July 10, 2018

THE END OF ACCOMODATION

Dear Investor:

Right now you have to think the glass is half full or more. The data that comes out each month continues to paint a fairly good picture of our economic situation. We currently have solid growth and almost rock bottom unemployment. This has led the Fed to be very clear and straight forward in stating their plans to continue to raise rates at a steady pace. Chairman Powell has said recently, " with unemployment low and expected to decline further, inflation close to our objective, and the risks to the outlook roughly balanced, the case for continued gradual increases in the federal funds rate is strong." Since they began in December 2015, the Fed has now raised rates six times. The Core PCE inflation index, which the Fed follows very closely, hit their goal of 2% in May for the first time in six years. This shows me that the economy has apparently been able to absorb these rate increases without losing momentum. You have to wonder if the picture would be different without the tax cuts, but there's no way to know for sure. Clearly there is energy in the economy, and the Fed doesn't want to let inflation accelerate much beyond 2%. The market is currently expecting two more increases in 2018, and more increases in 2019 as the crisis era accommodation comes to an end.

The economy grew at a 2% rate in the first quarter, and is expected to be in a range of 2.8% to 3.8% in the second quarter. The job market is doing exceptionally well. Everything I read talks of labor shortages and problems companies are having finding qualified workers. I read an ad in the Wall St. Journal a while ago where Union Pacific railroad was offering $25,000 bonuses to find workers. I don't know what the terms were, but that's a lot of money. There is also huge demand for truck drivers, construction workers, and many other types of skills. The only sector doing poorly is retail workers, and we all know that internet shopping is the reason. The "quit rate" is the highest since 2001, which means that people are confident they can quit their current job and easily find a better one.

I've mentioned the housing market a couple of times in the last year. The intense situation with supply and demand has not changed. New home sales are up over 14% from last year. Housing starts and permits are both soaring. Existing homes sell in days, but realtors still say there is not enough supply. They could easily sell more houses. Nationally, prices are on a tear and are still rising much faster than inflation, which does concern me. The number of renters has fallen for well over a year now, and more Millennials have told researchers they want to be owners. Many have entered the market, but high prices are a very strong headwind for them.

Strong consumer spending is also contributing to the growth. It fluctuates from month to month but overall has been increasing. The thing that does concern me is credit. Credit card usage accelerated again in May, and the savings rate has fallen to around 3%. I mentioned last time that banks have been tightening up in response to rising delinquencies. At the same time, they are sending out

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millions of new credit offers to drum up business. Haven't we seen this movie before? Human nature being what it is, people do get tired of scrimping and saving, and they want to spend. It's important that lenders keep control of the situation and don't let credit expand to a dangerous point again.

The market has progressed very slowly over the first half of this year. That might seem surprising considering how well things are going. We know the market is always looking ahead, so understand that the good conditions we are experiencing now were already priced into last year's market which was up over 21%. This year we had a big surge in January, which I mentioned before was a touch of euphoria in my opinion. That was followed by a sharp, but brief, selloff in February. Since then, things haven't gone very far. There are really only a few sectors that have been advancing. Technology and Consumer Discretionary are both up over 10% thru the first half of the year. In Q2 there was also a modest rally in Energy due to rising oil prices. That sector is up about 5%. The rest of the market has been flat to down, with Consumer Staples and Telecom down over 10%. I've been thinking this is somewhat like a stealth correction. Overall, P/E ratios have come down significantly since January, and are now at much more reasonable levels. Except for the two hot sectors I mentioned, prices in the other sectors of the market are in good shape relative to their 5 and 10 year averages. This should make them attractive to buyers in the months ahead. The earnings growth rate for Q1 was almost 25%. According to Factset, industry analysts are expecting double digit earnings growth every quarter this year. If this happens, they believe it would lead the market notably higher a year from now, around 13% higher in their estimation. I want to stress this is not guaranteed in any way. This is the current outlook and there are many things that could change anytime that would lower the earnings projections.

Trade tensions are definitely holding the market back right now. Although I'm reluctant to use the term "trade war" at this point, we are clearly in a situation where tariffs being imposed by several nations on each other's products are escalating. We don't know how much of this is negotiating tactics, or if many of these tariffs will remain in place for extended time periods. This creates substantial problems for business leaders as they make their plans and investment decisions. It also creates problems for investors and analysts in trying to determine company earnings. Some of these tariffs have already raised input costs for some of our companies. The overall effect on the market is substantial uncertainty as there is no way to know how this will ultimately play out. It could fizzle out with little impact or possibly drag on for many years. Uncertainty is never something the market likes. I expect we will be talking more about this in the coming months.

Best Regards,

David E. Keim

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