September 30, 2018

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ECONOMIC & MARKET UPDATE

After a first half of the year when both stocks and bonds produced returns that were either slightly positive or slightly negative, the third quarter turned out to be more satisfying. The stock market resumed its uptrend, while bonds, both corporate and municipal, had to compete in a rising interest-rate environment. Bond returns remain marginally negative year to date, but the short maturity structure of the portfolio has been very helpful in limiting the downside.

> "It was the best of times, it was the worst of times...."
> Charles Dickens, *A Tale of Two Cities*

While Dickens writes of two cities, we use the famous opening line of his book in a different context: economic and financial. On September 15, 2008, almost exactly ten years ago, Lehman Brothers filed for bankruptcy, setting off the financial crisis that led immediately to the Great Recession, the largest contraction in Gross Domestic Product (GDP) since the Great Depression of the 1930s. Indeed, it was the worst of times. Now, ten years later we find ourselves in a very strong economy with a stock market that has just reached all-time highs. For many investors it is the best of times. In this letter we will look briefly at where we were, where we are, and where we might be headed as an economy. As always, there will be implications for investment.

THE WORST OF TIMES In observance of the ten-year anniversary of the financial crisis, much has been written, appropriately so. With the passage of time it is easy to forget just how frightening those days were. As the financial markets seized up so did the economy. Unemployment quickly went to over ten percent, and the stock market declined more than 50% peak to trough. While the damage to the stock market was over in about six months, its psychological impact figured strongly in the minds of investors for a long time, causing many to forsake equity investments to their great detriment. The economy bottomed in the spring of 2009 and began a long, slow climb toward health, aided by the Federal Reserve (Fed) reducing short-term interest rates to zero and leaving them there for years and the nearly trillion-dollar Obama stimulus plan enacted by Congress. The recovery was steady, but averaged only 2% GDP growth per year until this year. This brief summary does not do justice to the pain inflicted upon homeowners, retirees, stockholders and ordinary working people. Fear was pervasive. The financial system and our economy were at risk of collapse. It is fair to say that it was the worst of times.

We should add that bondholders in general fared better if they were invested in the highest quality bonds--corporate, municipal or Treasury. We stress the importance of high quality, for lower quality bonds and, in particular, junk bonds were in most cases damaged like equities. The bonds considered safest actually benefitted as interest rates moved sharply lower as a result of Fed action, validating the belief that bonds can play a major role in capital preservation.

THE BEST OF TIMES We fast-forward to the present where we find ourselves enjoying a growth spurt in economic activity that is broad, encompassing the consumer and business sectors. Second quarter GDP growth was the fastest since 2014, unemployment remains under 4% as the economy continues to produce some 200,000 new jobs per month, capital spending this year is on the rise, confidence among consumers and businesses is high, and, as mentioned above, the stock market is at all-time-high levels. The Trump corporate tax cut has been a boon to corporate profits, partially accounting for gains in earnings of 20% or more compared to last year. Much of the corporate earnings are going into stock buybacks and, to a lesser degree, dividend increases. With the exception of the fact that a disproportionate amount of wealth and income is being created at the top end and wages are just now beginning to approach more normal levels, it is a very good picture.

WHAT WE LEARNED Much of what we learned from the experience of the last ten years was actually a reinforcement of beliefs we have held and practiced for many years. We know from our thirty-eight years of history that every economic cycle is different, bringing new challenges and offering fresh rewards. This one was certainly no exception. Here are some of the things we learned.

- Even in the darkest of times, do not lose faith in the enduring strength of the U.S. economy. Excesses can develop that leave the economy unbalanced and vulnerable. We are never in a perfect economic state, but the system's ability to adjust and correct excesses has been proven time and again. Both monetary and fiscal policy can be successfully brought to bear on economic problems, as was the case in the Great Recession. Blind optimism is not the answer, but informed optimism is usually the best course.

- Stick with quality. This applies to both bond and stock investors. Every economic cycle has two sides: the upside and the downside. In order to enjoy the upside and be protected on the downside, owning the stocks or bonds of companies that are built to last typically enables the investor to achieve success over a full market cycle. Our selection of these high-quality companies is informed in large part by their ability to pay dividends and raise them on a consistent basis.

- Stay fully invested. At the bottom of the cycle when things look the bleakest, it is very easy to capitulate and sell out. However, once out of the market, one has to decide when to reenter. In the case of stocks, they are forward-looking, and they always begin their recovery well in advance of improving economic conditions. Over the years many investors have attempted to call these turns in the market, most often with little success. A better approach, in our view, is to own the highest quality companies and benefit by participating in the up cycle but enjoy the downside protection they provide when market weakness is most extreme. Owning strong companies and growing with them over the long term has proven to be a lower risk, successful approach.

WHERE DO WE GO FROM HERE? Looking ahead, we recognize the difficulty of predicting the future. We will not attempt to do so. But regardless of the twists and turns of economic activity, our informed optimism suggests that there could be opportunities for successful investing over the long term. On a shorter or more intermediate basis, we know that this economic recovery/expansion has gone on for a long time. This does not necessarily mean it is about to end, but at this late stage being on watch for excesses is prudent. We also know the Fed is in the process of normalizing interest rates, raising the federal funds rate steadily in an effort to maintain balance between consistent growth and stable inflation. Knowing how far to go and in what time frame to execute this policy successfully is difficult, and policy errors can be made. We know that the federal budget deficit is almost sure to be widening as a result of the recent corporate tax cut. We also know that our trade policy is under dramatic revision with an uncertain outcome. These are all risk factors that are best kept in mind.

The U.S. economic engine seems to be running very smoothly at this time, and we hope that current conditions are sustainable. We do note, however, that some have conjectured that we are enjoying the best economic activity of the cycle right now and that we are about to start on a long journey back toward economic growth that is more typical of the 2% level of the last ten years. Giving credence to this point of view is the basic economic law that GDP growth is a result of population and immigration growth and productivity. Demographics assure us that slow population growth lies ahead. The hope is that productivity can improve as a result of greater capital investment by companies.

Balancing our longer-term optimism with the potential risks that we have noted, we will employ the above-mentioned lessons learned as we move forward with your investment program. Expect us to maintain a constructive view of the longer term, stay fully invested, and above all, invest in the highest quality instruments we can find.