Investment Review and Outlook – 2019 Begins

The Economy – A Stumble Out Of The Starting Gate:

The U. S. economy is stumbling in early 2019 with effects from the partial government shutdown, softness in existing home sales, an easing in consumer sentiment and scattered weakness in both manufacturing and non-manufacturing activity. In addition, there remains uncertainty about global trade with China and an economic slowdown among some other global partners. On the positive side, there was a large increase in December job growth. 2018 experienced more job creation than during the two previous years.

Although there was a conditional agreement by Congress and the President to reopen the Government last Friday, the 35-day shutdown took its toll on the economy in the form of lost income, reduced consumer spending and delays in capital investments. It is estimated that each week the government was shut down, Gross Domestic Product was negatively impacted by about 0.1%, a reduction of about 0.4% for Q1 2019.

The agreement to reopen the government is essentially a three-week truce until February 15th. If negotiations between Congress and the President remain deadlocked and prevent an agreement to secure the southern U.S. border with a funding plan, a further negative economic impact could result. Even without the impact of the 35-day government shutdown, it may have been a struggle for the economy to exceed more than 2% growth during Q1 2019, compared with the 3.4% reported for Q3 2018 GDP.

Overall, however, the U.S. economy is likely to be on firm ground, once the government shutdown ends permanently. Strength in most consumer and industrial sectors should be sufficient for GDP growth to move back into the 2-2.5% range for the full year 2019, despite the slow start to the year. An important component of this outlook is the historically high level of employment and income growth. Consumer spending accounts for more than 70% of the economy and is the driver of long-term economic growth.

Fourth Quarter 2018 Corporate Earnings Results – Continuing To Exceed Expectations:

Corporate earnings season is shaping up nicely and living up to analysts' expectations. With more than 70% of S&P 500 companies reporting thus far, there have been many more positive earnings surprises, exceeding forecasts for Q4 2018, than those that missed expectations. Overall, earnings are expected to show a 10% gain for the final quarter of 2018. Although that would be a slightly smaller rise than in recent periods, it is very respectable given the duration of the current business cycle. Companies have capitalized on recent economic growth and benefited from the Tax Cuts and Jobs Act, lowering taxes.

The Federal Reserve – Further Interest Rate Increases? Not So Fast!

Given the recently uneven business environment in the U.S., it appears increasingly likely that the Federal Reserve will be less inclined to raise interest rates again anytime soon. In fact, Federal Reserve Chairman, Jerome Powell, recently lifted investor spirits by suggesting that the central bank would be "patient and flexible" in making future interest rate adjustments.

It has only been a couple months since the Federal Reserve signaled that several interest rate hikes might be forthcoming during 2019. However, now the Fed is announcing a more patient approach, which also suggests an acknowledgement of moderating economic conditions. This development was likely the result of what the seven Fed Governors observed within the twelve Federal Reserve Districts.

Moreover, it has even been suggested by some who are close to the Fed Governors that they may vote to reduce interest rates at some time during 2019, mindful that monetary policy may need to become more accommodative again in support of sustainable economic growth. Although this seems a bit premature, it also suggests that a spirit of openness to a possible policy change exists among the Governors, which pleases investors who have been concerned about further interest rate hikes over the near term.

China – A Trade Agreement Is Looking Better But Caution Is Required:

China and the United States appear to be making progress toward reaching a trade agreement as Beijing is coming under increasing pressure to make a deal. This week in Washington, the U.S. and China will hold their highest level talks since the two sides struck a temporary truce to their trade war last November. The two countries have until March 1st to develop a compromise on their differing trade issues or additional trade tariffs will likely be put into effect by the U.S.

The trade war may not have caused China's recent slowdown, but it is definitely making things worse for the country. Growth data released last week showed China posted the slowest expansion rate since 1990. Other trends are more troubling including a decline in consumer sentiment and rapidly weakening retail sales. Increasing pressure on the Communist Party leaders is evident because of a weakening economy. This was underscored by rare commentary by President Xi Jinping, whose legitimacy is based in part on keeping the Chinese economy strong and its 1.4 billion people happy. The U.S. and China reportedly are having trouble agreeing on safeguards for U.S. technology and intellectual property. A recent offer by China to increase its U.S. imports by $1 trillion over a 6-year period appears to be more of an attempt to "change the conversation" than to address the core problem of intellectual property piracy by the Chinese.

Conclusion and Investment Strategy: Despite The Negative "Breaking News," We're OK:

Despite the "stumble out of the starting gate," the stock market bulls are back, as they are pushing stocks solidly higher once again, after a sharp selloff late last year. At that time, worries about high valuations, slowing earnings growth in 2019 and rising interest rates took much of the bloom off the investment rose. These concerns have now been muted as security valuations are more in line with historic levels and investors are finding equities attractive again. This is supported by current company earnings reports exceeding expectations. In addition, a strong signal from the Federal Reserve that their policy will be "patient and flexible" is reassuring and comforting for Wall Street. Investors who wisely refused to panic during the fourth quarter of 2018 are now benefiting from the latest rebound. However, from time-to-time we also expect periods of security price volatility and will take advantage of that to benefit portfolios.

During the period ahead we will be exercising care in stock selection, focusing on companies with solid balance sheets and the ability to sustain a rising stream of attractive dividends. Security valuation will be a key ingredient as we evaluate both revenue and earnings prospects for the next 12 to 18 months.

Historically, a calm hand on the wheel at this time in the investment cycle has proven to be critical in terms of capital preservation and identifying opportunities, whether in stocks or safe havens such as U.S. Treasuries or high-grade corporate bonds. This will be our strategy going forward as the present bull market environment continues to be resilient with impressive staying power.

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January 28, 2019