

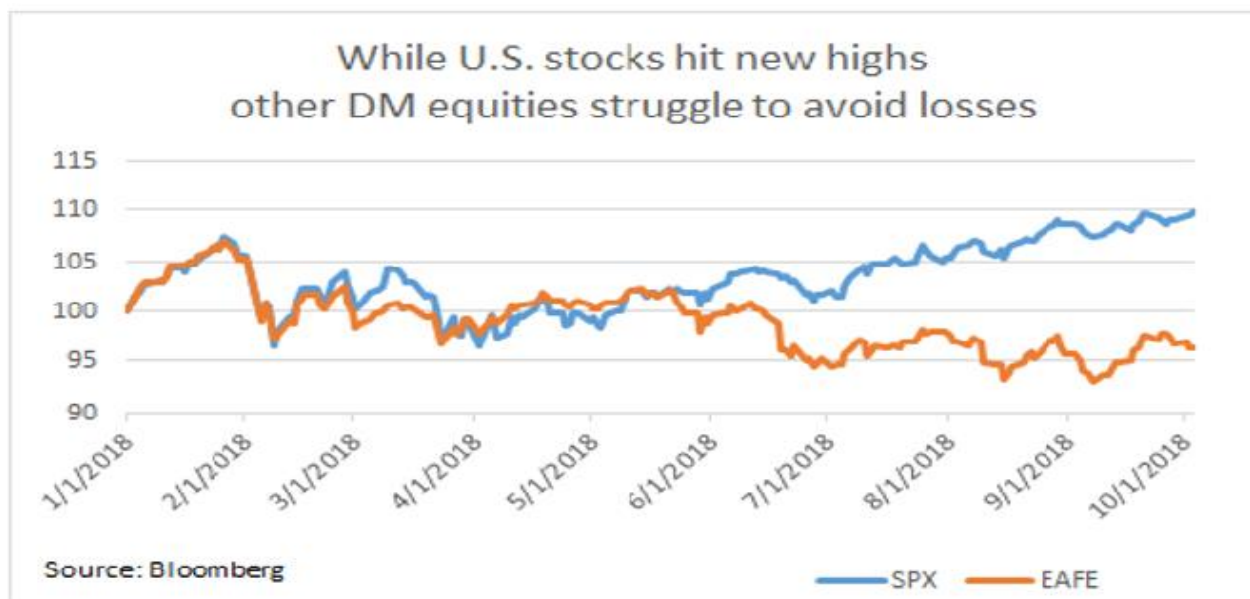
**Q4 2018 Market Commentary-  
Economy is strong now, but rising debt levels and interest rates could cause  
problems in the future.**

While we head into the final quarter of 2018, the economy continues to improve, and we expect the improvements to continue in the near term; however, we are starting to see some items that concern us. In this report, we will comment on why narrow market leadership, rising interest rates, and long term debt levels give us cause for concern. We will also discuss why we believe the economy should be strong for at least another year.

The current equity bull market is the second longest on record. However, it is not the length of the bull market that concerns us. In fact, during the current market rally, the U.S. economy has only recently begun to match growth rates of prior bull market economies. Rather what concerns us is that the current equity market leadership has been very narrow in 2018. Most stocks have not moved much this year. Traditionally this has been a red flag. If the leading stocks pull back, the rest of the market pulls back with them. According to Goldman Sachs, during the first half of 2018, four top performers- Amazon, Microsoft, Apple, and Netflix were responsible for 84% of the S&P 500's return. These are all great companies, but they currently are expensive using traditional valuation metrics. While the S&P 500 traditionally trades at 16x forward earnings, Amazon currently trades at 77x 2019 earnings, Microsoft at 23x 2019 earnings, Apple at 17x 2019 earnings, and Netflix 86x 2019 earnings. Thus, we are concerned how long these stocks can continue to carry the market.

In addition to narrow equity market leadership, other asset classes such as fixed income, real estate investment trust, and emerging markets are flat to down double digits on the year.

The Fed has now raised rates eight times since December 2015, leaving U.S. interest rates far above their developed market counter parts. For example, the U.S. ten year government bond is now over 3.2% while Germany (the largest economy in Europe) is yielding only 0.46%, and Japan yields just 0.16%. The rising rates have caused the value of existing fixed income investments to fall. According to William O'Neil, the Barclays aggregate bond fund index (AGG) is down -3% year to date. Moreover, the rising US rates have pushed the dollar higher which have hurt many emerging markets with dollar denominated debt. Countries such as Argentina, Turkey, and Pakistan now face crises situations as they struggle to pay back dollar dominated debts. The fear is that the currency problems facing these countries could spread to larger economies such as Russia or India, similar to the Asian financial crises in 1997. We fear these discrepancies could lead to political problems as well.



DM= Developed Markets

Rising interest rates will also raise the cost of borrowing, which will not only slow corporate profits, but also put pressure on leading industries such as housing and autos. Rising

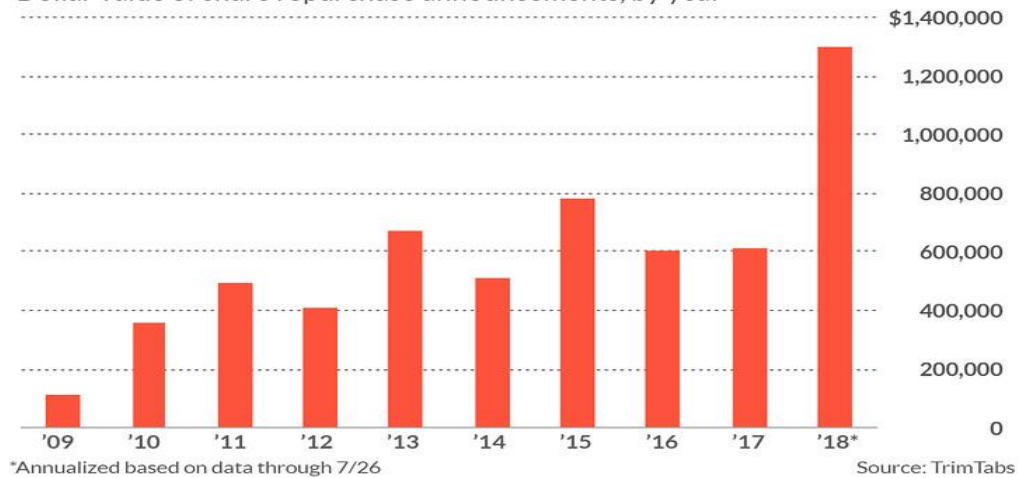
interest rates are also creating an alternative income stream to investors other than dividend stocks, and perhaps most important, create tremendous pressure on the U.S. budget.

While the overall economy remains strong, two of the largest industries, housing and autos have begun to stall due to higher interest rates. Both sectors are interest rate sensitive. As interest rates go up, the cost of financing a home or a car goes up. This is important because the National Association of Home Builders estimate that housing (residential investment and consumption spending on housing services) contribute roughly 15-18% of U.S. Gross Domestic Product. Housing starts this year are already lower than last year's level. According to economists at Bank of America Merrill Lynch, the top is already in for existing home sales, which make up 90% of housing transactions in the U.S. They cite higher mortgage rates, and worsening affordability as the biggest headwinds in the real estate market. Likewise, over 1.7 million people work directly in the auto industry while another 8 million people are employed in goods and services related to autos.

As mentioned above, rising yields create an alternative income stream to dividend yields. As the yield on bonds go higher (the two year bond now yields more than the dividend yield on the S&P 500 index) investors may pull more money out of equities and invest them in safer alternatives. Currently, companies bringing in cash from overseas is offsetting these withdrawals, but this will eventually slow down and stop which will create a problem for stocks because company stock buy backs have been a major support for the market.

## Buyback explosion!

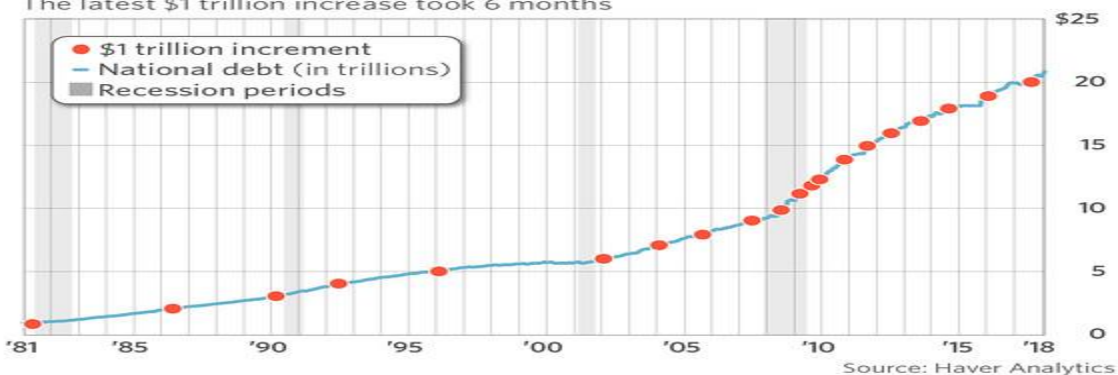
Dollar value of share repurchase announcements, by year



At the end of FY 2018 the gross U.S. federal government debt is estimated to be \$21.48 trillion, according to the FY 2019 Federal Budget. Moreover, the duration of this debt is short, just over five years. Rates on the five year note have grown from 1%, to 3% in the last two years, with a big portion of that move coming into the last six months. If these rates hold, that 200 basis point rise in interest rates will translate into over \$420 billion in additional interest cost as the U.S. debt rolls over. Current U.S. government spending is \$4.407 trillion. Unfortunately, just a handful of programs: Defense, Medicare, Social Security, and interest already consume 85% of spending, before borrowing. Thus, this additional interest cost is going to cause U.S. government deficits to balloon.

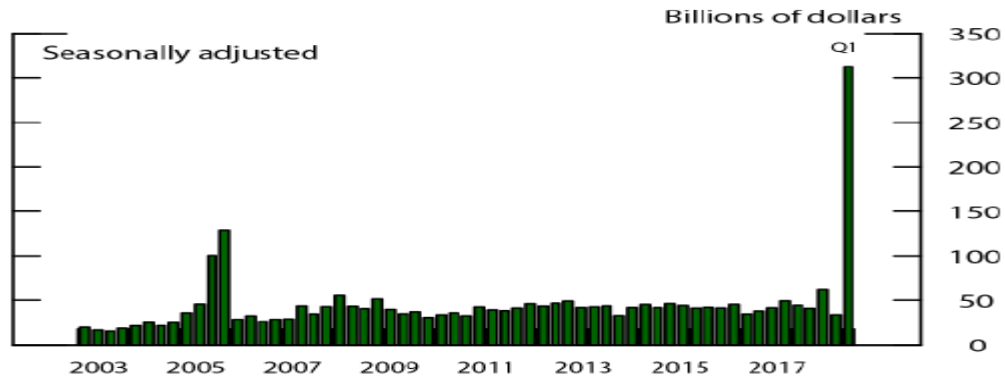
## How the national debt has grown

The latest \$1 trillion increase took 6 months



**Economy looks poised for growth for the next year with the current stimulus in the pipeline and should offset the negatives of rising interest rates and Federal Reserve tightening in the near term.**

Although we fear higher interest rates will eventually slow the economy, increase the budget deficit dramatically, and potentially put the United States into a recession if rates go high enough, we do not see that happening right away. In fact, the next six months to a year actually look strong for the economy. The unemployment rate is now the lowest rate since 1969, business confidence is at high levels, and wages are increasing. We think that so much stimulus is already in the system that the momentum will continue for the next several quarters. Indeed, the corporate tax cuts enacted earlier this year will continue to boost the S&P 500, as only two corporate earnings reports have been announced since the tax cuts have passed. So, we will likely get another two strong quarters of double digit plus earnings growth from the S&P 500 as the corporate tax rate is now 21% instead of the previous 35%. After the year over year comparisons roll over and the quarters show the same tax rate year over year, the earnings growth will slow, which will happen in the autumn of 2019. In the meantime, American corporations are taking this corporate windfall of cash caused by the tax cuts and repatriating money back into the United States. This is also helping to offset the Federal Reserve actions of taking money out of the economy every month under their new quantitative tightening program to slow the economy down (currently the fiscal policy of the United States is very growth oriented, while the monetary policy, which directed by the independent Federal Reserve, is actually getting restrictive).

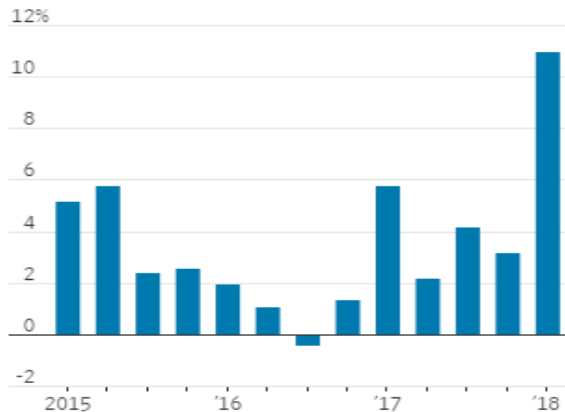


**CNBC- Chart of Money coming back into the USA since the tax cuts.**

Corporations are also using their increased profits to buy back record amounts of stock. These buybacks are helping to fuel the market higher.

**Capital Idea**

Chief financial officers' expected change in capital spending over the next 12 months



Source: Duke University

To be fair, corporations are also using the money to hire new people (hence the lowest unemployment rate in almost 50 years) and reinvest in their own businesses. This can be seen by Chief Financial Officers future spending plans as seen on the chart to the left.

**Rail traffic and the American**

Association of Truckers also confirm the stronger economy with both rail and truck traffic hitting all-time highs. Of note is intra modal traffic, which usually consist of consumer goods, is up 6% this year, which is the strongest in years (this may also be due to tariffs on Chinese goods as stores try to stock up on goods before tariffs kick in). Anecdotally, the American consumer also seems to be getting stronger as both Target and Walmart announced same store sales growth in excess of 4%. This is the strongest number in years, and suggest that average Americans are starting to shop again. Likewise, the strong economic data is reflected in the Index of Economic

Leading Indicators which is hitting all-time highs. This is an index that we are watching closely because once it starts to turn down, a recession usually starts within 13 months later. So what we are seeing is an economy that is doing well, but it is being fueled by corporate tax cuts, which is causing business to spend more freely not only on larger share buybacks (which the stock market loves) but also in hiring more people, increasing wages, and expanding capacity. However, we fear once the initial year over year comparisons wear off, and the one time overseas cash repatriation from the tax cuts wear off, the economy could slow at the very time the Federal Reserve is raising interest rates and the budget deficit is expanding.

In conclusion, we believe there is enough stimulus in the economy to keep corporate earnings strong and unemployment low for at least the next six months to a year. Looking further out, we fear the Fed may overshoot by rising rates to high. Even now, American interest rates are now far higher than anywhere else in the industrialized world and will eventually slow the economy and add hundreds of billions to America's interest cost on federal debt. We believe this will be negative for stocks in the near term but will also create opportunities for investors to increase cash flow by capitalizing on higher yields. To navigate this stormy situation, we plan to remain conservatively invested, pick up higher yielding investments, and focus on companies with strong balance sheets who are returning cash back to investors from both stock buybacks and dividends.

As always, we thank you for your continued support.

Sincerely,



William H. Schnieders  
Principal



James F. Schnieders, CFA  
Principal



John C. Schnieders, CFA, CFP®  
Principal