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QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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A GOLDILOCKS ECONOMY

Will Williams *Chairman, President & CEO*

Once upon a time… typically is the introductory line of a classic fairy tale. Under these circumstances, it frames up DVI's market commentary as to the "Goldilocks" nature of the current economic backdrop. An environment that has been described by some as being not too hot, nor too cold, but "just right." Add to the mix historically low market volatility and the combination of these two factors made for an extremely productive first quarter.

Much can be said for the benefit of stability, or expressing it another way, markets absolutely hate uncertainty. If there was a theme in the relief rally that occurred during the first quarter of 2019, it was all about less is more. Less issues arose on matters such as trade, interest rates, political uncertainty and corporate earnings than what was anticipated by market participants at year end. This is not to suggest in any way that many of these prominent issues were put to rest, but at minimum *some* progress has been made. Oftentimes, that which provides the market a lift is simply the fact that things are not as bad off as the headlines would appear to suggest.

Interest Rates

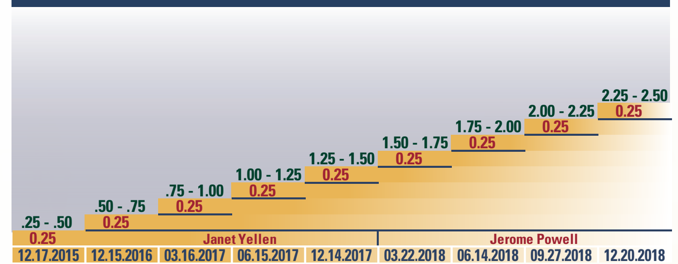
Federal Reserve Policy would be a prime example of how expectations have been turned upside down in a relatively short period of time. It was highly speculated that the Federal Reserve would continue its stair-step approach of modest 25 basis point rates increases in 2019 with at least two additional rate increases implemented throughout the year. The Fed has now embraced a much more patient approach. They are now taking the position that as long as inflation remains in check, below their 2.0% threshold, they are willing to stay the course with interest rates and maintain the Fed Funds target rate at 2.5%. Beyond short-term interest rates, they have softened their plans to allow for the ongoing roll-off of balance sheet assets ($3.8 Trillion) accumulated throughout their "Quantitative Easing" experiment dating back to 2008.

Long-in-the-Tooth

According to the National Bureau of Economic Research, the length of the current economic expansion that began in June 2009 is now 117 months old. The longest economic expansion in U.S. history dates to the ten-year period ending in March of 2001, so as DVI founder David Vaughan would say, this expansion is "long-in-the-tooth." So, with full knowledge that we are statistically over twice the duration of the typical economic expansion, it is quite understandable why everyone is mentioning the dreaded "R-word" (including my colleague Brian Christensen). At minimum, most analysts are describing the statistical fact pattern today as "late cycle," with characteristics such as: (1) low unemployment rates, (2) contracting Fed Policy, (3) economic growth believed to be moderating and (4) earnings per share growth rates under pressure.

Some would suggest the current Bull market in U.S. equities is also "long-in-the-tooth," dating back to the Great Recession and March of 2009. The S&P 500 Index barely avoided ending its winning streak in Q4 of last year by suffering a sharp loss, but not declining the specified twenty percent that classically defines a Bear market.

FED FUNDS TARGET RATE – HISTORY



Source: Federal Open Market Committee

Just Right

At least for now, as the "Goldilocks" nursery tale would suggest, the economic backdrop for the U.S. equity market appears to be "just right" as evidenced by the strong results in the first quarter of 2019 for all risk-on asset classes. The combination of historically low long-term interest rates, modest rates of inflation, steady, albeit moderating economic growth, modest valuation multiples and low-price volatility is traditionally a sweet spot for equity investors. I just hope as the year unfolds that I do not need to brush up on another classic bedtime story, "Little Red Riding Hood."

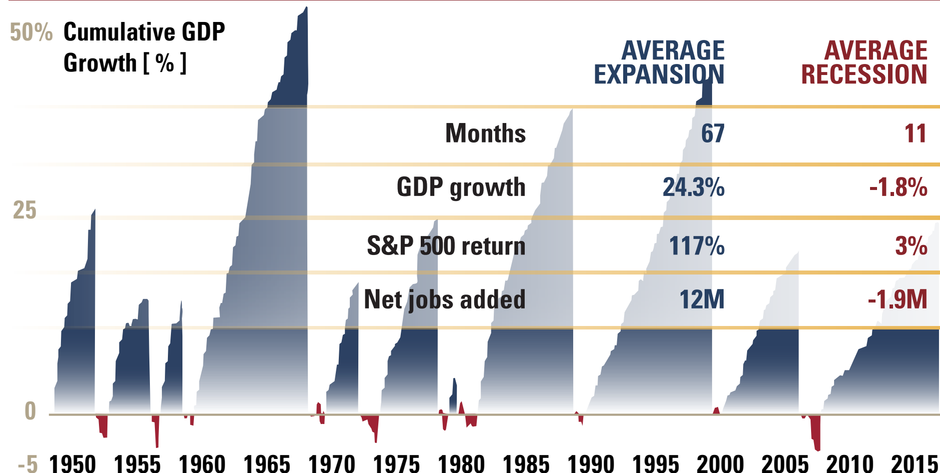
Brian Christensen, CFA
Senior Vice President & CIO

RECESSION RUMBLINGS

At the end of 2018, Google searches for the word "recession" spiked reaching levels not seen since 2011 when Europe was facing a debt crisis. On Twitter, the activity was similar as Tweets mentioning the word "recession" reached levels not seen since 2016 when oil prices collapsed and growth in China declined to a 25-year low. Given the U.S. equity market correction during the fourth quarter, it is easy to understand why investors are now asking questions about the health of our economy.

Recessions are defined as at least two consecutive quarters of negative Gross Domestic Product (GDP) after a period of growth. Typically, recessions are triggered by some imbalance in the economy or shock to the financial system. Rising interest rates, inflation, and higher commodity prices have all been blamed at times. Some notable recessions over the past 70 years include:

RECESSIONS ARE PAINFUL BUT EXPANSIONS HAVE BEEN POWERFUL



Sources: Capital Group, National Bureau of Economic Research, Thomson Reuters. As of 9/30/18. Since NBER announces recession start and end months rather than exact dates, we have used month-end dates as a proxy for calculations of S&P 500 returns and jobs added. Nearest quarter-end values used for GDP growth rates. GDP growth shown on a logarithmic scale.

So, just how fearful of recessions should we be? Over the last 65 years, recessionary periods have represented less than 15% of all months. On average, economic expansions have lasted 6 times longer than recessions. A comparison of recessions and expansions is shown in the Capital Group chart above.

- **1945 –** Demobilization from World War II – 8 months, GDP declined 11.6%
- **1953 –** Demobilization from the Korean War – 10 months, GDP declined 10%
- **1973 to 1975 –** OPEC oil embargo, wage and price controls – 16 months, GDP declined 15.5%
- **1980 to 1982 –** High interest rates and inflation – negative GDP for 6 of 12 quarters
- **1990 –** Savings and loan crisis – 9 months, GDP declined 5.5%
- **2001 –** Technology stock bubble and Y2K scare – 8 months, GDP declined 2.8%
- **2008 –** "Great Recession" – 18 months, GDP declined 15.7%

Corporate profits, unemployment, housing, and the Leading Economic Index have all been identified as economic statistics able to warn of an impending recession. However, probably the most widely followed recession indicator is the inverted yield curve. An inverted yield curve exists when short-term interest rates are higher than long-term interest rates. Most commonly compared is the spread between the 2-year Treasury yield and 10-year Treasury yield. The

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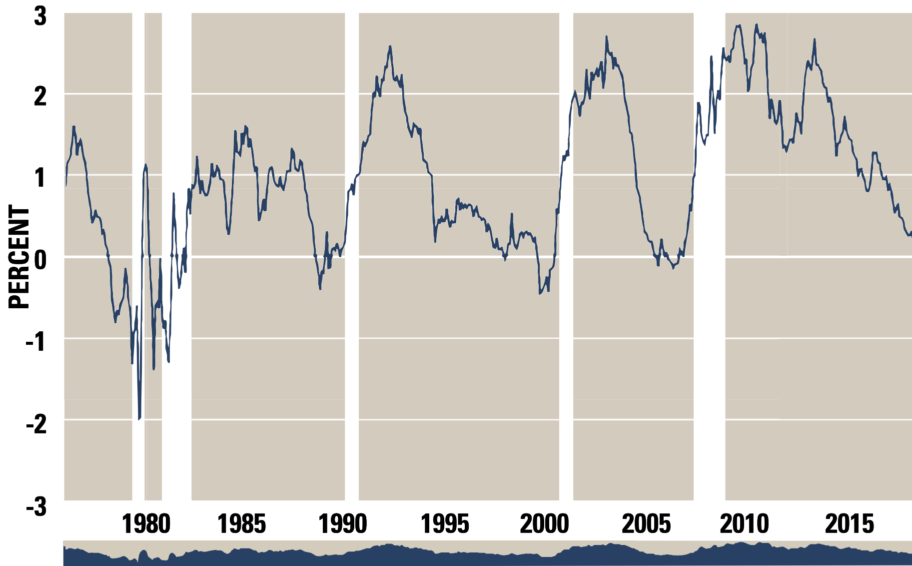
FRED – 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity



Shaded areas indicate U.S. recessions

Source: Federal Reserve Bank of St. Louis myf.red/g/n10y

chart above shows the current relationship. As I write, the 10-year yield stands at 2.52% and the 2-year yield is 2.39%. No inversion yet.

Every U.S. recession over the past 50 years has been preceded by an inverted yield curve. Historically, an average lag of 16 months has occurred before recession appears following inversion. As 2019 progresses, this indicator will continue to be at the top of investors' minds.

Maybe the most important question for investors is how best to position equity portfolios in the face of a recession. It should be no surprise that stocks in the Utility, Consumer Staples, Health Care, Energy, and Telecommunication sectors have all outperformed in declining markets. Companies with higher dividend yields operating businesses that are less economically sensitive, weather storms well. The chart below offers additional insight.

It should not be a surprise that over 60% of the DVI Model equity portfolio is currently invested in the sectors identified as providers of superior capital preservation in declining markets. Risk management has always been a hallmark at DVI, recession fears or not. The next recession will arrive one day but patience, discipline and an unemotional approach will win that day.

SECTOR PERFORMANCE DURING MARKET VOLATILITY

During the last eight severe declines, some sectors held up better than the overall market

SECTOR	NUMBER OF PERIODS SECTOR FINISHED: < Below S&P 500	Above S&P 500 >	DIVIDEND YIELD	
Consumer staples	0	8	3.1%	Higher Average
Utilities	0	8	3.4%	Higher Average
Health care	1	7	1.7%	Higher Average
Telecommunication services*	1	7	5.3%	Higher Average
Energy	4	4	3.5%	Higher Average
Materials	5	3	2.1%	Lower Average
Consumer discretionary	6	2	1.4%	Lower Average
Financials	6	2	2.1%	Lower Average
Information technology	6	2	1.6%	Lower Average
Industrials	7	1	2.2%	Lower Average

Dividends can offer steady return potential when stock prices are broadly declining

Sources: Capital Group, FactSet as of 12/31/18. Includes the last eight periods that the S&P 500 declined by more than 15% on a total return basis. Sector returns for 1987 are equally weighted using index constituents from 1989, the earliest available data set.

**The telecommunication services sector dividend yield is as of 9/24/18. After this data the sector was renamed communication services and its company composition was materially changed. During the 2018 decline the sector would have had a higher return than the S&P 500 using either the new or old company composition*

Jeremy R. Hanshaw
IT Manager & Database Administrator

BEWARE OF PHISHING

Phishing emails are fraudulent messages that appear to be legitimate. They are sent in the hope of stealing your personal information, holding your computer ransom, or infecting it with a virus. The vast majority of malware today is delivered via email as attachments or in web links. Combine that with the fact most people are unable to spot a sophisticated attack, and it becomes a big problem for businesses and individuals alike.

At DVI, we take these threats seriously. Our Associates are trained to spot these attacks, and we are constantly testing them to make sure the training is effective. This training can be used in any situation, so we can provide you with a few tips to keep you safe as well.

Maybe the most important tip is to maintain a suspicious frame of mind. Review the details before you click on anything potentially dangerous. First, make sure the email is coming from the correct email address. Attackers may take on a similar email address, but it is misspelled in some way. If the message has an attachment, you should be extra suspicious of files that may contain scripts, installers, or other unusual file types. Even a normal looking file has the potential to be dangerous. Finally, hover your mouse over links before clicking on them. There will be a small pop-up comment that shows where the link will really take you. Does that link look like a place you want to go?

There are other context clues that, if in the message, are red flags indicating something may not be quite right. See below:

1. **UNKNOWN**
   The message is from an unfamiliar company.
2. **UNEXPECTED**
   The message is about something you didn't do (i.e. place an order) or is too good to be true (i.e. winning a contest).
3. **URGENCY**
   The message says to do something as soon as possible.
4. **GRAMMAR**
   The message is filled with spelling mistakes or broken speech.
5. **MONEY**
   The message asks for money or gift cards.
6. **PASSWORDS**
   The message wants to verify your password.
7. **PERSONAL INFO**
   The message asks about your social security number.

If you receive one of these messages, delete it and don't click on anything. Where possible, flag the message for your spam filter. Hopefully, this information is helpful and will prevent some attacks from being successful. ***If you would like to read more about phishing, the following website provides more information:*** **www.knowbe4.com/phishing**

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