2019 SUMMER INVESTMENT OUTLOOK

The stock market, after booking an exceptional rebound in this year's first quarter, has made additional progress in the spring months. The domestic economy continues to grow at a moderate rate with rising wage growth and low unemployment while global growth is slowing and corporate profits are expanding at a notably reduced rate versus last year. The S&P 500 P/E ratio reached a full level of 17.1x in the early weeks of spring with many widely owned companies commanding much higher valuations.

In the second quarter, investor sentiment initially shifted to a more measured tone as soft spots have shown up in a broad number of company revenue streams and cost pressures have impacted profit margins. Investor reaction to results falling short of Wall Street expectations has often been severe and has been exacerbated by high velocity computer trading where there is no human intervention.

The key catalyst for this year's stock market progress has been the Federal Reserve decision of January to put additional rate increases on hold pending further data collection. The Fed also announced it will cease reducing its balance sheet assets (currently $4.1 trillion), an additional sign of accommodation. Dovish statements at this week's June meeting that the Fed will seek to "sustain the expansion" cheered investors and market forecasters are now predicting a 100% chance for an interest rate cut at July's meeting. The ten year benchmark US Treasury reflects this Fed change of policy and today yields 2.02% compared to 2.69% at year-end 2018 and 3.23% in early November. Lower interest rates and indications of further accommodation are supportive of common stock prices other things being equal.

On the geopolitical front several issues should give investors reason for pause. The ever present United States-China trade dispute tops the list, while tensions in the Middle East and Persian Gulf in particular continue to mount as do challenges in many parts of the globe. How the UK and the Eurozone come to terms with Brexit also remains a challenging issue.

Year-to-date stock market returns remain well above average with the S&P 500 reaching a new peak on June 20th and the Dow 30 and NASDAQ Composite not far behind. The MSCI All Country World Index excluding the U.S. has trailed U.S. markets reflecting the ongoing global slowdown and strong U.S. dollar.

2019 YTD Total Returns

	06/20/19	% Change
Dow 30 Industrials	26,753	+14.7%
S&P 500	2,954	+19.0%
NASDAQ Composite	8,051	+22.0%
MSCI All Country World Index ex-USA	285	+13.7%

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Outlook

Many variables should be considered in the outlook. One key element is the likely length of the current economic expansion which celebrates its tenth anniversary this month and now takes first place as being the longest expansion cycle in this country's modern economic history dating back some one hundred years. There is no maxim in economics that says a cycle can't be very lengthy but then all cycles do end, typically when excesses appear in key economic sectors. For example, notable excesses were evidenced in key sectors prior to the recessions of 1973-1974, 1980-1982, 2000-2002, and the great recession of 2008-2009. In another measure, OECD and U.S. leading indicators have been in a slowing trend, and while by no means conclusive, have merit.

While there are no clearly identifiable macroeconomic excesses in the current cycle, the present expansion period is notably different from previous post-World War II cycles in several regards. For one thing, the 2009-2019 expansion has been supported by continuous fiscal stimulus starting with deficits exceeding one trillion dollars per year in the first Obama administration, then trailing off to roughly half a trillion dollars per year in his second administration. Tax cuts and incremental spending implemented in the Trump era have pushed deficits up again to the $900 billion area with even higher deficits projected in the years ahead due to entitlements.

In previous cycles, deficits declined after several years of fiscal stimulus and in some cases turned into budget surpluses as occurred in President Clinton's second term. The current practice of continuous federal government deficits and little if any concern by policy makers for the rising federal debt (presently $22 trillion, a figure modestly above our country's GDP) draws little if any attention. The annual interest cost of carrying the rising debt is consuming a growing percentage of government spending, a pressure tempered in the near term by ten years of easy money and the current low and slightly inverted yield curve. Federal government interest costs would have a material negative impact on the budget if anything approaching a normal yield curve were to develop for whatever reason.

Monetary policy, similar to fiscal policy, has been notably stimulative since late 2008 when recession conditions were severe and it was clearly the right policy decision. As in the case of fiscal policy, and again unlike previous cycles, monetary policy has remained accommodative, and the country has now experienced a decade where real interest rates (federal funds rate minus inflation) have been close to zero. While the Fed did put in minor quarter point increases in the feds fund rate in the last two years, it has shelved plans for further increases and is preparing to reduce rates over the balance of the year.

One Fed justification is that inflation, again unlike other cycles, has remained subdued at or below its 2% target. There is a range of thinking as to why this is so given unprecedented fiscal and monetary stimulus, and its future course remains an open question. There is some concern at the Fed, however, that low inflation and zero real interest rates will hamstring its ability to become more accommodative the next time the economy is in recession. Zero real interest rates also encourage business risk taking and poorly made risk decisions will be unmasked when the economy inevitably slows.

Various sectors of the capital markets are, however, suggestive of excess. Venture capital, a favored and growing asset class among large institutional investors, is a prime example. Venture capital funds have used the low interest rate environment to fund and leverage the companies they buy and invest in. Privately financed companies become known as unicorns once they cross the one billion dollar market capitalization in later stage financing valuations. Many such companies typically experience rapid sales growth as incremental financings are spent on product, marketing, and sales development with less regard for profitability. The investment community currently values this business model on sales and market expansion rather than traditional profitability and positive cash flow.

Several widely followed unicorns have recently raised substantial new capital in initial public offerings (IPO's) only to find their valuations were above what the market would bear and hence fallen below the public offering price. Ride hailing companies such as Uber and Lyft (down 2% and 14% from their public offering prices) continue to be unprofitable and are notable examples. Since such companies continue to consume cash and are now tapping the public markets for it, it seems fair to opine that the high risk of venture capital is being transferred to the public market place, a new and unwelcome phenomenon.

Many credit and lending practices also can be deemed to fall in the category of excess. Ample bank credit is available in the so called $1.4 trillion leveraged loan market and has been deployed by private equity and other investors to leverage balance sheets in buyouts and other transactions. Traditional measures of risk such as the ratio of total debt to EBITDA have been stretched such that there is little room for error when business conditions inevitably slow. A number of private equity firms are also using "adjusted EBITDA" as a measuring stick in calculating leverage ratios or, as one pundit has opined, turning a 5 foot eight inch individual in to a 6 foot two inch frame by financial methodology. Corporate debt has risen significantly, notably in the lowest investment grade category, and many bond indentures carry so called "covenant light" provisions exposing creditors to higher than normal levels of risk. Nonperforming loans at the nation's ten largest banks rose 20% in the first quarter and, while bank capital remains adequate, is not a comforting direction.

Global corporate debt issued YTD through April is at an all-time high and has raised concern at the IMF. In addition, with central banks currently taking a very accommodative position, negative yielding bonds (the lender pays the borrower) have recently expanded to nearly $13 trillion in value, a figure higher than the total U.S. municipal market of $3.6 trillion or the U.S. corporate bond market of $10.3 trillion. The head of dynamic allocation strategies at William Blair in Chicago ($70 billion of assets under supervision) summarizes these developments: "What happens after every significant period of accommodation is a reckoning. This time the bubble is low-rated credit and illiquid private assets."

The political landscape is always part of the backdrop impacting investor decision making. The long awaited Mueller report has done nothing to mend the deep partisan divide within the country, and the Executive Branch and House of Representatives are engaged in an escalating struggle over separation of power and financial disclosure issues. Voices calling for impeachment hearings are gaining volume despite the best efforts of the House Speaker to have the issue settled at the ballot box come November 2020.

The depth and strength of the U.S. economy should not be underestimated. Corporate profits are at a record level despite this year's slowdown in the rate of growth. The U.S. remains the world's largest economy by a factor of more than two, maintains its position as the leading reserve currency in global trade, is a leader in technology development, continues to grow at a moderate rate while others are slowing, and is governed by the rule of law. These are competitive advantages which have driven the stock market to new highs over the last ten years.

Investment Conclusion

As a long term investor, this firm has found success by focusing on well managed companies with distinctive competence features and some history and experience in staying the course during more difficult economic periods. That being said, the present appears to be one of those times when protecting capital is going to be more important than extending risk. While no one can predict the timing or magnitude of the next economic downturn, there are sufficient warning signs that one will be along in due course. Overpriced common stocks can be prudently reduced in size (charitable donations of overly large low cost positons is one very tax efficient strategy), issues not achieving fundamental expectations can be thoughtfully reduced, and new positions taken when the purchase price has a margin of safety. As regards the latter, the Wall Street community and its growing reliance on algorithms rather than judgement will continue to misprice both sectors and individual issues, which fundamental investors can benefit from when making purchase decisions.

Fixed income investments should remain strictly investment quality with short maturities since the flat yield curve offers no incentive or premium for extending. This component along with quality cash equivalents will buttress portfolios from any broad market pullback while providing purchasing power for new stock investments at the right price and future time.

June 21, 2019