Commentary: 3rd Quarter 2018

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Commentary by Lead Portfolio Manager:

James T. Moylan, MBA, CFA

US economic activity, corporate earnings and domestic equity returns were all strong this past quarter. We expect these robust fundamentals to moderate some going forward but they should still exhibit highly favorable growth trends.

US GDP growth was above 4% in Q2 and is expected to exceed 3.5% in Q3. US corporate earnings growth approached 20% in Q2, with just less than half of that the result of corporate tax cuts. The S&P500 index increased by more than 7% during the quarter and is up roughly 10% for the year.

Our main concern now is that the rest of the world is not experiencing the same strong fundamentals. Euro-area economic growth is less than half the US growth rate, unemployment is more than twice the US rate, and Europe's equity markets are flattish so far this year. China's growth has been slowing and its equity markets have declined by 9%. Emerging markets generally have been weaker with currency weakness exacerbating import costs (e.g. oil) and increasing the financial risks of holding dollar-denominated debts - particularly for Turkey, Argentina and Indonesia. The overall concern is that slowing growth around the world may impact US growth.

The US dollar is structurally attractive relative to other global currencies because it is supported by much higher short-and long-term interest rates. Going forward, we believe that the Fed's interest rate policies and balance sheet normalization will result in continued dollar strength. This is favorable for US assets although it could result in slower growth domestically and reduced exports internationally.

Finally, the broadening of the trade war with China into a more protracted economic event will also be a headwind for US trade, and may cause a slight bump in inflation as the costs of some goods rise. However, this trade skirmish is more expensive to China -- they seem to be prolonging negotiations largely for domestic political reasons. Other countries, including the US, are benefitting as companies are concluding that China isn't quite as attractive as it once was as the low cost producer. On balance, we remain optimistic that this ongoing negotiation with China will end with a satisfactory result.

Putting this mosaic together on behalf of our clients, we still believe equities have a better long-term risk-reward than bonds. We feel the headwinds mentioned above will be more than matched by the continued strength of US consumer spending and business investment. Q4 is typically the strongest quarter of the year for equities and we expect favorable US fundamentals to continue this quarter and well into 2019.

About the Author: Jim, a Chartered Financial Analyst, co-manages SFE's US–Equity All-Cap Core Growth & Income strategy. He also has investment management responsibility for SFE's Pathways™ (SRI) All-Cap strategy. These are separately managed accounts created for clients interested in socially responsible investing. Jim is a shareholder in SFE, serves on its Investment Committee and writes the firm's quarterly market commentary. Before joining SFE in 2007, Jim was an equity analyst and portfolio manager for 12 years at McCullough, Andrews & Cappiello, a value-oriented investment management firm in San Francisco.

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SFE Investment Counsel Inc.
801 S. Figueroa Street, Suite 2100 Los Angeles, CA 90017
Telephone: 213.612.0220 Toll Free: 800.445.6320 Fax: 213.612.0329
Registered SEC Investment Advisor