CARMICHAEL CAPITAL INC.

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2019 Second Quarter Review
"Federal Reserve Fireworks!"

Last quarter we looked at the about-face that the Federal Reserve Board had made from their stance last December. At that time, they planned several more interest rate hikes in 2019, while continuing to reduce their balance sheet (a type of monetary tightening). The markets threw a fit through Christmas Eve and then started to advance as it looked as though the Fed might put further rate hikes on hold, perhaps indefinitely. By the end of the second quarter, the Fed had not only turned around, they announced plans to march in the opposite direction. They now plan to *reduce* interest rates even though just 6 months ago they projected several more rate hikes. Investors reacted with excitement and the stock indexes jumped. The Dow Jones Industrial Average finished the quarter up 14% while bonds also rallied on the prospects for lower interest rates.

This reversal of policy by the Federal Reserve Board is shocking for several reasons. The Fed usually lowers rates to avoid or end a recession. We are currently still in one of the longest expansions of the American economy on record. The Federal Reserve usually cuts rates when they have become "too high" and threaten to choke off economic activity. However, we still have historically low interest rates with the 30 year US Treasury Bond yielding less than 3%. If the Fed is cutting rates now, when the economy is still growing and interest rates are still historically so low, what do they see that makes them bring out the life vests when it's a sunny, calm day at sea?

First, the Federal Reserve Board governors saw the markets tank through year-end with the worst performance for stocks for the month of December in over 80 years. Second, they have had to withstand withering criticism from the President and veiled threats of firings and replacements before their turnabout. Perhaps most importantly, they see economic activity in the world slowing down, with leading indicators in the US showing a slowdown as well, and rising risks of further slowing due to trade wars and tariffs disrupting international commerce and supply chains. It appears as though the Fed has now been convinced that we are going into a recession unless we *cut rates now*. That would mean that the economy may be more fragile and equity investments riskier than investors are generally assuming. If the Fed sees the clouds on the horizon and starts to lower the life boats, maybe we should be concerned about coming storms instead of being distracted by an impressive display of fireworks lit by the Fed's turnabout.

Growth vs. Value

We have kept equity allocations at conservative levels in order to protect your assets from being overly impaired during another market sell-off. That alone has held back our performance relative to the indexes. We also have a "value" orientation which makes us want to buy stocks that are statistically cheap while avoiding the more expensive equities characterized by sometimes very high valuations, called "growth" investing. These can often provide increases in return but can also plummet in value during downturns. In the past, "value" and "growth" investing have often traded places in providing the best performance, with "value" investing catching up during downturns. In the last several years,

however, "value" investing has lagged the "growth" style and the difference has increased recently. According to one study by Goldman Sachs, the disparity between value and growth investing performance is at a record high.

Highlight – Pharmaceutical Stocks

In our more seasoned portfolios, we have several pharmaceutical stocks that have performed extremely well for us over the years. We are holding large gains in them, but those stocks are beginning to come under pressure as the election draws near and the industry can be easy targets for politicians offering plans to keep drug prices low. These plans will be floated as trial balloons all the way to the election, and may actually turn into policies that may hurt the pharmaceutical companies' businesses. Additionally, both Bristol Myers and Abbvie have recently caught investors off guard by announcing major acquisitions recently. Accordingly, the stocks have lagged still more in the recent advance. We are trimming some of those positions in order to reduce exposure to the potential for changes in government policies that might reduce their prospects in the near future. However, with our basis being so low and the stocks still being relatively cheap, we may retain reduced positions for the long haul.

We have started to use, in certain circumstances, some of the commission-free equity and fixed income ETF's (Exchange-Traded Funds) that Schwab and others now offer. In cases where we want to gain greater exposure to equities or bonds quickly, they can be useful to establish positions while individual securities can be chosen to replace the ETFs later. Also, for small IRA accounts, a portfolio of ETFs can provide diversification that is otherwise impossible to attain without incurring at least a modicum of commission costs. Now the transactions for many are free of charge which allows the reallocation of assets, particularly for smaller accounts, to be much more cost-efficient.

If you would like to be more or less aggressive in your portfolio, please give me a call and we can discuss the best ways to balance your portfolio with your personal desires for opportunity or caution.

As is our annual regulatory duty, we assure you that we share none of your personal information with anyone without your express consent. We also offer to send you a copy of our regulatory filing "ADV brochure" with more information on Carmichael Capital upon request.

Please review the enclosed reports at your convenience and give me a call with anything you would like to discuss. Here's hoping the rest of the summer is healthy and satisfying!

Sincerely,

Claude R. Carmichael CFA