Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook – 2018 Begins

The U.S economy is experiencing a broad-based expansion with industrial activity gaining and consumer spending showing very solid results. As we enter 2018, business and consumer confidence continue to climb. Such broad participation augurs well for 2018 during which time the nation's gross domestic product is likely to expand at an annual rate approaching 3%.

Moreover, recent government legislation that significantly reduced the corporate tax rate from 35% to 21% will boost corporate profits in 2018 and going forward. This legislation could also lead to acceleration in wage growth that should provide added support for the economy, for both the consumer and corporate America.

On Friday, January 26th, an article in *USA TODAY,* written by Adam Shell, titled "Did your company pay you a bonus with tax savings?" stated the following:

> "More than three dozen of the biggest American companies have shared their tax-cut windfalls with employees, mostly through one-time bonuses but also with hourly wage increases and bigger 401(k) matches, following the new tax law passed in December. As of Friday, at least 39 companies in the Standard & Poor's 500 index have said they are providing additional financial rewards to workers, citing benefits from the new tax law, according to a *USA TODAY* analysis of corporate press releases and company statements, as well as other forms of publicly available communications."

Noteworthy is that most of these cash payments are not wages, rather one-time bonuses. Importantly, wage inflation will not likely be impacted by the awards. This is because bonuses are considered "irregular payments" and are not included in the government's widely watched average hourly earnings (AHE) compensation measure.

That being said, while inflation remains remarkably subdued, the current brisk pace of business activity has also resulted in some modest increases in costs for housing, utilities and medical care. This has not fallen on "deaf ears" at the Federal Reserve. Their policy of gradually increasing interest rates, in small increments, should be expected during 2018.

Reported fourth-quarter 2017 earnings have been encouraging, with most corporate results doing very well and largely exceeding forecasts. In fact, many Wall Street analysts appear to be a little behind the curve when it comes to accounting for lower corporate tax rates and how that will impact future earnings. Companies have also just begun to update their 2018 revenue and profit guidance. This, along with a healthy macroeconomic global backdrop, suggests that a lot of upward earnings revisions are likely to be announced in the months to come.

Summary: If progress on the corporate earnings front continues to meet expectations, the bull market is likely to continue. This constructive outlook also assumes that the tenuous global geo-political landscape is contained, that optimism about economic expansion continues and that the Federal Reserve will proceed cautiously on interest rate increases.

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Investment Strategy: Our investment strategy has remained constant since the last letter we wrote in October 2017. At that time we stated the following:

> "With overall positive economic fundamentals most likely to be in place for 2018, and perhaps beyond, our investment strategy continues to seek out high-quality companies, both in the U.S. and abroad, that have an attractive growth profile, a strong balance sheet, and are reasonably priced in the market. These are among the criteria that we employ during our research process as we strive to identify new investment ideas. Companies that qualify for inclusion in our client investment portfolios need to measure up to this research discipline and pass the test.
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> "This time-tested approach of carefully evaluating corporate fundamentals and the industries in which they operate reduces the element of negative surprise and provides a measure of downside protection when the stock market experiences periodic setbacks."

Being mindful of the longevity of the present bull market run, we are increasingly selective in adding new ideas to our client portfolios. If anything has changed from a few months ago, we are now tilting our research and security selection more toward non-U.S markets where there is wide-spread macro-economic improvement and where consumer spending and industrial expansion is occurring. This focus is likely to be an important investment strategy during 2018, especially in emerging markets.

In the U.S, we will continue to seek investment opportunities in companies that are beneficiaries of the new administration's policies, especially in the area of infrastructure investment, both by the government and by corporate partnerships. In addition, we continue to favor aerospace/defense companies that will benefit from a significant increase in government military spending over the next few years. Also, as the increase in interest rates develops, companies within the financial sector will become increasingly attractive as investment vehicles.

Many companies within the industries mentioned above, both in the U.S and abroad, appear to be well-positioned to take advantage of these developing trends and should have continuing success reporting above-average revenue and profit growth, both in the short term as well as over the longer run.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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