# Investment Review and Outlook - Spring 2015

## Overall Economic Health:

The slower pace of economic expansion during the recently completed first quarter of 2015 is unlikely to be repeated as the year unfolds, a similar pattern to what occurred in early 2014. Last year, a flurry of weather-induced delays and losses in business caused the nation's gross domestic product to decline by 2.1% in Q1 2014. This year, weather, although less severe, was again a factor during the first quarter. Additionally, a strong US dollar, which reduced export activity, and the West Coast port strike are expected to be contributing factors leading to an economic growth forecast of only about 1% for Q1 2015, better than the year earlier but very sluggish.

In recent weeks, consumers are spending more, buoyed by better weather, an early Easter, and savings in heating oil and gasoline prices. Improved sales were seen in autos, building materials and apparel. In the months to come, continuing low energy prices should also support higher retail spending. Overall industrial activity has been a bit mixed of late, with service sectors doing well while manufacturing levels have softened. Durable goods orders have also weakened.

All told, the current April-June quarter should bounce back from Q1 2015, with modest 2-3% growth, and continue for the balance of the year. We believe that the economy is just going through a "soft spot," but not experiencing a change in direction This irregular growth pattern has been seen several times over the past six-year span of economic recovery which commenced in June of 2009.

## First Quarter 2015 Company Earnings:

The parade of companies reporting Q1 2015 earnings has begun. While a majority of the companies comprising the S&P 500 Index have exceeded forecasts, expectations were lower at the beginning of the year than in previous quarterly periods, due to a very strong U.S. dollar, weak exports and listless demand abroad. Thus, outperforming expectations is less of an achievement in the current "earnings season." However, companies that are meaningfully exceeding these lower estimates are being rewarded nicely in their stock prices while the opposite is also true, taking companies who disappoint "to the woodshed."

## Employment Levels:

The most recent March employment report reflected a slowdown in job creation with only 126,000 new positions added, about half the total that was forecast. It was also the first month since February 2014 that job growth fell below 200,000 and the fewest additions since December 2013. The unemployment rate remained unchanged at 5.5%. Some of the disappointment in the new jobs number could point to postponement in hiring in regions of the U.S. that experienced adverse weather conditions, especially in the Midwest, Northeast and South. The trend of new job creation will be important in coming weeks and into the summer. A notable positive in the March report was that average hourly earnings rose slightly.

## Housing:

Conditions would appear to favor this sector going forward. However, even though mortgage rates are near record lows and years of significant pent-up demand have not been satisfied after a six-year economic expansion, new residential construction has been uneven. Specifically, housing starts increased less than expected in March, and building permits (a forward-looking measure of new residential construction) suffered its biggest drop since May 2014. Sales of new single-family houses in March also fell sharply from February, when they were quite strong. Meanwhile, sales of existing homes reached an 18-month high, showing a promising beginning to the spring home buying season.

**Interest Rates and the Federal Reserve:**

In our January 24, 2015 client letter we made the following observation:

*"An interest rate hike by the Federal Reserve could be further down the road than previously thought. Such an irregular pattern of economic growth in recent months has enabled the Fed to remain on an accommodative monetary course. The Fed's pending challenge will be to extricate itself from years of unrelenting and often unconventional monetary accommodation. Such an unwinding process will not be easy."*

Collectively, the Federal Reserve Board of Governors remains in favor of maintaining their long standing, accommodative monetary policy, with no imminent increase in interest rates. While there has been much speculation relating to the timing of a rate hike, perhaps in June, the Fed has recently suggested that it was in no hurry to raise interest rates. Given, the aforementioned weak jobs data, and sluggishness in several industrial sectors, the strength of the U.S. dollar and the low level of inflation, it appears the Fed might consider looking further out before implementing a rate hike, perhaps even into 2016. This would also reduce the possibility of nudging the U.S. economy into a protracted slowdown.

**U.S Stock Market:**

For now, the bulls are holding the line, despite the present elevated market level. True, there have been selloffs along the way, but overall, investors have taken the varied economic and profit wrinkles in stride. This is encouraging. Corporate balance sheets continue to improve and are in significantly greater condition than they have been in years. Future corporate profits do not have to show extraordinary, period to period growth, but just remain steady to rising, coupled with a monetary policy of small adjustments that the markets can absorb. In that environment, investors should have a largely supportive backdrop in the months to come.

"Choppiness" is also a way of life on Wall Street. For example, back-to-back sessions in mid-April saw a nearly 300-point drop in the Dow Industrials followed by a more than 200-point jump in that index. The current level of the market and the frequency of surprises on the global stage have resulted in investor anxiety, from time to time. As we know from experience and history, security price advance occurs in an irregular pattern, but it also provides investment opportunity for those who practice patience. We think the stock market will continue to do fairly well during 2015, but will also have periods of setback.

**Investment Strategy:**

We continue to be very focused on the duration of the current economic cycle as we gradually reposition portfolios with companies that have greater defensive characteristics, especially those with product or service uniqueness and higher than average growth profiles. We are avoiding energy companies at this time. Due to the significant collapse in the price of oil, these companies are very likely to face significant headwinds in both revenues and profits for some time. We are also avoiding banks and most financial institutions, due to regulatory uncertainties in the U.S. and unsettling geopolitical developments that could have an impact on the global banking system. Selective choices among consumer non-durables, utilities, telecoms, and companies with rising dividend payouts should add ballast to investment portfolios in the period ahead. As we seek broadly diversified, global growth opportunities, our core research focus is always the preservation of invested capital.

G. Frederick Schroeder, CFA
President and Chief Investment Officer

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