Investment Review and Outlook – Spring 2018

The U.S. Economy: The economy remains on track for a strong year, despite trade war concerns. Things should go smoothly as the spring moves along. Our optimism reflects the generally solid performances in core business and consumer categories, including durable goods orders that are at multi-month highs, leading economic indicators, a predictor of economic performance, now standing at the highest level in seven years. The unemployment rate has remained at 4.1% for the past 6 months and is now at the lowest point in 17 years, going back to February 2001.

For the full year 2018, GDP is likely to grow by approximately 3.0%, which would be the best annual performance since 2015. The overall economy is in a nice comfort zone, in which GDP growth should be supported by gains in both key consumer and industrial markets. Consumers and businesses alike will also benefit from "The Tax Cuts and Jobs Act", enacted in December 2017. Generally, most Americans will realize greater take-home pay, while businesses are likely to invest more in plants, equipment and technology, thanks to more liberal depreciation rules within the new tax law. In addition, the current surprising strength in housing starts and building permits is likely to continue, due to a combination of high demand and depleted inventories, and should have a positive impact on overall economic expansion during 2018.

Company Earnings: With nearly one-third of the S&P 500 companies reporting earnings and revenues for Q1-2018, almost all are stronger compared with the Q4-2017 earnings season. If this is maintained, earnings for the first quarter of 2018 will be the best reporting period in seven years. Of note, 83% of the companies who have reported earnings have exceeded analysts' expectations by an average of 7% since the last quarter of 2017, and had a gain of 28%, compared with the prior year. These early results are very encouraging. Improving business fundamentals and a reduction in the corporate tax rate from 35% to 21%, following passage of tax reform legislation, are combining to lift 2018 earnings appreciably.

The Federal Reserve: Not surprisingly, the Federal Reserve is becoming more aggressive, with the bank voting to raise interest rates last month. Expectations now are that the Fed will do so again in June and September but perhaps refrain from additional rate hikes for the balance of the year. Meanwhile, the Fed is unlikely to "break up the party" in their effort to prevent the economy from overheating. Importantly, with few imbalances in the economy, the Fed would appear to have plenty of room to maintain a pattern of gradual rate increases. Based on the Federal Reserve's projections of accelerating GDP growth, a possible uptick in inflation, and continuing low unemployment, we think the upturn in interest rates will continue into 2019, unless the economy stumbles.

International Trade Relations: A comparison of the trade data between the U.S. and its five largest trading partners: China, Mexico, Canada, Japan and Germany, is quite revealing and underscores significant concerns going forward. These five countries comprise over half of all U.S. imports. The U.S. imported the most goods from Canada until 2007 when China replaced our neighbor to the north. In 2017, these five countries supplied 58% of the $2.4 trillion U.S imports. Of the 58%, China alone accounted for 37% of that amount. More concerning, the U.S. has the world's largest trade deficit and that has been the case since 1975. The overall U.S trade deficit with all countries in goods and services in 2017 was $566 billion. China had a trade deficit with the U.S. of $375 billion, representing 66% of the total U.S. deficit with all countries.

The numbers speak for themselves: China's trade relations with the U.S. are a significant concern going forward. Beneath all the bluster and proposed tariffs, neither side wants a harmful trade war. Both countries seem to be cautiously edging toward possible talks to seek trade agreements that each can accept. The consequences of any newly imposed tariffs will be closely monitored by the Federal

Reserve and how any such actions might impact small firms, which are historically the first businesses to react to changing economic conditions, good or bad.

Domestic and International Unrest: The "plate is pretty full" with uncertainty relating to ongoing and broadening investigations in Washington, a severely fractured Congress, growing mistrust of some of the highest level departments of the U.S Government, namely the FBI and Justice Department, along with serious immigration policy issues. Add to this, heightened tensions in the mid-east and our uncertain relationships with Russia (on a wide range of issues) and China (primarily trade). The ebb and flow of these issues continue to bother both Main Street and Wall Street.

The Korean Peninsula: One of the most unexpected developments on the global stage in a long while occurred last Thursday when Kim Jong Un became the first North Korean leader to set foot on South Korean soil in the 65 year period since the Korean War. The fighting commenced on June 25, 1950 and ended three years later on July 27, 1953, when an armistice, not a *treaty*, was signed, creating the Korean Demilitarized Zone that separated the North and South and allowed the return of prisoners. There were over 54,000 casualties during the war with 7,700 American soldiers still unaccounted for. However, no peace treaty was ever signed and the two Koreas are technically still at war. The two countries have been confrontational on the Korean Peninsula ever since, despite their agreement to stop fighting.

The South Korean President, Moon Jae-in, was at the site of the demilitarized zone to greet Kim Jong Un. What eventually followed was a formal meeting and discussions with representatives from both North and South Korea. Later, at a state dinner, each toasted a new beginning for their countries and to work toward a combined Korean Peninsula. Kim Jung Un reportedly agreed to make an anti-nuclear pledge and discussed a peace treaty to officially end the Korean War.

Given the history of North Korea's actions regarding human rights and indifference toward the welfare of the North Korean people, along with their failure to adhere to previous diplomatic agreements, a large measure of skepticism is appropriate concerning this recent development. However, this historic event could also be a catalyst for possibly starting a long-term process of reuniting the Korean peninsula, benefitting all Korean citizens and improving their world standing by working for peace. This development is also an important element in the preparation for the expected summit meeting between Kim Jong Un and the U.S in coming weeks.

Summary and Investment Strategy: Investors have a lot to ponder, with alternating optimism and pessimism on the trade front, cheering the good news on the economy and strong first quarter 2018 reported earnings, uncertainty regarding future Federal Reserve decisions and an assortment of issues, both domestic and abroad. From time to time, these issues will create volatility in both equity and fixed income securities markets.

Our sense is that political flaps or overseas flare-ups will not affect the longer-term direction of equities. Bull markets typically end with declining GDP, rising inflation, a decline in corporate earnings and a dramatic rise in interest rates. None of these factors are in view at the present time, although the recent climb in Treasury yields does raise a warning flag.

Meanwhile, Corporate America is buoyed by the new tax legislation and a strong economic fundamental backdrop. We are optimistic about the U.S. economy and see attractive investment opportunities in the global arena, both domestic and international. While we continue to maintain a very careful approach to security selection and portfolio construction, we have a sharp eye trained on limiting risk. As we have said repeatedly, our long term investment objective is asset development and capital preservation. At this point in the economic cycle, capital preservation is at the forefront of our strategy.

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