Investment Update—April 2018

This is a quarterly update of economic conditions and investment strategy.

Macroeconomic Outlook — The S&P 500 Index began 2018 at 2,674. It ended the first quarter at 2,641. After accounting for dividends, the S&P generated a relatively small negative return of -0.76%. If you somehow managed to ignore the financial media between January 1st and March 31st and just looked at these numbers, you might think it was a fairly uneventful quarter. Alas, that was not the case. During the first quarter, the S&P 500 saw 23 daily moves of plus or minus 1% or more. This compares to a mere eight in all of 2017.

2018 began with the highest level of bullish investor sentiment since 2010, as tracked by the American Association of Institutional Investors. In 2010, quantitative easing buoyed equity markets. In 2018, tax cuts and strength in the global economy formed the basis for optimism. The quarter began with the best January in eight years, but ended in the red for the first time since 2009. While earnings rose meaningfully, the market's price-to-earnings multiple fell.

In our opinion, equity market risk has increased in the past 90 days and the risk/reward trade-off for the next 12 months has shifted from favoring risk to a more balanced view. In the near-term, we would not be surprised by more market weakness and higher than normal volatility. Despite our fairly balanced view, we do look for what could go wrong. Below are three near to medium-term risks.

1. **A peak in global growth coupled with a more hawkish Fed** – There is no imminent danger of a significant deterioration in global growth, but the rate of improvement is likely peaking. A more moderate pace of growth, in and of itself, would not be enough to cause an equity market sell-off. However, if it is coupled with a less accommodative monetary back-drop (i.e. continued Fed tightening), equity multiples will likely contract further. In this scenario, the decline in price-to-earnings multiple would likely more than offset positive growth in earnings.

   Under Janet Yellen's leadership, it seemed unlikely that the Fed would press ahead with rate hikes if macroeconomic growth slowed appreciably. Under a new Chairman and with several Federal Reserve Board vacancies to be filled, the situation could be different. The Fed, as expected, raised rates in March despite recent financial market turbulence. Federal Open Market Committee participants revised upward their projections for both economic growth and the fed funds rate. Six participants now expect four rate hikes this year compared to only four in December. An overly hawkish Fed is still not our base case. We think when the preponderance of evidence shows economic growth slowing, the Fed will adjust its policy actions accordingly.

2. **Optimism and financial market instability** - As mentioned above, optimism was at an eight year high at the start of the year. A simple word search on the terms "strong global growth" and "weak global growth" illustrates this extreme optimism nicely. Articles mentioning strong global growth shot up in frequency in late 2017, while articles mentioning weak global growth fell to their lowest level in a decade. A picture, or in this case a graph, is worth a thousand words.

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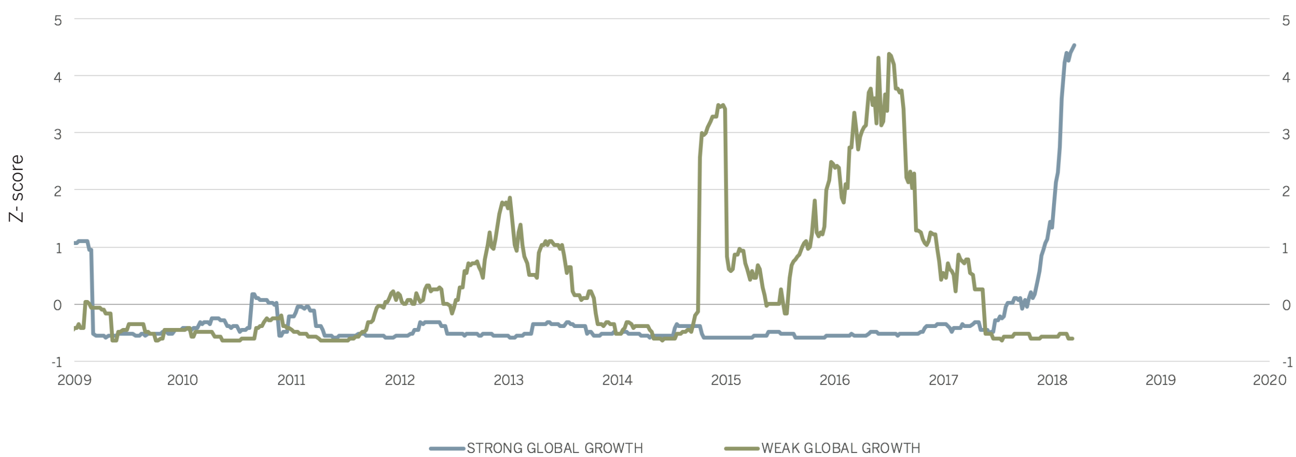
Optimism Spiked in Late 2017



Source: CornerstoneMacro

More recently, euphoria has faded in response to equity market weakness and volatility. Still, a majority of investors and economists seem focused on positive macroeconomic momentum and strong earnings growth, the logic being that bear markets and recessions go hand in hand and leading indicators are not pointing to a recession.

While this analysis is sound on the surface, there is a possibility that a sufficient tipping point of financial market weakness and volatility could trigger a recession. Risk assets are now five times greater than global GDP. Causality doesn't always run from the economy to financial markets. In major downturns, causality can run in reverse. Specifically, the last three economic downturns had their genesis in financial markets. The bursting of the dot.com bubble triggered the downturn of 2001; the large scale mispricing of U.S. mortgages caused the Great Recession of 2008; and the explosive widening of euro area sovereign credit spreads resulted in the euro area recession of 2011. We expect volatility to continue to shake out weak equity holders and reduce investor optimism. This will be good for future returns as long as it does not create panic and instability. Again, our base case is that market participants will cope with volatility and avoid a bear market, but the risk that volatility could reach a tipping point has increased.

3. **Rising protectionism** – This risk is harder to analyze. We know President Trump faces few constraints in escalating protectionism. But we do not know whether he will actually pursue what would be a destructive path or if it is simply verbal posturing. A trade war with China would severely damage both countries, and in turn, world growth. Equity markets are likely to continue to negatively react to signs of increasing tensions, and positively react when rhetoric cools.

In conclusion, we expect equity markets to continue to be volatile in the near term. If the Fed recognizes a slowdown in growth and reacts accordingly by slowing the pace of interest rate increases, it is not implausible that the bull market we have enjoyed for the past nine years resumes. However, if the Fed pursues an aggressive trajectory and/or trade tensions escalate, equity markets could drop below the February 9th low of 2,532. This "break" could scare technically focused investors and cause some algorithmic selling. In this scenario, it is possible that the S&P Index could fall 5-7% below the recent low. All other things being equal, we would view this as a buying opportunity.

To reflect the increased risks outline above, we have rebalanced portfolios. We trimmed position sizes in several of our biggest winners, mainly technology related stocks, and increased more defensive holdings. This rebalancing has not reduced exposure to our themes and thematic holdings. When volatility rises, concentrating on our highest conviction investment ideas has served us well in the past and we believe it will do so now as well.

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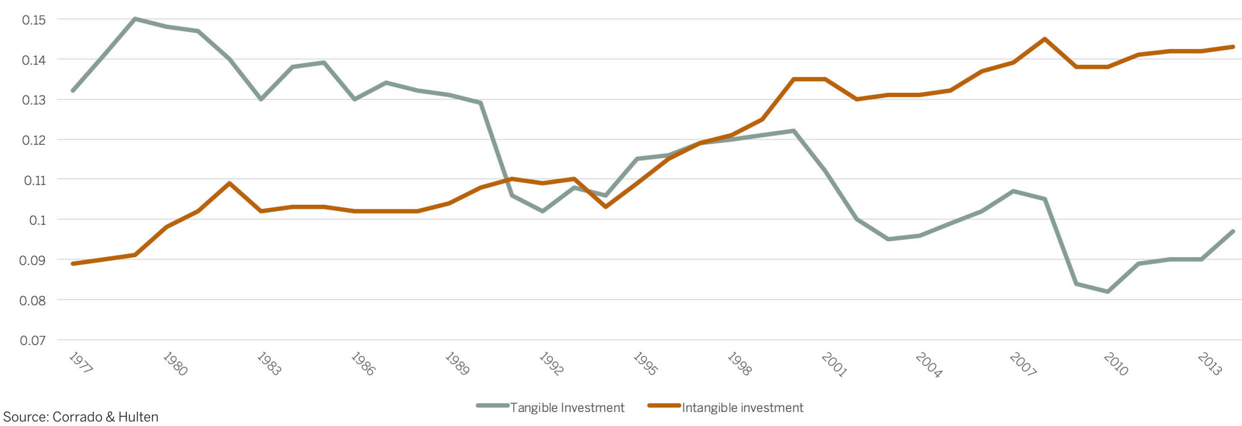
Thematic Update

The growing importance and systematic undervaluation of intangible assets has been an important and successful theme for Chevy Chase Trust. We have long believed that corporate balance sheets understate intangible investments. For the most part, spending on intangibles is treated as a current rather than a capital expense. In contrast, investments in tangible assets, such as machinery, trucks or warehouses, are capitalized on corporate balance sheets and depreciated over long periods of time. Understatement of intangible investment has led to undervaluation of intangible assets. Many intangibles, like non-public consumer data, research and development and large user networks are increasingly valuable but difficult to measure. These characteristics have provided opportunities to earn excess returns by owning intangible-rich companies.

We recently read an insightful book, "Capitalism Without Capital: The Rise of the Intangible Economy," by Jonathan Haskel and Stian Westlake. Over the past few decades, the nature of investment in many developed markets, including the U.S., has changed. As shown in the chart below, U.S. investments in intangibles, such as software, research and development, market research and branding, now represent a greater share of economic output than tangible investments.

Investment, Private Industries, 1977 to 2014

(ratio to existing GDP, excluding real estate/housing)



Source: Corrado & Hulten

The authors describe how, in their opinion, intangible assets most critically differ from physical goods.

- Intangible assets do not follow the same set of physical laws as tangible assets. They can generally be used over and over by different people in different locations, often at the same time. They are scalable in a way tangible assets are not. For example, a software package or a drug formulation can be used in offices or labs in multiple countries by multiple users at the same time. The same is not true for a piece of machinery or a delivery truck. Further, once a business has invested in creating or acquiring an intangible asset, it can usually reuse it continually at very little cost. This scalability allows intangible-intensive businesses to grow fast.

- It is hard to recoup money spent on intangible assets if the investment is not successful. Physical assets are often easier to sell or repurpose if things go wrong. In contrast, investments in intangibles often represent sunk costs. This characteristic makes them much harder to finance, particularly with debt.

- Ownership of intangible assets tends to be more difficult to establish legally than ownership of tangible assets. As a result, investments in intangibles are more easily copied by competitors. The company making the investment does not always reap the reward. In economic terms, the original investor may not appropriate the benefits of intangible investment. This characteristic tends to discourage corporate investment spending.

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These characteristics of intangibles help explain some perplexing relationships in today's economy. As the authors explain, "one of the most troubling and widely talked about trends in economics at the moment is secular stagnation: the fact that business investment is stubbornly low despite every indication that it shouldn't be." In the past, when interest rates were low, investment spending increased. The greater uncertainty associated with investing in intangibles, and the increased difficulty in funding intangible investments, may at least partially explain the current breakdown in the relationship between interest rates and investment.

Another unusual aspect is that corporate profits in the U.S. and elsewhere are, on average, higher than they have been in decades and seem to be steadily increasing. However, these profits are increasingly unequal. Normally, over time competition levels the playing field between leading and lagging firms, as profit margins regress to the mean and the laggards go out of business. This does not appear to be the case now. In part, this may be due to the scalability of intangibles and the ability of certain very large firms to dominate.

While we value external validation of our thematic research, Capitalism Without Capital and similar articles put a focus on the theme and make it more likely that other investors will begin to fully value intangible corporate assets. When a theme is recognized by other investors, we benefit from being an early investor, but the future opportunity to earn excess returns diminishes. Some of our best performing holdings have been in companies with unique intangible assets. Some have doubled or tripled in price. Today, the valuation gap is smaller than it has been. We still think there are opportunities to invest in companies with undervalued intangible assets, but the opportunities are shrinking.

We often get asked "when and why would we exit a theme?" One of our requirements for a theme is that we believe that other investors will begin to discount the theme in their valuation models within a reasonable time frame, which for us, is three to five years. We would not be surprised if within the next 12-18 months the valuation gap in this theme will have closed and the overall theme will have lost its advantage. Of course, we are always researching potential new themes.

Fixed Income

Similar to equity markets, the first quarter of 2018 was tumultuous for fixed income investors. U.S. 10 year bond yields started 2018 at 2.41% and rose rapidly to a high of 2.95% on February 21st. Since late February, equity market volatility and protectionist policies led investors to seek safety in bonds, causing yields to recede about 20bps (0.2%) to close the quarter at 2.74%. Of course, rising yields means falling prices. Interestingly, shorter term bond yields followed a similar trajectory. Two year Treasury yields started the year at 1.88%, rose to 2.34% on March 20th, and receded to close the quarter at 2.26%.

One of the more consensus views beginning the year was that rapid global economic growth would lead to meaningfully higher bond yields. Most economists predicted that 10 year U.S. bond yields would exceed 3.0% or even 3.5% by year-end. We have been more conservative in our estimates (more optimistic on prices), and still believe consensus expectations are too high. That said, a trade war or change in foreign appetites for U.S. debt could meaningfully impact prices. These risks are difficult to handicap.

We continue to view high quality, shorter-term bonds with ample liquidity as the most prudent investment option in volatile markets.

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