MP McShane Partners

August 2019 Insights

Investment Overview

When The Bond Market Speaks, Listen

Given the quizzical behavior of the capital markets recently, the reliability of the prophetical power of the bond market has been rightfully questioned by bullish market participants who claim the Federal Reserve's nontraditional, aggressive monetary policy has disrupted established market mechanics. Despite near-term dysfunction created by manipulative monetary policy, the Investment Team believes that the bond market's predictive power remains intact: the past does not always repeat itself, but a failure to respect and learn from it can have disastrous consequences in financial markets. Excessive levels of debt and leverage have consistently fueled prior economic recessions , and the bond market is an adept barometer of growth expectations and underlying credit quality. Historically, investors who have failed to heed signals from bonds have ended up paying the price.

With **±$13 trillion** and **±$25 trillion** of negative-yielding and below-inflation-yielding debt, respectively, the unprecedented level of monetary policy manipulation is clearly driving investors to take on more risk (*Source: Barron's*). The policy objective being to stimulate the deployment of "risk capital" and spending activity by disincentivizing saving, as negative interest rates guarantee an immediate, well-advertised loss in principal: **seriously, who would buy a bond where you are not only guaranteed to *underperform* inflation but,**

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Wealth Advisory Overview

What You Should Know About Regulation Best Interest

As financial professionals, we are often surprised by how little people know about the firms and individuals that manage their money. We all delegate tasks to other people: sometimes because we lack the tools, ability, or competence to perform the task at hand (i.e. tree removal), and sometimes because we simply do not want to do the task with which we are confronted. Other times, we may engage individuals because we feel like they can improve the outcome of our situation by imparting their wisdom, professional experience, knowledge, and skill. For instance, we generally know the level of education and licensing requirements for medical professionals and would probably not feel as comfortable with a heart valve salesperson performing our open-heart surgery vs. a licensed cardiovascular surgeon. When it comes to entrusting someone with our life's savings, however, people often make decisions because someone is friendly, convenient, or because they sponsor our daughter's softball team. While those are all good reasons to choose to work with someone, they should never be the ***primary*** reason! Therefore, it is important to understand the motivation and obligations of the professionals you hire to make important financial recommendations for you and your loved ones.

RIAs & Broker-Dealers

In general, the majority of all financial advisors fall into one of two broad categories: Registered Investment Advisors ("RIAs") and broker-dealers. RIAs

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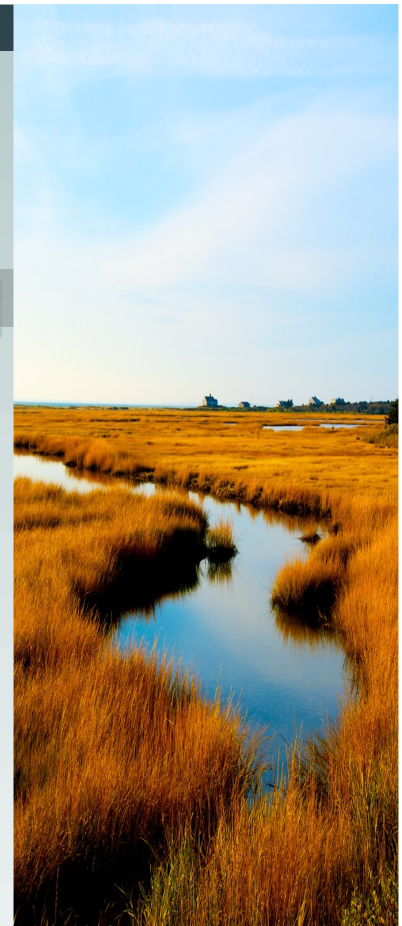

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Special Points of Interest

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also, lose capital? This, like many other current anomalies in the market, makes no logical sense which is why our process harkens back to the basics of investing. The bond market normally flashes warning signals prior to a recession-driven equity market correction. The premonitory symptoms of recession in the bond market primarily come in two forms: (1) yield curve inversion and (2) widening credit spreads. Recent headlines have focused on the current yield curve inversion of the U.S. treasury bond market and its predictive power, but we find widening credit spreads to be equally as important, with more imminent predictive power. Thankfully, they are behaving, for the time being, giving us relative comfort in staying actively invested in the market despite acknowledging the obvious warnings signals flashing in this mature market.

The normal correction course present in the majority of previous recessions is an inverted yield curve, widening yield spreads with associated outperformance of treasuries at the expense of high-yield and corporate bonds followed by deterioration in the equity market and finally a documented recession, defined as recorded negative gross domestic product ("GDP") growth. The graphic below outlines the approach and arrival of a typical recession. Currently, the yield curve is inverted, but the average time from inversion to recession is **±343 days**, so the inverted yield curve *without* widening credit spreads delays urgent reallocation given our relatively conservative positioning across investment portfolios.

Analysis of yield curve inversions as predictors of economic recessions is quite compelling,

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Progression to Recession

Yield Curve Inversion → **Widening Yield Spread** → **Equity Market Deterioration** → **Negative GDP Growth**

Yield Curve Inversion: Short-term treasuries trade at *higher* yields than longer-dated treasuries, producing an ominous downward slope (i.e., inversion) in the yield curve, suggesting investors are wary of long-term growth prospects

Widening Yield Spread: Widening spreads, led by both investment-grade and high-yield corporate bonds, indicate credit risk is increasing and bond owners are demanding higher rates of return

Equity Market Deterioration: ±20% drawdown in the equity market, crossing threshold into bear market territory

Negative GDP Growth: Documented negative economic growth (i.e., negative GDP growth) for two consecutive quarters indicates beginning of recession

Monthly Index Review
USD Total Return

Data as of July 31st 2019	July 2019	2019 YTD	2018	2017
S&P 500®	+0.66%	+20.24%	-4.38%	+21.83%
Dow Jones Industrial Average	+0.67%	+16.69%	-3.48%	+28.11%
NASDAQ Composite	**+1.08%**	**+23.94%**	-2.84%	+29.64%
Russell 2000	+0.38%	+17.66%	-11.01%	+14.65%
MSCI Emerging Markets	**-2.01%**	+9.50%	**-14.24%**	**+37.75%**
MSCI EAFE	-1.73%	+13.05%	-13.36%	+25.62%
Bloomberg Barclays U.S. Aggregate Bond Index	+0.34%	+6.35%	**+0.01%**	+3.54%

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registering only one "false positive" over the past ±50 years, as illustrated below in Chart I. The red portion of the yield spread in Chart I (**the dark blue line**) indicates instances where the spread between the yields on 10-Year U.S. Treasury Bonds and 3-Month U.S. Treasury Bills inverted. Notably, all of these instances preceded a U.S. recession, as depicted by the vertical blue bars in Chart I, except for the "false positive" in 1966-1967.

The Importance of the Yield Curve

Across fixed income markets, the concept of the yield curve reflects the fundamental relationship between interest rates and the *time value of money* ("TVM"). Normally, the difference between long-term and short-term interest rates (i.e., the spread) is indicative of the higher rates of return required by lenders when loaning money for longer periods of time: essentially, loans with longer-dated repayment terms (i.e., maturities) are priced farther out on the yield curve at higher interest rates than comparable loans with shorter-dated maturities. The spread also suggests that investors and lenders are relatively optimistic that, long-term, interest rates will rise, driven up by continued economic expansion: as such, an upward-sloping yield curve is considered to be a positive reflection of the health of the underlying economy. Conversely, a downward-sloping (i.e., inverted) yield curve is an ominous signal for financial markets, as it has been one of the more effective and consistent indicators of impending recessions as the bond market is predicting a slow down in growth and anticipating deflation resulting in lower yield expectations.

When short-term interest rates are higher than long-term interest rates, the slope of the yield curve becomes *downward sloping*. An inverted yield curve has been an exceptionally accurate predictor of recessionary periods throughout developed economies. According to research published by the Federal Reserve Bank of San Francisco ("FRBSF"), a negative interest rate spread between the yields on 10-Year U.S. Treasury Bonds and 1-Year U.S. Treasury Bonds has correctly signaled all nine recessions in the U.S. since 1955, with only one false positive in the mid-1960s, when economic activity slowed down but failed to decline to official recessionary levels (*Source: FRBSF 2018*).

Additional research has shown that spread analysis across other segments of the U.S. Treasury yield curve has certain predictive power as a *leading economic indicator* ("LEI"), as well, such as

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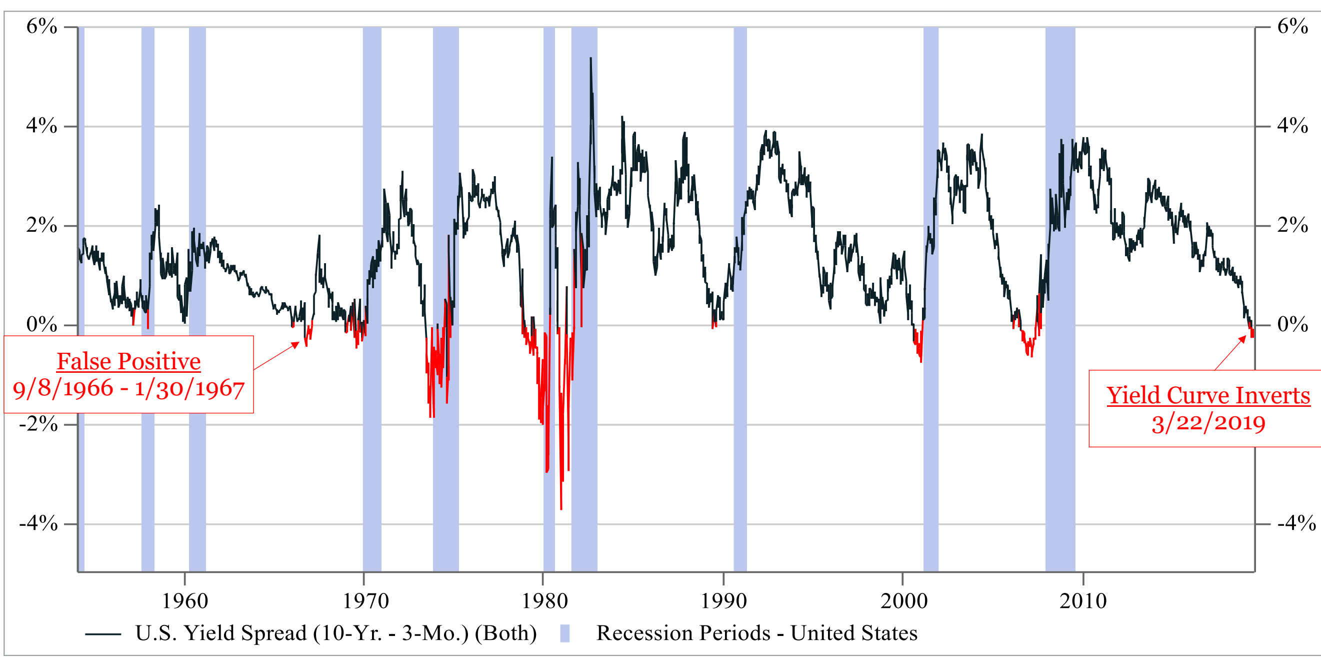
Chart I: U.S. 10-Yr./3-Mo. Treasury Yield Curve & Spread Analysis



Source: McShane Partners - FactSet Research Systems, Inc.

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the spread between the yields on 10-Year U.S. Treasury Bonds and shorter-term 3-Month U.S. Treasury Bills (i.e., the U.S. 10-Yr./3-Mo. Treasury Spread), which the Investment Team has illustrated previously in Chart I. Over the past 50 years, the U.S. 10-Yr./3-Mo. Treasury Spread has consistently inverted and dipped into negative territory, on average, a little under a year prior to the U.S. economy entering into a recession. As indicated below in Table II, the average timeframe from the initial inversion of the U.S. 10-Yr./3-Mo. Treasury Spread to the U.S. economy entering a recession is approximately **±343 days** (*Source: FactSet Research Systems, Inc. & McShane Partners*).

While there are several technical variables and explanations as to why an inversion in the yield curve has been such a consistent predictor of recessionary periods, much of the fundamental explanatory power can be attributed to the fixed income markets' function as a leading economic indicator assimilating fundamental economic data into a cohesive outlook, as financial markets are forward-looking in nature. Short-term interest rates are primarily driven by monetary policy. However, the market cycle drives long-term interest rates which anticipate a late-cycle slowdown in economic activity while facing the Fed's near-term manipulation of interest rates as a factor in credit availability. As a result, as central banks (e.g., the Fed) begin to normalize monetary policy by raising short-term rates from unusually low levels, the shape of yield curve gradually flattens, and eventually, inverts.

"The worse a situation becomes, the less it takes to turn it around - and the bigger the upside."

- George Soros

The Importance of Credit Spreads

Credit spreads measure the difference in interest rates (i.e., coupons) on corporate bonds and U.S. treasury bonds with the same maturities. Alternatively, it is the incremental coupon a fixed income investor requires to buy and hold a corporate bond vs. the risk-free interest rate provided by a U.S. treasury bond with a similar maturity, implying that a bondholder should be compensated for the incremental *credit risk* (i.e., potential default risk) associated with owning a corporate bond. When credit spreads *widen* (i.e., increase), this means that bondholders require a *higher* rate of return to compensate them for a perceived *increase* in the credit risk of corporate bonds - relative to treasuries - and tends to signal increased investor concern regarding credit quality.

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Table I: Yield Curve Inversions & Recession Timelines

Date of Yield Curve Inversion	# of Consecutive Days Inverted	Date of Next U.S. Recession	# of Days to Next U.S. Recession
12/30/1968	39	1/2/1970	368
6/1/1973	384	12/3/1973	185
12/15/1978	501	2/1/1980	413
10/27/1980	141	8/3/1981	280
7/21/1989	3	8/1/1990	376
8/1/2000	170	4/2/2001	244
7/17/2006	315	1/2/2008	534
		Average	±343 Days

Source: McShane Partners - FactSet Research Systems, Inc.

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As can be seen below in Chart II, corporate bonds, both investment-grade (**the light green line**) and high-yield (**the red-orange line**), experience credit spread widening ahead of the U.S. economy entering the two most recent recessionary periods, as evidenced by the upward slope in each line, which spike and hit peak levels at in the depths the recession. As the recession matures, these lines retreat, signaling the corresponding end of the respective recessionary period and often the bottoming in equity markets. As you can see, the spreads are currently very low indicating investors are not concerned with credit quality or risk.

As indicated in Table II, below, credit spreads consistently widened for an average of **±464 days** leading up to the last two U.S. recessions; moreover, the average time from the initial perceived

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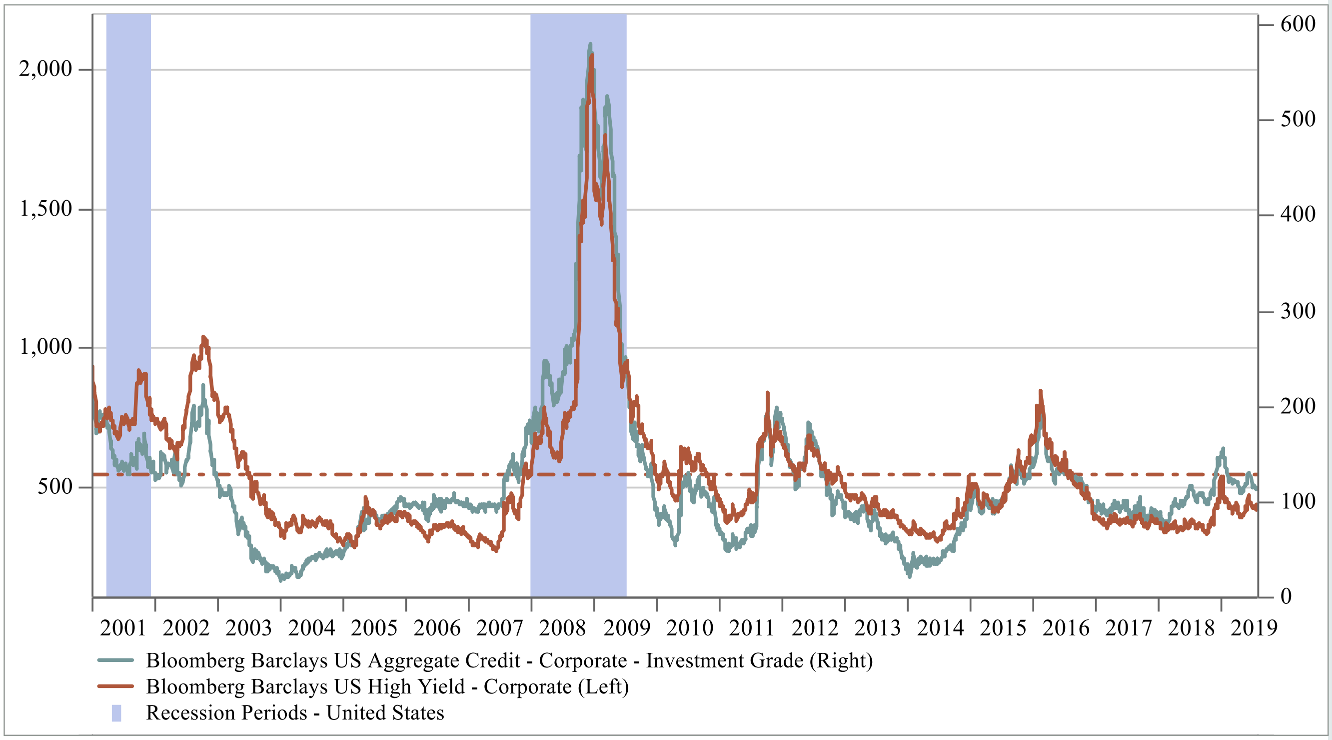
Chart II: U.S. Investment Grade & High-Yield Corporate Credit Spreads



Source: McShane Partners - FactSet Research Systems, Inc.

Table II: Credit Spread Widening & Recession Timelines

Credit Spread Indicator	Widening Start Date	# of Days Widening	# of Days to Next U.S. Recession
FDS U.S. Corporate Bond AAA (vs. 10-Yr. Treasury Bond)	January 4th 2000	337	454
Bloomberg Barclays U.S. High-Yield Corp. (vs. 10- Yr. Treasury Bond)	January 31st 2000	343	427
FDS U.S. Corporate Bond AAA (vs. 10-Yr. Treasury Bond)	June 14th 2007	634	202
Bloomberg Barclays U.S. High Yield Corp. (vs. 10- Yr. Treasury Bond)	June 21st 2007	544	191
	Average	**±464**	**±318**

Source: McShane Partners - FactSet Research Systems, Inc.

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widening in credit spreads until the "designated" beginning of the recessionary was **±318 days** - *less than* a full calendar year.

Summary & Outlook

Although the consistent predictability of the dreaded inverted yield curve can be crippling and warrants respect, the absence of widening credit spreads keeps us cautiously constructive with respect to our near-/intermediate-term outlook for global financial markets. Were credit spreads to suddenly, or imperceptibly, begin to creep up and widen, we would become increasingly cautious. Given the startling amount of debt in the system, as well as the Federal Reserve's determination to keep credit conditions accommodative, it is our expectation that credit spreads will begin to widen over the next **±12-18 months**, as there is already an irresponsible and uncomfortable amount of debt on consumer, corporate, and sovereign balance sheets.

Second Quarter 2019 Economic Overview Webinar

Date: Tuesday, August 13th

Time: 10:00 AM EST

Registration Information

Please use the following link or be sure to look for additional registration reminders, which will be sent out in the days leading up to the webinar.

To register for the webinar, please click here.

A recording will be available on our website after August 15th.

Stock & Strategy Spotlight

Name	Ticker	2019 YTD
Cal-Maine Foods, Inc.	CALM	**-4.99%**

Description & Investment Thesis

Cal-Maine ("CALM") is the largest egg vendor in a fragmented market, wherein it is the "acquirer-of-choice" allowing it to grow its share of the egg market. Shares of the company are highly correlated to the price of eggs, which is currently depressed given recent oversupply issues. During prior periods of oversupply, these inefficient supply-side dynamics have corrected themselves relatively quickly, as farmers actively reduce their "layers" (i.e., female chickens laying eggs) to achieve better, more attractive pricing, effectively stabilizing the market and reverting or adjusting to equilibrium supply-demand levels. During this most recent period of temporary oversupply, the corresponding drop in egg prices has predictably materialized in disappointing earnings for the company, which has, in turn, translated into disappointing performance for shares of CALM. Historically, this has been a good entry point to buy the stock. Currently, the company has an extremely healthy balance sheet and strong fiscal positioning, making *price-to-tangible book value* ("P/TBV") an appropriate valuation metric for shares of CALM. The company's normalized P/TBV multiple has historically fluctuated between a range of approximately **±1.8x** to **±4.0x**. Currently, shares of CALM are trading at a P/TBV multiple of **±2.1x**; therefore, even if the multiple were to deteriorate and the stock traded at the lower end of its historical range (i.e., **±1.8x**), the Investment Team believes the implied downside would be limited to **-13.0%** from current levels. Conversely, if the stock were to stabilize at normalized long-term mean/median valuation levels and trend upwards towards the premium range of ±**±4.0x**, the implied upside from current levels is almost **+100%**. As such, the Investment Team believes the relative risk-reward proposition in shares of CALM is extremely compelling and justifies owning the stock at current levels across long-term investment portfolios, even if it requires waiting for supply-demand dynamics to return to equilibrium.

Wealth Advisory Overview

What You Should Know About Regulation Best Interest

are *fiduciaries*, while broker-dealers are not. Currently, broker-dealers are held to a *suitability standard* when offering financial and investment advice, which is not the same as the *fiduciary standard* for RIAs. This means that their advice must be "suitable" for their clients' needs at the time the advice was given. The suitability standard is less stringent than the fiduciary standard and can lead individuals to give advice that benefits the financial advisor or their firm over the client.

RIAs, in contrast, are held to the fiduciary standard. Fiduciary is a fancy term that simply means an advisor is required by law to offer financial and investing advice that is in the best interest of the client, not the firm. In addition to being held to a fiduciary standard, the other main difference between an RIA and a broker-dealer is in the way in which an advisor is compensated. RIAs can charge their clients a percentage of assets under management ("AUM"), a fixed fee, or an hourly fee. They are *not* permitted to accept commissions from any products used by their clients. Broker-dealers, on the other hand, often receive most of their compensation through commissions based on the investment products they recommend and sell to their clients. Therefore, it can be difficult to ascertain the total amount that broker-dealers are earning from your investments.

Regulation Best Interest ("Regulation BI")

In June 2019, the U.S. Securities & Exchange Commission ("SEC") adopted Regulation Best Interest ("Regulation BI") by a 3-1 vote. Regulation BI is the first significant change to investment-advice standards in more than two decades. In its introductory paragraph, Regulation BI states that the SEC intends to, "improve investor protection by: (1) enhancing the obligations that apply when a broker-dealer makes a recommendation to a retail customer… and (2) reducing the potential harm to retail customers from conflicts of interest that may affect the recommendation."

Three Points to Note

Regulation BI will raise the standard for broker-dealers from "suitable" to "best interest" - while most experts agree this is a step in the right direction, "best interest" is *still less* than the fiduciary standard required of RIAs. In addition, the definition of "best interest" has yet to be clarified, interpreted, or policed, and most of the new rules rely on investor disclosures to satisfy the requirements around conflicts of interest, rather than prohibiting them.

1. Regulation BI prohibits some, but not all, sales contests and quotas. While product-specific contests are no longer allowed, asset accumulation and total products sold contests are still permitted. Therefore, this may still incentivize recommendations that are motivated by the broker's self-interest.
2. Reg BI is set to take effect in 2020, however proposed legislation may prevent its ultimate adoption. The Regulation has been widely criticized for not going far enough to protect investors and for 'misleading investors into thinking that brokers who comply with the rule are putting their clients' interests first'.
3. Reg BI is an attempt by the SEC to prevent the worst abuses by individuals who are entrusted with your financial well-being. Therefore, it is important to understand how the person giving you financial advice is compensated, especially when you are making decisions based on those recommendations. McShane Partners is a Registered Investment Advisor, regulated by the SEC. We are required to act in a fiduciary standard with respect to our clients. We appreciate the ability to work on behalf of our clients free from conflicts of interest because it ensures that we are always recommending what we truly believe to be in your best interest.

Around McShane Partners

McShane Partners Attends 40th Annual Estate Planning & Fiduciary Law Program

Daniele and Leah traveled down to Kiawah Island this month for the *40th Annual Estate Planning & Fiduciary Law Program*, which is a two-day event attended by attorneys, CPAs, trust companies, and other estate planning professionals from North Carolina. McShane Partners hosted an afternoon Cabana pool party at the Sanctuary Resort.

One Great Day of D.E.A.R.

Freedom School Partners

McShane Partners enjoyed connecting with students during the Marie G. Davis Freedom School "**D**rop **E**verything **A**nd **R**ead" Day!

On Wednesday, July 17th our team supported a city-wide *One Great Day of D.E.A.R*. Each volunteer was paired with a scholar to spend an hour reading books followed by a craft. It is a wonderful opportunity to share your love of reading and connect scholars to supporting our local community.

Classroom Central

Classroom Central

SUPPLYING OUR STUDENTS

McShane Partners collected supplies for Classroom Central this summer. Classroom Central serves more than 127,000 students and their teachers across 6 school districts in 199 high-poverty schools.

Classroom Central's mission is to equip students in need to effectively learn by collecting and distributing free school supplies to their teachers.

McShane Partners Beats the Heat!

Be sure to ask about our new beach towels and sunscreen before summer's over!

McShane Partners' Second Quarter 2019 Economic Overview Webinar

We invite you to join us for our Second Quarter 2019 Economic Overview Webinar on **Tuesday, August 13th at 10:00 AM EST**.

This is a dynamic and interactive opportunity for clients, colleagues, and friends to hear McShane Partners' CEO and Chief Investment Officer, Daniele Donahoe, discuss our thoughts on the significant financial, economic, and political developments throughout the quarter, as well as our perspective on current economic conditions and our near term outlook for global financial markets.

To register for the webinar, please click here.

McShane Partners

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

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