CARDEROCK
CAPITAL® MANAGEMENT, INC.

July 15, 2019

As we now begin the third quarter of the year, old September valuations that were barely tagged at the end of the first quarter have finally succumbed to a shift in the Federal Reserve's view of what it takes to keep its chairman, its independence and its path clear of the White House. The answer is of course that as "keep" is (for now) the new "next fired", there's no surprise in the market's choice to follow a Presidential lead and vault to new highs rather than wax wroth over mothballed memories of a 1970's-style inflation or 2008-like debt-fueled recession.

Critically, we feel the course ahead will track towards less and less as values trend higher. We expect growth rates will slow despite the Administration's focus on juicing the 2020 election with higher returns. But with the big guns of tax cuts and regulatory relief fired long ago, these efforts will ultimately prove too-little, too-late – if not work at cross purposes. Yet neither the current trade dust-ups (China, Europe and our North American partners) nor the ominous signs from the bond market mean an economic divot is necessarily in the offing. Truth be told, taking a stroke of slower growth isn't the worst option. And as if taking their cue, the markets have applauded in confidence that the green shoots of growth abroad together with global monetary expansion and record low interest rates will prove enough to extend the cycle. Bottom line, the conditions for serious, real change have not been met, and though the traps ahead may come more frequently, it's best to keep swinging.

And it is the reasonableness of an outlook focused more on actual results than on the prediction of an alternative course that appeals to our inner technician's mind. Though we may believe the markets are in the process of establishing a long-term, extended top, we don't find conditions so singularly adverse as to warrant decisive action. Rather we've maintained our exposure through frequent review and tight adherence to our disciplines. While plenty of reactions and retrenchments of the sort seen in 2018 may lie ahead, we're also likely to see a number of rallies and even new highs. And unless we're mistaken, the sum is that we'll make slow progress until either rising wages cut into margins, or inflation tops the combination of growth and productivity gains. In the meantime, we expect investors will remain sanguine about financial assets and stocks in particular.

As we look ahead, though it's been good to see our modest Investment Plan forecasts repeatedly bested by strong, favorable experience, we're afraid this may fade and results run closer to our conservative projections. Much as we don't relish the prospect of being right as returns run soft and would prefer to make more money by being wrong, it's not a choice we control. Nevertheless, we're concerned how narrowed returns might exaggerate the impact of small changes – even monthly cash flows, and ultimately affect your long-term goals. With the summer months a great time for slowing down and renewal, if it's been a while since we last sat down together, we strongly encourage you to call, and let's discuss how we're doing and what we're about in furtherance of your goals.

Warmest Regards,

James W. Mersereau, CFA, CIC
President

Daniel A. Kane, CFA, CIC
Managing Director

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

2 Wisconsin Circle, Suite 600 Chevy Chase, MD 20815 P 301.951.5288 F 301.951.0411 www.carderockcapital.com

ANGLE:

Many took the angle of responding enthusiastically as the Federal Reserve conceded it might rethink its course for re-establishing normal rates. This means the whole straight-line up thing is clearly off the table – a forecast we never found credible anyway. Yet we're not agreed either that the corollary response has to be an immediate 50 basis points cut (followed by a series more) in order to "save the expansion". A central bank's panic of this sort at the sight of 2% growth would be a first. Yet there's no mistaking that fear of rates falling back towards "zero-and-below" has stampeded many into buying income-paying assets at any price. Were this sort of FOMO ("Fear of Missing Out") to continue its run unbridled, we might instead risk sparking a new, second Fed-caused Financial Bubble, but more than likely, this too will pass.

ASSESSMENT:

In the meantime, we find ourselves most concerned that this sudden buying surge could begin to bleed into the High-Quality securities we favor. This would not only reduce our appetite for new purchases, but, leave fewer and fewer places to hide as well. With the ascent of prices now closing in on valuations levels of the third quarter of 2018, this raises the prospect of another retrenchment as we look once more towards Fall. Accordingly, we may see cash reserve levels begin to rise, and this presents challenges of its own.

ACTIVITY and ATTRIBUTION:

The skinny is that with **STOCKS** we've basically put back the money removed in the fourth quarter of 2018 – and then some. In turn, we've allowed the market to do us one better and push the whole ahead by more than twice our contribution. Over the course of the last six months, we've made net additions to stocks of roughly 12% of December's values. In this, purchases running closer to 18% of that figure were combined with taking a slice out of issues "spiking" and/or overheld to reduce the net change. Significant additions were made in all sectors with the exception of Finance and Materials where opportunities appeared more limited. With the greatest part of last year's fourth quarter collapse concentrated in Technology, it should not be surprising that Technology received almost half our re-investment dollars.
If these efforts prove successful, then we will have helped re-diversify, raised prospective returns, and reduced short-term risks – all in the course of adhering to our disciplines and controls. Yet with anticipation of a tougher third quarter, progress could be slow before a more typical year-end rally.

In terms of attribution, returns ran strongest at the start of the year in January, and have steadily downshifted in contribution month-by-month through April before running negative in May. June then closed the six months with a solid bounce. Year-to-date more than half the dollar returns came from Industrials, Health, Finance and Technology. And happily, performance was strong across the board, running well into double digits in all but Energy and as high as 31% in Materials. Relative to their peers in the S&P1500 for the second quarter, our sector results outpaced in all cases with the exception Technology where our reassignment of a number of Fin-Tech issues out of Tech and into Finance probably accounts for some measure of the difference.

With **BONDS,** our progress was steady and constructive. In our defensive, high quality, short-maturity part of the market, returns ran consistently positive month-to-month. For the first time, we actually saw returns begin to match our Investment Plan expectations – though this was accomplished with the strong positive rate signals from the Fed. The likelihood of this gift offering further positives through the third and fourth quarter looks tenuous, and thus our expected activities attenuate upon the development of selective opportunities.

Random Gleanings

"Low interest rates, which foster leverage and speculation, require still lower rates to protect the fragile corporate structures that those very rates make fragile. Yet the battle against defining 'deflation' as a sub-2% rate of inflation is positively lost. And, yes, it is true that a decade's worth of low real funding costs may have so deeply wormed their way into the structure of finance that to raise those rates now is tantamount to forcing the next recession. Easy money takes no getting used to – it goes down like a cold glass of lemonade. What requires constructive adaptation is the absence of easy money.

That said, perhaps the yield curve has lost some of its predictive power following a decade of unconventional monetary policy. Since December 2007, the Fed, the European Central Bank, the Bank of Japan and the People's Bank of China have trebled their balance sheets to$ 19.4 Trillion. Today some $11.6 trillion's worth of debt trades at a yield of less than zero." James Grant, **Grant's Interest Rate Observer**, June 14, 2019.

"The traditional playbook says that with the current yield curve inversion investors should prepare for very weak economic growth, if not recession. And most investors are focused on the yield curve, but what if fiscal juice proves to be the better signal? Fiscal juice is as large today as almost at any time in the last 50 years. There is a widespread expectation that U.S. economic growth is poised to slow significantly in the coming year if not recess, but could this odd late-cycle fiscal juice put a floor under how much economic growth weakens?" James Paulsen, "*Beware… Fiscal Policy May Screw Up the Conventional Playbook?*" **Leuthold Group, LLC,** July 1, 2019.

"We think of bloodletting as we do of ultra-low interest rates. It can't be that if the first application fails, the next and the next and the next must succeed. What seems to be the irrefutable logic of brilliant people may just be a mistake. Sooner or later, humanity figures it out." James Grant, **Grant's Interest Rate Observer**, June 28, 2019.

"This early surge may be unsustainable as the gains in exports and inventories reverse due to the now raging trade war with China, and there is no assurance consumer spending will pick up the slack. Our deteriorating trade relations with China will exact a toll; the question is just how severe that toll will be. While the economy's fundamentals appear sufficiently sound to prevent a recession this year even without progress on global trade, activity will be more labored than in 2018. Yet the risks that a worsening backdrop dampens business investment, weakens industrial production, slows retail sales, and raises jobless rates is highlighted by the frequent frenetic action by which shares rise and fall." "*Selection and Opinion*", **Value Line Investment Survey,** May 31, 2019.

"The question is whether all of this is leading to a global recession with bear markets in stock prices around the world. The answer is most likely yes, if President Donald Trump's trade war with China escalates to the extent that he slaps a 25% tariff on all $500 billion of Chinese goods imported to the U.S. If a deal is struck this summer, as we expect, then there could very well be a "peace dividend" that boosts global economic growth with the flow of central-bank liquidity likely to push asset prices still higher, especially in the U.S. Indeed, a melt-up in stock prices is once again a possibility." Ed Yardeni, "*Morning Briefing*", **Yardeni Research**, June 11, 2019.

"I don't see a world in which we have either a meaningful contraction or meaningful expansion. We have completely taken away the toolkit of how normal economies should work when we started with QE. The odds that of a recession in any Western country are next to impossible now, save an unforeseen financial externality. The fact is central bankers have lost all intestinal fortitude to actually put a country through a recession" Chamath Palihapitiya (CEO of Social Capital), **CNBC Interview**, May 1, 2019.

"With most investors not anticipating a rebound in activity, there is room for growth surprises around the world. Investors expect little from the global economy outside the US, yet easing liquidity and financial conditions, a temporary shift in Chinese policy preferences and passing idiosyncratic shocks in Europe all point to improvement in global economic activity. Above potential growth in the US and rebound activity in the rest of the world are consistent with higher – not lower – US inflation. Most bear markets are linked to recessions. It follows that if the US business cycle can be extended and the Fed remains on the easy side of neutral for longer, then the S&P500 has more upside, and so do global equities."

"Profit components of our valuation indicator may look healthy today, but this may not remain the case. At 31.7% EBITD margins are currently extraordinarily elevated. In fact, if profit margins were to normalize to their historical averages, the Shiller P/E would skyrocket to 40.3 from 29.9 today, implying the stock market may be just as expensive as it was at the start of 2000. For margins to remain wide, wages will have to stay depressed relative to selling prices." *Monthly Forecast and Analysis*, **The Bank Credit Analyst**, April 2019.

"I think you will get new highs on all of the averages, and that takes you to where you say: "FOMO" – fear of missing out. One group sold a net liquidation of $148 billion in December and hasn't gotten back in. The second (complacent) group didn't sell in December, and are now ecstatic that everything has come back. New highs in the market will pressure each group to recommit. That may carry the market, but I think you have to be concerned about rising risks." James Grant quoting James Farrell, **Grant's Interest Rate Observer**, April 19, 2019.

"The threat to slap tariffs on Mexico over immigration immediately rattled markets. There's a sense that something's shifting in capitalism, and it isn't confined to American investors. Deutsche Bank's chief economist is regularly interrupted by clients asking about politics. Many of their questions are tough to answer because, "…we just don't know what form and what shape populism will come in. It's a new uncertainty, it's very uncomfortable, and it's everywhere." Craig Torres, "*A Bull Market for Wonks*", **Bloomberg Businessweek**, June 10, 2019.

"Vanguard feels the lure of private equity, and you could knock us over with a feather. The Vanguard Group built a business by buying the S&P500 at the lowest possible cost. Now it's weighing a new business of buying illiquid investments at a necessarily not-low cost. In a decade marked by historically low interest rates, return-starved pensions and sovereign wealth funds have poured money into private markets. The move has reshaped capital markets with the number of initial public offerings in the US down sharply from a high in the 1990's. The decline in US public listings raises questions about whether smaller institutions and everyday investor are getting left out of a burgeoning source of wealth - or not as we would say. In the 10 years through 2018, pooled returns of all private equity operators barely topped those of the S&P500." James Grant, **Grant's Interest Rate Observer**, June 28, 2019.

"Washington – and especially its antitrust power – was back on investors' radar with a vengeance this week, erasing in a single trading day almost $140 billion in the market value of Amazon, Facebook and Google parent Alphabet. The trouble began with reports that the Justice Department was opening an antitrust investigation of Google, while the FTC would probe Amazon and Facebook. As Monday progressed, reports added Apple to the list as well, and suggested the House Judiciary Committee planned its own antitrust investigations competition in the technology industry. With a market so focused on growth stocks, any weakness of these heavyweights and the lack of a clear leading sector may make it harder for the market to keep climbing. That's particularly true with trade policies that augment uncertainties." Michael Regan, "*Anti-Trust Wall Street*", **Bloomberg Businessweeek**, June 10, 2019.

CARDEROCK
CAPITAL® MANAGEMENT, INC.

SHORT TAKES
June 30, 2019

RESULTS

The **S&P 500 index** rose **4.30%** for the 2nd Quarter and **18.5%** Year to Date.

Stocks:

Size: – Large-Cap Stocks outperformed both Mid and Small Stock Indices during the 2nd Quarter.
S&P 500 Large-Cap 4.3%, S&P 400 Mid-Cap 3.1%, S&P 600 Small-Cap 1.9%

U.S. Economic Sectors: – 2nd Qtr. S&P 500 Index Sectors with Ranges from: –
S&P **Financials** rising **3.9%** to S&P **Energy** stocks losing **-6.2%**

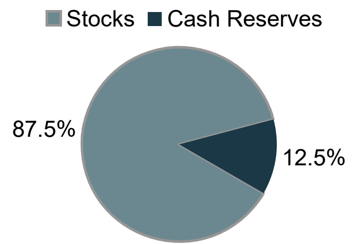
Bonds – Fixed Income returns were strong for the period based on lower rate expectations for the 2nd half of 2019. The Yield Curve inverted - 1 Month T-Bill (**2.18%**) vs. 10 Yr. Treasury (**2.00%**).

2nd Qtr. 2019 Returns:

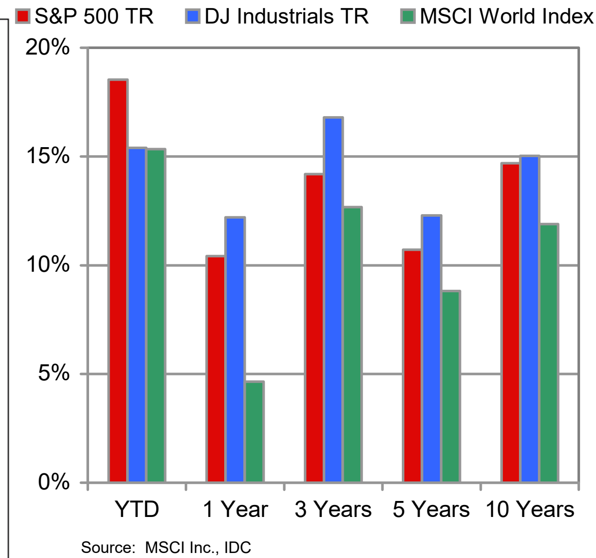
- Lipper Short-Int. U.S. Govt. Index: **1.5%**
- Lipper Short-Int. Municipals Index: **1.3%**
- iShares iBoxx **(LQD)** Inv. Grade Corp. Bond Index: **5.4%**
- iShares iBoxx **(HYG)** High Yield Corp. Index: **2.2%**

Source: Lipper, FactSet and Blackrock

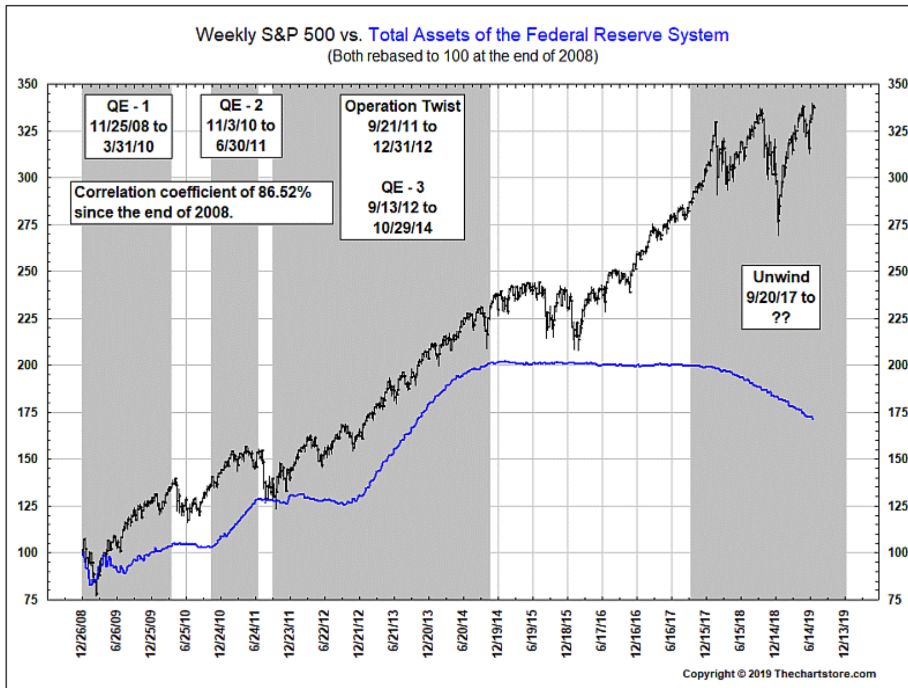
Carderock Equity Target Allocation



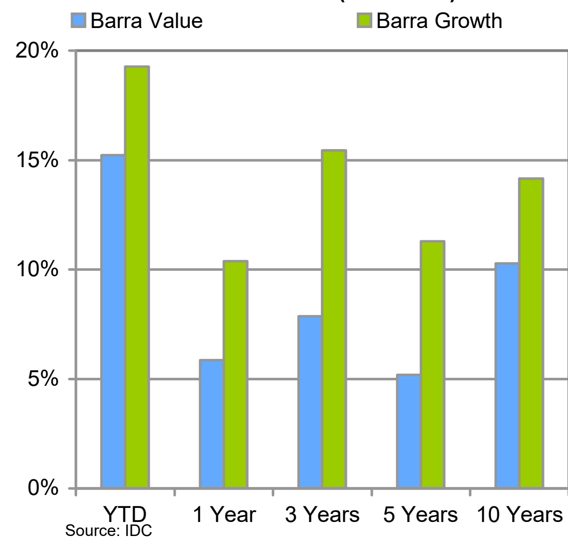
Global Stock Market Annualized Performance (6/30/2019)



S&P 500 Index vs. Federal Reserve Policy



Growth vs. Value Style Annualized Performance (6/30/2019)



U.S. Treasury Yield Curve – Real Rates