NEVILLE, RODIE & SHAW, Inc. / *INVESTMENT COUNSEL*
*Established 1933*
200 MADISON AVENUE, NEW YORK, N.Y. 10016

TELEPHONE: (212) 725-1440
FAX: (212) 689-8746

March 2019

**Quarterly Review and Outlook**

After a volatile fourth quarter which ended with the month of December having its worst monthly decline in over 25 years, the S&P 500 rebounded in January and for the first quarter posted its best start since 1991. This rapid reversal in the equity markets was a result of clarity on a trio of risks that had concerned investors as 2018 drew to a close.

The principal concern of investors was the fear that the monetary policy of the Federal Reserve was too aggressive. After raising interest rates four times in 2018 to a 2.5% target at year end, the market was concerned that if the Fed continued to increase rates at a steady and consistent pace, it could have a negative impact on future economic growth and possibly push the U.S. economy into a recession. After their January meeting, Chairman Powell indicated that given a slowdown in economic activity and an inflation rate that was under control, the Fed was going to take a more patient approach to rate increases. This pivot to a more accommodative stance was again reiterated in the most recent FOMC meeting in March. We will closely monitor the Fed's meeting minutes to see if this tone changes, but for now, it appears they are intent on holding rates steady for at least the balance of the year.

Continuing political uncertainty in Washington also had a negative impact on investor sentiment which was exacerbated by the longest government shutdown in U.S. history. The negotiations, or lack thereof, to try and reopen the government reinforced just how sharply polarized the political climate in the U.S. continues to be. The gridlock between the House and the Senate has created a difficult environment for positive bipartisan legislative progress and will most likely prevent any substantial policy amendments. Investors were relieved that in late January, Congress and the President finally agreed upon a budget to re-open the government through September 30th. Looking forward, the political rhetoric that is building in the lead up to the 2020 presidential election will no doubt continue to send mixed messages and create continuing volatility.

Trade tensions with China escalated further in December and, at times, there were concerns that no deal would be accomplished. There are now tangible signs that trade negotiations are progressing and although the dispute has not yet been resolved, it appears an agreement will be forthcoming as both sides have a vested interest in reaching a deal. China's economy has been slowing noticeably over the past year and a continuing trade war with the United States would only compound China's economic woes. While the U.S. economy is on relatively firmer footing, the pace of economic growth has slowed. Should negotiations drag on with little sign of improvement, business confidence would be undermined, and corporations will be less likely to greenlight stimulative projects requiring capital expenditures. Ultimately, what the trade deal will contain and whether each side will comply to the agreed upon terms remains to be seen, but any movement toward fairness in trade practices would be welcomed by the market, particularly if it results in greater access to Chinese markets and intellectual property protection.

Gaining clarity on these three issues relieved the worries of impending doom that had dominated investor sentiment late last year and thus allowed the S&P 500 and other major equity indices to rebound strongly in the first quarter. While economic conditions are weaker on balance relative to 2018, the question is, are U.S. economic and profit growth just slowing or will they turn negative? As we exited the fourth quarter, many economic metrics including those associated with retail spending, housing, and jobs-related data looked to be weakening. Despite important first quarter data releases being delayed due to the government shutdown, it appears that many of these same metrics have begun to improve. While these latest data points suggest a more moderated pace of growth relative to 2018, the stabilization of these measures bodes well for the balance of the year and support a more positive view on economic and profit growth.

While it is clear that first quarter growth for the U.S. will be relatively weak, it is important to keep such weakness in perspective. Consumer and corporate confidence were affected by the stock market sell-off, but with the financial markets having regained much of the ground relinquished in the fourth quarter, a number of leading economic indicators look more encouraging. Retail sales numbers have improved and, although consumer spending might be getting off to a slow start for the year, it does not seem to have been affected by last quarter's financial market turbulence. The decline in interest rates since the fourth quarter should help the housing market and indeed mortgage applications are trending upward. The government shutdown skewed the unemployment numbers, but with government employees back at work, jobless claims have declined.

Corporate earnings in the 4$^{th}$ quarter were better than feared, but lower than previous quarters in 2018 as the impact from the corporate tax benefit faded and global growth slowed. Earnings should continue to grow this year and are expected to be up about 6-7%. However, the ongoing trade dispute with China has been presenting challenges to economic growth around the world. Some large multinational companies who missed their earnings estimates and issued negative commentary for the rest of 2019 cited slowing international macroeconomic conditions and weaker global trade. A resolution of the trade dispute with China is very important for business confidence, enhanced capital spending and continued gains in corporate productivity as costs are reduced. If an agreement is reached, we would expect to see a quick and upward revision of growth expectations for both the U.S. and international economies.

Due to rapid technological advancements and increased globalization over the past two decades, financial markets have become quicker to discount both good and bad news developments. The byproducts of these changes, including periods of intense stock rotation and portfolio rebalancing were on full display in the past six months. We do not see this volatility easing any time soon. While we remain constructive on the economy, we acknowledge that it will most likely grow at a slower rate during the first half of 2019. Given the sharp rally in equity markets, we are comfortable maintaining cash positions to take advantage of any future market dislocations that might occur. The risk-reward profile of the market is favorable and equity valuations are reasonable at 16.5 times realistic 2019 earnings expectations. We remain focused on analyzing the fundamentals of the companies we own, preferring to focus on sound balance sheets, sustainability of earnings, free cash flow, enterprise value and stability of operating margins. We continue to look for companies to augment our holdings in the technology sector as well as specialty healthcare. We are also looking at companies in the industrial and transportation sectors, as a successful resolution to the trade dispute should boost business confidence and lead to an increase in capital spending.

Within the fixed income portions of portfolios, now that the Fed intends to pause future interest rate increases, we see potential for better opportunities in longer maturity issues in the government, corporate and tax-exempt sectors. We will continue to assess the fixed income portion of our portfolios and make any changes where appropriate on an account by account basis.

Continued political jousting, ongoing trade negotiations and changing economic policies will no doubt impact both corporate and investor conviction and present many challenges during the year. We will continue to be vigilant and responsive to opportunities that arise.