Investment Review and Outlook – Fall 2015

Interest Rates and the Federal Reserve:

The Federal Reserve will meet on Oct. 27th and 28th to determine if there is sufficient reason to adjust its monetary stance. Next week's gathering follows the one in mid-September when the Fed kept rates unchanged. It is interesting that the last increase in the Fed Funds rate occurred over nine years ago.

Traditionally, the Fed is focused on two variables in making monetary decisions: employment and inflation. As to employment, news is generally good with the unemployment rate at a multiyear low of 5.1%. However, the September jobs report was weaker than expected and the **labor-force participation rate** continued to decline, remaining at a historically low level of 62.4%. This measure refers to the number of people who are either employed or are actively looking for work. The **employment to population ratio**, which includes the proportion of the 15- 64 year old working-age population who are employed, declined to 59.2%, the lowest level during the two previous economic cycles.

Regarding inflation, the present level remains below the Fed's 2% target. Following recent reports on weak industrial and consumer prices, there is little to suggest that inflation will soon reach the Fed's 2% objective. Until recently, the general belief had been that the Fed would raise interest rates by the end of 2015. That assumption now appears doubtful. At this point, an interest rate hike by the Fed may occur further down the road to avoid nudging the U.S. economy into a recession.

Current Economic Landscape:

Meanwhile, the overall economy continues to edge forward and is experiencing a modest rate of growth. Advances in personal income and consumer confidence are translating into strength in new home and auto sales along with higher consumer services. On the other hand, manufacturing activity, especially for capital goods producers, appears to be slowing. This has largely been the result of the strength of the U.S. dollar and sluggish economic activity in several global economies, especially China, leading to a widening trade deficit. The overall rate of U.S. economic expansion is expected to remain positive for the balance of 2015 at approximately 2.5%, somewhat slower than the 3.9% advance reported for Q2 2015.

Third Quarter 2015 Corporate Earnings:

We are in the middle of the Q3 2015 "earnings season." Early results are mixed, as has been the case for several previous quarterly periods. What is noteworthy is that several companies have lowered their "earnings guidance" for future results due to the impact of the higher U.S dollar vs. other global currencies. Generally, companies with significant overseas business exposure have had disappointing results when the value of their offshore sales is translated back into U.S. currency. Conversely, U.S. companies with a dominant or exclusive domestic footprint are doing well.

Overseas Developments and Middle East Tensions:

Conditions are less settled overseas than they have been in some time. We see economic slowing in China and across portions of Europe and Latin America. Also, confrontations in the Middle East are accelerating. The unfolding drama involving Russia, Syria, and the U.S. defies a solution for now. A festering situation, reminiscent of the long-dormant Cold War, is now seeing Russia and the U.S at odds over Syria. Recently, Israel has also been under serious attack by dissidents. We are very mindful that short-term developments abroad could lead to asset price volatility in international financial markets and could eventually have an effect on the U.S. economy. We monitor these developments continuously.

U.S. Stock Market:

The stock market seems to have thrown off the early Fall setback, although developments on the global economic stage and the geopolitical landscape continue to be unsettling. The frequency of surprises over the past few months and ongoing uncertainty relating to Federal Reserve policy have conspired to keep global securities market volatility more pronounced, especially since mid-August.

Currently, investors generally remain in a forgiving mood despite the recent unnerving market gyrations. This also explains the absence of extended market selloffs beyond a few trading sessions. In fact, after all major U.S. equity market indices recorded a decline for the third quarter, the stock market perked up again. As we moved into early October, reduced valuations made stocks attractive once again. As outlined earlier, the basic economic trends look sufficiently positive and support an optimistic outlook for equities for the balance of the year, albeit a cautious one. If a disproportionate number of corporate earnings reports are weaker than expected, or perhaps if there is an unwanted surprise from the Federal Reserve, we could see more volatility in global securities markets. However, given the present environment and duration of the economic cycle, securities markets are not expecting extraordinary growth in profits from corporations, just steady to rising results. Similarly, a measured Fed monetary policy with small adjustments, which is the likely scenario, would likely be received positively and could be absorbed by the markets.

Investment Strategy:

In late April 2015, we made the following observation relative to our investment strategy that we were employing at that time:

> ***"We are avoiding all energy companies, globally, at this time, and have sold our holdings as they are very likely to face significant headwinds, both revenue and profit for some time. We are also generally avoiding banks, due to global uncertainty relating to geopolitical and regulatory tightening. Selective choices among consumer non-durables, utilities and telecoms companies with higher than average dividend yields should continue to add ballast to investment portfolios in the period ahead." --- April 24, 2015***

In general, our broad investment strategy is relatively unchanged from what is stated above. The significant decline in oil and commodity prices continues to have a wide-ranging impact on the U.S. economy, benefitting consumers while adversely impacting producers. Energy industry capital spending reductions and employee layoffs are also mounting. The avoidance of these investments in our portfolios will continue for the time being as global economic health, the outlook for energy demand, and the potential for further pricing pressure on oil and other commodities remains unclear. Any profit improvement for these companies will have significant headwinds in the period ahead.

We continue to be very focused on company research that identifies additional companies that stand out with greater defensive characteristics, both operationally and financially, as the current economic cycle is extended. We are especially drawn to companies with little or no debt in anticipation of a higher interest rate environment in the future that could penalize those firms with heavy debt loads as they face higher costs of borrowed capital. In looking at corporate America, the good news is that balance sheets continue to improve and are in significantly better condition than they have been in years, especially since the 2008-2009 periods. This positive financial development has also increased the universe of higher quality companies that are available as attractive candidates for investment in our client portfolios going forward.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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