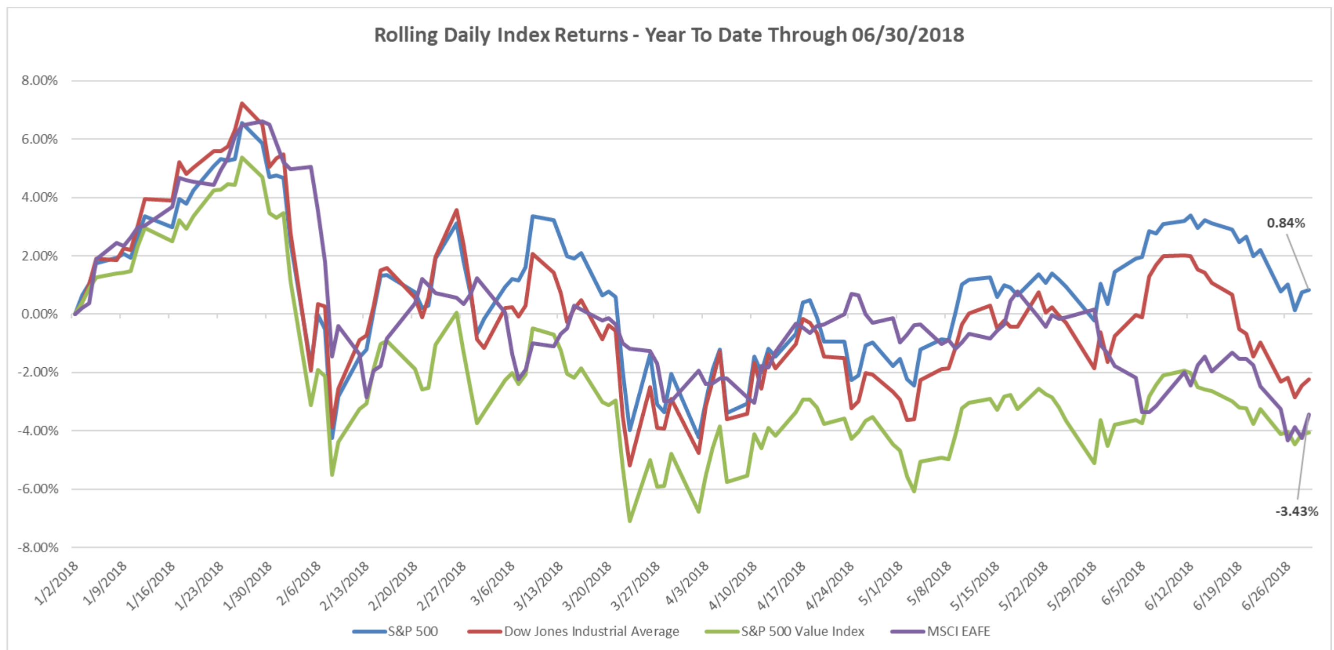
July 18th, 2018

Dear Turtle Creek Client,

U.S. equity markets advanced only slightly during the second quarter of 2018 as investors struggled to reconcile conflicting signals. On the positive side, U.S. corporate earnings continued to expand at a rapid clip and the overall economy maintained it's slow but steady expansion. Off-setting these trends were a litany of macro-economic concerns ranging from increased global trade tensions to rising borrowing costs and a flattening treasury bond yield curve. Through the mid-point of the year, returns on various global stock market indices have ranged from small gains to losses.



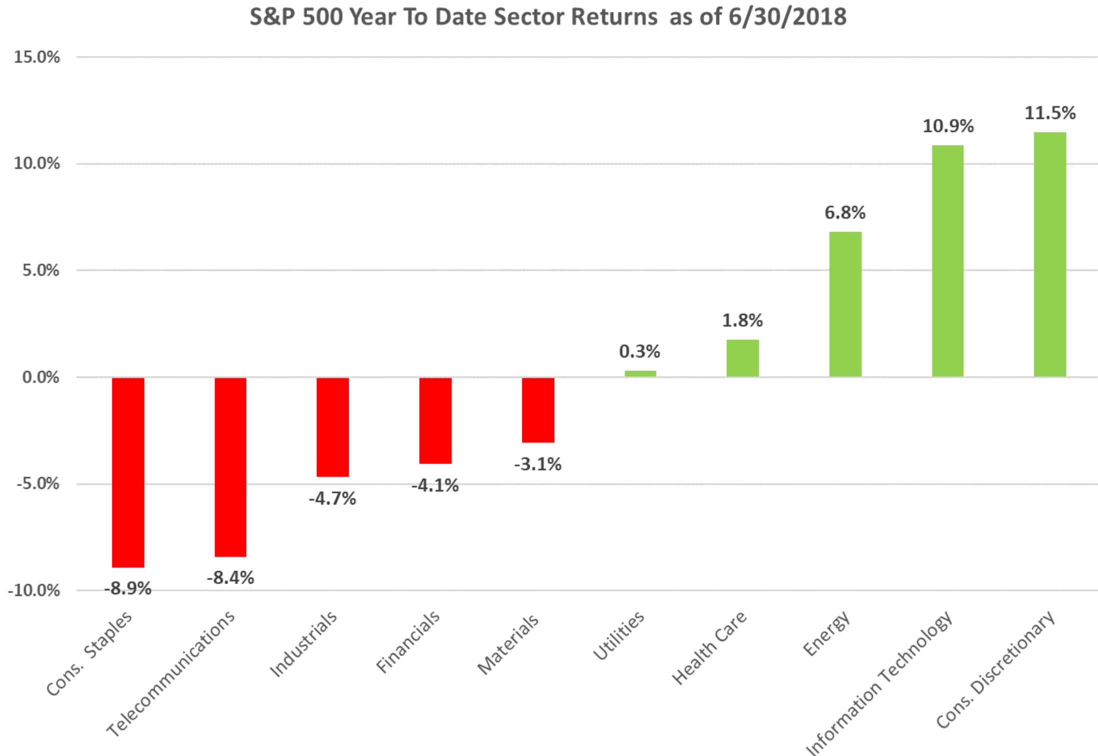
Source: Bloomberg

Drivers of 2018 Stock Market Performance

Growth-oriented and economically sensitive companies continue to drive overall stock-market performance at the mid-point of the year. Consumer Discretionary, Technology, and Energy companies generated strong results while defensive industries such as Telecommunications and Consumer Staples posted losses.

This theme did have several exceptions. The Financial Services sector gave up some of its notable gains from the prior year. Expectations for rapid interest rate hikes by the Federal Reserve moderated in the second quarter and the outlook for financial company profitability moderated in turn. The Health Care sector, usually a defensive stalwart, posted gains as the implications of heightened regulation seemed less severe. Finally, the usually pro-cyclical Industrial sector posted losses due increasingly negative political rhetoric over tariffs and trade. Industrial firms are the front line of global trade and this sector discounted the potential downside of new trade policies quickly.

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com



Source: Bloomberg

A Note on Tariffs and Trade Wars

A large volume of political rhetoric has been offered to justify the increasingly aggressive stance by the U.S. Government in re-ordering the current state of global trade. The proposed costs and benefits for the overall economy and the American worker are best evaluated by professional economists.

The implications of new trade policy for your investments, however, is undoubtedly negative. Tariffs are at their core taxes that restrict the addressable market for American goods and inflates input cost for American enterprise. This reduces the earnings and free cash flow of your investments and impairs their intrinsic value. If we must choose between a larger pool of demand and profits to be captured by your investments or a smaller one, we choose the larger pool each time.

By the numbers, the track record of tariffs and import restrictions is a dubious one. The Smoot Hawley tariffs of the 1930s aimed to shield American Industry during the Great Depression but in hindsight prolonged economic malaise. President George W. Bush's steel tariffs of 2002 lasted only a year and were judged to have increased unemployment and reduced American economic growth. Much of the economic growth of the 20th Century was built off the back of international trade agreements that improved the cross-border flow of goods and until recently consigned trade wars to distant history.

Global markets have so far signaled a relatively benign conclusion to global trade negotiations, bouncing back from the sharp draw-downs that occurred in the earliest stages of the trade war of words between the U.S. and its key trading partners. Markets are wagering that current headlines amount only to negotiating rhetoric that will not translate to action We hope this prediction is correct as the downside to unrestrained trade hostility is significant.

Fixed Income Markets

The U.S. bond market changed its tune during the quarter as the rapid increase in bond rates that marked the beginning of 2018 stalled over the last three months. The probability of an over-heating economy and above-trend inflation diminished based on macro-economic datapoints signaling only modest inflation. The Federal Reserve also moderated its previously hawkish tone in its public comments.

Source: Bloomberg

Short-term interest rates still advanced during the quarter but longer-term bond yields have refused to budge from historically low levels. A 30-year Treasury bond currently offers investors a measly 50 basis in additional yield compared to its 2-year counterpart. To understand the potential significance of this trend, one must first understand the concept of the yield curve. Bonds are issued in a wide range of maturities with some coming due in less than a year and others maturing decades down the line. In theory, plotting the relationship of these yields provides an insight into the bond market's best guess at economic conditions in the future. Ideally longer-rates will be materially greater than shorter rates, signaling a faster pace of economic growth in the months and years ahead. The current curve featuring a flat range of yields does not provide a vote of confidence for future economic growth.

There are many discussions as to why the yield curve's current signal should not be taken at face value. Since the credit crisis of 2008, the Federal Reserve has meddled significantly in the bond market to stimulate economic growth. Foreign investors encountering small or in many cases negative yields at home have bought up U.S. treasury bonds voraciously. Still, we are wary of saying "This time its different" and will be monitoring this historically relevant risk signal closely.

Portfolio Positioning in the Current Environment

With the corporate profit boom in full swing and few obvious excesses on display in the economy, downside risks to your equity holdings currently appears medium-term in nature. Corporate earnings are forecast to expand briskly through at least the 2019 market year, providing a tail-wind for the ongoing stock market expansion.

The macro-economic risks discussed in this letter and issues raised in prior communications remain relevant to the longer-term expected returns of your equity holdings. Defensive investments retain their important diversification role in your portfolio even if current returns are not keeping pace with the overall market. The implications of historically rich stock market valuations and potentially unsustainable profit margins on your longer-term equity returns remain front and center.

With the interest rate tightening cycle still in progress and compensation for credit risk remaining small, we have not changed our view that fixed income portfolios should emphasize holdings of short duration and high credit quality.

Based on these factors, we do not see a need for adjustment to your current portfolio strategy. As always, we appreciate the trust you have placed in our firm. Please call or write with any questions.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA