Economic & Market Commentary

For investors sitting here in 2018, it is almost hard to believe that a decade ago financial markets around the globe were faced with a truly annus horribilis. Many had great difficulty understanding what was going on and thought we were facing a true financial Armageddon. In the U.S., a number of major financial institutions faced existential housing-related debt problems and were acquired (Bear Stearns, Countrywide Financial, Merrill Lynch, Washington Mutual), filed bankruptcy (Lehman Brothers) or required financial assistance from the U.S. government (American International Group/AIG and Citicorp). Goldman Sachs and Morgan Stanley decided to become commercial banks, while General Electric had problems rolling over its commercial paper.

The U.S. auto industry was on its back. Iceland, Russia, Argentina and Ecuador were in deep financial trouble. Oil sold at $147 per barrel in the summer of 2008, before shrinking to $38 per barrel in the fall, while other commodities crashed as well. Governments around the world were hoping to stabilize the financial system by throwing money around like drunken sailors. Short-term U.S. Treasury rates approached zero. And to put frosting on the cake the largest Ponzi scheme in the history of the world (Madoff) was uncovered. It simply took your breath away.

Yet, since bottoming in early 2009, stocks have been on a tear for nearly a decade, producing one of the longest bull markets in history. Only 8 of the 40 quarterly periods during that period saw negative results for the S&P 500, and that index appreciated more than 350%.

The pattern has continued into 2018. After a sharp correction from all-time highs in January, stocks have strung together six consecutive monthly gains, pushing the S&P 500 up 10% for the nine months. Small cap and growth stocks were the winners during the third quarter, just as they have been throughout the year. Bonds produced meager results, and were largely negative across the yield curve for the nine months, in the face of the Fed's moves to raise the Fed Funds rate and allow its balance sheet to begin the process of normalization. Globally, the U.S. was the place to be, as only eight of the more than seventy markets monitored by The Wall Street Journal did better than the U.S. (in dollar terms).

As was the case earlier in the year, equity performance was narrow for both the quarter and year-to-date. Four of the eleven S&P 500 sectors bested the index for the quarter, and only three did so for the nine months. Technology, Consumer Discretionary (largely media stocks) and Healthcare were the standouts for both periods. The disappointing laggards were Financials (due to a flattish yield curve) and Energy (in spite of rising oil prices). We've talked about growth's dominance of equity performance many times, and it deserves mention again. We wrote last time: "Ten years ago, if you had simply bought the Russell 3000 Growth Index and gone away, you would have outperformed the S&P 500 by 25%." This is largely attributable to a small number of stocks dubbed the FAANGs (Facebook, Amazon, Apple, Netflix, and Google). Once again this handful has dominated equity market performance, accounting for 66% of the year's

S&P 500 gain. Without these six, the S&P 500 would be up 3%, not 9%. This makes life difficult for investment managers who rely on economic fundamentals to make investment decisions, as the prices of many of these stocks are not justifiable from a fundamental point of view. Painfully, we have learned that stock markets can remain oblivious to fundamentals for extended periods, and have a proclivity toward overreaction, which can be frustrating.

As we wrote last time, we do own a number of the FAANGs that we think are justifiable on their economics, and are valued reasonably. Were it not for the FAANGs we do not own, our growth portfolios would be ahead of the benchmark for the nine months. This, of course, begs the question – why don't we own the others? As we have written in the past, we view our job as finding businesses that have the ability to grow revenues, earnings and cash flow, with economics that will support that growth in the future and that are understandable. Importantly, we pay great attention to the price we pay for that opportunity. Academic work and anecdotal evidence shows that the price paid is a large determinant of the return generated over time, with a high valuation generally resulting in lower returns. Netflix (NFLX) is a good example of applying this process, as it is the best performer of the FAANGs, gaining 86% for the nine months. It is a subscription-based media company that allows subscribers to directly access an array of visual entertainment. So what do you own with NFLX and what are you asked to pay for that ownership?

- A stock selling at $375 per share
- A business that has 130 million worldwide subscribers, growing at more than 20% per year
- Revenues of $16 billion growing at more than 25% per year
- Earnings of $2.63 per share estimated for 2018, growing at more than 30% per year
- Negative free cash flow and a balance sheet that is becoming highly leveraged

For these characteristics, investors are asked to pay more than 140x earnings, while the S&P 500 sells at roughly 17x, with earnings growing at about 7% per year.

In order to make some sense out of this data, we can use a model that seeks to determine relative value by examining the relationship between the growth rate and earnings power of a stock and that of a broad index (S&P 500). In this case, Netflix has a premium growth rate to the index, but also has a premium valuation. If one were to assume the current growth rates continue for 10 years:

- Subscribers would grow to over 800 million (more than the estimated total global (ex. China) broadband homes in 2028)
- Revenues would be $150 billion
- Earnings per share would be $36.00

These are clearly heady assumptions. Finally, our model indicates that in order to amortize the premium valuation paid for NFLX vis-a-vis the S&P 500, earnings estimates would have to be correct for close to 12 years. Sustaining this level of earnings growth for more than a decade is highly unlikely, particularly since Netflix faced little competition in the past, and it will now encounter some large new competitors (Amazon, Disney). This, to us, implies risks that we are unwilling to take.

As this is written, most U.S. equity indices are at all-time highs, breaching the levels reached in January. The U.S. economy is vibrant, with real GDP growth expected to exceed 3% for the year. Employment is full, inflation is low, consumer confidence is high, liquidity is more than ample and the cost of borrowing remains relatively low. Corporate earnings are great, expected to exceed +20% this year and another +10% next year. Add to this the recently diminished trade tension with Mexico and Canada, and the waters seem to be calm. As a result, stocks (using the S&P 500 as the benchmark) are selling at 19 times this year's estimated earnings and 17 times next year's consensus, a couple of multiple points higher than the last time we wrote. For today's generation of investors who have never seen high inflation, or high interest rates, much less a bear market, the sailing appears to be clear

But as we have pointed out before, it's more than "just the economy, stupid". There are clouds on the horizon that could produce squalls. We have discussed many of these before, but at the risk of being called the "little boy who cried wolf" they are worth updating.

- The global economy which was thought to be synchronized, is now desynchronized. Developed markets are sluggish, and emerging markets are in trouble with the strong U.S. dollar and weak commodity demand
- Populism is spreading around the globe and Brexit is unresolved and messy. Right wing populist parties are now in power in six of the European Union's 28 countries, with more to come. This could have push back on the U.S.
- Trade issues with China are still in a tit-for-tat mode. China is more important than our other trade partners, and there is little indication of how or when this will be resolved
- The U.S. economy is facing an expanding fiscal policy – (heavy debt issuance) and a contracting monetary policy (quantitative tightening replacing quantitative easing) with the Fed increasing interest rates and decreasing the size of its balance sheet. In addition, demographic and productivity trends are not encouraging for long-term growth. So all may not be as calm as assumed.
- Corporate profits are at record levels in terms of dollars and margins. While corporations are faced with the lapping of tax cuts, a strong dollar that could impact sales and profit translation, tariffs that could increase costs, and tight labor supply, which could lead to higher labor costs.
- Mid-term elections, which could change the tone and substance of economic policies. Add to that the general dysfunction in Washington and you have a giant political cloud.

Putting this all together, we think it raises the yellow caution flag higher. We wrote last time that we like what we own. We still do. Our holdings have better profitability, better secular growth, strong balance sheets, and are selling at a lower valuation than the S&P 500. Our frustration is that it is taking much longer for those good fundamental attributes to be recognized. As we approach 2019, the euphoria of a good economy could wear off and many of these risks, which currently appear to be ignored, could become more real.

FI Review 3Q18

Unlike equities, fixed income markets continued to face a particularly challenging 2018 due to the headwinds of three Federal Reserve Fed Funds rate increases this year, with a fourth likely in December. For the first nine months, the total return for the Bloomberg Barclays Aggregate Bond Index was -1.60%, while the shorter duration Bloomberg Barclays 1-5 Year Government/Credit Index has been basically flat (-.07%). At the same time, the Treasury yield curve is becoming increasingly flat, with a 32 basis point spread for the 2 year to 10 year Treasury yields and just 14 basis points separating the 5 year to 10 year Treasury yields. These spreads are all well below recent historical averages.

The yield curve remained extremely flat throughout September, as Treasury yields rose across the curve between 10-21 basis points, which was not unexpected as the Federal Reserve raised its target Federal Funds rate for the third time this year. The Federal Reserve signaled its intention to hike interest rates one more time this year in December, with 3-4 additional rate hikes expected for 2019. Although we thought the Federal Reserve might push off the December rate hike until next year, the modest pickup in wage growth from 2.7% to 2.9%, continued strong employment growth (134,000 increase in September) and unemployment reaching its lowest level (3.7%) since Neil Armstrong was taking man's first step on the moon, has emboldened the Fed to raise rates again in December. The 2.9% level for the wage growth is noteworthy because it has nearly reached the 3% wage growth targeted by the Federal Reserve.

At the same time, there is growing concern about the flatness of the Treasury yield curve and about it potentially inverting (where shorter-term rates are higher than longer-term rates). This, along with the uncertainly created by trade disputes between US and its trading partners, resulted in several Federal Reserve Board members stating publicly that they do not see a need to increase U.S. interest rates further this year, echoing the concern that long-term rates have moved up very slowly, while the Fed has been raising short-term rates. Currently, the market believes that the probability has increased from 62% to 70% for a fourth rate hike in 2018 in December, based on Fed Funds futures.

A more hawkish tone from the Federal Reserve emerged when Fed Chairman Jerome Powell stated he would consider allowing rates to move above the neutral rate (the rate that neither stimulates nor hinders economic growth in an economy operating near its potential). He also remarked that we are a long way from reaching the neutral rate, which makes sense given the projected 3-4 rate hikes for next year. Currently, the Fed policy makers' median view for the long-run neutral rate is 2.9%, which means that we should reach and potentially exceed that level in 2019. To put this in perspective, back in 2012 the neutral rate estimate stood at 4.25%, so we would still be well below that level, even if the Fed increases rates slightly beyond their current neutral rate estimate.

Since the Fed's September rate increase, yields have risen across the curve with the 10-year Treasury Note yield reaching its highest level since 2011. At the same time, the Federal Reserve is maintaining a careful balancing act to "…sustain the expansion and keep unemployment low and keep inflation right on target", as Chairman Powell noted in recent comments.

In terms of portfolio positioning, rising rates do offer the benefit of an increased income stream. At the same time, we have a limited duration exposure, in order to mitigate the impact of rising rates on the value of the existing holdings. This strategy should deliver greater interest income to client portfolios, while reducing portfolio sensitivity to rising interest rates.