Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook– Early 2016…
Another Year of Global Challenges

Review of 2015:

During 2015, the U.S stock market activity can be characterized as a succession of rallies and sell offs, few of which were sustained for a very long time. Alternating advances and declines, some of which lasted just a few days, reflected ever-changing investor sentiment and an unusual array of economic and geopolitical challenges. Falling prices for crude oil and other commodities were historic, the result of global oversupply and reduced demand, due to slowing economic growth in many important countries around the globe. A sharp rise in the U.S. dollar, largely the result of a currency "flight to safety" by global investors, was a challenge for companies with significant business activity abroad. A strong dollar reduces revenues as sales in foreign currencies convert into fewer dollars. There were also very unsettled geopolitical conditions in many important Mideastern countries, Russia, Africa and the Far East, along with widening global terrorism. Finally, there was the on-again, off-again expectation that the Federal Reserve would raise interest rates. In late December, the Fed acted for the first time in nearly a decade and increased the Fed Funds rate, the interest rate banks charge each other on loans used to meet reserve requirements, by 1/4% in a target range of 1/4-1/2%. At the time, this action implied that the six-year economic recovery was on relatively firm footing. Through it all, the bull market stayed intact in 2015.

2016 – The Stage is Set:

The current year will have its share of challenges, perhaps more than in 2015, which should be expected after a prolonged period of economic expansion. Many concerns are likely to be a continuation of what we witnessed in 2015: whether energy and raw material prices will decline further, and what that impact could have on the global economy, and the timing of any further interest rate increases by the Federal Reserve. Europe's economic outlook is still muddled, China's growth continues to slow, tensions in the Middle East are on the rise (now between Saudi Arabia and Iran), and more recently, an unpredictable North Korea, reporting that it tested a nuclear weapon and a long range rocket. Additionally, the upcoming presidential election, very unconventional in the early going, creates uncertainty. A possible "sea change" in government policies, compared with the past 7 years, could impact areas such as the federal tax code, our transitioning healthcare system, new priorities in spending and the complexion of the Supreme Court, making 2016 a year of challenges for the U.S. economy and investment community.

The Dramatic Price Decline in Oil and Gas – Pluses and Minuses

Since April 2011, the price of a barrel of crude oil (peaking at $111) has declined by approximately 75%. In aggregate, lower prices are clearly very good for the U.S. economy and dampen inflationary pressures. This decline is akin to a significant tax cut for both consumers and businesses, helping fuel economic growth with the unexpected savings channeled into other forms of spending and business investment.

Overall consumer spending on goods and services represents two-thirds of the U.S. economy. However, oil and gas capital spending, adversely impacted by lower energy prices, amounts to only about 1% of GDP and less than 9% of overall U.S. capital spending. Thus, the benefit of lower energy prices to the consumer and businesses outweighs the significant hit to energy companies and energy-oriented industry investments. Also notable, however, is the negative impact lower oil prices have on potential employment within the energy industry, profitability, balance sheet health and the difficulty companies have in maintaining dividend payouts to shareholders.

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Economic Health of the U.S. Economy and Abroad:

The New Year is starting in much the same way that 2015 ended, with the U.S. service sector holding its own along with positive results in vehicle sales and housing. Household spending and business investment have also been moderately increasing in recent months. However, manufacturing activity has been uninspiring and net exports have been soft due to the strong dollar. Inflation is also running below 1%. Q4 corporate earnings have generally been reported in line with expectations. With numerous cross currents in the U.S economy and a rather tenuous global economic outlook, the Federal Reserve recently announced that the Fed Funds rate would remain unchanged. Also reported was that labor market conditions have improved but that economic growth slowed in late 2015. Subsequently, GDP growth of 0.7% for Q4 was reported, somewhat lower than expected.

Meanwhile, the focus is on oil prices and global economic growth. On the positive side, forecasts expect higher growth in Mexico, our second largest trading partner, in India and some gradual improvement in Europe. However, China, the world's second largest economy, reported their slowest rate of expansion in over two decades. The depressed manufacturing level is creating economic strain while its currency and financial markets are under mounting pressure, especially impacting emerging market economies. This continues to dampen global oil demand and creates additional stress in already depressed oil markets. Also, with Saudi Arabia severing diplomatic ties with Iran, the Middle East faces new challenges in securing oil price stability as Iran and other key producers in the region begin producing more oil.

U.S. Stock Market:

The U.S. stock market has lost ground since year-end as investors grapple with the myriad of issues outlined above. While the aforementioned may appear daunting, fundamentals in the U.S economy are relatively healthy on the world stage and a business slowdown does not appear likely any time soon. Just last week, stronger than expected retail sales were reported for January. One caveat to a good result for the U.S. Stock market during 2016 may be a further decline in oil prices. Debt-heavy, energy-related companies could impact both stock and credit markets as well as banks with large oil loan exposure.

Despite negative sentiment of late, we believe there is little fundamental justification for stocks to have sold off to the degree they have and the recent decline provides an attractive opportunity to reposition portfolios in the months ahead. Valuations are much more attractive for companies that have positive growth prospects than they have been in some time and they are not historically excessive. This does not suggest all "smooth sailing" in the equity markets during 2016. We expect periods of financial market volatility and perhaps some "unnerving" setbacks as we approach 7 years of the stock market recovery.

Investment Strategy:

Our focus is conducting vigorous global research to identify high-quality investment candidates, emphasizing balance sheet strength, and being positioned in industries with superior prospects for growth, both in the U.S. and abroad. While progress in the stock market is anticipated during 2016, the process of finding rewarding portfolio positions will be increasingly selective at this time in the economic cycle. At times, what one does ***not*** own compared with what ***is*** owned is the reason for good performance. Currently we are attracted to companies that are defensive in nature: consumer-related staples, healthcare, telecom/utilities and high-yielding preferred stocks. We continue to avoid energy-related, industrial, basic material/commodity and financial companies that are challenged by uncertain global fundamentals.

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