J.W. Burns & Company

Investment Counsel

Quarterly Update - July 2018

Strong Fundamentals Or The Sound of Cannons

"The stock market is a device for transferring money from the impatient to the patient." - Warren Buffett

Dear Clients and Friends,

We are halfway through 2018 and, as of June 30th, markets are relatively flat, with the S&P 500 Index up 2.5%, the Dow Jones Industrial Average down -0.73%, the Lipper Balanced Index - comprising of stocks, bonds, and cash - up 0.17%, and international stocks, as measured by the MSCI-all World Ex USA Index, down -3.44%.

> **"We remain very constructive on the positioning of your portfolio as well as the outlook for the stock market as we head into the back end of 2018."**

That being stated, there were some strong segments of the U.S. stock market. Small cap stocks, as measured by the Russell 2000 Index, were up 10% year to date through June 30th, largely reflecting investors' fears of a trade war by buying smaller companies with minimal foreign exposure. Also, the well-known FANG stocks - Facebook, Amazon, Netflix, and Google - continued to roar; according to CNBC, a full 70% of the returns this year in the S&P 500 Index can be attributed to just these four stocks. Fortunately, we have some exposure to both small caps (primarily through the S&P 600 Small Cap ETF, symbol: IJR) and some of the FANG Stocks. Most importantly, we remain very constructive on the positioning of your portfolio as well as the outlook for the stock market as we head into the back end of 2018.

Equity markets in 2018 are engaged in a fierce tug of war, shifting between explosive earnings growth on the one hand and a fear of an escalating trade war on the other. The indisputable fact is that the U.S. economy is healthy and getting stronger; unemployment is at an 18-year low, the Atlanta Fed recently raised their GDP forecast to 4%, and the Consumer Confidence Index just hit a 15-year high of 128[1]. Small businesses - a key driver for sustainable economic health - are also growing, with the NFIB (National Federation of Independent Businesses) Index climbing to 107.8 in May, the second highest level in the survey's 45-year history! No doubt, the recently enacted tax cuts, along with a significantly reduced regulatory environment, have helped to improve sentiment for businesses large and small, including this one!

The bottom line: the U.S. economy is strong and, barring a serious trade war, is unlikely to fall into recession over the next year or so.

The earnings power of your portfolio companies, and the overall market, has been outstanding.

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The overall earnings on the S&P 500 companies were up a powerful 26% in the first quarter, and their positive momentum is expected to continue this quarter, with estimates for a 25% increase. Here in mid-July, the second quarter earnings reports that we have seen so far have been strong and higher than most analysts' expectations.

In fact, with the continued acceleration in the economy and earnings blowing away expectations thus far, I believe the stock market could have been up 8-10% through the first half of this year; but then President Trump started tweeting…

Tweet War or Trade War?

"Buy at the sound of cannons; sell at trumpets" - Old Wall Street saying

"Despite the negative headlines, the beginning of tariffs has not disrupted equity markets. In fact, the S&P 500 is up more than 3% for the month of July."

Despite trade issues simmering for several months, the first salvos were not fired until early July, when the United States rolled out 25% tariffs on over $34 billion of Chinese imports. Billed by the Chinese as "the largest trade war in economic history," they immediately responded by imposing tariffs on U.S. soybeans, meats, cars, and other goods.

Then, on July 10th President Trump further escalated the trade war by proposing more tariffs on Chinese goods to the tune of $200 billion. Additionally, tariffs have been levied against Canada, Mexico, and Europe, who in turn have fired back with tariffs of their own on U.S. goods.

The primary questions for serious investors are: how long will trade tensions last, and how will they impact my portfolio? First, I do believe President Trump is correct in principle on many foreign trade practices that are clearly unfair to U.S. businesses. However, his seemingly impulsive approach is questionable, in my view.

Both the United States and China have solid cards to play. China is a communist dictatorship that does not have to face its electorate and has control over its media and most operations of its economy. This gives China greater flexibility to "hold out" against U.S. tariffs. Indeed U.S. Chief Economic Advisor, Larry Kudlow, recently stated that China has not responded "at all" to recent U.S. requests surrounding trade issues and intellectual property theft. Overall, however, the United States has an edge in this trade dispute. For one, the United States is a more dynamic and diversified economy and is far less economically reliant on China than China is on us. China's stock market has also been hit hard since tariff tensions began brewing, with the Shanghai Composite Index currently down more than 15% year to date.

Back home, despite the negative headlines, the beginning of tariffs has not disrupted equity markets. In fact, the S&P 500 is up more than 3% for the month of July and, as I write this, the Dow Jones has crossed 25,000 for the first time this summer.

My best guess of how this plays out over the next few months is that we see at least some resolution on trade issues with the European Union and our NAFTA allies, but that trade tensions with China will continue for some time. While I do not expect an all-out trade war, tariff issues and trade headlines will make for heightened volatility in the financial markets.

Currently, President Trump is also likely using trade tensions to drum up enthusiasm with his base ahead of the midterm elections and, despite rhetoric on both sides, neither country wants to commit economic suicide. So while there is risk here, both countries (particularly China) will feel economic pain the longer this goes on and, hopefully, be drawn to the negotiating table.

Or, as President Trump would say, "We'll see how it goes."

Now let's go to your questions:

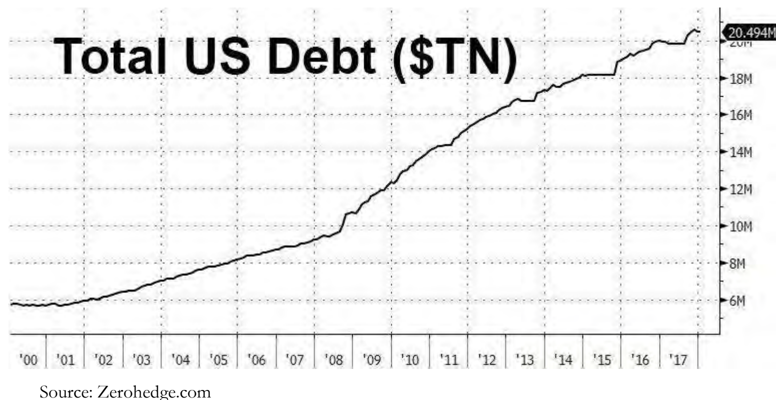
Q: What is your biggest short-term concern and long-term concern for markets?

A: Well, obviously, barring a serious escalation in the trade war, I believe higher inflation could become an issue that both the stock and bond markets will have to deal with. While some inflation is healthy in a growing economy, inflation expectations are currently quite low. However, incipient signs of inflation are on the horizon; the consumer price index is up more than 2.5% compared to last year, gas prices are estimated to finish 14% higher than last summer and businesses are starting to implement price increases across the board. For example, Starbucks recently hiked their coffee prices $0.20 in some areas and the prices of washers and dryers have gone up an average of $50 this past year, largely due to the tariffs. In fact, tariffs, by definition, are inflationary, as they are a tax on imported goods. Should inflation numbers come in above expectations, it could pose a real challenge for stocks.

"While I do not expect an all-out trade war, tariff issues and trade headlines will make for heightened volatility in the financial markets."

Additionally, large states have increased their fiscal spending 6%, on top of massive amounts of federal deficit spending. This is creating an even more favorable environment for rising inflation and leads me to my biggest, long-term concern…

The U.S. National Debt. Currently looming at $21.2 trillion or $174,394 per tax payer (ouch), the National Debt remains a significant long-term shadow over the United States economy. The chart above shows how total U.S. debt has skyrocketed in the 21st century, growing (under both Republican and Democrat Presidents) from roughly $6 trillion in 2000, to now over $20 trillion in 2018. Congress has not passed a balanced budget in twenty years and, if this trend continues, long-term economic growth would be severely hampered.



Source: Zerohedge.com

Q: What are your views on rising interest rates and how they will impact the markets?

A: As we have seen, the Federal Reserve has been relatively cautious in its monetary policy, engaging in very gradual, incremental rate hikes. In June, the Fed voted to lift the target range for the federal funds rate by 25 basis points making it the seventh rate hike since late 2015. The Fed expects two more additional hikes for 2018 and believes the United States economy is healthy and accelerating. Currently, our view is that if interest rates are rising due to strong economic growth, they should not be detrimental to equity markets. If the Federal Reserve is forced to raise rates because of higher inflation, that would be negative.

To sum up: the positives of this bull market - strong economic momentum, robust earnings growth, reasonable valuations, and healthy consumer confidence - currently outweigh the negatives of trade worries and rising interest rates. We believe the second half of 2018 will be stronger than the first, with potential solid returns of 5-11% still very much in the cards. Your portfolio(s) remains well positioned and, most importantly, focused on growth.

You know, despite the emphasis of this client letter on macro-economic issues, I would reiterate that the core of our work here at J.W. Burns & Company is on buying and holding "great companies, with great managements, selling at attractive prices." We conduct an

intensive, in-depth fundamental analysis of companies in various industries, while adhering to a clear, disciplined investment process. The three words that best reflect the companies we have positioned in your portfolio are: **quality, consistency, and growth.** I stress to our team that we **must** remain "hounds for information and knowledge," primarily on stocks, but also on the economy, politics, emerging trends, and disruptions in what most of society takes for granted.

We are on it!

As always, thank you for your continued confidence, and have a wonderful summer!!

Best wishes,

James C. Burns, CFA
President

P.S.- I am pleased to introduce two new hires that we are very excited about. They are both hardworking, quality gentlemen who have a passion for the markets and delivering performance to our clients. I will say, they are eager beavers, getting in here very early and staying late; trust me, I will make sure this habit continues!

Drew Derrenbacker - Portfolio Manager/Analyst

First coming to J.W. Burns & Company as an intern several years ago, Drew has never left. After doing work for the firm throughout his college career, Drew was offered a full-time position as a portfolio manager upon graduation. Drew graduated from Colgate University cum laude, where he studied economics and political science. Along with investing, Drew has a passion for writing, politics, and playing golf.

Chris Barker - Portfolio Manager/Analyst

Prior to joining J.W. Burns & Company, Chris worked at A.G. Edwards with institutional clients in Switzerland, Germany, and Austria and also managed a local independent brokerage firm. Chris studied at the University of Rochester, earning degrees in both economics and chemistry. In his free time Chris can be found on the golf course, in the kitchen or in front of a computer.

Now get to work boys!

P.S.S- See below a picture of our own Peter Bunitsky, fishing at his summer home in Kodiak, Alaska. We look forward to eating some of the fine salmon he has been catching...go get 'em, Bunitsky!

J.W. BURNS & COMPANY, INC.

INVESTMENT COUNSEL

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1 Haverford 2018 Summer Outlook