October 10, 2019

THIN ICE

Dear Investor:

The ten-year old expansion is on thin ice. We are currently facing two major headwinds. I would say the largest of these is still trade. The situation appears to have gotten worse since my last letter in July. What exactly is it that we are fighting for? According to Peter Navarro, one of President Trump's top trade advisors, these are the seven issues:

Theft of Intellectual Property
Forced Technology Transfers for Business Access
Hacking of Our Computer Networks
Product Dumping into Our Markets
Heavy Subsidies from State Owned Enterprises
Stopping the Exporting of Fentanyl to the US
Stopping Currency Manipulation

You may be aware of the implications of many of these issues. They are serious, and most people realize they have been very unfair to the US and put us at a substantial disadvantage in world trade. This is much bigger than just our trade deficit with China, currently around $400 billion a year. It's about the way they do business and working toward a "level playing field". As investors, it might be easier in the short term if we just dropped the whole thing, but I think you can see that we need to make major progress on these issues.

Right now, we are seeing the effects in the manufacturing sector of our economy. In July, the first month of this quarter, the ISM Manufacturing Index dropped to 51.2, the slowest reading in three years. The drop continued in August with a reading of 49.1, which was the first contraction in 35 months. New orders and production both contracted. Things were much worse in September as the Index went to 47.8%, the lowest level since June 2009 at the end of the Great Recession. Most of this is being blamed on the trade war, as the index was over 60 in the summer of 2018 before all this started.

The other big headwind is the slowdown in the global economy. This time last year there was synchronized growth in the major developed markets and everything looked good. Economists are now saying that most of the major world economies are slowing. The new head of the IMF (International Monetary Fund) has said that they are expecting slower growth in nearly 90% of the global economy this year. She is urging countries to forget their differences and work together to try and turn things around. She cites the following "fractures" as the cause: trade disputes, geopolitical tensions, and Brexit, as just part of the problem. They currently plan to lower their outlook for 2020 also.

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com

Naturally, this has all led to a lot of talk about that famous R word, recession. If you do follow business news at all, I'm sure you've heard it. There are signs of things slowing down all around us. Our forward momentum definitely seems to be waning. I'm convinced the high GDP growth rate of a year ago was mostly produced by the Trump tax cuts and was somewhat of a sugar high that's fading. Unemployment is at a 50-year low, but monthly job gains have been noticeably smaller in recent months. The Leading Economic Indicators have been declining, although they are still positive. There have also been some signs of the manufacturing slowdown seeping into the service sectors which make up 90% of our economy. This may continue which will spread more economic weakness. There has also been a lot of talk about yield curve inversions. We have had them recently, and they have generally been a very reliable indicator of recession risk. There are some legitimate reasons to think this may not be the case right now, as the inversions have been caused by the long end of the curve falling, which is not what has happened in the past.

However, on the positive side, consumer spending and consumer confidence have both held up reasonably well so far. Wages have been rising in the 3% range which has clearly helped people keep up. The rapid growth in housing prices has been slowing every month for the last year. Prices are still high due to tight inventory, but the situation is moving in the right direction. Perhaps soon, housing will be more affordable for many. Corporate earnings are still rising, although the growth has been very weak thus far this year. Jobless claims and the unemployment rate are still at rock bottom lows, which means there are a lot of people with money to spend. Data show that debt payments as a percentage of disposable income are still lower than they have been in several decades. This is good news as consumers are still being cautious and have not forgotten the Great Recession. Many economists say that consumer spending has been carrying the economy for the last year, as the uncertainty produced by the trade war has slowed business investment.

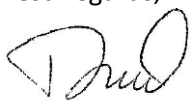
Against this mixed backdrop, the Fed has already cut interest rates twice, and the market is showing an 80% chance that they will cut again at the end of this month. You can see that we are indeed on thin ice. Will we keep slowing down and head toward a recession, or will the rate cuts, currently being sold as insurance, do enough to relieve the situation? We don't know the answer to that. There's a good chance that rate cuts alone will not be adequate to change the path we are on. Many believe the US is doing fine, and we are being forced into this due to the world situation. If President Trump makes a decent deal on trade, the biggest headwind will die down and our economy should continue to do well.

I just returned from our National Conference in the Denver, Colorado area. I heard presentations from many of the top firms in the investment world, including Blackstone, Goldman Sachs, Alliance Bernstein (now called AB), Pimco, and Fidelity. There were several common themes that emerged in varying degrees. Most everyone believes that the global slowdown in growth will continue, but that does not necessarily mean we are destined for recession. We are late in the cycle, and many things that were tailwinds the last 20 years are now headwinds. Some see US growth next year as low as 1.25% - 1.75%. That's still not a recession. There's agreement that the bond market is telling us the

future looks more uncertain than it did a year ago. Most think it's likely the Fed will continue to cut rates, but some are hoping October is the end. There's an awareness that we could be pushed down the same path to zero interest rates that Japan and Europe have gone down. No one really wants that as there's no evidence from the countries mentioned that it works. There almost seems to be much more of a feeling that it doesn't work, and we don't want to go there. On the other hand, no one is specifically predicting a recession in the immediate future. There is an awareness that we are on thin ice and the downside risks are clearly elevated. We are at a vulnerable time where things could easily turn down. While lower rates may help a little, the big headwind is the trade situation. If we could settle that, things could get much better. Some believe if we don't get a trade deal, we will be pushed into a recession. Looking past these immediate problems to the future, there's close to universal agreement that the next decade and beyond are likely to bring very modest stock market returns. We are talking mid-single digit returns as far as the eye can see. Gone are expectations for double digit returns, there's not enough growth in the world to produce them. If these projections are correct, we will all have to learn to be satisfied with a much more modest growth rate.

I hope you enjoyed the summer. Please contact me anytime to discuss your portfolio.

Best Regards,



David E. Keim

DEK/jg

5788 Widewaters Pkwy | Suite 203 | DeWitt, NY 13214
315-701-5750 | Fax 315-701-5751 | dkeim@keimassetmanagement.com
www.keimassetmanagement.com