Schroeder | Capital Management, LLC

Global Investment

Investment Review and Outlook – Fall 2014

As we conclude October, investors have been taken on a roller coaster ride, a month that has had its share of twists and turns. Our analysis of the current investment landscape is as follows:

The US economy went through gyrations during the first-half of 2014. A severe winter weather-induced retraction of 2.1% in Gross Domestic Product occurred in the first quarter followed by a resumption of growth in Q2 of 4.6%, the fastest rate of expansion since Q4 of 2011. The recently concluded September quarter showed mixed results. While weakness was seen in retail spending, strength was also recorded in industrial production, factory utilization, homebuilding and job growth, leading to an annualized economic growth rate of about 3.0% that is likely to continue for the balance of 2014. We also think the economy will stay on a modest growth track during 2015, with help from historically low interest rates, improving job creation and a further revival in housing activity. In addition, lower oil and gasoline prices will be an advantage to both industrial producers and consumers in the near future, especially during the coming holiday spending season. One caveat, relating to the US level of growth during 2015, could be the health of the Euro zone economies (described below). European growth is under strain and with the present strength of the US dollar, exports could be held back, to some degree, and temper economic growth in the US.

Earnings results during the recently concluded third quarter for the largest companies in the US are very encouraging. With 20% of S&P 500 companies reporting, 64% have exceeded estimates of industry analysts. Entering this "earnings reporting season," investors were concerned that the recent strength of the U.S. dollar could hurt the near-term earnings power of multinational companies that have significant asset and earnings exposure in foreign markets. However, stronger-than-expected earnings guidance from many blue-chip companies for the balance of the year has eased concerns, suggesting that their overall business prospects are quite solid.

The Federal Reserve is closely monitoring the recent drop in the Producer Price Index and softening commodity prices in general for any hint of deflation in the US economy. In addition, recent strength in the employment data along with only a modest increase in real wages is in line with the central bank's dual mandate of fostering maximum employment with price stability. This combination, along with a weaker global economic outlook, could allow the Federal Reserve to delay raising interest rates until perhaps the middle of 2015, or beyond, a time frame that would prove popular with investors. As the data unfolds in the coming months, rumors and speculation on this subject will persist.

A key challenge for the Fed will be to keep price stability in place well into 2015. The timing of a program to slowly increase interest rates will be critical and how well the economy responds to the effect of higher rates will play a major role in the ultimate staying power of the current economic expansion, now over 5 years old, commencing in June of 2009.

Internationally, geopolitical tensions are running very high while overall economic growth is mixed. Ongoing violence continues in the Middle East on several fronts. The most important, troubling conflict is associated with the Islamic State in Iraq, known as ISIS, that started as an Al-Qaeda splinter group, and currently controls hundreds of square miles from Syria's Mediterranean coast to south of Baghdad and has become a significant threat on a global scale.

In addition, not only has our relationship with Russia soured over the past several years, but tensions now rival the Cold War era. Russia remains a significant threat in the Ukraine and the Baltic region. Significantly, in early September at the NATO summit in Wales, President Obama declared that the US military will maintain a permanent presence in the Baltic states of Estonia, Lithuania and Latvia, which border Russia. He vowed that “US air and ground forces will remain poised forevermore to respond to claims of Russian aggression by the governments of these countries.”

On the global economic front, many economies in Asia and the Euro zone are either advancing unevenly or backtracking altogether. Growth in China is also slowing as the economy transitions from rapid industrial development to a more consumer-based economy. In the Euro zone, problems largely center on slowing growth in Germany, the largest economy in Europe, and the impact such softness could have on other Euro zone members. Significant weakness in Germany’s factory orders, industrial production, exports and sentiment have raised concern that a recession may be on the way for the first time since 2009. Along with the latest signs of weakness in the Euro zone, many economists are calling for the European central bank (ECB) to step up action to revive the region.

The US Stock market: It’s little wonder that the stock market has gyrated during October, given the aforementioned global concerns. Securities markets are responding to multiple geopolitical events and economic reports, both in the US and abroad, as we move toward 2015. Of significance, a large measure of emotion, often irrational, is also in the mix. This negative factor includes the “trigger response” to developing news regarding the Ebola virus, the seriousness of it and how it will be contained. Without question the “daily news” of the aforementioned induces stock and bond market instability and volatility in the global financial arena.

In recent days, investors have been emboldened by solid corporate earnings news. In our view, the bull market is bent, but not broken. In part, this is due to supportive Fed policies and a further decline in long-term interest rates, making fixed-income vehicles an even poorer alternative to stocks. The stock market sell-off early in the month was overdone in the short run with negative stories and reports conspiring to dampen investor enthusiasm. As always, investors need to exercise patience and tolerance relative to levels of market volatility. Price swings can be unsettling on any given day but a sense of fortitude and longer term perspective is helpful. Currently, the picture of the US economy is quite bright but uncertainties will always linger as new developments unfold.

Investment Strategy: Over time, using periods of market pullback to take positions in well-run companies with strong fundamentals has been a winning investment strategy. We remain in the positive camp regarding the US stock market and have a perspective that there are always undervalued, attractive opportunities in foreign markets. The US market will likely remain on a bullish path for awhile, perhaps with more volatility and less assurance to investors than what we have experienced over the past couple of years. At the present time, we are harvesting some portfolio gains, adding to cash for future investment opportunities, while maintaining a sharp focus on both economic and company fundamentals. That is our discipline. Right now, solid overall economic fundamentals at home and supportive policies at the Federal Reserve are a tough combination to beat.

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