Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Fall 2019

A Decade of U.S. Economic Growth and Still Counting....

The U.S. is continuing to experience the longest period of economic expansion on record, now in its 125th month, commencing in June 2009 and surpassing the previous record of 120 months from March 1991 to March 2001. By historical standards, however, the current rate of expansion has been notably slower than previous periods. The annual growth during the current run has averaged only 2.3% since 2009 vs. a 3.6% rate of expansion during the 1990s.

The Last Business Contraction:

The period from December 2007 through June 2009 has been labeled the "Great Recession". A financial crisis in the U.S was set in motion by the bursting of a bubble in housing prices in 2006. Falling home prices severely impacted the wealth of many American households, especially in the bi-coastal markets, and resulted in a jump in mortgage foreclosures, which caused huge losses on Wall Street and in the commercial banking industry. It took many years for the economy to recover to pre-crisis levels of employment, residential and non-residential business investment. Bank lending reforms were put in place along with balance sheet strengthening. Consumer confidence was slow to recover as well. The economy improved briefly in the summer of 2008 only to retreat once again and endure a "double-dip" recession.

Recently Reported Third Quarter 2019 Gross Domestic Product:

On October 30th, The Bureau of Economic Analysis reported that gross domestic product (GDP) for Q3 2019 advanced at an annual rate of 1.9%, down from 2.0% during Q2. The deceleration reflected weaker personal consumption expenditures and slower federal and state government outlays. Weaker manufacturing activity had also been impacted by the 40-day United Automotive Workers strike against General Motors that ended on October 25th.

Outlook for the U.S. Economy:

Despite the historic duration of the current economic expansion, most statistical data trends still suggest that further growth is likely. The economy should continue to post modest growth of perhaps 1.5% - 2.0% for the next several quarters. Helping to sustain this decade-long upturn should be housing, historically low mortgage rates, a resilient job market and solid consumer sentiment. In October, employment rose at a faster pace than forecast, with upward revisions for August and September, while wages continued to edge higher. However, manufacturing activity has contracted along with business spending and retail sales at department stores. While such developments do not necessarily point to a notable erosion in business and economic fundamentals, they suggest that we are experiencing a gradual and contained slowing in the decade-long period of expansion that we have enjoyed.

A common thread relating to the current slowing economy is our trade dispute with China which has hurt demand in an array of industries and impacted overall business investment. However, increasing optimism has developed recently, with a consensus emerging that a limited agreement may soon be hammered out, as both parties seem open to possible compromises. While such an outcome would further lessen the odds of a recession, which is generally viewed as a low probability over the next several quarters, a deeper economic contraction cannot be ruled out.

Federal Reserve Policy Over Recent Years and Its Current Posture:

The fed funds rate, the interest rate banks charge each other to lend Federal Reserve funds overnight, is also a tool the nation's central bank uses to control U.S. economic growth and a benchmark for interest rates on credit cards, mortgages, bank loans, and more.

The Federal Reserve has repeatedly warned it would need to raise interest rates to temper any excessive, rapid growth as the economy recovered. However, expansion was rather anemic for a long period of time with reported economic measures below Fed expectations along with an inflation rate that languished below their 2% target. As a result, the Fed delayed hiking interest rates. Over the past couple of years, however, significant tax cuts for business and consumers along with governmental regulatory rollbacks have resulted in increased business investment. Subsequently, the Central Bank started ratcheting up interest rates at the end of 2016 that would eventually amount to a total of 2% over the next two years. However, the Fed put its monetary tightening campaign on hold after its December 2018 meeting, as the U.S equity market was in correction mode, trade-related tensions with China, Mexico and Canada were stymied and a partial government shutdown all conspired to rekindle fears of a global economic slowdown.

Since the Fed is more concerned about inhibiting growth than about preventing inflation at the present time, they lowered the Fed Funds rate by ¼ point in July 2019, the first time in 10 years, followed by a second ¼ point reduction in September to a range from 1.75% to 2.00%. Then, due to the current sluggishness of economic activity, the Fed reduced rates again by ¼ point to a range of 1.50% to 1.75% on October 30th. A partial statement by the Fed after its decision is as follows:

"This action supports the Committee's view that sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes."

"Although household spending has been rising at a strong pace, business fixed investment and exports remain weak. On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. The labor market remains strong, economic activity has been rising at a moderate rate, job gains have been solid and the unemployment rate has remained low."

In the months ahead, as the Fed monitors economic data and the impact of its recent action, along with the overall vitality of the U.S. economy, additional rate adjustments could follow, if growth weakens further. However, the Fed has also suggested that it may "pause" for the time being before lowering interest rates further, unless the economy loses additional traction.

Investment Outlook and Investment Strategy:

There are always numerous elements to consider when formulating investment strategy. In the current environment this task has been compounded by several very complex factors on the overall global stage that transcend traditional analysis of economic trends, the posture of monetary authorities at the Federal Reserve and global developments.

Around the globe, there are troubling concerns with respect to recent developments in Syria and Turkey with Mid-East implications. Along with the long reach of Iran and Russia, these events get very complicated and have the potential to significantly impact oil markets, international trade and global economic progress along with straining relations within the geopolitical arena. Then there is ongoing discord between the U.S and North Korea. And, there are the weakening economies within Europe and the Far East. However, the major international concern centers on our trade relations with China. While global turmoil is unsettling, especially to investors around the world, over the longer term it ultimately does set the stage for investment opportunities for both international companies and investors.

Things are hardly quiet on the domestic front either. Despite the specter of a possible impeachment of President Trump that hangs in the nation's capital, the consensus appears to be that the Republican-led Senate would likely vote for exoneration, should the House of Representatives impeachment articles be forthcoming. This somewhat balanced prospect of "maintaining the political status quo in Washington" is helping to calm jitters on Wall Street, at least for the present time.

Investors are taking much of the foregoing in stride, as stocks continue to advance to record highs, even with the occasional selling squalls that have hit the market. Equity markets appear to be relatively well-behaved with the ebb and flow of news stories, at times producing sharp swings in security valuations, and once again, an opportunity to introduce new ideas to investment portfolios and to harvest past capital gains. The bullish case for further gains in the securities markets is also supported by optimism on global trade, not only with China, but in finalizing agreements with Mexico and Canada.

Providing a nice lift to the stock market are very positive company earnings reports from the recently concluded third quarter. While there have been some profit misses and guidance disappointments along the way, the "earnings season" is winding down in reassuring fashion with more than 75% of the S&P 500 companies having topped expectations. This credible showing is helping to underpin a stock market that continues to make new highs. With earnings still the main driver in the stock market and for Wall Street analysis, any missteps are being absorbed thus far by investors.

Currently, investor spirits remain high and the bulls are holding their own with generally more strength than weakness in the daily market action. Strong corporate earnings, a responsive Fed, encouraging trade news and the ability of this resilient market to overcome periodic headwinds are all pushing stocks higher and aiding in the confidence of the consumer and investors.

Schroeder Capital's Investment Strategy Perspective:

As the economy continues to grow into its eleventh year, with good reasons for optimism about 2020 and perhaps beyond, we are more vigilant than ever in monitoring changing trends in economic activity and measuring the health of both corporate and consumer sectors within the economy. We are very focused on securities research and are working to identify less volatile, more rewarding companies that have above-average dividend payouts that act as a buffer in our client investment portfolios during times of market volatility.

With fixed income securities at historically low levels, we continue to be attracted to securities that have high dividends that outpace traditional corporate bonds and bond mutual fund investments. A good example is ATT that currently has a dividend yield of 5.2%, consistently increases its dividend annually and is regarded as a very safe "bond equivalent". ATT is currently a meaningful position in all Schroeder Capital managed client portfolios.

As we have stated previously, our research emphasizes security selection with a keen focus on the safety of client portfolio assets and capital preservation. We believe the selective accumulation of quality stocks, especially when periods of market weakness occur, is a sensible approach to asset and wealth development. We think the stock market remains in a good comfort zone and equity prices are still reasonably attractive in this low interest-rate environment.

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