Equity Investment Outlook - January 2019

January 25, 2019

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The fourth quarter of 2018 saw U.S. equities decline materially, with especially steep falls in December. During the fourth quarter the equity market as measured by the S&P 500 generated a total return of -13.5%, bringing full year S&P returns to -4.4%. While disappointing, these results need to be seen in the context of a broader and much more severe downturn in global equity markets. Developed international markets finished the year down more than 13% while emerging markets were down almost 15% for the year. Fixed income markets were also challenged by rising rates and widening credit concerns. Against this backdrop of uncertainty, as we would expect, U.S. Treasuries provided an offset and produced positive returns due to a strong rally in December.

The fourth quarter was characterized by significant volatility, reflecting a fierce debate about the economic growth rate and what the correct multiple should be for that growth. Anticipating these concerns, we focused our portfolio over the past year on higher quality companies and reduced our exposure to cyclicals and companies with more levered balance sheets, thereby positioning the portfolio to better handle volatile markets.

Nine years into a bull market, it is not surprising to see the market undergo a correction. While unnerving, corrections result in a more favorable repricing of equities, and, as long as fundamentals do not meaningfully deteriorate, provide the opportunity to add to existing positions or initiate new positions at lower prices. During the fourth quarter, investors clearly focused on potential negatives and began to price in the possibility of recession. The narrative focused first on the Trump administration's recent trade threats, particularly against China, which have had a tangible, negative impact on their economy and have hurt sentiment here. Recent global economic data have also shown weakness, with slowing growth in China and Europe—including the bellwether German economy.

Adding potency to this argument, the yield curve inverted briefly late in the fourth quarter. Yield curve inversion has typically been regarded as a precursor of recessions, even those that ultimately failed to materialize. Said another way, inverted yield curves have predicted "seven out of the last five recessions". In the current case, we think the yield curve is indicating unease with the recent rate hike in the face of slower growth rather than a recession or actual economic contraction in the near term.

We believe that the global economy has experienced a synchronized *slowing* of growth that is likely to continue for the foreseeable future. This is supported by many positive indicators that reflect economic strength: unemployment of 3.9% continues to improve even as the labor participation rate expands; wages are growing at 3.2% versus last year; inflation is coming in under 2%; and GDP continues to grow at 3.4%. These data lead many market participants to believe the expansion will continue through at least 2019 and 2020. Moreover, interest rates are still low from a historical standpoint and the benefits of tax cuts and a business-friendly regulatory environment should continue to benefit domestic equities.

Since this debate about growth versus contraction is not entirely new, what exactly prompted markets to sell off in the quarter? Two issues seem to have sparked recent volatility: the continued escalation and uncertainty around the U.S./China trade dispute and actions by the Federal Reserve (the Fed), specifically rate hikes based on continued stability and economic data.

First, threats by the Trump administration to impose trade sanctions and tariffs on China have erupted into a full-blown trade war. The U.S. has imposed tariffs on $250 billion in Chinese goods and has threatened tariffs on substantially more. China has responded with tariffs on $110 billion of U.S. goods. Negotiations continue, but the outcome remains uncertain. Trade wars do two things: raise costs to the importing nation and create uncertainty. Inflation has been very tame for most of the recovery here, and we are monitoring for signs of increased inflation. Uncertainty can lead businesses to defer investments as management teams contemplate a more uncertain world with potential new tariffs and changing consumer behavior. As the trade war escalated, the markets began to factor in its potential impact on corporate profits and hence stock prices. Stay tuned.

Second, in December the Fed raised interest rates. While widely expected, the fear that higher interest rates could dampen liquidity and ultimately push the U.S. economy into recession clearly spooked the market. In many ways the Fed is in a

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bind. As U.S. economic health improves, the Fed is carrying out its policy of gradually normalizing interest rates from historically low levels. The tightening labor market and trade war both raise the risk of growing inflation. The risk that the Fed might raise rates too aggressively and inadvertently push the economy into recession sent stock prices significantly lower and led to a flight to safe havens such as U.S. Treasuries. We believe that the Fed will be more measured going forward with interest rate increases, which could allow markets to better reflect economic growth. Fed Chair Jerome Powell recently said as much in the face of recent weak Institute of Supply Management (ISM) readings in the U.S., a softening global manufacturing Purchasing Managers Index (PMI), and China's PMI falling below 50. The Fed now expects two federal funds rate increases in 2019 based on this information instead of three, as previously signaled.

Other factors causing markets angst include expected legislative gridlock, the partial government shutdown (which is now the longest in U.S. history), significant turnover within the Trump administration and the decline in oil prices. Additionally, uncertainty surrounding Brexit has injected further ambiguity into the outlook for the U.K. and European economies.

Oil prices collapsed from roughly $75 per barrel in September to just above $45 today. As is often the case, it is unclear how much of the selloff is related to actual demand slowdown, excess supply or simply concerns about a slowing economy. Regardless, the result has been sharp markdowns of valuations for energy companies and sectors tied to oil. Agnostic as to the cause of the energy selloff, we have largely avoided investing in companies tied directly to oil and expect that lower oil prices should boost consumer spending and confidence.

While there is certainly a litany of worries we can dwell on, we would rather take a more balanced approach. None of these issues is new to us. We have been monitoring each of these concerns for at least a few years and have expounded on them in recent letters. Meanwhile many economic indicators remain positive and reflect economic strength. Importantly stock market dislocations like the one we recently experienced often create the best buying opportunities as stocks become cheaper and potential future returns become greater.

Our view is that it is especially important in the current environment to own extremely high-quality companies—those with healthy balance sheets, stable and growing cash flows, secular tailwinds and seasoned management teams. Over the past year, as the risks we have enumerated in this and past letters have cropped up, we have migrated to a set of very strong businesses with robust growth potential. This has served us well through the recent volatility. By the same token, our pipeline of potential new investments has expanded significantly over the past couple months. We are evaluating numerous stocks that are down significantly from their highs, but which have clear prospects for future growth. We have added several to our clients' portfolios. Over time, we expect these companies to compound for many years to come.

In summary, the current environment is uncertain and requires careful attention. We like our current positioning but are actively looking for new opportunities created by the volatility in the market. Please call or email us with any questions or thoughts.

Sincerely,
John Osterweis

Past performance is no guarantee of future results. Index performance is not indicative of fund performance. To obtain fund performance call (866) 236-0050 or visit osterweis.com.

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The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance. One cannot invest directly in an index.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

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