



December 2018

As I sit down to write these letters I always go back and reread the last couple. I look for errors, changes in direction or opinions and review the overall theme. The Q4 2017 newsletter outlined a positive but lackluster 2018 and that is not too far from reality. The economy continued to move along, corporate earnings continued to grow and the markets fell a few percent. That last point is out of place but understandable. In 2017 the SP500 closed up almost 20% and part of that was due to the 2018 corporate tax cut. 2018 had, and still has, the economicumph to continue higher but a handful of economic concerns started blurring the picture and making investors nervous. The potential trade war with China has been the biggest concern. There are very real issues that need to be addressed concerning this relationship and this is a fight that has been coming for a while. If we dodge it this time, it will come back up sooner rather than later. I will leave it to the experts to debate whether the current administration is up to the task but the war itself will always be an undercurrent of any discussion involving international economics.

Valuation Measure	Description	Latest 12/31/2018	25 year average
P/E (forward)	Price to Earnings	14.4	16.1
P/B	Price to Book	2.7	2.9
P/CF	Price to Cash Flow	10.6	10.7
Div./Price	Dividend Yield	2.3	2.0%

*Data as of 12/31/2018 - Current price divided by consensus analyst estimates of earnings, book, cash flow, sales and earnings growth for the next 12 months. Data provided by J.P. Morgan Asset Management

Equity

The equity markets in 2018 were disappointing. They were erratic, volatile and disappointing. Corporations reported strong earnings growth, with or without the tax cut, yet markets finished down a few percent across the board. The worst performing sector of 2018 was Energy. This is great news when you are filling up your car, but overall it isn't the good news that it once was. The United States has become a major producer of oil and the lower prices hurts far more people than it did in times past. It has been difficult to get good data but I suspect that cheap energy is still a net benefit to the U.S. economy but that may not be the case going forward.

The markets are priced as if to assume that earnings will be down during 2019. I fully expect the rate of earnings growth to be down from 2018 due to the temporary bump that we received from the tax policy change but overall earnings should be better than 2018 across all sectors of the economy. We will continue to invest in strong companies at reasonable prices.

Fixed Income

Rates are going up and the Federal Reserve will continue to tighten. If history is any indication, the Federal Reserve will continue to tighten for a least a quarter to two past when they should stop. This will continue to put pressure on fixed-income prices and make generating a return in fixed-income very difficult. The majority of the largest fixed-income funds (measured by assets) barely broke even or generated losses in 2018. There are real risks in the fixed income markets but we are starting to see a little light at the end of the tunnel. I hope to start making more meaningful investments in fixed-income, where appropriate, during 2019.

Economic Overview

"The economy, stupid", was coined by James Carville in the 1992 presidential campaign and has since been co-opted by many of us as "It's the economy, stupid" but either is appropriate today. The economy and the markets are not the same. The markets are typically a good indicator of the economy but as Paul Samuelson once joked, "The stock market has predicted nine of the past five recessions." The markets are forward looking but they are not always correct. The U.S. economy is strong. Unemployment is at historical lows and hourly wages are going up at a rate of 3.5%. In order for workers to feel as if they are doing better, the rate of increase needs to exceed inflation. Wage growth is currently exceeding inflation by over 65%. Household debt payments as a percentage of disposable income is as low as it has been since 1980. The labor participation rate is still below the 2006/2007 levels and this is frustrating. The labor participation rate continues to improve. Now that wage growth has started moving, we should see the participation improvement accelerate.

Conclusion

2018 was a frustrating year to be an investor. This was the year that political stories overshadowed economic growth and value meant far less than headlines. The economy will grow slower in 2019 than it did in 2018. We will most likely trend back towards 2.5% GDP growth but that is a far cry from a recession. Too many of us get caught up in the day to day drama. Traders base decisions on trends and headlines. Investors base the decisions on balance sheets, income statements, business models and management. Traders get caught up in rumors while investors focus on people and the business' they run... we are investors.

The markets are currently trading at levels that assume everything will continue down the wrong path. The downside risk is limited and barring a black swan event, the chances at an upside surprise are strong.

Cheers to a better 2019!

A handwritten signature in black ink, appearing to read "Rick Sanford", written in a cursive style.

Richard "Rick" L. Sanford, II
President