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Update on Current Market Conditions

Mark Burkhardt, Portfolio Manager July 18th, 2014

In the second quarter, we saw our stock market continue to make new all-time highs as the belief that our economy is strengthening becomes more widely held. The final first quarter GDP numbers came in much worse than any economist had predicted, showing that the US economy shrank by a rather shocking 2.9% annual rate. Obviously there was more at work there than just a very cold winter as an unfortunate pattern has emerged that has typified this recovery since 2008. There have been numerous occasions where the economy has appeared poised to finally get on a sustainable path for growth only to suffer yet another loss of confidence.

It is important to realize that confidence in the future is really the life blood for a business. It is the key requirement that has to be in place for any business to take out a new loan, hire a new employee, or open a new store. Any damage to that confidence carries huge repercussions as that reluctance to take on new risks can reverberate throughout a nation's economy. Depending upon one's political leanings, there are a number of culprits for this confidence killing concern. Government over regulation, high tax rates, costs associated with the Affordable Care Act, a lack of wage growth and political gridlock are and remain the usual suspects. The good news is that in spite of all of these headwinds, economies are by their very nature, self-healing creatures. If time does heal all wounds then the actions of our government will be instrumental in determining whether they can either accelerate or retard that healing process.

In the near term, the biggest risk to our investments and to a lesser degree our economy, remains the numerous geopolitical risks that continue to swirl unresolved around us. We saw last month the price of crude oil spike as the terrorist organization ISIS continued to grab large swaths of territory in Iraq. Thereby raising fears that the country's oil production which both Asia and Europe are dependent upon might be either substantially reduced or damaged. Just five years ago, those fears would be having a severe impact on our energy prices, but times have changed dramatically. If it wasn't for the oil shale boom in the US and Canada, oil would be trading at more than $150 a barrel or 50% higher than where it trades today. With nearly eight million barrels of daily oil production, we have become the world's biggest producer of crude, natural gas, and refined products. As a nation we are becoming less dependent and thereby ever more insulated from Middle Eastern supply concerns.

While that is good for us, the energy demands of the rest of the world continue to increase and therefore those economies are growing more dependent and increasingly vulnerable to any disruption of critical Middle Eastern supplies. While we all remember the Arab oil embargo of the early 1970's and how damaging that was for our economy, those risks have now moved to other areas of the globe. Demand for energy from the growing emerging markets and especially Asia are increasing the foreign demand for Middle Eastern oil and all the risks that their dependence entails.

The second major area of concern that has its own unique set of risks is the ongoing Russian backed separatist movement in the eastern Ukraine. Obviously the downing of the civilian airliner this week has brought this conflict to the front of the world stage as demands for accountability becomes a shared global priority. Aside from the tragic nature of this latest incident, the impact on our investments could prove significant if this crisis is not resolved quickly and diplomatically. It is important to remember how integrated our portfolios are with the global economy. More than half of the revenues for all the S&P 500 companies come from overseas sources. Any dramatic increase in economic sanctions targeting Russia's oligarchy could have an impact on Russia's largest trading partner which is Europe. The political brinksmanship that Putin is seemingly committed to further carries the risks of economic retaliation against the substantial business investments that many American firms have made in Russia over several decades. With the European economy teetering on recession, their reliance on Russian supplied energy makes the pursuit of moral indignation all that more problematic. Geopolitical events, while alarming, don't always translate into economic events. The key point is that the stronger our economy becomes, the more resilient it is to foreign policy events and better insulated from commodity price shocks.

China remains the biggest global economic wild card as concerns continue to mount regarding the country's increasingly speculative financial system. Many economists view the excessive leverage and inflated housing sectors as symptoms of a growing investment bubble, sharing many similarities to where we were before our housing crisis. Many fear that as the number of non-performing loans increase dramatically, that a day of financial reckoning lurks somewhere in the future. There are other powerful forces at work as well, especially with regard to demographics. The communist party's one child per family policy will ultimately cripple China's ability to sustain its economic growth as it will become the first developing nation to grow old before it grows rich.

Turning to home, we are well into the sixth year of what has become the weakest recovery since the Great Depression. While the investor class has been the biggest beneficiary of the Federal Reserve's extraordinary monetary actions, and have prospered handsomely since 2009, most of our fellow citizens have not. Most Americans, other than what they have put away in their employer's retirement account, have very limited savings. Add to that an economic landscape in which average household incomes are still not showing any signs of growth. That's great if you're a shareholder as your labor costs haven't been rising, but not so great if you're the employee. The latest census report found that median household income, adjusted for inflation, was $51,017 in 2013, down about 9 percent from an inflation-adjusted peak of $56,080 in 1999.

With a 15 year track record like that, it is completely understandable when you see the latest polls showing that for a majority of Americans they feel that their goal of a comfortable, middle class life is becoming harder than ever to attain. It is my opinion that the Federal Reserve is over estimating the current slack in the labor markets and that we could be reaching a point for rising wages much sooner than they currently expect. A large portion of the nation's unemployed are what we term the structurally unemployed in that they either lack the skills employers are seeking, have lost the desire to work, or are very close to qualifying for social security benefits that they are unwilling to undertake a new career. There is growing evidence that across the country, large numbers of job openings remain unfilled because of a lack of qualified applicants. So what we will see develop is a two tiered labor environment, one group comprised of the chronically unemployed and another of highly sought after skilled workers who in an increasing competitive environment can demand and get the higher wages their prospective employers will be forced to pay. Skills and trades that were once common in this country such as precision welders and machine tool operators are becoming increasingly hard to find and companies that need to fill those positions are often forced to train recruits in-house or on the job.

From a portfolio management perspective, the US equity markets are much closer to being fairly valued than the undervalued levels that they enjoyed just over a year ago. That's not to say the markets are overvalued but rather priced to perform as expected. The margin for error, such as missing earnings or revenue estimates is much narrower and therefore the market will be much less forgiving of any such disappointments. Before the financial crisis, US companies were very much like a group of out of shape former athletes. They were bloated, had poor internal controls and a general lack of discipline with regard to the amount of debt they were exposed to. The financial crisis was a seminal event, it was as if all these companies were sent back to training camp and we would see which ones would make the team. The companies that emerged are now in the best shape of their corporate lives. Debt has been pared back and refinanced, operations are lean and constantly scrutinized to reduce costs as managers are poised to exploit every opportunity to increase revenues both here at home and abroad. The only thing that is missing from what should be an ideal earnings environment is the conviction that economic growth will be both robust and sustainable.

For the remainder of the year I will continue to follow the prudent investment path that has served my clients well for the past 25 years. Investing in companies and industries that offer compelling value, long term sector growth and significant dividend income has been the one of the best ways to create and perpetuate wealth. All the while being mindful that unexpected events, such as a dramatic increase in interest rates, would create risks that would necessitate my taking a much more conservative and defensive investment posture. I am fully aware of my responsibility that once created, a client's wealth must also be protected and preserved from the market's inevitable risks. Risks that can only be identified and avoided through my constant vigilance and objective analysis of global economic events.