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Year End Review and Outlook

The year just ending is unlikely to be fondly remembered by most investors. During a period of continued strong economic performance in the U.S., which featured steady employment gains, impressive growth in corporate earnings, increased capital spending, and moderate inflation, we have been buffeted by unsettling turbulence in our equity markets. While there were concerns throughout the year about trade and tariff issues and sluggish European economic activity, a surge in negative sentiment became pronounced in the final three months of 2018 as focus on claims of Chinese industrial espionage and cyber-attacks, new signs of growing U.S. political dysfunction, intensified attention on future Federal Reserve policy, and scattered disappointing earnings reports impacted investor confidence and convictions.

Without the intention of either belittling the foregoing concerns or of being a Pollyanna, we think an effort to take a balanced view is prudent and justifiable. If, in fact, these issues are the motive forces for the recent disquieting rise in equity volatility, they are not all newly discovered factors, but should be reviewed and carefully weighed again.

Trade and tariff developments have been with us for an extended period. There have been positive changes regarding European, Canadian, and Mexican issues; and, even with the Chinese, there has been progress on trade differences. The larger issue of industrial barriers and cyber security is still unresolved but is unlikely to reverse trade policy gains.

Economic activity in the Euro zone has been affected by a series of one-off events. Many of these have been adjusted, and growth should recover. The Brexit woes continue to beset the U.K. economy, but clarification is likely by mid-2019.

The political climate in the U.S. continues to be sharply polarized. The outlook for positive bipartisan legislative progress and programs is very murky. Any reversals of prior beneficial policies are unlikely in the next two years, and our financial markets usually respond favorably to such stand-offs.

The worries about a potential U.S. economic recession in the near future have returned in recent weeks. Some concerns are reactions to modest drops in business confidence measures in companies most impacted by trade and tariff issues. So far, these concerns have not been widespread or increasing; but they bear watching if they affect capital spending plans. Some slowing in U.S. economic growth metrics is expected in 2019 as the positive impetus of the earlier tax reductions and corporate incentives play out. But, importantly, our view is that the continuing growth in personal income will be supportive in an environment of still benign inflation and reviving corporate productivity and moderate earnings growth as well as a very healthy banking sector. Our best estimate for the domestic economy is for some moderation in 2019, but the overall outlook continues to be broadly positive for growth into 2020.

The worry factor which currently seems to be the most pressing for investors is the future path of Federal Reserve policy for interest rates and monetary liquidity. Our Fed adopted a program of quantitative easing as a response to the serious financial market disruptions in 2007-2008. This playbook included measures to peg short-term interest rates at historically low levels and to inject substantial liquidity by systematically buying outstanding government bonds and other financial assets. These policies changed in 2014 under the guidance of the prior leadership and since have been aimed at gradually reducing the Fed's balance sheet and achieving a "market neutral" interest rate level.

To our mind, the new Fed chairman is proceeding with the same policies as the prior leadership. But, fixed income and equity investors now fear that certain critical elements and cross-currents are not being given proper and timely consideration as to their effects in capital and securities markets now and on the economy in the future. These concerns include the gradual convergence of less expansionary policies by other major central banks, the impact of higher interest rates on our housing sector, the still unknown extent of negative feedback on exports from continued tariff impositions, the sharp decline in the price of crude oil and other industrial commodities, and the upcoming change in the balance of legislative power in the U.S..

The recent increase in interest rates by the Fed was accompanied by some modest reductions in its projections of future rate boosts. Investors were disappointed in the comments by the Fed chairman, who did not seem to acknowledge the negative sentiments of the investment markets or to be concerned that the rate of quantitative tightening was excessive. Chairman Powell is obviously a strong proponent of sound monetary policies and keenly aware of the impact of trends in fiscal issues, such as taxes, debt levels, and government deficits. His comments, which often seem too academic and pedantic, leave the impression of inflexibility to market perceptions of economic and financial risks. As a result, we are subjected to increased market volatility and evaporation of investor confidence.

We think there are valid reasons to expect some changes in Fed actions and guidance in the coming year. Rates have been raised seven times in the past two years, and given the magnitude of these combined increases from a low base and the normal time lag for the effects to be seen in the economy, a pause and a change in projections seem likely. Also, the Fed's Open Market Committee is the group which sets interest rate and balance sheet actions. This group will experience some changes in its composition next year, which could portend some altered policies. If so, the Fed will now be having press conferences after each monthly meeting, and a change in tone may become evident in a matter of weeks.

If our reasoning is correct, then this is where we don our Pollyanna outfit. Our confidence is high for economic and earnings growth in 2019, albeit at reduced rates from those achieved in 2018. Valuation levels for many companies are at low points, and those entities with sound balance sheets, steady free cash flow generation, and demonstrated sustainability of earnings should prove to be rewarding longer term investment opportunities. We are dedicating our efforts to rescreening our existing holdings, while also searching for new portfolio additions.

In the non-equity sectors of portfolios, we are continuing to maintain liquidity positions appropriate to the needs and comfort levels of each client. In the fixed income portions, we continue to favor U.S. Treasury issues in a laddered structure of shorter term and intermediate maturities until we see a definitive shift in Federal Reserve policies.

The last few months have been trying and confusing, but we have maintained our focus on the underlying fundamental forces which have always supported successful investment strategies and longer term results. The economic, financial, and political cross-currents are likely to continue, and we will remain committed to being alert and flexible in our investment actions.

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