Holt Capital
Partners, L.P.

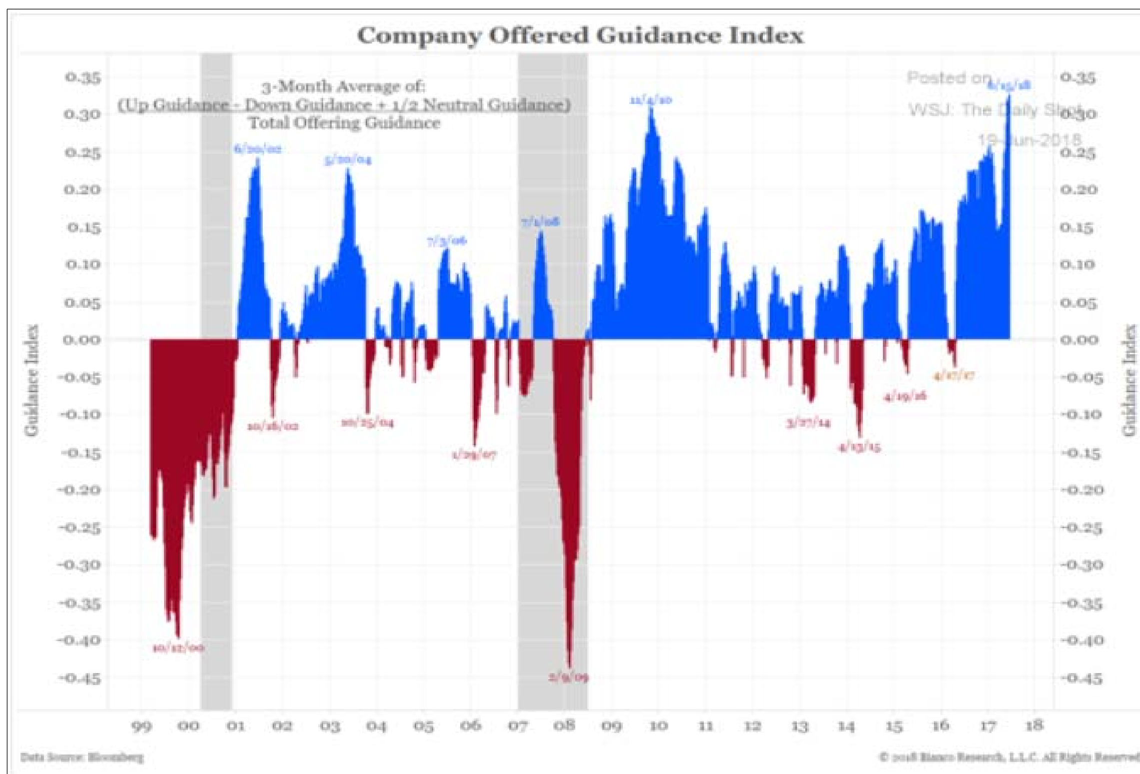
Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

June 30, 2018

Strong Economy, Strong Earnings

- The second quarter was one of those that, upon reflection, causes you to respond, "had I known all of that in advance, I would not have guessed that stocks would be up."
- U.S. tariff proposals met with retaliation and, tit for tat, escalated over the quarter to cover $200 billion of Chinese goods, included a 20% tariff on EU autos and raised tensions with Canada. OPEC conspired to boost oil prices. The FBI raided the office of the President's attorney. The Federal Reserve raised interest rates, while the ECB announced the end of its quantitative easing. The U.S. continued to break with its Western allies by withdrawing from the Iran nuclear accord and declining to join a G7 communique. Italian politics re-ignited discussions about the viability of the European Union. And the list could go on.
- But, the economy and earnings were strong and that was the difference, as is typically the case. The Michigan Consumer Sentiment Index neared historic highs, while Initial Jobless Claims were at the lowest level since the 1970s and the Unemployment Rate dipped below 4%. Positive earnings surprises reported in the first quarter were near the all-time high and management guidance about future earnings, as shown in the chart below, has been resoundingly positive.



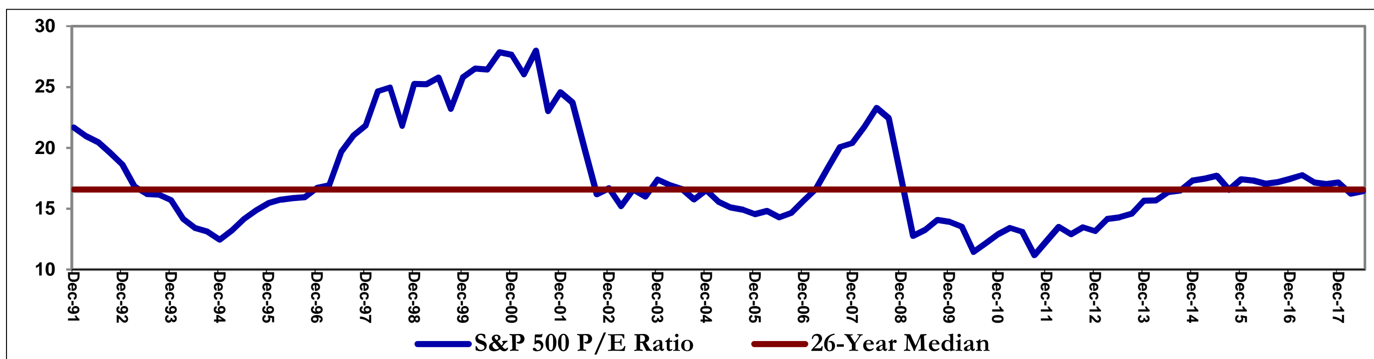
TARIFFS

- The prospects for a global trade war have risen.
- The overall gains from trade are well documented throughout history, as is the reality that tariffs reduce economic growth. Tariffs increase the cost of consumption, which often hits hardest those that were negatively affected by the opening of global markets in the first place. The knock-on effect is that protectionism destroys more jobs than it creates.
- While a segment of Trump's base yearns for a "mercantilist" policy that protects U.S. industry, that can't be the end game. The aggressive posture must be to rebalance the terms of trade more in favor of the U.S., or perhaps even to broadly *reduce* global tariffs.
- Markets have largely ignored the saber rattling over trade, possibly in part because of Trump's tendency to follow startling policy statements with partial retreats. But, global positions are calcifying and the risk/reward seems lopsided, with the risk of a disruption to growth imminent while any benefits are likely years away. Without a compromise that Trump can call a victory, markets will start to care.

EQUITY VALUATION

- In 2017, the S&P 500 earnings rose at an above-trend rate of 12%, while the index gained 19%. So, investors enjoyed strong earnings growth along with an *expanded* valuation.
- Earnings for the S&P 500 in 2018 are expected to increase 20%, in part resulting from a lower tax rate, but also benefitting from a strong economy. Since stocks are up only modestly this year, the market's P/E multiple has *contracted* and is now approaching its 25-year median.
- Given P/E multiples that are neither rich nor cheap relative to history, we would expect earnings and the macro-economic outlook, rather than valuation, to be the primary drivers of near-term stock prices. Over the long-term, the current valuation level offers the prospect of mid to high single-digit returns.

S&P 500 Price-to-Earnings Ratio
(1991 - 2018)



INDEXOLOGY

- The last remaining original member of the Dow Jones Industrial Average, General Electric, was removed from the index and replaced by Walgreens Boots Alliance. While this is fun trivia, "The Dow" is not a meaningful stock market gauge, as we have written before, and much less than 1% of index fund assets track this index.
- The high-profile change to an often-cited index is an opportunity to share a couple thoughts about the importance of index selection in designing investment strategies. The Dow is comprised of relatively few companies, each weighted based on stock price and as such, is not useful for building portfolios. The most popularly tracked index by index funds and ETFs is the S&P 500, which with 500 companies provides greater diversification. But, each stock is weighted by its total market value resulting in the most highly valued companies often having the greatest index weights.
- Both academic and applied research identify that long-term investment performance can be improved through intelligent index selection. Indices offering different methods of construction, such using equal or fundamental weighting schemes have demonstrated superior long-term performance. Additionally, indices that emphasize certain factors such as value, dividends, quality, and size have demonstrated superior long-term performance.
- While it is often given inadequate attention, the *active* decision in passive investing involves index selection. It is this decision process that is most likely to have a meaningful impact on long-term returns.

GROWTH VERSUS VALUE

- While growth and value are really two sides of the same coin, investment strategies have come to be lumped into those two buckets. Value strategies tend to emphasize low P/E stocks that are out of favor. Large weights in the S&P 500 Pure Value Index include CenturyLink, Macy's and General Motors. Growth strategies often prefer popular stocks that exhibit high EPS growth and strong price momentum. Large weights in the S&P Pure Growth Index include Netflix, Amazon, and NVIDIA.
- Growth and value investing styles have historically behaved in a cyclical fashion. The following chart displays a ratio of growth versus value with growth outperforming when the line is rising. As is evident, outperformance by growth stocks is nearing levels last seen during the technology boom of the late 1990s. Absolute valuations of technology stocks are not near the extremes of that period. But, the current pace of outperformance is unsustainable and a rotation to value stocks seems likely.

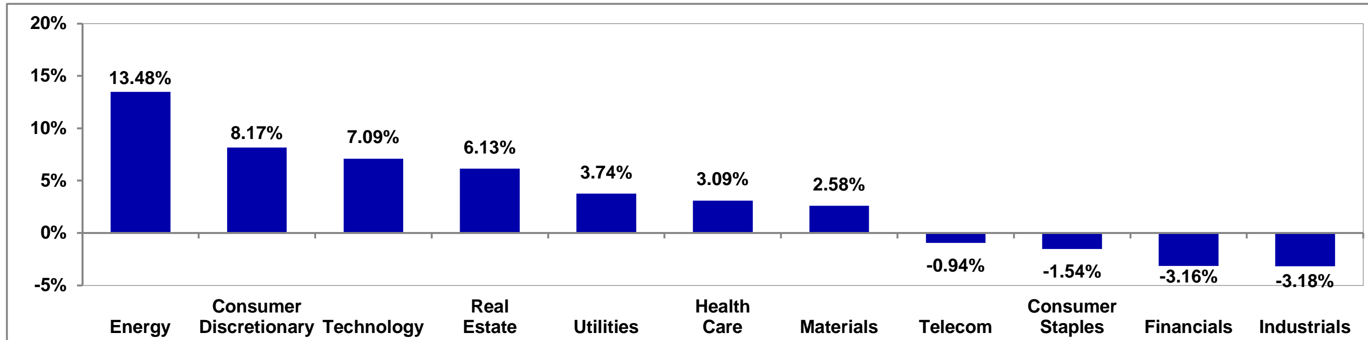
Source: Bloomberg

Conclusion

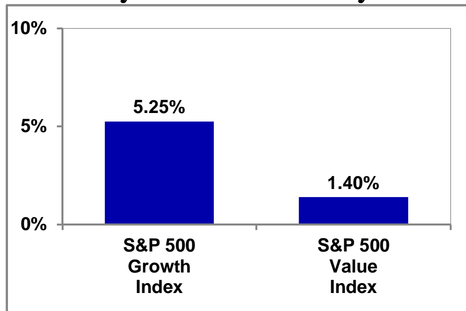
- The economy remains robust and precursors to a recession, such as an inverted yield curve, a year-over-year decline in the Index of Leading Indicators, and widening credit spreads are not present.
- Risks to the outlook include an overly aggressive Fed, which has acted in a measured fashion thus far, or some other policy error, with the escalating trade tensions being the most concerning.
- As the economy has moved closer to full employment, the growth benefit of idle labor re-entering the economy is complete. Continued growth requires a "supply side" phase driven by capital investment and productivity improvement. This phase can last several years, but is sensitive to tax incentives and business confidence.

Second Quarter Investment Performance (including income)

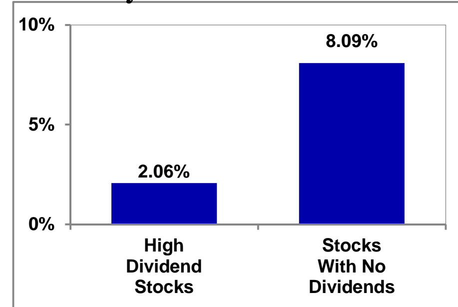
By Economic Sector



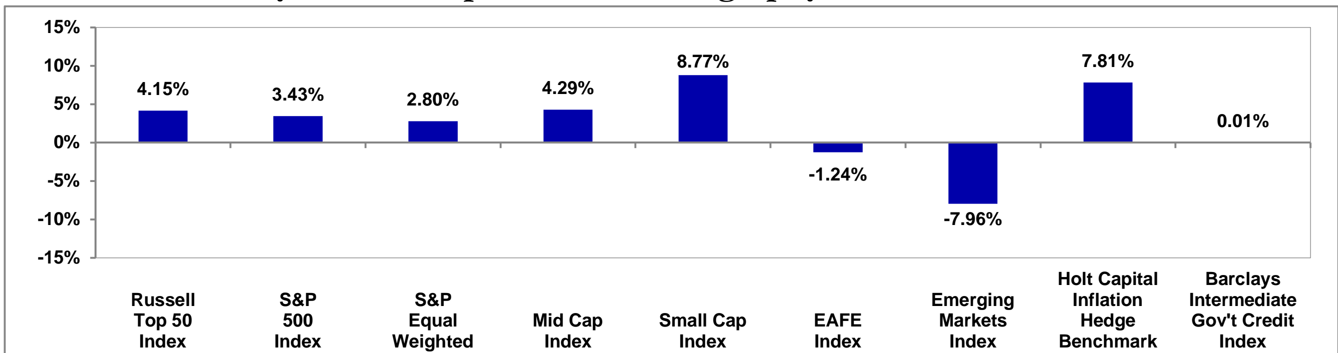
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Energy stocks were boosted by the rally in crude oil and posted the best returns in the second quarter. Interest rate sensitive sectors, such as real estate and utilities, rallied late in the quarter as bond yields fell. Financial stocks, which generally benefit from rising rates, moved in an inverse pattern.
- The strength in small stocks, which are more domestically-oriented, was partially a function of their perception as a safe haven from the global trade concerns. Emerging market economies tend to rely on global trade and these markets moved lower based on those same trade-related issues.