Value Opportunities can Arrive During Difficult Markets

The year 2018 ended on a very sour note with the S&P 500 declining by -13.5% in the fourth quarter. Several indices caught up in the rapid drawdown fell closer to 20%. This performance is somewhat ironic given that Federal Reserve Chairman Jerome Powell stated in early October, “There’s no reason to think this cycle can’t continue for quite some time, *effectively indefinitely*.” Hubris is often seen near market peaks. While 2018 was a good year for the economy with GDP growth around 3% and average hourly earnings up 3.2% financial markets may be signaling much tougher times ahead.

In addition to the stock market turmoil, every other major financial market is volatile as well. Commodities, Oil and Industrial metals have corrected sharply. The bond market may also be flashing warning signs. Ten-year Treasury yields have declined by 0.55% since the mid-term elections, a huge move. Junk bonds sold off by 5% in the fourth quarter as credit conditions tightened.

Financial markets are concerned about several things. First and foremost is that to varying degrees central banks around the world are pulling back on stimulative actions. Manufacturing surveys are softening globally but still in positive territory. Positive effects from tax reform are fading in the US. Chinese retail sales grew at the slowest pace in 15 years in November and their manufacturing sector contracted in December and investors are worried more tariffs and further trade disputes will deter investment and exacerbate a global slowdown.

These concerns are starting to be reflected in earnings expectations. According to Factset, earnings growth for companies in the S&P 500 in 2019 has declined from 10.4% in September to 7.9% currently. The typical pattern is for these estimates to further contract as the year progresses.

For the time being we are heeding the warning of the financial markets and taking a more conservative approach. Our cash target for equity accounts is 10%, and we expect to stay at this minimum level until we feel more confident about the direction of the economy. The stock market tends to be volatile in both directions during corrective phases so we’ll continue to sell into strength but will most likely wait for meaningful weakness before buying**. At the same time, it’s important not to panic and get too conservative as valuations are more attractive now. The S&P 500 is trading at 14.2 times forward earnings, well below the high of 17 times in January of 2018 and beneath the average of 15.7 times for the past five years. Moreover, parts of the stock market are downright cheap and have the potential to perform very well even in a sloppy market.** Should quick solutions amend some of the economic issues discussed above the market could see a positive reversal, but there are numerous issues to consider affecting the global economy.

The biggest surprise for us in 2018 was how poorly value stocks performed both on an absolute and relative basis. Despite growth stocks leading the decline in the fourth quarter, they still outperformed value by about 9% during the year! **We had expected value to hold up much better akin to 2000-2002 but that did not happen. As a result we are in unprecedented territory. According to BlackRock, “we are in the longest and largest growth outperformance cycle in history at 59 months, measured by 10-year average annual performance versus value. 57 months was the previous longest growth cycle in history from 1996–2000. *Historically, whenever growth outperformed value by over 2% over a 10-year period, value outperformed growth by +7.2% in the following three years.”*** While our enthusiasm for value was misplaced in 2018 the data argues to continue to overweight this factor.

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OUTSIDE COMMENTARY

GMO- Quarterly Letter - 4th Quarter 2018
"And the Winner was...T-Bills"-
Returns in Recessionary Markets (excerpt)

Returns were certainly a bit better on average during expansions than recessions – +8.6% real versus +6.7% real. But it is abundantly clear that any narrative that says “stocks do well in expansions and poorly in recessions” is silly. Markets tend to do badly when disappointed and well when positively surprised. The onset of a recession usually comes as a disappointment. If you can predict that disappointment, you will indeed avoid some pain. But predicting a recession, as hard as it is, is not enough. You need to predict that things will be worse than the market expects. If you believe there will be a recession and the market agrees with you, there is no sense in selling your equities. Similarly, once the recession starts, its end will probably come as a positive surprise. If you wait until it is easy to see the recession is over, you may well miss out on a significant market recovery.

So, what gives? It comes down to expectations. The simple answer is that markets came into 2018 with an unrealistic set of expectations, and more or less all of them were disappointed. Bond markets assumed inflation and growth would be so muted as to dissuade the Federal Reserve from raising rates four times, as it had suggested was its plan. Stock markets assumed growth would be strong, and appear durable, driving earnings and the expectations for future earnings high enough to keep stocks competitive with the higher yields available on cash. Credit markets assumed that growth and inflation would be muted enough to keep rates low, but corporate cash flow high enough to keep default rates at cycle lows. Real estate assumed that growth would be strong enough to stimulate demand, but rates low enough to keep financing costs from rising. As it turned out, growth was too strong for the bond market’s liking, and too weak for the other asset classes. It is a clear reminder of the truth that it doesn’t take a disaster to lead markets to losses, only a disappointment. Disasters certainly aren’t very good for portfolios, but investing is far more complicated than simply avoiding risk coming into a recession.