President's Letter – July 2017

For many investors summer is a time to focus on barbeques and vacations and to spend less time worrying about the daily moves in their portfolios. We, however, remain watchful.

As we move into the third quarter, market volatility remains low—albeit higher than it was—but certainly within a comfortable range. The economy continues to make solid progress. With unemployment falling and wage growth improving, consumers and businesses have maintained a favorable outlook on our country's prospects (see the chart below). The stock market has rewarded companies who have shown they can grow their earnings and punished those that have not. We have witnessed a momentous shift since the election last year as sectors that performed well right after the election have pulled back (financials, commodities, industrials) and sectors that were initially down after the election have recovered nicely (technology, healthcare). This sector rotation serves as a dual reminder that (1) markets frequently misprice securities in the short-term and (2) long-term investors should act with a level head when digesting market news and events.

One of the most significant changes taking place in today's economy is monetary policy. The Fed has now raised short-term borrowing rates four times over the last 18 months (a total of 1%). While this represents a small move by historical standards, it signals the economy is strong enough to stand on its own without the benefit of artificially low interest rates. Fed Chairwoman Janet Yellen has proposed further rate hikes, as long as growth remains on track. We watch the Fed's rate hikes carefully because higher rates have the potential to discourage borrowing and to impede economic growth (and we are a country of borrowers). Since the financial crisis, consumers have shown themselves to be less willing to borrow at the high levels, like the ones we saw leading up to the 2008–2009 market correction. While

this is ultimately a good thing, it has served to slow down economic growth and, some might argue, extend the recovery (lower growth for longer).
As the Fed continues to focus on rate normalization, the surprising lack of inflation in the system has remained in the spotlight. Prices for many goods and services remain subdued, and rates have followed suit. With low inflation, and reduced expectations about President Trump's ability to generate growth, the 10 year US Treasury bond is only yielding 2.3%. This benchmark rate is indicative of rates in the broader bond market and shows inflation expectations remain low. Without an uptick in inflation the Fed—whose primary job is to control inflation—will be hard pressed to continue tightening monetary policy. Janet Yellen and her colleagues will certainly follow this carefully as they determine what their next steps will be.

We remain vigilant and focused in our efforts to uncover value and monitor the key pieces of information in our economy and the markets. All signs clearly indicate we are in the late stages of a bull market. Companies today are tasked with finding ways to grow their businesses and providing higher returns to their shareholders. The easy money has been made: Gains going forward will accrue to those who can deliver fundamental improvements to their businesses. Fortunately, the economy remains on sound footing and overall is providing a favorable environment for business. Geopolitical risks and turmoil in Washington will continue to provide head winds and potentially act as a catalyst for increased volatility. With the recent failure of President Trump's efforts to replace the Affordable Care Act, questions remain about how much of his agenda will be put into place. Ultimately time will tell. In the meantime we continue to seek out good companies, whose share prices are trading below where their intrinsic value lies. Strong balance sheets can provide a cushion to higher rates, dividend payments have proven to be a very important part of overall investment return, and companies selling valuable products and services will always find a market. Seeing through the noise and focusing on the fundamentals is an exercise in which we must continue to engage, no matter how loud the noise becomes.

Thank you for your continued support and trust; as always please do not hesitate to call or email with questions or concerns.

Sincerely,

Eric

Eric O. Kallen
President, Hayek Kallen Investment Management