SASSER

INVESTMENT MANAGEMENT, INC

Disciplined Value Investing

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Q2 2018 Commentary: political headwinds are just that

Generally, politics has little impact on our investment process and decision making. Most government policy just does not impact the outlook for our investment portfolio in a meaningful way. For the first time in a long time, however, politics is forcing its way into our thinking about the investment environment.

Foremost among concerns for the bull market's prospects are the trade conflicts the US has started with countries around the world. Unfortunately, the threat of tariffs and trade wars is not going away any time soon. At this point, the conflicts are only skirmishes and we do not believe they will develop into something that dramatically alters the investment landscape. The economic impact is not yet significant, and the greatest impact has been on stock market valuation. If the threats continue or escalate, investor uncertainty will increase, and investors will become more cautious. The impact on the stock market of investors becoming more cautious is a lower valuation of stocks. Our outlook could change, but for now tariffs are only a headwind for the market and not something that will cause a serious stock market event.

The US economy keeps chugging along. Job growth has been steady, adding around 200,000 new jobs each month. The unemployment rate fell to 3.8% before ticking back to 4.0% last month. The reason for the uptick was due to people re-entering the job market which is actually a sign of strength. In his semiannual testimony before Congress, Fed chairman Jerome Powell was unequivocal that the economy was strong. He reiterated that tax cuts and government spending would sustain demand going forward and there is little threat of recession. Inflation is running close to the Fed's 2.0% target which has allowed the Fed to take a measured approach to interest rate increases which investors have accepted without problem.

In response to economic strength, the Federal Reserve raised rates in June to a range of 1.75% to 2.00% and signaled that it was prepared to continue raising short term rates steadily into 2019. However, a byproduct of the Fed's interest rate action is what's called a flattening yield curve in which short-term and long-term interest rates converge. The 2-year US Treasury yield was recently just 0.24% lower than 10-year US Treasury yield. The spread was the lowest since 2007. Historically, a flat yield curve has not necessarily provided a reliable signal about the economy. However, an inverted yield curve, in which short term rates rise above long-term rates, has been a significant event that often precedes a recession. For this reason, the yield curve has attracted a lot of attention. The situation is a concern, but again not so much that we change our outlook. An inverted yield curve is a rare occurrence and until it happens we can stand pat.

Investor sentiment has become more cautious and that has been reflected in higher volatility this year. Investor concerns have led to the first half of 2018 being a mixed bag for the stock market. Still, the S&P 500 is up for the year. We must not forget the economy is sound, inflation is under control and earnings growth continues to be robust. Third quarter S&P 500 earnings are expected to grow by over 20%. Meanwhile the market price to earnings valuation is a comfortable 16 multiple. We have been in a long bull market and at some point, it will end, but we do not think it will happen any time soon.