Investment Review and Outlook – Fall 2018

The Current U.S. Economic Landscape:

The Commerce Department reported last Friday, October 26th, that U.S. gross domestic product expanded at a 3.5% annual rate during the recently completed third quarter. This was on top of a 4.2% growth rate in the second quarter of 2018, one of the best six-month stretches for the U.S. economy in the past decade, as most industrial and consumer categories showed strength. Increased government spending on military and infrastructure also aided results. The employment picture remains sufficiently bright to suggest further solid economic growth of approximately 3% for the balance of 2018 and 2019. While economic growth may advance at a slower pace in the coming months, current conditions are very strong. In September the jobless rate fell to 3.7%, its lowest point since 1969 and average hourly wages were up 2.8% during the past year.

The current business expansion appears well-grounded and capable of handling the present, tougher monetary stance by the Federal Reserve, as most sectors continue to press ahead at a healthy pace. A particularly welcome barometer, the index of leading indicators, has risen for 12 straight months. Also, the latest consumer price data suggests inflation will not push sharply higher anytime soon. In addition, third quarter 2018 corporate earnings reporting season is underway and results have generally been very strong. Of the S&P 500 companies that have reported results so far, 80% have exceeded profit forecasts.

The Federal Reserve – Interest Rate Outlook:

The Federal Reserve's monetary stance is now less accommodative than it has been over the past several years which has led to steadily rising interest rates. On September 26th, the Fed continued tightening its monetary reins with its third, one-quarter percent rate increase so far during 2018, as it endeavors to prevent excessive upward inflationary pressures or financial instability in the future.

Just today, however, the Commerce Department announced that the closely watched personal-consumption expenditures price index rose only 0.1% in September over August. We have now seen four straight months in which this index, the Fed's preferred inflation gauge, fell short of the monthly pace needed to meet its 2% annual target triggering interest rate adjustments. This is good news for advocates who favor holding off on a further rate increase in the near-term. On the other hand, proponents of staying the course of gradually increasing interest rates argue that policy changes take months to tamp down rising inflationary trends. And, rates are still relatively low, the unemployment rate is the lowest in nearly five decades and economic growth is strong.

A less accommodative monetary policy and a gradual "normalization" of interest rates would also help recapture the flexibility needed by the Fed to fight future business downturns, switching to a policy of monetary stimulus. Therefore, it seems prudent to anticipate the likelihood of another small interest rate increase by the end of 2018 and a series of small rate hikes during 2019.

Trade and Tariffs with China –Trump and Xi Jinping To Meet In November:

There is no question that a full-scale trade war would be detrimental to both China and the U.S. While it already appears to have had a negative impact on China's economy, it is also likely to have had an impact on the U.S. As a result, a "truce" of sorts between President Trump and President Xi Jinping at their private meeting during the G-20 Summit in November in Buenos Aires seems likely.

The two leaders could agree to delay tariffs planned for January with talks continuing to resolve differences between the U.S. and China on a new trade agreement. Both parties are likely to offer compromises. President Trump is unlikely to make demands that China would not accept and President Xi may be more flexible as well. As China's Vice-Premier Lie He revealed in a recent interview, "China and the U.S. are now in contact with each other." Stay tuned...

Wall Street's Current Focus:

In addition to the uncertain trade relationship between the U.S. and China, Wall Street is focused on several other factors. Most important is whether rising interest rates will create headwinds for the overall economy. Also, as the corporate earnings season unfolds, a watchful eye is evaluating results vs. expectations. As we have seen recently, investors have no tolerance for companies that report disappointing earnings or revenues relative to analyst's expectations, given the current level of stock market valuations, particularly in the technology sector. There is also uncertainty surrounding the mid-term elections and any potential change in the control of Congress that results in policy changes.

Internationally, there are also other concerns relating to the persistent woes in the Italian banking system and what impact that may have on members of the European Union, Great Britain, as it strives to exit the European Union and relations with Saudi Arabia, due to the recent assassination of a journalist who had been critical of the Saudi regime. How these concerns play out is of great interest to investors, especially as it pertains to the Middle East and our relationship with our allies. There are also worries about how economic weakness abroad could impact businesses in the U.S.

Conclusion and Investment Strategy:

The U.S economic expansion remains resilient. The backdrop is positive with most consumer and industrial markets continuing to press ahead. We expect further solid economic growth of approximately 3% during the balance of 2018 and into 2019, as long as current Federal Reserve policy is measured and higher interest rates are not a hindrance to continuing economic expansion.

In this environment, the stock market should be able to overcome the occasional headwinds, such as we are experiencing now. We expect occasional periods of security price setbacks and volatility. These are normal, especially following the stock market advance we have experienced for several years. During October, periods of sharp setbacks as well as recoveries in stock prices have provided opportunities to reposition investment portfolios, both buying and selling.

Stocks with well-above average dividends continue to be attractive in our client portfolios for relative safety. An example of this is AT&T which currently has an annual dividend yield of over 6%. All of our client portfolios have a meaningful position in AT&T. There are also other companies that have very generous, safe dividends that we are currently researching as candidates for our investment accounts. Finally, we are also targeting some fixed income securities, such as short duration U.S Treasury notes, which have become more attractive now that interest rates have risen. This is in keeping with our strategy of providing for asset preservation in client portfolios going forward.

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October 30, 2018