# Market Review & Outlook: Quality

**Miles T. Kirkland, CFA**
Senior Vice President &
Portfolio Manager
Wealth Management Services

## *Executive Summary*

- *Corporate earnings grew 25% in the first quarter and are expected to be 20% higher for 2018 than 2017.*
- *Tariffs and a flattening yield curve raise concerns.*
- *After a somewhat confusing deceleration in first quarter GDP growth, the economy should recover a 3% pace for the balance of the year.*
- *We believe that high quality assets are always a foundation for a successful portfolio, so there should not be a need to overhaul a portfolio to prepare for tougher times.*

US equity markets delivered a positive return in the second quarter. First quarter corporate earnings were very strong. Not only was the 25% rate of growth very high, but also most companies delivered better than anticipated earnings per share with most seeing higher than anticipated revenue growth. According to Factset Research, approximately 78% of S&P 500 constituents reported better than anticipated earnings and 77% beat sales expectations. Business is good and company guidance suggests it will stay that way. On the other hand, there are some open-ended points of uncertainty. The trade war is escalating. The accepted relationship between unemployment and inflation seems to be breaking down. The Fed is confronted with a very flat yield curve as members consider future interest rate increases. This fall, we have mid-term elections in the United States and Europe faces several significant tests with Brexit negotiations, and potential new directions in Italy and Germany. China is attempting to maintain healthy growth in the face of heavy indebtedness and higher tariffs. Other emerging markets are suffering as the rising dollar makes dollar denominated debts more difficult to repay.

As the bull market continues into its ninth year, strategists and analysts are encouraging people to prepare for tougher times. Many suggest a move to "high quality" stocks (and bonds), which makes sense…sort of. This brings up reasonable questions. Why would someone want to own anything else? What does that even mean? The simplest qualifier is past performance. Sadly, it is used a lot. Stocks that have done well over time are usually presumed to be the best place to be going forward; however, the past (and present) are littered with disappointments

## Equity Market Index Returns

*As of June 30, 2018*

| Asset Class | Index | 2Q 2018 (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 10 years (%) |
|---|---|---|---|---|---|---|---|
| Large Cap U.S. | S&P 500 Index | 3.44 | 2.65 | 14.38 | 11.93 | 13.42 | 10.17 |
| | Russell 1000 Large Growth Index | 5.75 | 7.25 | 22.50 | 14.98 | 16.36 | 11.83 |
| | Russell 1000 Large Value Index | 1.17 | -1.69 | 6.77 | 8.25 | 10.34 | 8.49 |
| | DJ US Select Dividend Index | 3.65 | 1.02 | 9.93 | 13.21 | 12.84 | 11.60 |
| Mid Cap U.S. | S&P 400 Mid Cap Index | 4.30 | 3.49 | 13.52 | 10.89 | 12.69 | 10.79 |
| Small Cap U.S. | S&P 600 Small Cap Index | 8.77 | 9.39 | 20.50 | 13.83 | 14.60 | 12.25 |
| Developed International | MSCI EAFE Index | -2.35 | -4.49 | 4.02 | 2.07 | 3.63 | -0.04 |
| Emerging Markets | MSCI Emerging Market Index | -7.85 | -6.50 | 8.60 | 5.99 | 5.39 | 2.60 |
| Commodities | Bloomberg Commodity Total Return Index | 0.40 | 0.00 | 7.34 | -4.54 | -6.40 | -9.04 |
| Real Estate | NAREIT Equity Index | 8.41 | 1.20 | 4.86 | 9.20 | 8.90 | 8.32 |
| Global Market Cap Weighted | MSCI World Index* | 1.74 | 0.44 | 11.08 | 8.47 | 9.93 | 6.26 |

**The U.S. represents about 51% of the MSCI World Index.*
*All returns greater than one year are annualized. Source: Greenhill Market Index Review as of June 30, 2018*

from this approach. I recently reread Jim Collins' 2001 bestseller *Good to Great*, which investigates companies with exceptional long-term stock performance (among other attributes). While the insight into traits of great companies are thorough and timeless, most of the specific examples he uses are either gone or have fallen from grace in some way. I can think of a few of my own. The Financial Crisis and poor acquisition decisions have eliminated General Electric from any conceivable "high quality" group despite a storied history of innovation and reinvention. It would have been at the top of the list ten years ago. Wells Fargo's celebrated cross selling culture created bad incentives that have stained the reputation of another erstwhile automatic qualifier. You could add AIG, The Hartford, Circuit City, Hewlett Packard, and many more to the list. Whether due to bad luck or bad decisions, the list is not stable over time and past performance is not a reliable indicator. Understanding current fundamentals for specific assets is necessary, but many investors default to single factors such as dividend yield or return on equity. Dividends get cut and return on equity is the product of many moving variables.

Beyond the basic problem of defining the term "quality", the idea of overhauling one type of portfolio for another involves many complications. We think it is more constructive to see "quality" as a discipline that plays into a larger strategy or game plan. As in all of economics, we start with the assumption that we are working with limited resources, including both accumulated savings and the talents and interests to deploy them well. There are strategies that specifically focus on low quality assets that can and do deliver good returns, but is the additional return in some periods worth the headache, risk, and amplified volatility of returns? We also face frictions such as taxes and trading costs. Finally, we face our own demons. Behavioral finance studies show that we are hard-wired to do the wrong thing at the wrong time because we are fundamentally emotional creatures. That being the case, "moving to quality" is going to involve a lot more than just knowing which assets to replace with which assets. When do you do it? What do you sell? What is the cost? The list goes on.

We believe the decision to adhere to certain standards of "quality" needs to take place earlier, at the time of portfolio construction. At Truxton Trust, we believe that a portfolio dominated by high quality assets is at the heart of a successful long-term game plan. For bonds, determining high quality assets is relatively simple; they are the ones most likely to pay you back based on consistent and reliable income, total indebtedness, and where you stand in the line among claimants. For equities, it is more complicated, but we think credit worthiness is a good place to start. A healthy balance sheet and consistent cash flow become extremely valuable during difficult times. We also think the management team's ability to reinvest in the company effectively is a sign of quality, so we focus on companies with high return on equity and return on invested capital. Finally, the soft subjects such as durable competitive strengths, clear strategy, consistent execution, and shareholder friendly financial policies are clear signs of quality that need to be considered. We believe that a portfolio built (from the beginning) around well-diversified, "high quality" assets and allocated to accommodate an individual's risk tolerance is our best game plan. The slight changes in allocation and securities that anticipate changes in the environment are more like half-time adjustments with limited impact on taxable income or the overall nature of the portfolio. We do not claim to know everything, but we know what we know. We like this game plan and believe that it makes sense for most investors.

The US economy continues to perform well. First quarter GDP was below expectations with several downward revisions bringing the final annualized growth to 2% reflecting weaker consumer activity. Forecasts for the second quarter and the full-year anticipate the trend returning to the 3% range. Inflation has reached the Fed's 2% target. The June ISM readings support stronger growth with the ISM Manufacturing Index rising to 60.2 from 58.7 in May. ISM Non-Manufacturing increased to 59.1 from 58.6. These are surveys measuring the outlook for near-term economic activity for which any reading above 50 indicates growth. The economy added 213,000 to payrolls in June raising the year-to-date average to 212,000 per month. The unemployment rate increased to 4% due to an increase in the labor force participation rate. Average hourly earnings increased 2.7%, about the same rate we have seen since the beginning of the year. Housing remains lumpy, but healthy. While auto sales are not growing, they remain stable at a high level. The consumer seems well-positioned to consume.

The European Union has seen some moderation in GDP growth. Annualized growth fell to 2.4% in March from 2.7% for the quarter ended in December. While this is not cause for alarm, several anecdotes have raised some concern that trade concerns are already starting to impact business. Politics have also soured as immigration and debt have reemerged as issues in several regional elections. China's trade arguments with the US and the headwinds of a much stronger dollar have raised some concerns among emerging markets. Export oriented economies typically need to attract a lot of foreign capital. Declining yields on the 10-year Treasury suggest that this capital is being temporarily siphoned off. Despite somewhat less clarity than in the second half of 2017, we believe that these economies will continue to grow and the potential for growth warrants continued investment.

The Federal Reserve has raised rates twice in 2018 bringing the Fed Funds rate to 2%. The derivatives markets suggest one more increase in 2018 and the Fed's message is that it will continue to raise rates steadily for as long as growth (and inflation) remain healthy. The rest of the yield curve is not cooperating. The yield on the 10-year Treasury has fallen while the 2-year has risen consistently with Fed actions. The result is that the spread between the 2-year and the

## Yield Curve Flattening

2 year 10 year spread tightens as Fed raises rates


**10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity, Percent, Daily, Not Seasonally Adjusted*
*Source: Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org, as of 7/9/18*

10-year is only 0.29 percentage points. A flat yield curve raises concerns that we are on our way to an inverted yield curve, which is a reliable predictor of recession. The Fed has a tough job. Members clearly see the benefits of normalizing rates so that the Fed will be able to respond to the next emergency. Managing the yield curve is a bit anathema. The Fed went to great effort to ensure investors that the process of normalizing the balance sheet would not be carried out in a way that "managed" the yield curve. On the other hand, Fed governors would face criticism over a rate hike that they know would push the 2-year yield above the 10-year. The behavior of long-term bonds is a head scratcher. Generally, changes in the 10-year yield reflect either fear of rising risk (lower yields) or rising demand for capital (higher yields). The equity market has been a little more volatile and remains below the January highs, but does not show much evidence of flight. Economic growth is healthy and employment is full so demand for capital should be healthy. In fact, banks are lending more money. The 10-year is a market determined yield so there is a buyer out there somewhere willing to commit capital for 10-years for a return of 2.86% annually.

While earnings are accelerating with the added benefits of the tax cuts and greater contribution from energy companies, valuations remain elevated but not extravagant. We have been here for a while now. There are several emerging stories that raise concerns that global growth could be slower in the foreseeable future. During times of uncertainty, a good game plan helps. A good game plan is based on an assessment of the available resources, identifying opportunities, and using fundamental understanding to limit the risk of disastrous results. In our opinion, adherence to a discipline based on quality assets is the best game plan. ■


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