Investment Review and Outlook – Summer 2016…

Modest U.S. Economic Expansion Continues Along With Divisive Presidential Politics

In January of this year, we addressed the presidential campaign in its early stages and commented on how unconventional and troubling it was even in the early going of the primary elections. While uncertainty should be expected regarding unforeseen developments that could result in dramatic policy changes impacting the U.S. economy, our observation turned out to be even more appropriate than we could have imagined. In a few months, we will be choosing between two of the most controversial presidential candidates in our history and many have questioned the personal qualities of each candidate relating to trustworthiness, honesty, credibility and, importantly, the ability to galvanize the country to heal many of the wounds in today's society. Furthermore, if some of the far-ranging, often divisive statements made by both candidates were ever to became policy, profound changes could result in our economy and society. In January, we made the following observation regarding the possibility of radical change from policies now in place:

> "A possible 'sea change' in government policies, compared with the past 7 years, could impact such areas as the federal tax code, our transitioning healthcare system and new priorities in government spending, making 2016 a year of continuing challenges for the U.S. economy and the investment community." - January 29, 2016

I would now add that the newly elected president will likely face the most significant, difficult challenges in our lifetime, perhaps never seen before. New policy decisions will have a far-reaching impact on both our domestic economy as well as the global economy, especially relationships with our trading partners. At home, new tax-based incentives are needed for the growth of small businesses and for plant and equipment capital spending, while promoting a workable regulatory environment. Stimulative measures will be critical to generate a higher rate of economic growth in the future. A troubling fact is that the current, seven-year economic expansion is the slowest since World War II, averaging only 2.1% growth annually.

Also extremely challenging for any new administration will be how our society's numerous, very serious problems are handled and how we represent ourselves as a nation to those abroad. How we use our personal freedom of speech, communicate through social media, relate to each other as individuals, develop improved policies for Homeland Security, cyber security and immigration, improve our judicial system and confront the spreading threat of global terrorism all need to be key elements of a plan to regain our leadership role and respect on the global stage. While this is hardly a complete list of challenges, it is one that will be very daunting for anyone who is the next President of the United States.

U.S. Economy – Sluggish Growth Continues:

Today, July 29th, the Commerce Department released its report on the health of the U.S. economy for the second quarter of 2016. Gross domestic product (GDP), the broadest measure of goods and services produced across the country, grew at an annual rate of just 1.2%, about half of consensus forecasts and underscoring the fact that the economy continues to expand at a very slow rate.

The GDP report was in some ways at odds with other recent gauges of the economy. The unemployment rate has been relatively low and job gains were well-above expectations in June, the strongest reading since last October. Home sales also rose to a post-recession high and consumer spending expanded at a 4.2% annual rate, the best reading since late 2014. Consumer confidence rebounded sharply in June, generating the largest advance since late last year, and wages have begun to rise. Nevertheless, the recent GDP report did not confirm expectations that overall economic growth was accelerating.

The U.S. economy is being held back by a lack of business investment and is having difficulty escaping the slow level of expansion experienced over the past several years. During the second quarter, business inventories also edged lower, perhaps due to uncertainty surrounding the presidential election and potential new policies as well as concern about the overall strength of several key international economies and how that might impact trade with the U.S. In addition, there are concerns relating to the United Kingdom's exit from the European Union and the future economic health of the EU. The second quarter GDP measure was also affected by a lower level of government spending than had been expected.

Meanwhile, "earnings season" is now in high gear and there is relatively good news. With over 25% of the S&P 500 companies reporting results, 68% have exceeded Wall Street's cautious expectations. On balance, investors seem satisfied with generally positive corporate earnings reports for the recently completed second quarter and the accompanying corporate guidance by many companies for the balance of the year. This has given investors encouragement and also hope that the level of economic expansion could be elevated during the second half of 2016.

Looking to the future, the Federal Reserve recently reported that most areas of the country continue to experience modestly better business trends. Analysts' estimates for GDP growth during the balance of 2016 are for approximately a 2% rate of growth. This level reflects some pickup from the first six months but still a relatively slow economic expansion. As we move toward the important back to school and holiday shopping season, continued positive momentum in consumer spending, nearly 70% of GDP, will be a critical factor in how the economic landscape develops in the months to come.

Interest Rate Outlook:

The latest report by the Federal Reserve's Open Market Committee, released July 27th, made it clear that the current Fed Funds rate will remain unchanged and their policy will also continue to be accommodative. Their statement outlined the elements of their assessment going forward relating to the timing of any further interest rate increase during 2016:

> "This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments. The Committee continues to closely monitor inflation indicators and global economic and financial developments."

The last sentence is in direct reference to the unsettled outlook in many key regions of the world as well as the United Kingdom's recent vote to exit the European Union, referred to as "Brexit," and the potential global fallout that event may cause. Banking health, international trade and overall global economic growth will all be watched closely in the months to come. While investors seem to be getting more comfortable that Britain's exit from the EU will be rocky, but manageable, the key hope is that the EU survives.

As a consequence, any further interest rate increase by the Central Bank over the near term appears to be quite unlikely, especially with U.S. inflation being well contained and following the recent disappointing second quarter GDP report. Also, an increase in interest rates in the current environment would further strengthen the U.S. dollar against weaker global currencies and have a negative impact on U.S. trade activity as well as on many international economies, including China and the European Union. The Federal Reserve's challenge going forward will continue to be to extricate itself from years of unrelenting and often unconventional monetary accommodation. Such an unwinding process will not be easy and will take time.

The U.S. Stock Market:

At mid-year 2016, the major stock market benchmarks were nearly unchanged from where they started in January. During the six month period, there were a series of issues that were noteworthy. Initially, there was fairly wide concern that the Federal Reserve might raise interest rates as the year progressed, following the December increase that was the first in almost a decade. There was also a continuing decline in the global price of oil and unsettling economic news coming out of China and Europe. These concerns set the stage for a setback in stocks early in 2016. However, once oil rebounded and the Federal Reserve signaled that it would not be raising interest rates in an economy that was barely expanding, the stock market recovered nicely. Then, in late June when the Brexit vote occurred, with the result that Great Britain was going to leave the European Union, investors across the world were unprepared and securities markets sold off.

During July, the U.S. equity market rebounded following the global over-reaction to the Brexit vote. As we enter the second half of 2016, there are some encouraging economic reports relating to the labor market, the strength in consumer spending and a pickup in Defense Department contracts that will boost government spending. On balance, we feel that securities markets will generally be "well-behaved" during the balance of 2016 and into 2017.

Due to the uncertainties posed by the upcoming presidential election, there are likely to be some "ups and downs" in the securities markets, both on the equity and fixed income fronts, until there is clarity regarding economic policies that are outlined by the next administration. While it can be unsettling at times when markets go through periods of correction, digesting negative information and the attendant lower valuation adjustments are to be expected. However, we view these occurrences as opportunities to introduce new ideas into our research universe that can be utilized in our client portfolios going forward.

Investment Strategy:

Our investment strategy is to maintain a keen focus on improving the quality of the securities in our managed portfolios. This takes into account developing changes in company fundamentals relating to revenue and profit trends, balance sheet strength and future growth expectations. Increasingly, we have avoided companies with above average debt levels that would be vulnerable to any future rise in interest rates that squeeze profits due to higher borrowing costs. Conversely, we have added several new security positions to our portfolios that have below average, manageable debt or are entirely debt free. Many of these issues also have above average dividend growth and yields. History has shown us that this class of securities tends to have a lower degree of market risk and a greater prospect for growth, especially in the sluggish economic environment that we have seen for several years.

Since the historically low interest rate policies of the Federal Reserve are likely to continue for awhile, fixed income investments are generally not appealing at the present time and represent above average risk. Higher interest rates erode the value of the interest sensitive securities as rates rise. At some point down the road, however, bonds and other fixed income securities are likely to be more attractive components of our portfolio universe than they are presently and that will represent new opportunities.

As noted in the past, the key focus of our money management business is preserving the capital of our clients while seeking diversified growth through vigorous research of industries and companies, both domestic and foreign. That has always been the hallmark of our portfolio management process and our investment philosophy as we strive to build and maintain wealth for our clients.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

July 29, 2016