DCM Weighs In On The Recent Pullback
10-25-19

Recent headlines have unnerved investors and sent stock prices reeling. We urge calm and patience during times like these. While only time will tell, we see no reason to believe this is the start of something more than a normal market correction. The US economy is strong. GDP is expected to have grown 4.0% during the third quarter. Company earnings have also been strong, with 21% earnings growth compared to the same quarter last year. Looking ahead in 2019, estimates for both economic and earnings growth are expected to trend higher than the long-term average.

We see three main drivers of the market's worries. First, there is concern the Federal Reserve will stall the recovery by increasing interest rates too quickly. Second, the ongoing trade spat with China continues to weigh on markets. Third, the upcoming elections are creating political uncertainty.

Volatility and market pullbacks are common, and generally signs of a healthy market. In an average year, the stock market drops by 5% or more three times per year and has at least one 10%+ decline. This year has been no exception. After beginning 2018 on strong note, volatility picked up in late January as the market dropped 10.2% in just 13 trading days. After panic sellers were out of the way, the market refocused on the strength and quality of corporate earnings and the economy. This same trend has played out recently. Volatility and panic-selling have gained steam after a strong move in the market during the 3rd quarter.

## The Federal Reserve

It has often been said that Bull Markets don't die of old age, but rather are ended when the Federal Reserve becomes too restrictive with monetary policy. They do this by raising the cost of borrowing by increasing the Federal Funds rate, and also by adding or removing money from the economy.

The Fed began increasing short-term interest rates in 2015 when the economy appeared to be on strong footing. They have continued this since, and have also shifted their language from being accommodative to becoming more aggressive with policy. Up until recently, the market has taken this in stride.

We understand the Fed's tightening policy is, by design, meant to keep the economy from overheating. We also understand the Fed doesn't act haphazardly. They analyze and interpret enormous amounts of hard economic data from around the globe. The Fed will not knowingly jeopardize the stability of the economy if there are signs that further tightening would be harmful.

## China

Tariffs and trade wars are not good for the global economy. The United States represents 24% of the global economy. China's economy is the second largest at 15%. A disruption in either could send ripple effects through the rest of the world.

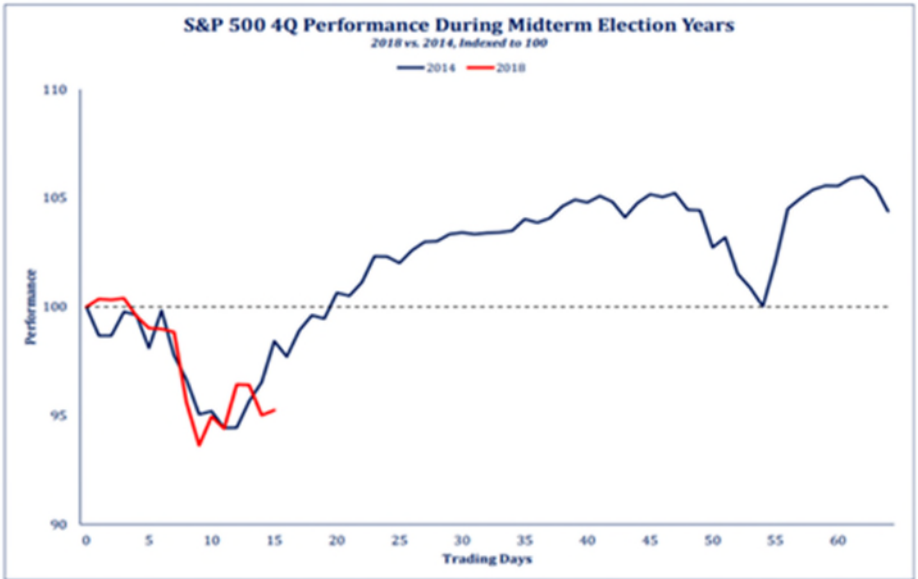
We don't invest in economies, governments or markets. We invest in individual companies that provide goods and services that are needed in both good times and bad. These businesses operate in different geographies with many different products and services. We understand where each company's business, supply chain, and manufacturing are focused and where their recent growth is coming from. We have taken steps to reduce the impact of trade by eliminating companies with a large share of their business or manufacturing coming from China. We will continue taking action, as warranted, as we move forward.

During the recent earnings season, tariffs are impacting the input costs of many manufacturing companies. If the additional costs cannot be passed along to customers, profit margins will compress. We anticipate this will be temporary, but continue to monitor it closely.

## Midterm Elections

We often consult history to help guide us through present times. October has a history of increased market volatility and we find midterm election years amplify this even further. This seasonal volatility is often a result of tax loss harvesting and re-positioning portfolios for the coming year.

When traders realign portfolios to take advantage of an expected change in the political landscape ahead of midterm elections, volatility increases. The illustration below overlays the S&P 500 this October with the last midterm election year (Q4 2014). So far, 2018's October market is right on course with 2014.




*Source: Strategas Research Partners, October 2018.*

As we recently highlighted in the Fall Issue of the Rising Dividend Report, politics and elections play a role in the economy and market, but far less than politicians would have you believe. We continue to believe that your portfolios are aligned to hold up well despite what Washington looks like for the next two years. However, we continue to monitor the impact of the elections on any one sector, industry or individual company. We will make changes if it appears necessary to align with the new political environment.

## Reasons for Optimism

The above negatives are weighing on the markets. However, we see some real reasons for optimism.

### Valuations are Attractive

Thanks to the recent sell-off, we're now seeing the average company in our portfolio about 20% underpriced over the next 12 months.

### The Potential for a Post-Election Rally

Since 1962, stocks have produced positive returns every year following a midterm election. Since 2004, stocks have gone up an average of 15% during the 4th quarter of a midterm election year. Both of these statistics bode well for markets following the midterm elections.

### A Strong Economy

The economy is expected to grow at a 4% clip in the Q3 2018. It’s rare to see a bear market (decline of 20% or more) without a recession.  And, at this point, that looks far off. The economy is the strongest it has been in quite some time.

## Increased Potential for Buybacks

Recent volatility also opens the door for companies to buy back more of their own shares. Regulations limit how much companies can buy based on trading volume. When volume increases, buybacks can increase as well. And lower stock prices allow each dollar to buy back even more shares than it could a few weeks ago. An increase in buybacks could put significant upward pressure on stock prices.

## Strong Dividend Increases

Based upon the robust dividend increases over the past year along with the expectation for future dividend growth, we are encouraged about the companies you own.

Over the last year, the companies held in our three investment strategies have increased their dividends by an average of 13%. Looking forward, they are projected, on average, to increase dividends 9.7% over each of the next three years. If these companies had concerns about their businesses or the economy going forward, we wouldn't see such strong dividend increases.

| Strategy | Dividend Yield | Last Twelve Month Dividend Growth | 3 Yr. Projected Dvd. Growth | Valuation |
|---|---|---|---|---|
| Cornerstone | 3.03% | 15% | 10% | 20% |
| Capital Builder | 1.87% | 15% | 12% | 21% |
| Income Builder | 4.11% | 10% | 7% | 17% |

We continue to move proactively will steer your portfolios toward the environment we anticipate rather than the one we are in. If we see signs that structural changes are occurring, we will measure the portfolio against those new expectations and make changes as necessary.

Please don’t hesitate to reach out to us during these times if you have questions or concerns.

Blessings,
Your Investment Policy Committee