SUMMER 2019 | VOL. 26 | NO. 3
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

OPTIMISTIC YET REALISTIC

Will Williams *Chairman, President & CEO*

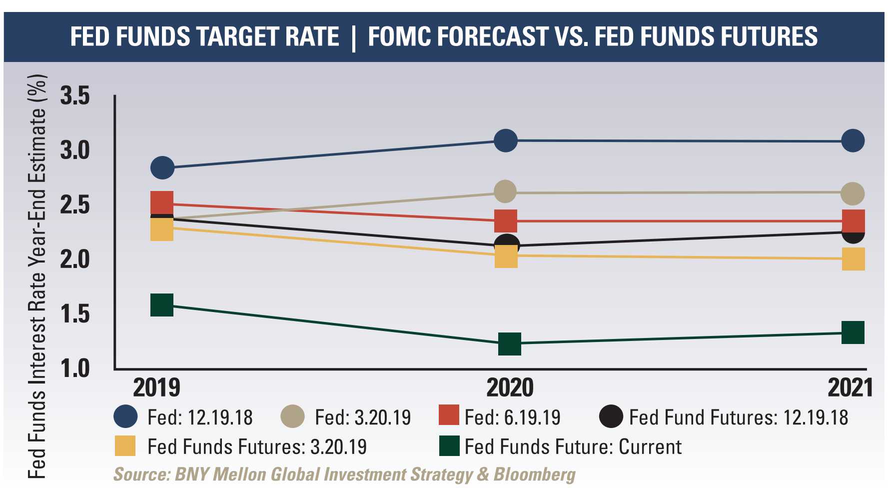
In recent weeks, I attended a conference of my investment management peers and spent a few hours in a breakout session listening to Charles Schwab & Co. analysts, Liz Ann Sonders and Jeffrey Kleintop, provide their 2019 midyear market insights. In tandem, they proceeded to rattle through a multitude of economic and market slides. Very early on in their presentation, the message that they were attempting to convey became quite apparent. It is their belief that the U.S. economy, now 120 months in expansion mode, is beginning to tire and could quite possibly be on the verge of recession. So much for an uplifting, glass is half-full presentation! I must admit, however, that they successfully laid out a compelling case that the global economy, primarily due to the disruption caused by the ongoing trade dispute, was beginning to lose steam. They did remind us that the current economic expansion, despite its longevity, was the weakest in history. In other words, it was not going to take much of an economic speed bump to derail its positive momentum.

It is hard to ignore the evidence that things have slowed down. It is not just one or two indicators that are providing warnings signs, but a host of leading indicators that are trending lower. Most would say that this contraction is more pronounced on a global basis rather than U.S. domestic basis, as the repercussions of the trade war are more impactful on exporting countries. All of this translates into a much slower Earnings Per Share (EPS) growth rate for the S&P 500 in 2019. According to Factset, EPS in the second quarter of 2019 is forecasted to come in 2.6% lower than the prior year. Earnings guidance has also turned a bit negative, with a 3:1 ratio of negative to positive releases going into Q2 earnings season.

Interest Rates

Interest rates have garnered a lot of attention of late. The ongoing drama between Fed Chairman Powell and the White House is interesting to say the least, but more important is the shape of the fixed income yield curve and the future direction of short-term interest rates. Last quarter we highlighted the predictive nature of an inverted yield curve (when short-term interest rates [2yr] are higher than long-term

(continued on page 4)



Brian Christensen, CFA
Senior Vice President & CIO

THE TIT-FOR-TAT NEGOTIATIONS OF U.S. TRADE AND TARIFFS

The on-going negotiations between the U.S. and its major international trading partners continues to be a hot topic among investors. In 2018, the U.S. announced several protectionist policies targeting trade with China. Items targeted since early 2018 include solar panels, washing machines, steel, aluminum and about half of China's imports. Chinese imports of U.S. agricultural products have seen reduced demand as a result. In response, China, the European Union, Mexico and Canada reciprocated with tariffs on various U.S. goods. By the end of 2018, a slow-down in global economic growth was clearly evident. Large export driven economies (China, Taiwan, Japan, and Europe) saw the greatest declines.

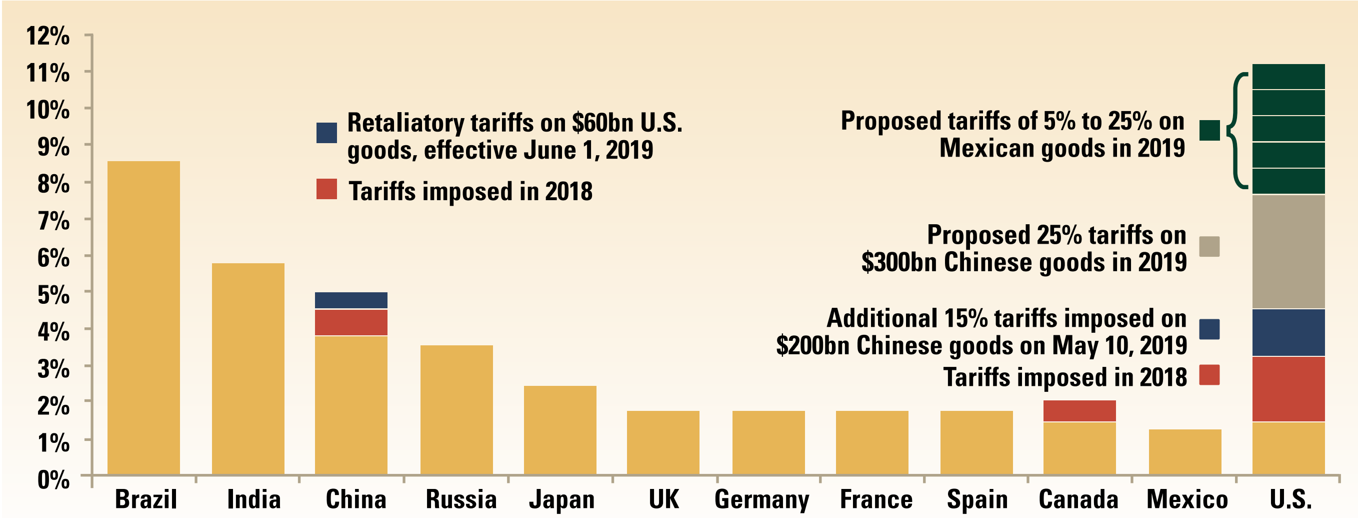
At the end of 2017, U.S. tariff rates sat at 1.4%, the lowest in the world. At the end of 2018, tariffs had risen to 3.2% placing the U.S. ahead of most developed market countries but behind the emerging economies of Russia, India, Brazil and China. So far in 2019, the situation hasn't improved and negotiations among countries, primarily the U.S. and China, have been unsuccessful. Effective June 1, the U.S. increased tariffs on $200 billion of Chinese imports to 25% from an earlier 10% level. In response, China applied a 25% tariff on $60 billion of U.S. goods. The U.S. average tariff is now 4.5%. U.S. threats of additional tariffs, if enacted, would place its tariff rate above 11% and be the highest among all major economies of the world. The chart on page 3 provides a glance at current and proposed global tariff rates.

So, what are the risks to our economy and financial markets if this trade war continues to persist?
First, many of the U.S. imports being affected by the tariffs represent a very small portion of our total. In 2017, washing machines and solar panels accounted for approximately 0.4% of total U.S. imports. Steel and aluminum were more significant but still only 2% of imports – and 70% of those imports are exempt from the new tariffs. U.S. foreign exports totaled about $1.7 trillion and imports totaled about $2.5 trillion in 2018. To date, the tariffs are not big enough to significantly threaten either the U.S. or China economies, but a further escalation from here will become problematic.

In 2018, the U.S. economy did not experience meaningful headwinds from the trade war. However, the lingering uncertainty, now fully present, can be expected to slow economic growth and reduce sentiment in financial markets and corporate board rooms. Uncertainty about future trade policies will cause businesses large and small to think twice before making investments in plant, and equipment, hiring new employees, expanding into new regions, or adding new products or services. All of this threatens corporate earnings growth. Both 2019 and 2020 earnings estimates for S&P 500 companies have declined 4% from the beginning of the year. U.S. based multinational corporations appear to be most at risk given their exposure to non-dollar revenue. Currently, a little more than 40% of revenue in the S&P 500 companies is

(continued on page 3)

CONTINUED FROM PAGE 2



Source: IMF, U.S. ITC, World Bank, J.P. Morgan Asset Management. Historical tariff rates are 2017 figures. Data are as of May 31, 2019.

from non-U.S. sources. Industries with relatively little exposure to Chinese or other sources of foreign revenue include utilities, consumer staples, telecom, domestic energy, and real estate and have been identified as potential safe havens should the trade war escalate.

President Trump and China's President Xi Jinping met separately in Osaka, Japan on June 29th while attending the Group of 20 international economic summit. While specific details remain unclear, both sides seem to have agreed to a truce on further tariffs and a resumption of negotiations. A similar truce that developed after a December 1st meeting in Buenos Aires only lasted until May when both sides initiated additional tariffs. Trade tensions between the U.S. and China don't appear to be escalating, but there still is no clear path toward a deal between the two largest economies of the world. Stay Tuned.

DVI GOES OVER THE EDGE

In June, DVI sponsored a team of 4 individuals who were elected to participate in the 2019 Over the Edge event to support Peoria Friendship House. All 4 DVI associates found the courage to climb up on the ledge of the iconic Pere Marquette Hotel and rappel down 12 stories back to the safety of the ground below.

With 8 teams and 39 participants, the Over the Edge event raised over $70,000 for Peoria Friendship House. The money raised at this event will go towards programs that provide valuable services, such as food, clothing, youth education, adult education, employment preparation, and finance and employment coaching, to individuals and families living in poverty in the Peoria area.

Will Williams
Chairman, President & CEO

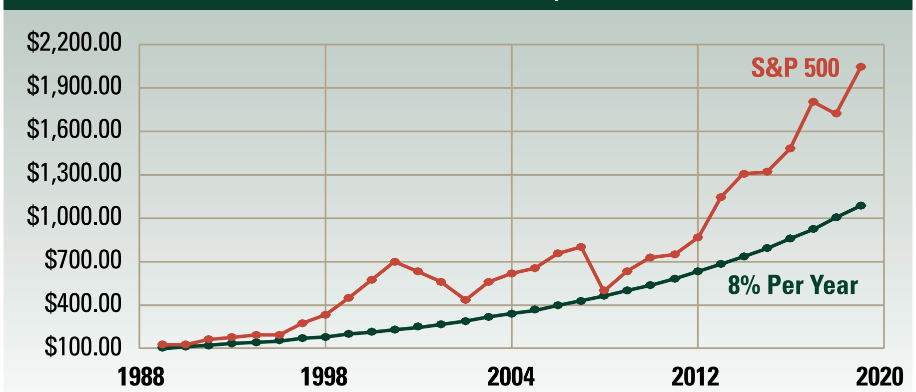
CONTINUED FROM PAGE 1

interest rates [10yr]) and recessions. At that time, Fed Funds Futures were pointing to a mild softening of short-term rates through 2020. Much has changed in the past quarter, with market expectations now pointing to a much steeper decline. Futures now forecast as much as a 1% drop in rates from the current target of 2.25 – 2.50% over the next twelve months. As a U.S. investor, we naively lose sight of the fact that many of the developed world economies continue to maintain a *negative* interest rate structure. So despite the fact we might experience lower rates for longer here in the U.S., our interest rates are far higher on a relative basis to many other large economies such as Japan, Germany and France.

Maintaining Perspective

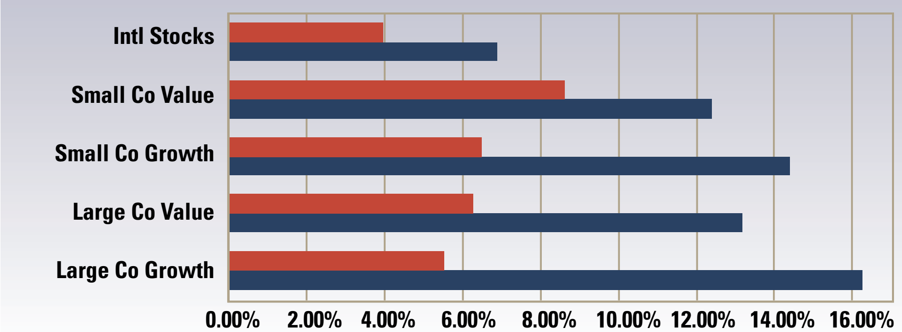
I often quiz colleagues and clients alike to gauge awareness of recent capital market results. In general, everyone gets the fact that it has been a pretty good run over the past ten years, but most do not have a sense of the magnitude of performance. Oftentimes we describe the 2000s as the "lost decade", where rates of return in the equity markets were abysmal. Twenty-year results as shown in the graph below are indicative of the headwinds faced during that time. Thankfully, this decade has more than made up for any lost ground.

S&P 500 HISTORICAL RATE OF RETURN | (12.31.1988 - 6.30.2019)



Data Source: Morningstar, Inc.

EQUITY MARKET RETURNS | PAST 20 YEARS VS 10 YEARS



	Large Co Growth	Large Co Value	Small Co Growth	Small Co Value	Intl Stocks
20 Year Annualized % Return	5.56%	6.31%	6.49%	8.64%	4.00%
10 Year Annualized % Return	16.28%	13.19%	14.41%	12.40%	6.90%

Data Source: Morningstar, Inc.

Opportunistic

It is clear that we are beginning to see quite a divergence between the perspective of equity and fixed income investors. Fixed Income markets are beginning to price in future interest rate cuts as the Fed will react to an increasingly sluggish U.S. economy. Equity markets on the other hand are gaining confidence that (1) the Fed will be most accommodative (2) the trade dispute with China will be resolved amicably and (3) earnings will respond favorably to both, as CEOs regain confidence in their ability to allocate capital. In the past, a divergence like this generally heightens overall portfolio risk.

With the wind at their backs, we are encouraging investors to assess their current state. If balance sheet adjustments need to be made, now is a great time to be opportunistic and right size debt, reallocate back to predetermined asset allocation targets and make sure liquidity levels are within tolerance. It is as important today to remain focused and disciplined as it is in the middle of a bear market. We remain optimistic, yet realistic.