CARDEROCK
CAPITAL® MANAGEMENT, INC.

January 15, 2019

With the first weeks of the New Year complete, we're delighted to see a bit of relief from the steady downbeat of 2018's year-end that turned nine months of progress into mud. And while a few days might not seem much to hang one's hat on, it's a start, and we're glad to find a more positive note in the suggestion box for 2019.

Last year's outlook at this time ran into a significant setback at the start, but then rallied strongly to top the old highs by summer. With a fourth quarter denouement that stretched into bear market territory for the first time in a decade, we find it hard not to look at the whole of 2018 as other than a classic blow-off double top. And yet the inability of sellers to drive oversold markets towards more painful discounts relative to fundamental value suggests important positives remain.

Odd as it may seem, salient among the positives may in fact be the very current acidic tenor to much of the news we commonly bemoan. Looked at from this perspective, the acrimony may measure no more and no less than a palpable sense that we are overdue for an economic reset to the balance between equity and efficiency, and the time of choosing is close. Elsewhere these choices are similarly playing out in the high stakes seen in Brexit, the Eurozone, and the slowdown weighing on China's Communist Party, people and private sector. But here in the U.S. the choice looks increasingly to run along generational lines where natural ties seem to offer a better shot at ultimately bridging similarly scaled differences. Done right, the reset promises a healthy shift in demand that lengthens investment horizons as well.

Our bottom line is less ambitious. If the recent retreat stabilized due to continuing economic strength, it's also true that the bright long-term outlook contributed as well. Here, we are enthusiastic that the mature unfolding of technology more broadly within industries could widen benefits and re-invigorate growth across the entire economy, ultimately rebuilding the middle class in ways not seen since the "greening of America" after World War Two. For another, we see potential for a fruitful change in share ownership structures as well. All of this suggests we'll ultimately see a return to normal that's neither a one-off nor a fantasy, but a real investor's environment – even re-establishing traditional risk premia.

With our practice of multi-year holding periods, the prospect for "normal investment" to come back into vogue suggests the crowd may come our way. Much as we like the thought of this, it could well mean that we'll want to see a broader resurgence in public offerings to assure that popularity doesn't limit opportunity. There's a lot that can slip between the cup and the lip, but for now, that's how the pieces look to fit together.

As always, we welcome your calls and look forward to the opportunity to discuss your progress.

Warmest Regards,

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Strategy: Managing through Turbulence:

Rather than belabor the negatives of the fourth quarter, it is worth a moment to savor the current reprieve from policies seeking to reverse or at least rebalance what had become long-term bets on free money, free trade and free labor (immigration) and instead focus on more granular changes affecting portfolios.

On this account, three things have been clear:

First, much as the market wanted to pocket the benefits of deregulation and tax cuts without bearing additional costs (higher interest rates, tariffs, and wages), the haircut of the fourth quarter more accurately reflects that sales and profits will likely run into cost pressure. The good news is that even after this belated adjustment, stock prices remain ahead of their November 2016 start; interim earnings growth has kept valuation reasonable; and at least for now, Final Demand appears intact.

Second, much of the fourth quarter's turbulence can be attributed to the singular event of the S&P's biggest ever reclassification of leading stocks – a factor not likely to trouble us in 2020. Pushing Facebook, Netflix, Google, Baidu, Tencent and 17 others out of the Technology sector into Consumer Discretionary, Telecom, Media and elsewhere shook valuations as ETF Sector and Index Fund investors adjusted. The good news is that this activity fueled demand for shares in peer companies buoying the "lesser darlings" we own in these other sectors rather nicely. For our part, we're thankful for broad portfolios of individual stocks that largely eschew these sorts of fads and escape some of their lunacy as well.

Third, while we keep a clear eye on the horizon for attractive new stocks, we gauge their prospects through a discipline we've used for over 30 years that diversifies according to duration (time), quality, growth and industry exposure. Used with forecasted returns, these factors provide the legs we need to keep your positions on track. From there, we incrementally manage the residual systematic ("market") risk by adjusting the proportions between stock holdings and equity cash reserves according to actual progress measured and volatility experienced. Our goal is to stay focused at the granular level where controls yield their fruit, where we avoid "paralysis by analysis", and make the necessary portfolio decisions.

Current Circumstances and Outlook:

In retrospect, we raised equity cash reserves from 12.5% at the beginning of the year up to 22.5% late in the fourth quarter as the downtrend strengthened. This bold move in many cases pushed realized capital gains ahead of those recorded in recent years. As conditions have settled, our inclination is to see whether we can step gingerly back towards recommitting a portion of these reserves as the market allows. For now, we are more liquid than we like, and primed primarily for defense should the economy tip into recession. If 2018 attests how an aging economic expansion tends to lower the odds of success for new positions, then there is a good case to be made for keeping our powder dry. For now, we'll wait and see.

Finally, the bottom line may be that just as complex weather models are often humbled by the "Farmers' Almanac", perhaps we could do worse than to consider how the four-year presidential cycle might anticipate an election year rally that begins in late 2019 and carries through the summer of 2020. By this score, 2019 could run a stronger finish for stocks than over the next few months allowing us the time to tiptoe back towards a higher stock allocation.

Random Gleanings

"James Carville's endlessly repeated witticism about wanting to come back to earth as the bond market because the bond market bosses everybody around is as dated today as the Clinton presidency. It's the stock market that a politically ambitious person would chose to become in a second life… Interest rates supposedly determine the present value of estimated future cash flows, yet the interest rate setters are watching the stock market. There is not one positive real rate to be had at any point along the government yield curves of Germany and Japan, and only one such rate along the French sovereign curve (30 years). And after inflation and tax, there's hardly a real rate of return available on the U.S. Treasury curve. The central banks have seen to it. James Grant**, Grant Interest Rate Observer,** 1/11/2019

"The fate of this bull market does not rest on settling a trade war nor on parsing commentary from the Federal Reserve. These issues and others like them certainly create headline trading opportunities but will not likely define how long and how much potential is left in this bull market. Rather, the continuation of this bull market is dependent upon changing the investor mindset. In recent months, collectively, investors are now simultaneously worried about "Stagflation". Either Stagnant growth or inflation could end the bull market and kill this recovery. However, should widespread fears generated by a deeper stock market correction reduce inflation worries and leave only stagnation concerns, investors may enjoy one last sustained bull market run. James Paulsen**, "**Stag or Flation?"**The Leuthold Group**, 12/17/2018

Zambia, a southern African nation and former British colony rich in copper and cobalt is spending $1 Billion on Chinese made telecommunications, broadcasting and surveillance technology. It's all part of China's "Digital Silk Road", a subset of its "Belt and Road" initiative that contributes an estimated $79 Billion in projects around the world according to RWR Advisory Group, a Washington consulting firm that tracks Chinese investments… What's playing out in Zambia is part of a larger contest between the U.S. and China for dominance over the future of technology and global influence. Companies from both countries sell tech products around the world, but Chinese businesses are offering a wide range of gear and relatively cheap financing in countries from Zimbabwe to Vietnam. They have an advantage in developing nations such as Zambia, which are looking to modernize their technology infrastructure… This rivalry risks dividing the world with a digital iron curtain. *"The Digital Iron Curtain",* **Bloomberg Businessweek,** 1/14/2019

"Vincent Deluard a macro stategist at INTL FCStone writes, **'**The technological age ended …on September 28, 2018. The Global Industry Classification Standard (GICS) split the Information Technology sector between Discretionary (eBay, Netflix) and a greatly revamped Telecommunications sector, including Facebook and Google. ...I think the more important consequence of the GICS change was the public admission that Technology is no longer special… the notion that technology would solve all these problems and that there were these visionaries who would make the world a better place crumbled. If technology is everywhere, the tech sector no longer exists. If the tech sector no longer exists, its premium
is no longer justified.'" Jemima Kelly, "*The Tech Sector is Over*", **Financial Times**, January 8, 2019.

"In reality, the Euro has brought low growth, economic instability, and political discord to Europe, yet its unaccountable leaders spin it as an unbridled positive at a time when ordinary citizens of Europe are donning Yellow Vests and bemoaning their plight. As Wynne Godfrey argued so eloquently when the Maastricht Treaty was signed in 1992, the strictures that it and the Euro would impose on Europe would lead to its impoverishment, not its prosperity: 'If a country or region has no power to develaue, and if it is not the beneficiary of a system of fiscal equalization, then there is nothing to stop it suffering a process of cumulative and terminal decline leading, in the end, to emigration as the only alternative to poverty or starvation." Steve Keen, "*The Delusional Leaders of the Eurozone*", **Patreon**, December, 2018.

"Mr. Trump, backed by a new Washington consensus, wants Mr. Xi to dismantle his 'Made in China 2025". It is one of Mr. Xi's signature drives. A climbdown would undo his domestic authority and upend China's national security goals. It would be a shock were he to agree to it. As a result, 40 years of US-China convergence is starting to unravel. It is hard to overstate the strategic importance of this reversal. Since they normalized ties in 1979, the U.S. has underwritten China's emergence on the world stage. With one or two pauses, notably after the 1989 Tiananmen Square massacre and tension of the Taiwan Strait in 1996, the US kept its faith in China's destine as an increasingly open – and decreasingly authoritarian – partner. America puts its faith in a 'win-win' relationship. The prism has now changed to 'win-lose'. This is creating two effects. The first is economic disengagement. The second is that other countries are being forced into an unwelcome choice." Edward Luce, "*The New Era of US-China Decoupling*", **Financial Times**, 12/20.2018.

"Over optimism and over confidence are two well-known psychological traits of our species. They are particularly dangerous in the late stages of an economic cycle. Real earnings growth in the corporate sector has been below the rate of GDP growth even after the significant boost from financial engineering known as buybacks. A breathtaking 25% to 30% of firms in the Russell 3000 are actually loss-making! Yet the stock market remains well bid. In large part, this bid is sourced from the buybacks (and mergers) from USA, Inc. itself. However, in portents of late-cycle capitulation, individual investors and global fund managers are throwing the towel and buying into U.S. equities. The corporate bid is really a massive debt for equity swap, with firms leveraging themselves up. This creates a systemic vulnerability and is potentially a Minsky Moment in the making." James Montier, "*The Late Cycle Lament*", **GMO White Paper**, December 2018.

"…having said Chairman Powell did the right thing, let me share my concern. No serious scientist would run a two-variable experiment. By that I mean, you run an experiment with one variable to see what happens. If you have two variables something either good or bad happens, you don't know which variable was the cause. You first run the experiment with one variable, and then do it again with the second. After that, you have the knowledge to run an experiment with both of them. The Federal Reserve is running a two-variable experiment (raising interest rates and aggressively reducing their balance sheet), and it is my opinion they should do one or the other, not both." John Mauldin, "*Thoughts from the Frontline: Bear Markets, Fed Mistakes and Quick Shots*", **Mauldin Economics**, 12/28/2018.

"When I think about the crisis of our liberal system, I am reminded of an encounter almost 20 years ago in Berlin with Wolfgang Kartte, a former president of the German cartel office. I asked why he and his successors often took such a conservative view on competition cases and in particular why they were so dismissive of economic arguments. He said he considered his job as helping the little guy to defend himself against the big guy, and was not interested in leveling the playing field, but in tilting it in favor of the little guy. The crisis of modern liberalism has similar elements. We have our own version of the little guy versus the big guy problem today but with no one to tilt the field in the other direction. InN the 1920's the German liberal order collapsed and drove a majority of the population away from supporting it no simply because of hyperinflation and depression, but also because industrial cartels threatened the livelihoods of small merchants and entrepreneurs. What often leads the supporters and defenders of modern liberal democracy astray is their addiction to macroeconomic aggregate variables that often show reasonable growth, but granular data often paints a different picture where household income stagnated for 60% of households. Any system that leaves behind 60% of households will eventually fail in an ultimate irony – due to market forces." Wolfgang Munchau, "*The Crisis of Modern Liberalism is Due to Market Forces*", **Financial Times**, 12/23/2018.

"A lot of bad news had been priced into equities in December, strengthening the case for an extended bounce. So does December represent a genuine washout of positions and the low for the market? The short answer is no. As we saw in 2008, counter-trend rallies can run pretty hard." Mike Kackenzie, "*The Washout Stakes*", **Financial Tim**es, January 8, 2018.

SHORT TAKES
December 31, 2018

RESULTS

The **S&P 500 index** plunged **(-13.5%)** for the 4th Quarter and **(-4.38%)** for 2018.

Stocks:

Size: – Large Cap outperformed both Mid and Small Stock Indices during the 4th Quarter.

S&P 500 Large Cap (-13.5%), S&P 400 Mid-Cap (-17.3%), S&P 600 Small Cap (-18.9%)

U.S. Economic Sectors: – 4th Qtr. S&P 500 Index Sectors Winners and Losers –

S&P **Utilities** – **(-0.5%)**; S&P **Energy** stocks fell **(-25.6%)**

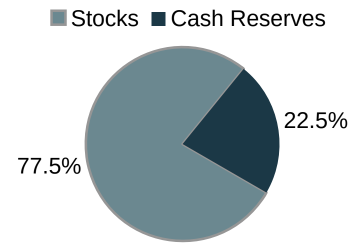
Bonds – Fixed Income returns were mixed; Longer term Taxable Bonds outpaced shorter, higher Quality issues during the period.

<u>4th Qtr. 2018 Returns:</u>

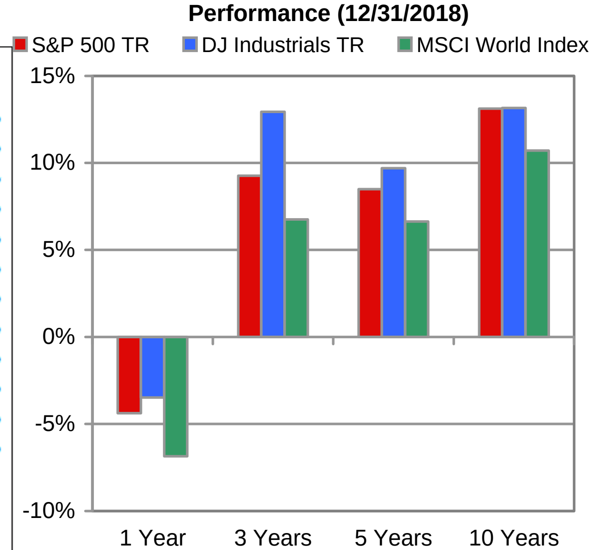
- Lipper Short-Int. U.S. Govt. Index: **1.4%**
- Lipper Short-Int. Municipals Index: **1.2%**
- iShares iBoxx **(LQD)** Inv. Grade Corp. Bond Index: **(-0.5%)**
- iShares iBoxx **(HYG)** High Yield Corp. Index: **(-4.7%)**

Source: Lipper, FactSet and Blackrock

Carderock Equity Target Allocation

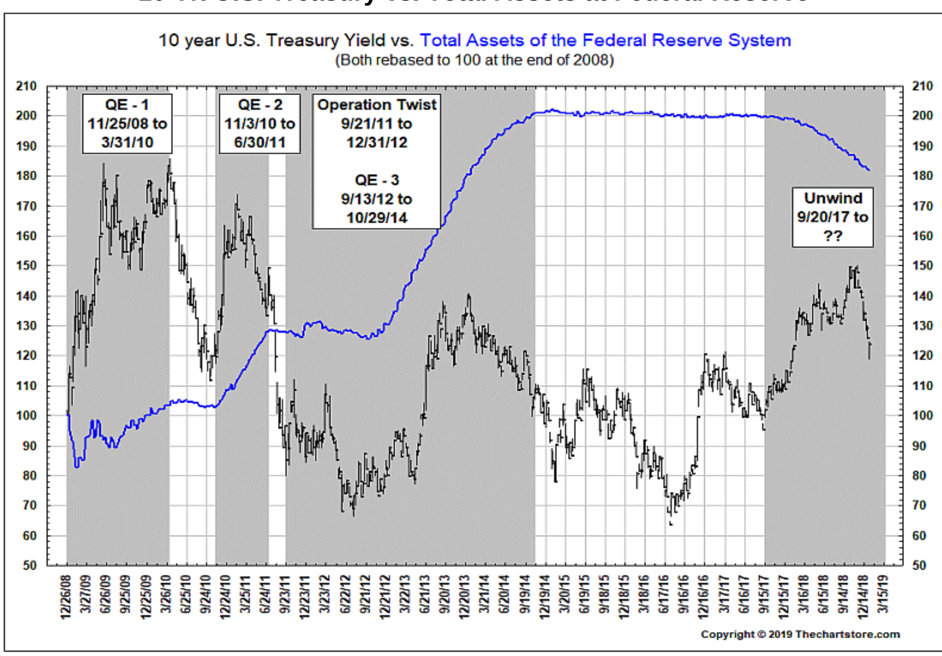


Global Stock Market Annualized Performance (12/31/2018)

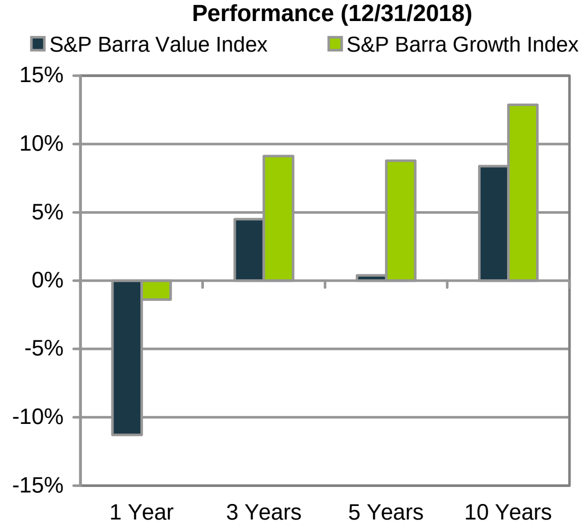


Source: MSCI Inc., IDC

10 Yr. U.S. Treasury vs. Total Assets at Federal Reserve



Growth vs. Value Style Annualized Performance (12/31/2018)



Source: IDC

7 Year S&P 500 Composite Index