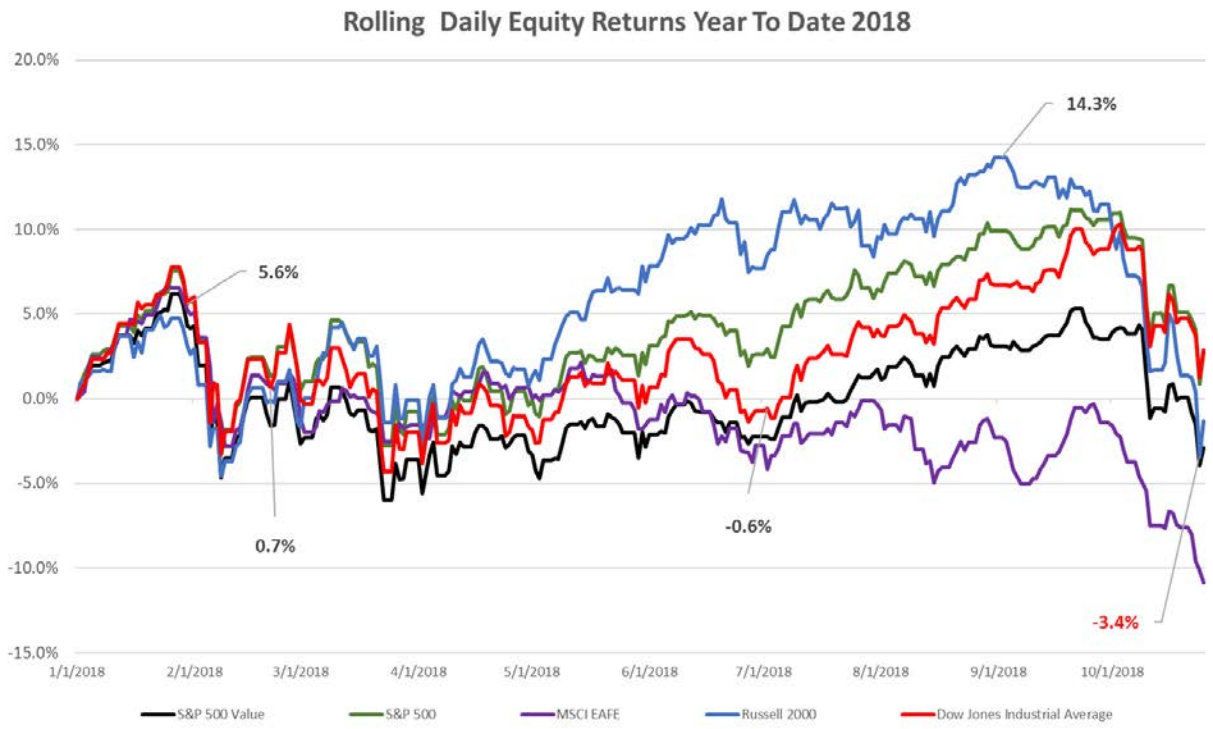
TURTLE CREEK

November 6th, 2018

Dear Turtle Creek Client,

The first weeks of October delivered a dramatic reversal to strong year-to-date performance in equity markets. Domestic stock market indices that had advanced more than 10% on average through the end of September swung to losses in a matter of days. International markets struggling to maintain value plunged by more than 10%. The U.S. bond market also continued to struggle during the third quarter in the face of the Federal Reserve's ongoing normalization of interest rates. The benchmark 10-Year Treasury Rate rose to a yearly high of nearly 3.2% as the Federal Reserve continued with its steady increases in base borrowing rates, pushing down the value of most all fixed income instruments.

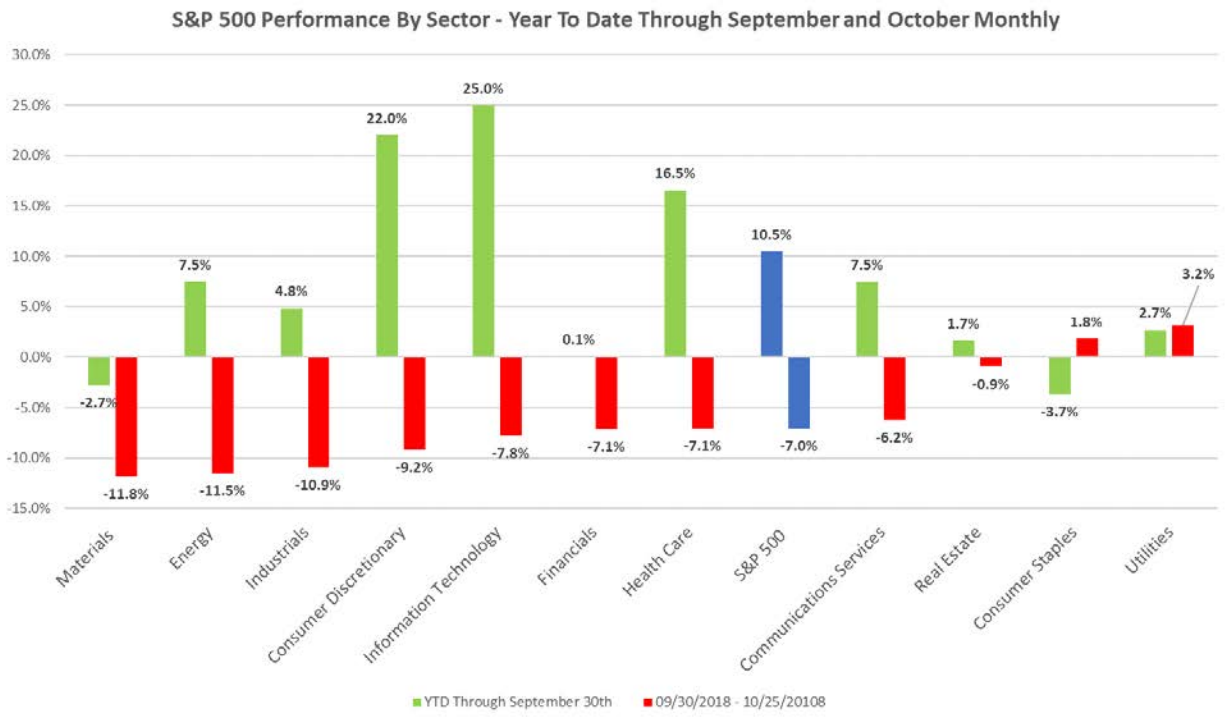


Source: Bloomberg

Factors in Year-To-Date Market Performance

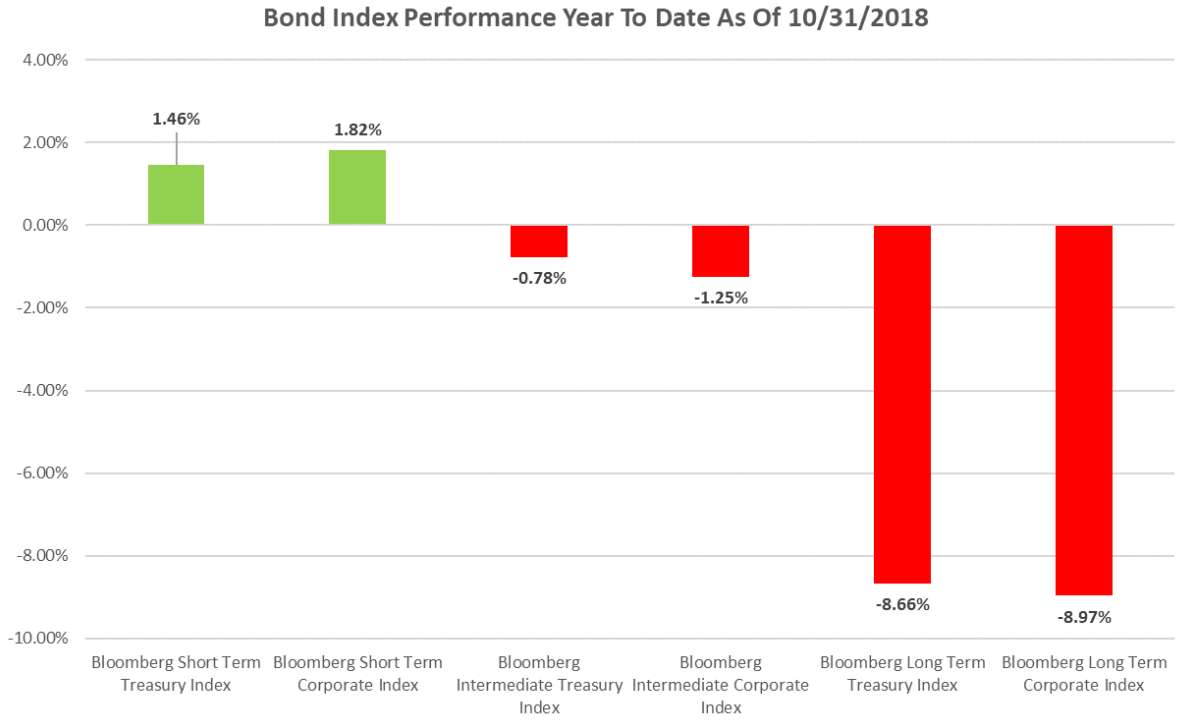
Stock advances through the first nine months of 2018 relied heavily on a few high-growth pockets of the market. Of the eleven economic sectors making up the S&P 500, only three posted results better than the market. Technology, Consumer Discretionary, and Health Care stocks posted outsized returns while the remainder of the market posted only marginal gains or losses for the year.

The sell-off of early October, by contrast, touched all parts of the market. Economically sensitive industries such as Basic Materials, Energy, and Industrials lead declines while growth-oriented industries also declined more than the market as a whole. Safe-haven groups such as Consumer Staples and Utilities were the only companies to maintain their value



Source: Bloomberg

Bond markets that traditionally serve as safe ports during equity market storms also lost value through the end of October. The Fed-induced upward march of interest rates continued unabated, pressuring bonds of longer maturities. The spread, or additional compensation, bond investors require for riskier bonds also increased. These factors extended the year-long trend of riskier bonds of longer maturities significantly underperforming their safer, shorter-maturity counterparts.



Source: Bloomberg

Making Sense of Market Volatility

Market analysts are conflicted on the root cause for these sudden market gyrations. Many pointed the finger at the Federal Reserve Bank. The Fed once again hiked its base borrowing rate and signaled more hikes to come, making investors worry that the Fed will mistakenly tip our economy into recession through higher borrowing costs. Others pointed to "peak earnings growth", or the fact that corporations will post slower profit growth in the months and years ahead. Fundamental investors noted the aging business cycle, historically rich market valuations and escalating risks ranging from trade wars to geo-political developments. Traders pondered the usefulness of any market signal in this day and age of volatile computerized buying and selling based on crude decision rules.

Each scenario is plausible. Fed rate hikes do raise the cost of home and auto purchases and sap consumer demand. Corporations will see their torrid pace of earnings expansion cool in the year ahead as one-time events like corporate tax cuts work their way through the system. The eventual cyclical downturn, as sure as death and taxes, will at some point pressure historically high profit-margins and corporate growth.

No explanation seems to fully justify the speed and size of the stock market sell-off however. While borrowing costs are increasing, they remain by any historical measure very attractive and many extraordinary government stimulus measures remain in place. While corporate earnings growth is slowing, current forecasts still predict healthy growth over the next several years. The most predictive leading economic indicators still show very positive signals, indicating no recession is imminent.

The most likely cause in our view was a significant re-assessment of risk by stock investors. For months, securities prices blithely ignored increasingly hostile trade war rhetoric and forecast little disruption to historically above-average returns and valuation multiples. The recent sell-off brings stocks to a level that more accurately reflects potential future outcomes. The spring-loaded nature of modern computerized trading systems exacerbated this adjustment, resulting in another bout of historic short-term market volatility.

The Missing Federal Reserve Lifeline

One big change for markets in 2018 is a sudden indifference to market volatility by the Federal Reserve Bank. For nearly 30 years Fed governors have cushioned investment markets during turbulent times. Alan Greenspan acted decisively to steady markets during the Crash of 1987, the Emerging Market Crisis of 1998, and the Dot.com Crash of 2000. His successor Ben Bernanke resorted to unprecedented crisis measures to combat the Mortgage Crisis of 2008. Janet Yellen went to great lengths to re-assure investors as she helped nurse the economy back to health.

The current Federal Reserve staff has taken a very different approach. Bill Dudley, the head of the Federal Reserve Bank of New York, described the steep market sell-offs of earlier this year as "Small Potatoes." Chairman Jay Powell testified to Congress recently that the Federal Reserve would only reconsider its interest rate plans in the event of a "significant and long-lasting market correction."

The Fed's indifference to market volatility is likely a positive over the longer-term. It will eliminate moral hazard, or excess risk-taking by investors on the assumption the Central Bank always backstops potential losses. It should also result in greater market volatility in the years ahead. The relatively serene market environment of the past several years rested on the foundation of historically abnormal government support. With this Fed safety net being pulled back, markets are now left to their own devices in pricing securities and that means investors should expect a bumpier ride going forward.

The Cautionary Tale of Red Hat

International Business Machines recently announced the acquisition of Red Hat Inc. A darling of the Dot.com era, Red Hat shares came to market in 1998 and soared more than 500% to a peak of $143 per share in less than a year, only to crash and burn with other Dot.com stocks thereafter. IBM's recent acquisition spared those folks trading Red Hat shares at the peak of Dot.com euphoria the ignominy of losing money over a multi-decade span. Red Hat shares were trading hands at $120 before the IBM acquisition offer, 18% below its peak valuation nearly 20 years ago.

Many lessons can be learned from Red Hats painful history, but the most relevant is that the price you pay for a security is a crucial factor in your long-run security returns. While Red Hat is an extreme example, it effectively underscores that investors usually overpay for high growth securities and impair returns in the process. We find it a timely reminder given the current stock market environment favoring high growth media and technology firms.

Portfolio Strategy in Light of Recent Events

The key question for investors is whether the stock market has experienced a "healthy correction" that sets the stage for realistic future returns or is entering the early phases of a more prolonged down-turn.

Given the ongoing growth in corporate profits, healthy U.S. economy, and no clear signal that the economic cycle is beginning a tilt towards recession; we cannot muster a case for another imminent downdraft in equity markets. Equities are now valued at levels roughly in-line with historical averages, which helps mitigate significant downside to stock returns. Should corporate earnings forecasts meet current expectations, positive stock market returns should be expected over the near-term.

We expect bond markets to continue their struggle for the remainder of the Federal Reserve's normalization process, so the current short maturity and high credit quality bond positioning remains the wisest choice. Despite the bond markets challenged outlook, fixed income still provides a crucial offset to the volatility of stocks and its risk management role in a portfolio's overall asset allocation remains as important as ever.

All this being said, we cannot ignore that all economic indicators currently reflect the very best of times and reversion to the mean at some point in the future is probable. The stable performance of more defensive equities in your portfolio during the recent market storm should help illustrate their value over longer cycles.

As always, we appreciate the trust and faith you place in our firm. Please call or write any questions.

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