Financial Market Sell Off, Part II

- Damage is concentrated in stocks with the 5% drop in the SP500 last week
- Investors are re-evaluating political & interest rate risks
- Speakers at last week's Naples CFA Forecast Dinner provided real time analysis
- Bloomberg study suggests an 8% upside to SP500 three months after the spikes in volitility

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Last week, most worldwide stock indices dropped by 5%. Selling appears to have peaked as stocks reversed a sharp selloff in the morning to close higher on Friday, February 9th. The damage is largely concentrated in the stock market although moderate loses were experienced in gold and bonds. Commodities followed stocks lower.

Economic Comments

The economy appears to be gathering momentum with little chance of recession. The recent tax cuts should support further growth this year as consumers and businesses in most, but not all, states will have more disposable income. While this will do little to increase the long-term economic viability of the economy, it will keep things moving in the short to intermediate term. Overall, Bloomberg reports consensus expectations for Gross Domestic Product growth this year of 2.7% and slowing to 2.3% next year with a 15% chance of recession within the next 12 months.

With the unemployment rate around 4%, we are entering the latter stages of the economic expansion, which typically occurs when inflation picks up as resources are being fully utilized. Wage pressures are growing. Pioneer Natural Resources, a new portfolio holding, stated during its quarterly earnings conference call that “labor costs may increase as much as 10% this year as the availability of qualified workers is limited, and new hires require significant training”.

The big economic issue will be the massively increasing U.S. Budget Deficit. Year-to-date, approximately 18% of the budget expenditures were financed by selling bonds. With the tax cuts and increased spending, the budget will be significantly higher and require the sale of a much larger amount of bonds. As bond yields increase to attract investors to buy the bond offerings, economic activity will begin to be affected. Higher yields will also reduce the theoretical value of financial assets. Our fear is that the economy gets too strong and leads to higher interest rates, which ultimately, will push investment portfolios lower.

Investors are Factoring in Political Risks:

Last year, investors overlooked the many poor economic proposals from the Trump Administration. This year may be different story. During last Thursday’s CFA Society Annual Forecast presentation, Stu Hoffman, Senior Economic Advisor with PNC Bank, cited international trade and restrictive immigration policies as significant risks and a reason why sustained GDP growth above 3% is unlikely. Further, the Federal budget proposal for Fiscal 2019 proposes increases in defense spending but cuts out nearly every other department. While defense spending tends to spur economic activity, the cuts in virtually every other department may lead to a contraction of economic activity. Cuts in research, NASA, and other leading edge innovative sciences is concerning as the government has historically engaged in early investments that evolve into life changing technologies many decades later. For example, the space program that was launched 40 years ago helped the computer industry and the defense department which invested in the development of Global Positioning System (GPS). This system allows me to navigate the Everglades with my Garmin GPS navigation device.

In reviewing the budget proposal, the big disappointment was the lack of the infrastructure plan funding. Basically, the Federal Government committed about $200 Billion and encouraged state and local governments to fund the majority of $1 Trillion or so. This would be a very good situation for Assured Guaranty, as this company guarantees municipal bonds, but the stock weakened due to the details of the plan which emerged today and were much less encouraging than the rumors.

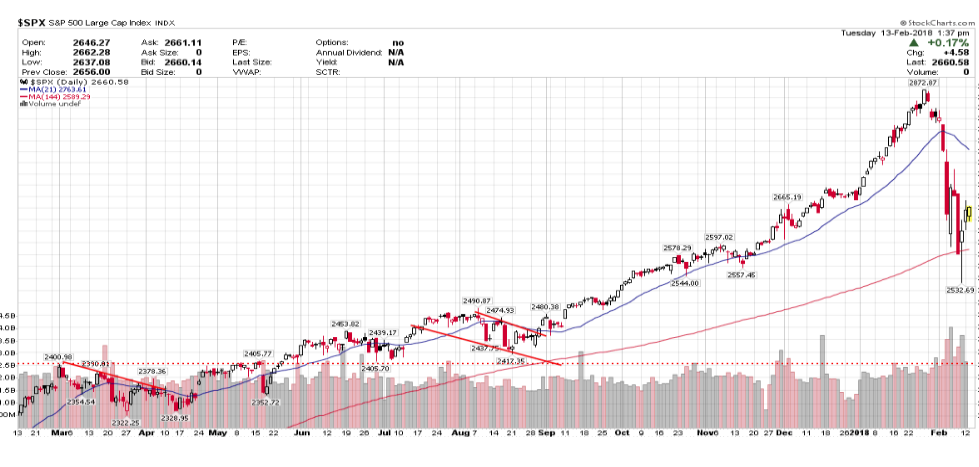
Financial Markets- The Worst is Probably Over for Stocks, but Things Will be Different:

The historic sell-off in the stock market ironically coincided with the Naples CFA (Chartered Financial Analyst) Society's annual forecast dinner, which featured Gina Martin Adams, Chief Equity Strategist with Bloomberg Intelligence, Stu Hoffman with PNC, and Brian Rogers, Chairman of the Board of T. Rowe Price.

We were able to "kidnap" Gina Martin Adams earlier in the day to speak before students from Florida Gulf Coast University, Hodges University, and Ave Maria University at the Naples Sailing & Yacht Club. In addition, we spent time with Ms. Adams on her thoughts on the financial market volatility. Ms. Adams feels this is an equity market problem as other markets are not showing signs of significant stress. For example, if the corporate bond market was very weak, that would be a signal that the economy may be at risk to a recession. Further, gold fell last week, certainly a strong clue that the world is not coming to an end.

Moving on to Ms. Adams' other thoughts on the equity market, she believes the current long-term bull market in stocks is far from over. However, the character might be changing as the "easy" times of steady increases could be over. Last week, Bloomberg released a comforting study that revealed that when volatility rises to extreme levels, which usually is associated with sharp declines in stocks, three months later, stocks are higher by 8%, approximately 80% of the time.

SP500: Trying to Find Support After the Sharp Sell-Off:

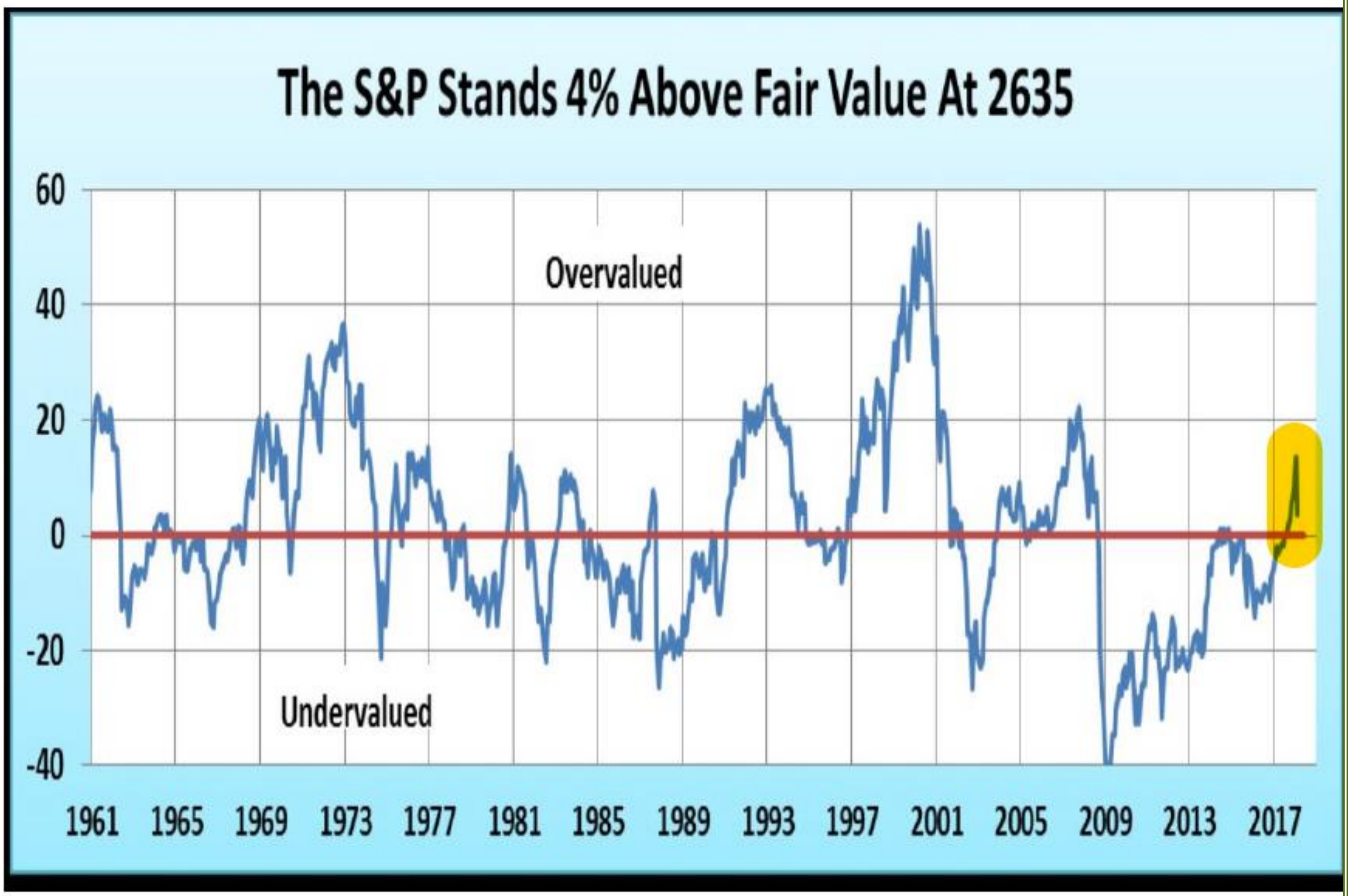


<u>Gina Martin Adams, Chief Equity Strategist at Bloomberg Intelligence:</u>

Another interesting relationship that Ms. Adams presented was the high correlation between increasing deficits and the falling US Dollar. As most clients know, we focus on the direction of the US Dollar to gauge the character of the financial markets. With the Budget Deficit increasing rapidly, we would expect to see the U.S. Dollar continue its path lower which could inflate commodity prices and further pressure interest rates higher. Hence, we have over-weighted energy stocks in most client portfolios.

Looking further at the equity market, companies are reporting solid earnings while the changes in taxes are creating some messy surprises. Investors in the equity market should gain comfort in strong earnings. Revenues are increasing better than the accepted growth of about 6%, while earnings are coming in better than projected. The increase in earnings projected for this year is making the valuation of stocks more reasonable. As the chart below from Argus Research shows, stocks are getting closer to being valued. Argus uses a model that includes all the major economic factors in valuing stocks including, earnings growth and interest rates.

We have recently upgraded equity portfolios with the addition of Pioneer Natural Resources, a leading energy company, also Microsoft, the largest software company that sports a AAA- credit rating. Given the decline in the equity market, we are considering additional upgrades to client portfolios.



<u>Shifting the Bond Market-Yields Grind Higher:</u>

While the financial media focuses on stocks, the bond market will set the foundation of the financial markets. Several factors will impact the bond market this year. First, we have a new leader as Jay Powell, Chairman of the Federal Reserve, took office one week ago. No major changes in policy are expected towards interest rate increases, however, an easing in bank capital requirements is possible. The Federal Reserve has two primary objectives: 1. maintain stable prices, and; 2. pursue a sustainable maximum employment "duel mandate." With the strengthening of the economy, it will most likely be accompanied with higher inflation. Further, the increasing deficit will require lots of bond buyers, many of which are foreign entities.

With the potential for higher bond yields, we have been positioning client bond portfolios accordingly. One strategy that we are moving to is investing in variable rate bonds and mutual funds. These holdings generally adjust the interest payments to investors based on movements of a benchmark interest rate. Many are tied to the 3-month LIBOR rate, current 1.80%.

Below, is a chart of the 10-year Treasury bond. The yield has risen to over 2.8%, the highest level in several years. The 10-year Treasury bond is important to investors as many mortgages and loans are priced based on the yield of this bond.

Portfolio Strategy:

Hopefully, over the next few weeks, the financial markets will calm down. We plan on reviewing client portfolios to ensure they are properly positioned based on our forecast for the performance of the stock, bond and commodities markets.

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<u>Disclosures</u>

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