EQUITY STRATEGY FOCUS

OCTOBER, 2018

IN VIEW: The Equity Landscape

Is Volatility Here to Stay?

This certainly has been a volatile year for stocks, and it isn't over yet. The volatility has mostly been attributable to the tug of war between President Trump's bullish and bearish policies. On the bullish side: deregulation and tax cuts. On the bearish side: widening federal deficits and an escalating trade war with China.

On balance, Trump's policies have boosted economic growth and further tightened the labor market. As a result, Fed officials—who did a good job of prepping the financial markets for a gradual course of hikes in the federal funds rate, aiming for a "neutral" 3.00% level by the end of next year, have recently been signaling even higher rates, i.e., turning restrictive.

Consequently, the trade-weighted dollar has soared. The combination of higher U.S. interest rates and a stronger dollar is suppressing U.S. inflation - while depressing commodity prices as well as the global economy, particularly emerging market economies. The situation is akin to driving a car with the left foot bearing down on the accelerator while the right foot taps the brakes, as we've mentioned in previous commentaries.

The outlook for 2019 volatility will most likely continue. That's assuming that tensions between the U.S. and China continue to mount. However, on the bullish side, the latest FOMC statement did hint faintly that a pause in the Fed's quarterly rate hiking might be possible next year. Meanwhile, the global economy continues to weaken. In any event, the growth rates of both S&P 500 revenues and earnings will certainly begin decelerating in 2019 versus the 2018 rate.

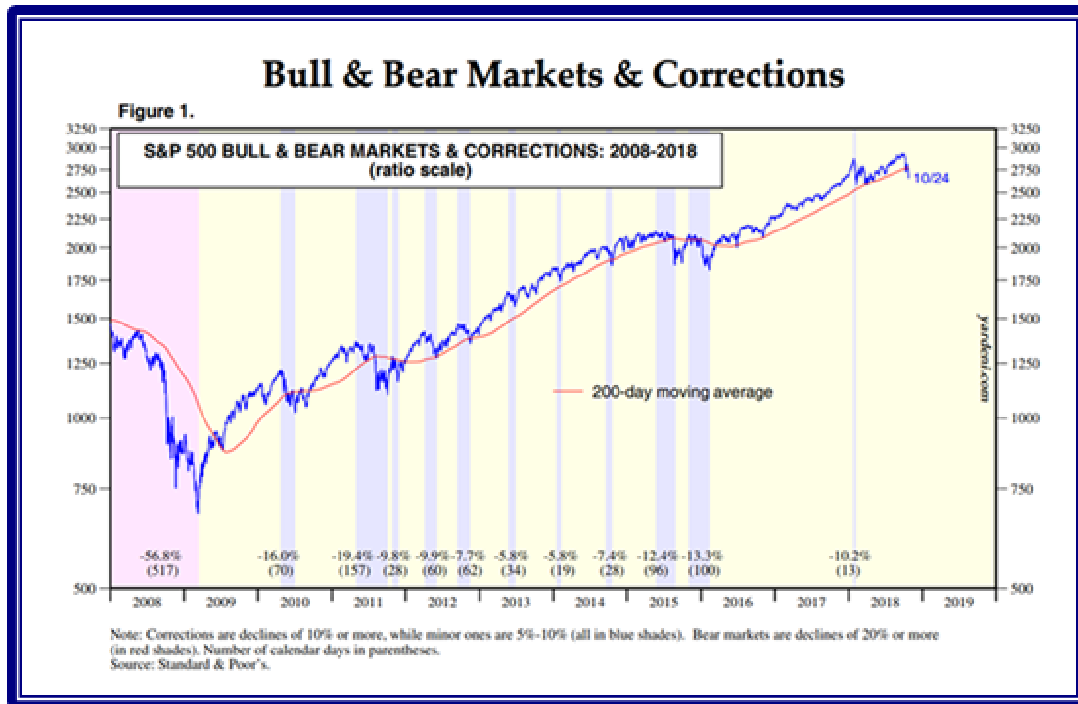
Overview

In the aftermath of the financial crisis, the economy was fueled by an accommodative Fed Policy that included near zero interest rate levels and an expansion of the Fed balance sheet. Lower borrowing costs worked to prop up corporate profits making stocks more attractive investment vehicles. The bull market that ensued is now in its 10th year. As the economy strengthens along-side a strong market, lower interest rates are no longer necessary. In fact, in order to stave off inflation the Fed has been unwinding its accommodative policies. Fearing inflation, investors are selling bonds as evidenced by the yield on the current 10-year Treasury which spiked as high as 3.2% in September.

Since the Fed began raising rates at a measured pace back in 2015, the economy has continued to improve. The unemployment rate has dropped to 3.7%, and wages growth has finally begun to take root. Given this data, it would not be prudent for the Fed to keep rates unnecessarily low in the coming years. Not only is the economy no longer reliant upon lower interest rates, but it is in danger of overheating if easy money is not curtailed. If delayed for too long, the economy would likely grow too fast. This overheating will begin to stifle production levels and cause prices to spike.

One phenomenon that has begun to develop, that could cause the Fed to pause its rate hikes, is the spread between short- and long-term treasury yields which has spread faster than previous tightening cycles. If this trend persists, we could see further erosion of equity prices in the U.S. and elsewhere, thus causing the Fed to keep rates stable for some time before resuming its tightening policy.

Stocks began the 4th quarter selling off nearly 10% in October on what seems to be a more emotionally-charged rather than fundamentally-driven basis. This most recent sell-off marks the fifth of its kind since the bull market began 10 years ago.

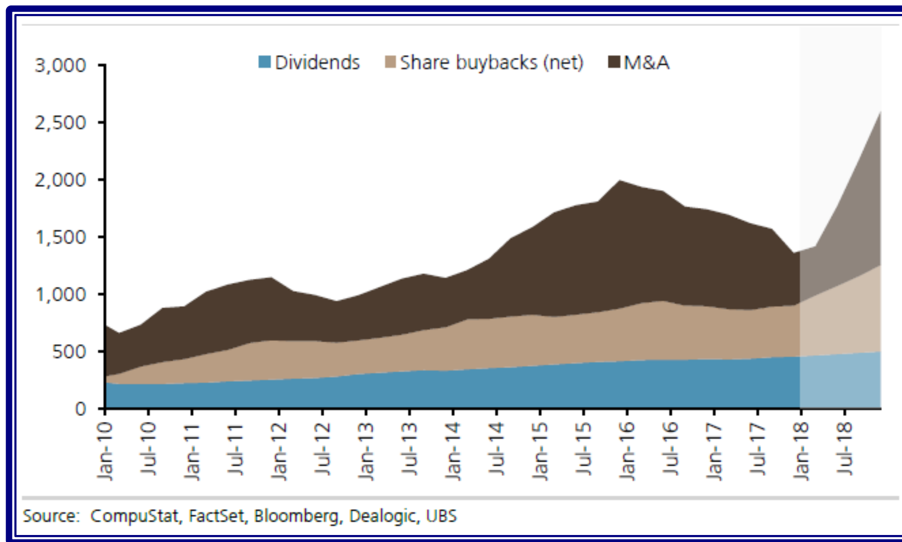


Inflation fears and rising interest rates are causing markets to sell off, as investors weigh potential Fed Policy action in the upcoming months. Market breadth both domestically and globally is under pressure, with only 28% of New York Stock Exchange Composite trading above the 200-day moving average. Globally, the number is just below 50%. Volatility has increased but volumes continue to wane indicating the lack of initiative to buy into the sell-off. As the benchmark S&P 500 index passed through its 50 and 200 moving averages since October, we see a buying opportunity in that fundamentals are still in place with strong incoming economic data. Market corrections like the one we are currently experiencing, are both expected and healthy for long term investors.

As we watch the pace of share repurchases double over year ago levels, analysts are expecting buybacks to reach upwards of $800 billion in 2018. Corporate restructuring in the aftermath of the financial crisis improved cash levels. Tax reform amounting to approximately $1.5 trillion in tax breaks for corporations further strengthened cash levels. What these elevated buyback numbers tell us is that companies see their stocks as undervalued and buybacks are therefore viewed by management as its best use of cash. Even Warren Buffet of Berkshire Hathaway (BRK) is looking more favorably towards stock buybacks. In July, BRK announced a policy which relaxes its rule that prohibits share buybacks above 20% of book.

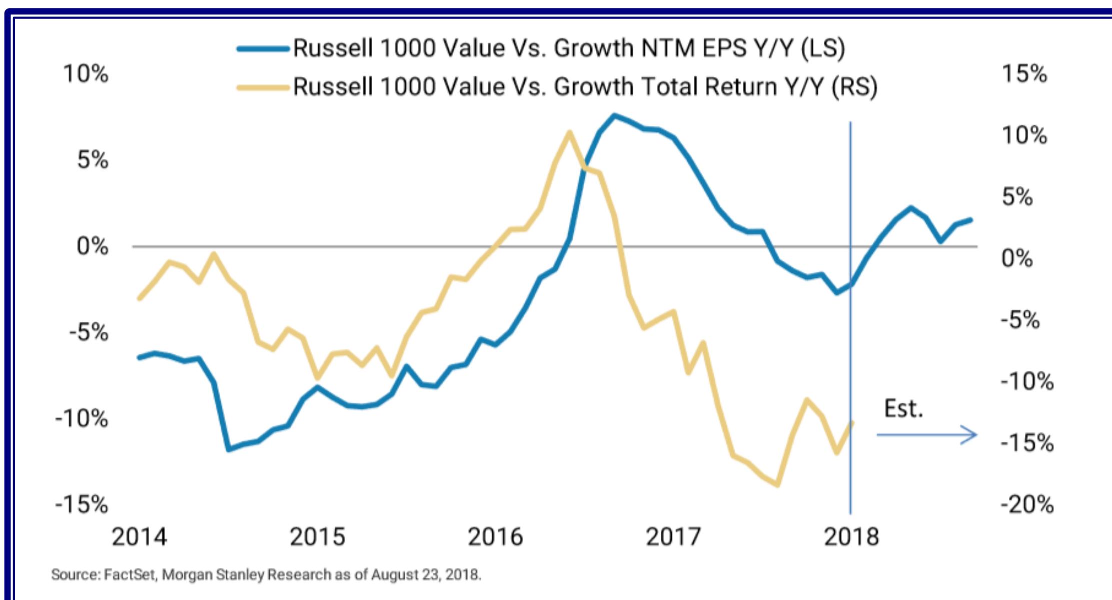
Tech stocks have seen the largest level of buybacks and have fared quite well this year, leading the benchmark S&P 500 index higher. In regards to investment style, growth stocks have benefited from higher buyback activity levels. We may see these numbers taper off from peak levels, as investors prefer to see cash deployed towards organic growth initiatives.

Returning Money to Shareholders is Common Among Technology and Other Growth Companies



The outlook for value stocks has improved relative to growth on a forward-looking earnings revision basis. The trend in relative performance is also beginning to improve, with a nod towards value. In fact, in the recent correction, value stocks out-performed growth by 180 basis points. This distinction between the performance of value versus growth stocks is particularly important when looking at the world stage and comparing valuations. U.S. stocks (22x P/E multiple) are not only looking expensive on an absolute basis but also relative to world developed and emerging market indices; 18x and 15x, respectively. Specifically, the S&P 500 index is trading at 21.6x earnings above its 10-year multiple of 17x. Style selection is critical over the long run. Despite overall market levels, prudent investors can find value which enables them to stay invested throughout various market cycles.

Value vs Growth Performance has Created a Buying Opportunity



CLOSE-UP: Equity Investment Overview

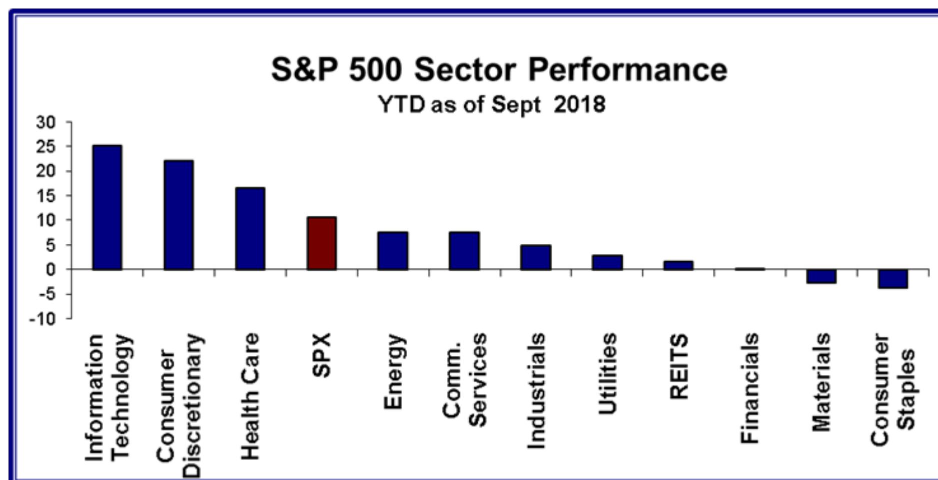
The latest earnings season seemed to contribute to the sharp sell-off in stocks during October, as some companies reported bullish earnings that were more than offset by bearish guidance about future earnings prospects. Collectively, however, the S&P 500 results through early November were 4.9% better than analysts expected at quarter end. As we've noted before, such positive earnings forecasting is par for the course.

In aggregate, the negative guidance corporate managements provided during earnings conference calls didn't seem to deflate analysts' consensus earnings estimates for Q4-2018 and the four quarters of 2019. In fact, the 2018 estimated earnings growth rate remained steady predicting 23.6% for the 2018 calendar year. According to Morgan Stanley Research, the 2019 estimated growth rate slid to 9.4% in the latest reading and the 2020 projected growth rate remained at 10.2%. In other words, the Q3 results didn't curb analysts' enthusiasm for earnings growth over the rest of this year and the coming two years. We are tending to view the future more cautiously.

Market Performance Overview:

For the first three quarters of the year, markets were dominated by domestic growth-oriented companies. Results pertaining to market cap were somewhat mixed. While the Russell core small cap and mid-cap indexes outperformed their large cap counterpart, the growth oriented large cap Russell index outpaced growth stocks with relatively smaller market caps. The technology heavy NASDAQ composite and Russell 1000 Growth indexes each outpaced the benchmark S&P 500 index by over 650 basis point. European and Asian markets all underperformed the U.S. markets significantly. Higher U.S. treasury yields, trade war implications on foreign markets along with dollar strength are all contributing to current U.S. market leadership.

Since the bull market began in early 2009, the performance of cyclical market sectors has outpaced those that are more defensive in nature. As expected, in the early to mid-cycle, profit growth, low inventories, consumer strength, and expansive monetary and fiscal policy all help lay the ground work for a continued recovery. Technology companies typically do well as corporations begin to spend more on systems upgrades via servers, hardware, and services. With sentiment on the rise, consumers step up their spending eager to make purchases while conditions remain supportive.

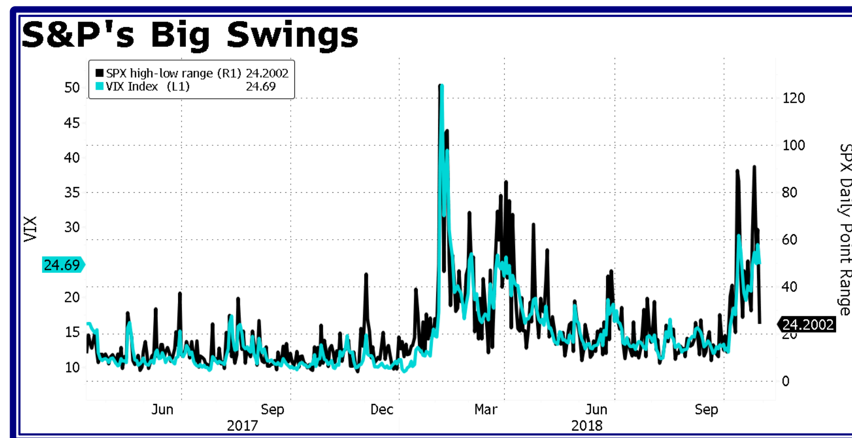


Source: Altman Investment Management Research and Bloomberg

Technology was strongest throughout the year, with the exception of semi-conductor stocks which underperformed the technology sector by 1500 basis points. Autos were the weakest industry within the Consumer Discretionary sector that as a whole was the second strongest performer this year.

In the midst of earnings season, earnings per share growth is tracking at 24.6% over last year. About one third of companies mentioned tariffs, but have yet to quantify its impact to any meaningful degree. Industrials will be the sector to monitor for developing trends on this front. Capex is growing at a rate of 16%, down from Q2 at this point. Diminishing capex spend, should it become more substantial, could be signaling managerial uncertainty with regards to trade war implications on growth. So far, on year-over-year top line sales, Energy, Real Estate, and Communication Services are leading the overall market. On bottom line earnings, it's Energy, Financials, and Material sectors heading the pack. All sectors are exhibiting positive year-over-year growth; however, Utilities and Consumer Staples have been the weakest.

Since March of this year, when trade war rhetoric began to hit the news stream, stocks continued to climb - ending up 10% through September. Giving it nearly all back, October was plagued with fear of rising interest rates, uncertainty surrounding growth, and lofty equity valuations. This spike in volatility is keeping investors on the sidelines, as evidenced by lower trading volumes. We expect the level of volatility, which is currently in an uptrend, to reign in to a more normalized rate within the next few months.



S&P growth stocks significantly outperformed value by a wide margin coming in up 17.24% and 3.51% respectively. In terms of our composite:

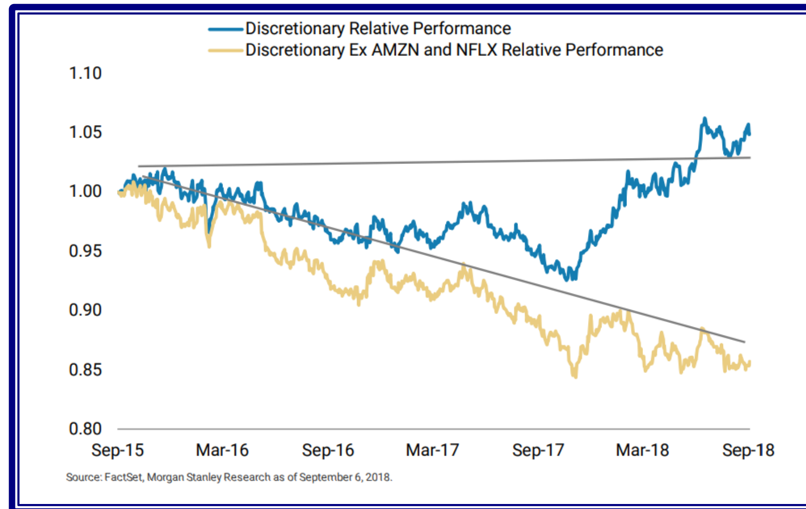
- For the 1st three quarters of 2018, Consumer Staples, Energy, Healthcare, REITS, Utilities, and Industrials contributed positively to performance. Consumer Discretionary, Information Technology, Financials, and Materials, and Communication Services detracted most from relative performance.
- The top 5 contributors to the AIM Core Value composite performance were Keysight Technologies, Microsoft, Conoco Phillips, Merck, and Cisco Systems.
- The 5 stocks detracting most from the AIM Core Value composite performance were Dollar Tree, Applied Materials, Halliburton, Wells Fargo, and Chubb.

Portfolio Strategy:

Bottlenecks in the Permian Basin involving the transportation of oil are holding oil prices down. This is evident in the widening spread between Midland oil prices and WTI crude prices. Prices in Midland have room to decline further before E&P companies respond by cutting production. Occidental Petroleum, (OXY) is positioned to benefit from widening differentials due to its leading production capabilities within the region and its relatively cheaper production capabilities. While competitors may be forced to reduce activity, OXY should be able to maintain its production levels. In fact, in August, OXY raised its full year production forecasts by 9-17 million barrels per day. High free cash flow levels should allow flexibility to offset impact of announced cap ex increases. Our forecast is that oil reaches $80/barrel by mid-2019, so any sell-off in other E&Ps or service companies as a result of this bottleneck would create a buying opportunity in the sector.

Consumer Discretionary stocks performed well as a group this year, up over 18%. Relative performance of the sector however is skewed to the upside with the inclusion of Netflix and Amazon (up 254% and 303% respectively since September of 2015). Excluding these two stocks, *relative* performance of the Consumer Discretionary sector is actually declining. It is possible that the "shot in the arm" the sector received from tax reform could be waning. As we near the mid to late stages of the economic growth cycle, Consumer Discretionary stocks could lack the breadth necessary to warrant additional investment.

Consumer Discretionary (Ex Amazon and Netflix) Remains in a Downtrend



Two new additions to the portfolio were made during the quarter.

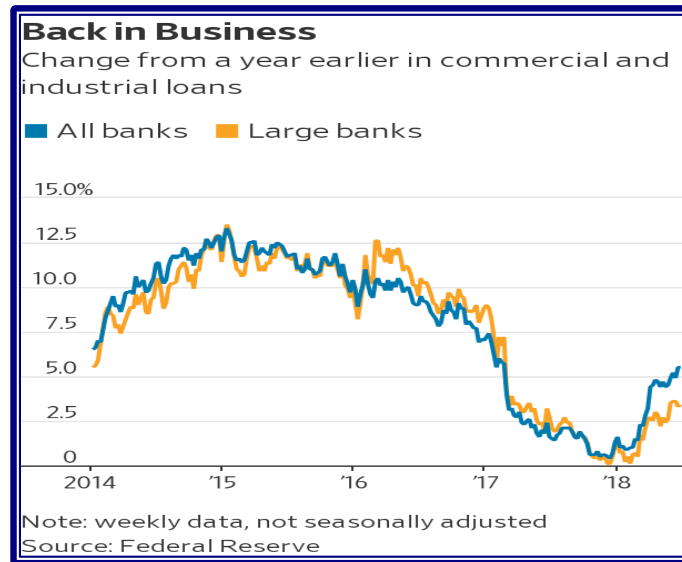
- **Walt Disney Co. (DIS)** – This company is a diversified media business that consists of theme parks, cable networks, and film studios. The recent announced acquisition of 21st Century Fox will help DIS supply greater content to customers and expand its international footprint in production and television units. Fox's interest in companies like Hulu and Sky is additive as well.

  In August, DIS reported earnings growth of 29% per diluted share and revenue growth of 7%. The revenue growth was led by double digit advances in Studio Entertainment. Media Networks and Parks and Resorts enjoyed mid-single digit growth while Consumer Product growth was negative. Catalysts going forward include synergies from M&A activity, movie franchise successes, and continued market strength providing support to consumer sentiment. Trading at 17x earnings, or a 32% discount to its long-term valuation, creates a buying opportunity in DIS shares at current levels.

- **Lincoln National Corp (LNC)** - Earnings results for this company came in ahead of expectations on favorable mortality rates in life insurance and acquisition synergies in group insurance. Positive momentum in sales is still overshadowed by overall net outflows in their annuity business. Recent volatility can be attributed to its interest rate sensitivity, but we look to its strong fundamentals, managerial competency and earnings capabilities in our ownership rationale.

Trends within the banking sector, in addition to rising interest rates and deregulation, continue to support investment in this arena. Many banks including Bank of New York, Wells Fargo, Regions Financial, and Bank of America continue to raise the dividend and/or increase share repurchases. Bank of America for example announced plans to return $26 billion to shareholders over the next year. Not only is this a record number for the company, it follows several years of limited payout during restructuring after the financial crisis.

Business loan growth improved in 2018, after a downturn that began after the 2016 election. The downturn was surprising given that most investors anticipated business borrowing would flourish under a Republican majority. Perhaps competition from non-bank entities overshadowed the influences of a strong economy in decision making process made by these businesses. The uptick this year is finally reflective of continued strong economic data reports.



Amid strength in the Technology sector this year, we trimmed our investment positions back a second time, taking profits in Accenture, Keysight Technology and Microsoft. Earlier in the year we took profits in Applied Materials (AMAT). Since we paired back on AMAT in March, the semi stocks have been weak. Exacerbated by trade wars and other geopolitical tensions, the semiconductor sector index (SOX) has traded off nearly 8%. The usual pressures on semis during a downturn, lead times and/or original equipment manufacturers, are holding up. The trade war has imposed the most stress on the sector with industries such as advanced automotive that are combating higher input costs. China is a significant investor in the semi fab market. Any tensions along these lines will impair semiconductor stocks at least in the short term.

Trading at 15x earnings, below its 15-year average of 32x, the Philadelphia Semiconductor Index (SOX) looks attractive here. Despite facing tough comparisons next year, Intel's notebooks, desktop and server units all increased this quarter and pricing competition continues to be muted. Applied Materials (AMAT) is broader in scope than most of its competitors which expands and strengthens their client base. The company has been lowering its cost structure, focusing on core initiatives by funding its research and development capabilities.

IN SUMMARY:

Growth rates in earnings and revenues are currently tracking at 25% and 8% respectively, but are expected to slow modestly in 2019, absent another round of major drivers i.e. tax cuts and increased government spending. While the current earnings season is strong, we are focused on guidance which is warning of a more challenging environment in the year ahead on tougher comparisons and a slowing global economy. As a result, we have tempered our profit growth forecast for 2019 from 15% to 10% and a CPI of 2.5%, and placed a lower ceiling on market valuations. If the trade disputes are settled peacefully, then the economy after a pause could reaccelerate back to a 3.0% growth rate.

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Any performance reference represents a hypothetical composite compiled from actual equity, fixed income or balanced client portfolios and includes cash. These three composites reflect aggregated returns that address differing objectives. As such, the performance of each composite does not reflect the actual total portfolio returns earned by our clients. The investment performance records are compiled from a capital weighted average of the equity, bond and cash components of a broadly representative group of discretionary accounts that meet certain minimum size thresholds.

No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

The composites were created in 2001 and the inception dates start on August 17th, 2001.The composites include only discretionary fee-paying accounts managed in the strategies, and additional information associated with the composites are available such as: dispersion in individual portfolio results as well as the % of the firms AUM in the strategy. All performance calculations are presented within the GIPS® guidelines of the CFA Institute. The CFA institute does not endorse or promote this organization nor does it warrant the accuracy of the content herein.

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