KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISOR FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

Investment Strategy
April 2019

The investment environment has changed markedly during the first quarter of 2019. Following the plunge late last year which included the worst December for stocks since 1931, all assets have bounced seemingly straight up during the first three months of 2019. This sharp reversal has been driven by the startling change in rhetoric emanating from the U.S. central bank. After persistently raising interest rates throughout 2018, the Federal Reserve abruptly stopped any further increases and promised to end their balance sheet reduction program. While Wall Street has cheered these moves, we believe this is another opportunity to reduce risk across client portfolios. One way we have been reducing risk over the past few years has been purchasing high-quality companies that are more U.S.-centric rather than firms charging into the emerging markets promising riches. We believe this will benefit portfolios because the U.S. is poised to better withstand any upcoming economic slowdown.

The Federal Reserve's change of tone and direction over the past few months was unprecedented in speed. Outside of a major crisis, it is highly unusual for such a sharp pivot in policy. The question an investor should ask: What did the Federal Reserve see to trigger this change? The general media believes the Federal Reserve was responding to an economic slowdown outside the U.S combined with a sharp decline in stock prices. The downshift overseas has come about as China attempts to control their large financial bubble centered around overpriced real estate and oversized infrastructure. China is trying to deflate this mania by tightening credit, but this prompted a quick deceleration in the Chinese economy late in the year. Given China now represents about 15% of the global economy, this weakness has quickly spread to the emerging markets and Europe. Thus far, the U.S. has not been significantly impacted by this weakness thanks to our much more diverse economy, but <u>it would be naïve to expect the U.S. to remain unscathed if this weakness continues or deepens.</u>

While the Federal Reserve may have been responding to weakness overseas, it is likely this was a contributing factor and not the whole story. The Fed generally focuses on the formation and flow of credit. Another factor that likely prompted the Fed's reassessment was a significant reduction in credit creation late in the year. In fact, December was the first month since 2008 the market failed to sell a new high-yield (junk) bond. If companies are not able to access new financing, the economy would be impacted by a string of bankruptcies and corresponding layoffs because there are many financially stressed businesses at this time. One area highly dependent on the flow of credit is the U.S. shale industry which has upended the global oil market over the past decade. Many of these companies fail to generate any excess cash from their operations and would quickly go out of business without the ability to secure cheap financing. If this came to pass, U.S. oil production would quickly decline, triggering a spike in fuel prices. With this in mind, we were aggressively purchasing shares in the world's premier oil servicing company, Schlumberger, during the first quarter as protection from this scenario. Schlumberger is also a very attractive long-term holding trading at levels last seen during the financial crisis while currently providing a 4.5% dividend yield.

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Despite the Federal Reserve's best efforts, we believe we are reaching the end of the current credit cycle and, therefore, market cycle. If the U.S does experience an economic slowdown, there will be companies that struggle financially and close operations. These initial failures will prompt greater scrutiny from investors which will be reflected in higher interest rates and lower stock valuations. Higher rates will stress additional companies, leading to further closures and job cuts. This is a very basic description of how every credit cycle ends. Our priority at this point is to prepare client portfolios for this natural process.

The most important first step is to own high-quality companies that do not require outside financing to operate. Ideally, investors should search for companies that generate large amounts of extra cash each year and haven't overburdened their balance sheet with debt. We always focus on these types of companies because they can support attractive and growing dividends which are an important (yet under-appreciated) component of investor returns. It's also preferable to own companies that have solidified competitive advantages and have endured a recession or two. These businesses will be more profitable and resilient during the next downturn.

We also believe it will prove beneficial during the current era to own companies that generate a higher proportion of their revenues within the U.S. The emerging markets and Europe are likely to suffer very slow and painful recoveries following their next recessions. Over the past twenty years, economic growth in the emerging markets has been super-charged by the unbelievable modernization of China. During this period, China purchased massive amounts of raw materials from the emerging markets. In recent years, China has been consuming roughly half the world's copper, iron ore, aluminum, and cement. A reduction in Chinese construction activity would have a dramatic impact on commodity-dependent trading partners. In addition, emerging market governments have binged on cheap debt over the past decade to build the necessary infrastructure to meet China's commodity needs. The combination of lower Chinese demand and a heavy debt burden will result in a painful readjustment for most emerging economies, likely resulting in unsatisfactory growth and civil unrest in the years to come.

Europe's economic future also looks troublesome for several reasons. The European economy is far more dependent on exports to China and the other international markets compared to the U.S. During the current China-led slowdown, German industrial production has particularly suffered. Secondly, the European financial infrastructure is rotten to its core. Europe never summoned the political will to properly repair their banking system following the mortgage crisis a decade ago. Many European banks have become "zombie" institutions unable to operate without government support. Without a major rehabilitation of their banking system, Europe will find it very difficult to generate a robust recovery following the next recession. Unfortunately, economic weakness is likely to test the European Union itself.

This leaves the U.S. as the only meaningful economy in the world that can continue to grind out economic growth and deliver rising prosperity without increasing exports. American companies generate most of the world's wealth through their ability to innovate and advance technology. This wealth creation supports a vibrant service economy, making the U.S. much less sensitive to outside forces. The U.S. also made difficult choices ten years ago to repair the banking system to its healthiest state in many years. Although unpopular, a strong financial system is critical to a well-functioning economy. For these reasons (among many others), we believe client portfolios will be better positioned for the next recession and subsequent recovery by owning companies that have greater exposure to the U.S. market. The following list reveals the U.S. revenue exposure for several of our largest holdings as well as new additions over the past two years. In comparison, the average S&P 500 company generates roughly 56% of their sales in the U.S.

Percentage of U.S. Revenue			
Largest Holdings		Newer Holdings	
Home Depot	92%	Cal-Maine Foods	100%
Verizon	100%	Weyerhaeuser	85%
Lamb Weston	69%	CVS Health	100%
Lockheed Martin	72%	Outfront Media	95%

While not all our holdings fit this theme, we believe the U.S. economy is clearly the engine to bet on for the next economic cycle. America's economy is unique in its ability to solve problems and fund new ideas. This will allow the U.S. to generate moderate levels of growth despite a likely period of economic stagnation overseas. We also anticipate the next U.S. recession will be relatively mild, while the upcoming recessions outside the U.S. have the potential to be far more destructive.

It is impossible to predict with precision the end of the credit cycle and a resulting recession. But it is possible to know when the chances are elevated. In fact, a model developed by the Cleveland Fed currently predicts a 1/3 chance of recession within the next twelve months. The huge market bounce to start 2019 is a great opportunity to continue de-risking portfolios. We plan to trim richly-priced and cyclically vulnerable positions while reallocating the proceeds into 1-year Treasuries and into more attractively priced equities. These changes will hopefully reduce downside risks while allowing portfolios to capture most of any additional gains.

Truly yours,

Keating Investment Counselors, Inc.