Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Summer 2014

Summary: With encouraging U.S economic fundamentals on the horizon, continuing strength in corporate earnings, a supportive Federal Reserve and the absence of attractive investment alternatives, the case for equities remains in place, notwithstanding the usual caveats on the foreign front.

During the opening months of 2014, there was a significant slowdown in U.S economic activity as severe winter weather blanketed a broad swath of the country, especially impacting our manufacturing base. Industrial production, multiple forms of transportation, utilities and consumer spending all suffered significantly.

Nearly one month into the third quarter, the economy is continuing the positive momentum seen at the end of the second quarter. Importantly, a healthy trend is developing in employment measures: a central focus of any period of economic expansion that had been murky until recently and now appears to be in "lock-step" with firming industrial production levels. June was the second monthly gain in industrial production while factory utilization matched its best level of the year. Consumers also stepped up their spending in June. Stronger sales were recorded at general merchandise, apparel, health and personal care stores and the internet. Improvements were also seen in the U.S. balance of trade and in the service sector.

The foregoing should not imply that we won't experience some back-sliding from time to time, which is typical of any lengthy period of economic recovery. However, if the current trend in job growth is sustained, this will be reassuring for continued economic growth prospects for the balance of 2014 and into 2015. Meanwhile, the trend of second-quarter earnings reports is generally quite favorable and exceeding expectations, especially among the larger companies.

At this point, it does not appear the Federal Reserve will initiate a tighter monetary policy any time soon and probably not until sometime in 2015. Stepping up the timetable for monetary tightening would obviously tamper with the overall, modest economic growth trajectory we are experiencing and risks an overall business contraction. Although the current economic expansion has been going on since June 2009, by historical standards, it has been quite anemic, with a very weak job market and low interest rates for some time. Therefore, it appears that employment levels, consumer credit extensions and, importantly, inflationary measures would need to be at much higher levels before the Federal Reserve would change its current course and raise interest rates.

Abroad, the economic situation is more complicated. The European Commission, the executive body of the European Union, recently published its forecast for the balance of 2014 and called for a continuing, modest 1.5% overall expansion of the 28 member economies for the full year 2014. For 2015, the forecast is 2.0% average GDP growth. Of note, aside from Germany and the

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UK, some larger economies are expected to lag the overall average forecast, namely France, Italy, Spain and the Netherlands. The EU's recovery began in the second quarter of 2013; four years after the U.S. recovery commenced, and remains fragile. The European Commission is also closely monitoring Europe's banking arena, which from time to time reminds us that monetary cracks could still exist within their banking system, especially for some of the smaller countries.

The persistent geopolitical problems around the world that we have all seen for years are now coupled with a recent escalation of violence throughout the mid-east that is of great concern. The Middle East continues to be embroiled in conflict while U.S. international relations are becoming more frayed, especially with Russia, as problems with Ukraine intensify. The accelerating warfare between Israel and Hamas in Gaza is very troubling. Furthermore, global emotions relating to the downing of the Malaysia passenger airline, allegedly by pro-Russian forces, run extremely deep around the world. This tragedy and the ensuing disregard for human life lost in the accident and the manner in which the victims were initially treated is simply unfathomable. On the heels of economic sanctions already put in place by the U.S. and other nations, due to the Russian invasion of Crimea and ongoing battles in Ukraine, we should expect further response from world leaders and possibly additional measures that could have wide-ranging global economic repercussions.

While both of these developments were geopolitical in nature, investors often cannot resist the emotion they feel and overlook the fundamentals of the securities that they own in their portfolios. Reactive behavior often manifests itself in "selling" that just feeds on itself in the marketplace. Noteworthy is that the stock market ended last Thursday down about 1%, the day the Malaysian aircraft was attacked and as the war in Gaza was escalating. However, Friday the markets recovered nearly all of the previous day's losses, and actually finished the week up fractionally. As we have all experienced, securities markets are vulnerable to unexpected news that creates temporary concern and reaction. However, it is how we absorb information as investors and our reaction to it that is important in the long run. Specific company fundamentals and the health of the economy in which one is investing drive investment values and portfolio performance and will eventually trump investor emotion.

History tells us that leading economic indicators usually foretell an approaching business contraction. The stock market is considered to be a leading indicator and discounting mechanism; that is, participants are always looking forward and prices are always adjusting according to the anticipation of future events. These events may range from actions of specific companies and/or their industries to aspects of the economy, or non-economic developments on a national or world scale**.** The market generally discounts activity 6 months in advance. As an example, if the economy is expected to improve or decline 9 months from now, the prices of stocks would be expected to improve or decline approximately 3 months in advance of that. However, bull and bear markets take time to develop as fundamentals change and become more apparent. This does not quickly occur, and especially not when an unexpected, non-economic event such as a geopolitical flare-up or tragedy develops and confuses the issue. Despite the five-year duration of the current economic cycle, we do not see indications of a business slowdown or a period of overall contraction on the horizon. The economy is still healthy and expanding.

Given the positive economic momentum that was apparent at the end of the U.S. second quarter and assuming that current geopolitical problems are contained, we anticipate modest growth in the range of 2-3% for the balance of 2014 and into 2015. Inflation should remain muted, despite higher food and energy costs, and interest rates should remain relatively stable going into 2015.

Our investment strategy remains unchanged: We continue looking for investment opportunities with both growth and value profiles, that have strong balance sheets and a uniqueness that separates them from their industry peers, both domestically and internationally.

We welcome your comments or questions.

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President and Chief Investment Officer

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