STEIGERWALD, GORDON & KOCH
WEALTH ADVISORS

Quarterly Newsletter

Second Quarter - 2018

Market Commentary

If 2017 was known for its lack of volatility, the first quarter of 2018 will be characterized by its abundance of it. Prices swung all over as investors started the New Year uncertain of how the recently signed tax reform package would influence markets here and abroad. Though January indices started in the same gangbuster fashion that marked most of last year, by the end of March, sentiment had changed with more uncertainty creeping into traders' psyches. Meanwhile, the economy continued to steam along on its way to challenging record-length in terms of consecutive months of expansion.

Economic & Political Overview

The transition of power at the Federal Reserve went smoothly with newly anointed Jerome Powell taking over for departing Janet Yellen. During his first press conference following a Federal Reserve Open Market Committee (FOMC) meeting in March, he outlined the same path as his predecessor with a slight bump in the federal funds rate and expectations of a balanced outlook. Whereas former chiefs Ben Bernanke and Yellen spoke on average for 57 minutes and 58 minutes, respectively, Powell gave the Fed's views and answered questions in a relatively short 43 minutes. The more business-like approach contrasted with his predecessors who had a more academic style which led to answering questions in more exhaustive terms.

Policy is not likely to change, regardless of Q&A length. "We're trying to take the middle ground, and the committee continues to believe that the middle ground consists of further gradual increases in the federal funds rate," he commented. His succinct answers meant there was little chance that something might be unintentionally construed by those listening. In Powell's opinion, being clear is more important than educating the audience on the nuances of monetary policy and Fed thinking. With John Williams being recently named the President of the New York Fed, only one more key post, that of Vice Chairman, remains to be filled. Those three positions need to work together in lock-step for monetary policy to proceed smoothly.

The FOMC released its economic projections last month which continue the same theme: lift rates gradually amid stronger economic growth while measuring the effect on business and consumer spending. Thus, as outlined in the December projections, this year should witness three rate hikes of 0.25% in the benchmark. However, the Fed did raise its projections for the long-term suggesting a steeper path of tightening in the years ahead. That gives them enough wiggle room to keep an eye on inflation while continuing to remove accommodative policies that have been in place since the end of the last decade but seem dated now with higher GDP prints.

The fourth quarter of 2017 reported GDP expansion of 2.9% annualized, revised up from a previous report of 2.5% growth. Consumer spending, accounting for nearly 70% of the total economy, grew a healthy 4%, revised higher from an earlier 3.8% level. Business spending on equipment rose 11.6% while residential investment saw a 12.8% expansion. Government spending was 3.0%, revised higher from 2.9% thanks to higher state and local outlays. Real final sales, which strip out trade and inventory effects, advanced a solid 4.5% contributing to the overall larger-than-expected upward revision for the quarter. According to the Bloomberg Economics team, growth for 2018 should be 2.8% followed by 2.4% next year.

Assuming the momentum does continue for three more months, the U.S. economy will become the second longest on record by the summer. The current second longest was the February 1961-December 1969 (106 months) interval with the record being the March 1991-March 2001 (120 months) period. There are a lot of reasons why by June 2019, a new record will be set. Yet, the current political tone could play a major role in if that will occur. President Trump announced tariffs on steel and aluminum and targeted around $50 billion in Chinese imports for new levies. Not unexpectedly, China responded with $50 billion of their own duties on U.S. exports of fruit, pork and steel pipes with the Chinese Foreign Ministry adding, "The U.S. has a list. China also will have a list."

What is worrisome about the dialog is that it is misguided. The U.S. has a trade deficit because we as a country spend more than we earn and finance the difference with foreign credit. This is a macroeconomic fact, plain and simple. The U.S. saving rate has fallen from nearly 8% in the 1990s to close to 5% more recently. And when Congress implements tax reform which lowers the statutory rate charged yet does not have concrete expense cuts or raises other offsetting revenues, the government's overall deficit will expand. That puts further pressure on finding "scapegoats" for why the U.S. has trillions of dollars in net debt. Deficits are, by and large, not a function of trade policy. Trade deficits exists because foreign countries create and export things the U.S. wants and makes them at a cost that is more efficient than what can be done domestically. A tariff does nothing but raise the cost for everyone in the form of a tax that eventually hits innocent bystanders because companies need to make a profit. When that is threatened, the largest single line-item on the income statement, employee compensation, gets reduced which means layoffs. Higher tariffs, just like higher taxes, lead to distortions. They reduce imports but also lead to lower exports resulting in a net wash in terms of the shortfall. When Trump's "America First" policy collides head on with Chinese President Xi Jinping's "Chinese Dream" philosophy, everybody loses. We will keep our fingers crossed that saber rattling is nothing more than merely tough rhetoric, and true negotiations begin sooner rather than later.

Whether the economy can continue to expand will be determined, in part, on international trade but, more importantly, on how consumers react. Confidence levels are high thanks to job creation which saw the U.S. unemployment rate at 4.1% in February. Housing starts and sales are encouraging but will depend upon how interest rates moderate for the remainder of the year. There is a noticeable lack of supply on the market which is leading to higher prices and brings affordability in question, especially for those wanting to trade up. With mid-term elections creeping closer, expect more musical chairs in the White House with changes at Secretary of State, Secretary of Veteran Affairs and National Security Adviser taking place in this quarter alone. There will be more vitriol over the airwaves including television, newspapers and Twitter. The political landscape remains as unsettled as ever even with the strength we have seen during a potentially record-setting economic expansion.

Market Review & Outlook

During January, the Dow Jones Industrial Average closed above 25000 for the first time and, by the end of the month, the S&P 500 was up 5.7%. Then the calendar turned to February. Even with a solid earnings reporting season underway, the fear of "have the markets come too far, too fast" coupled with tariff talk pushed the Dow and S&P into correction territory for the first time in two years. Within two weeks, that pullback was met with more "buy on the dips" and by mid-March the Nasdaq Composite was setting a new all-time high. The Chicago

Board Options Exchange S&P 500 Volatility Index, or VIX, was all over the map during the quarter. A higher number suggests more "fear" in the market as traders purchase put contracts to bet on a fall in prices. After ending last year at 11, the measure spiked to 37 in early February, fell below 15 in early March only to end the quarter close to 20. After all was said and done, the S&P registered a loss of 1.2% and the Dow Jones was down 2.5% for the first quarter on a price-only basis. International bourses fared little better with many in the red through the end of March including exchanges in Spain, Germany and Japan in dollar terms.

Even with the decline, the run in the markets has been impressive. Investors are still up about 300% since the market low on March 9, 2009 based on total return. The S&P 500 has been positive for each of the past nine years and 14 out of the last 15. This was the first quarterly loss in over two years. If the markets rebound and move higher over the remaining nine months of the year, the impressive track record will continue. There are no guarantees, however, as markets continually change based upon the flow of information.

Given the uptick in volatility, the market is providing clues that a transition may be taking place. The markets did not have a single 2% intraday move in 2017. This year, there have been six in the first quarter alone. The brief, 13-day correction in February suggested that investors were nervous about the heights the market reached. The first trading day of the second quarter produced the worst start in that quarter since 1929. The technology sector has been one of the leadership groups during the market climb. In March, the change in market value of the bellwethers was striking: Facebook lost $54 billion in market value, Apple surrendered $53 billion, Alphabet lost $49 billion and Amazon shrunk by $32 billion. Between concerns over Facebook's management of user data to President Trump's tweets against Amazon's sheer size, the sector was under attack as greater regulatory scrutiny cast a cloud over the group.

We also saw the market break through the 200-day moving average for the S&P on the first day of April trading. Though we do not often discuss so-called technical trading much in our writings, it plays a part in the market because many traders swear by it. At SGK we focus on fundamentals but also include it in our stock screens because it has been a key metric historically. The average roughly tracks trading for a year and provides a theoretical bottom to a stock's line chart. Once it is breached, it often becomes a line of resistance that a security must punch though to reach higher levels. Like any metric, it is not infallible but it does give a quantitative sense of market sentiment. Because so much of today's trading is done by super computers, this metric is an important input and investors need to be aware of it due to the daily trading volume attached to its value. It will have no implication on whether a company meets next quarter's sales target, but it may signal that markets as a whole will tread water until sentiment changes. Investors can take hope in the fact that the last time the S&P went below its 200-day moving average line was when the Brexit vote occurred in the summer of 2016. That was but a brief interlude as the average climbed sharply in the quarters that followed.

As we have written before, a pullback is not the worst thing that can happen. Intermittent corrections are "healthy" for the market because they wipe out some excesses that have seeped into the markets without leading to widespread panic. The expectation for first quarter S&P 500 earnings is up 18.5% year-over-year according to Thomson Reuters I/B/E/S. For the second quarter, it is even more robust: +19.8%. Potentially some of the market decline could be investors becoming more skeptical over how much of the tax reform cash will ultimately flow to them. Money spent on employee bonuses or capital expenditures does not end up in the pocket of shareholders. But that is no reason why a correction should turn into a bear market. Problems arise when companies fail to meet lowered expectations, not when firms cannot match lofty hopes.

The normal triggers to a recession are, for the most part, absent. There are no supply or demand shocks which would derail the economy. The U.S. is less dependent on foreign oil than at any time in recent memory and other factors of production, like soybeans, are not as important in keeping the economy humming. With consumers spending again, there is little fear of a lack of demand. In fact, the lack of inflation is an enigma the Fed has yet to solve given the strong labor market. What might trip up the current state is a policy mistake. Outside of the aforementioned excise issues, most of the major central banks are in the process of remove liquidity from their respective markets. Should that happen too quickly, it could lead to accelerated contraction similar to an engine seizing up when there is no lubricant. Recent history has many examples of such errors which bankers have hopefully learned from so as not to repeat.

By holding balanced portfolios, we aim to keep volatility down. Investing in high credit quality issuers helps generate steady income that is largely immune to swings in earnings from quarter to quarter. Corporate issuers oftentimes pledge an asset as collateral which makes repaying debentures key or else risk losing the resource. Unlike stock holders, who are the last to receive a company's cash flow, bondholders are usually first in line to get paid because of the contractual nature of the indemnity. For municipal borrowers, our focus on general obligation securities means the full taxing authority of the issuer is backing the bond. As bonds mature, we have the opportunity to reinvest proceeds at a higher yield if the Fed continues on its path of hiking.

Dividends should not be overlooked either. Though such payments are made at the discretion of the company's board of directors and can be halted or reduced at any time, most firms are loathe to change policy because it sends a negative signal to shareholders. According to Standard & Poor's, last year net dividend increases for U.S. common stocks gained 57% over 2017. Overall, companies in the S&P 500 returned a record $419.8 billion to shareholders last year. It was the eighth consecutive year of higher payments and the sixth consecutive year of record outlays. The trend should continue this year because the Tax Cut and Jobs Act lowered the federal statutory corporate rate by 40% which gives firms more flexibility to pay out more cash. The current yield on the S&P 500 at the end of the first quarter was 2.0%. Our SGK Core securities as a whole pay on average approximately 28% more. Given the "stickiness" of dividends and the inclination towards higher disbursements, client portfolios should disproportionately benefit.

The cacophony of today's headlines means separating the true noise from insightful data will continue to be a challenge. As fiduciaries of client accounts, we have a high responsibility to protect your wealth and aim to make it grow prudently. We understand that overpaying for a good company leads to the same result as buying a bad firm which means our desire for a margin of safety will not change. Paying the right price for a stock may coincide with periods of heightened volatility and poor short-term fundamentals that only through patience and time, justify taking such risks. Valuation will always trump earnings growth and, though stocks have become more attractive since the end of January, being cautious or even downright picky even in the face of impressive economic signposts is how market-beating returns compound year after year after year. Like all money managers we will make mistakes along the way which we try everything in our power to minimize. That is par for the course, as we know it is impossible to be right all the time, but that does not stop us from trying to grow wealth *over* time. We appreciate the opportunity and trust you have in our experience as we aim for solid long-term performance to help you achieve your financial goals.

If you would like to schedule a meeting with SGK, please contact Lisa Martin at 703-777-8826 or lisa@sgkwealthadvisors.com

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