays U.S. Aggregate Bond Index. Within this index, Treasury securities amount to 38% and mortgage pass-throughs account for almost 27%. From a global perspective, this index is weighted according the amount of debt issued by each country or company in the index. In other words, the entity with the greatest amount of debt has the greatest weight in the index, regardless of its credit rating or outlook. Taken to an extreme, it would appear that the issuers in greatest danger of failing in the next recession, the one with the greatest amount of debt, represent the highest concentration in the index. In today's very uncertain world, the structure of bond index funds, like so many financial instruments, is totally ignored until problems arise, causing investors unanticipated headaches due to a lack of due diligence prior to the purchase of these indices. As we say often at Metis Value Partners….."Know what you own".

One other closing fact about the explosion of debt issuance during the last several years. It is estimated by industry professionals that approximately 50% of all outstanding corporate debt is rated BBB, the lowest investment quality debt. This debt, issued by many companies of questionable stability, is ripe for default when and if the next economic downturn materializes. As a matter of fact, the International Monetary Fund estimates that 20% of all U.S. corporate debt will default in the next recession.

In conclusion, Metis Value Partners is aware of the many risks associated with elevated equity markets and has successfully managed value based strategies in a variety of economic environments for many decades. As we work diligently on creating high quality concentrated value strategies, our principal task is to intensely focus on balance sheet quality followed by analysis of the business through the eyes of a business owner. We are confident that our portfolios are well constructed and will perform well in whatever environment lies ahead. We appreciate the confidence you have placed in us and we stand ready to answer any questions you may have about our individual holdings or our overall strategy.

Stephen Kent, Jr.

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