Strategic Update – Navigating the Course Ahead

Mid-Year 2018

Maybe the excitement of the World Cup has clouded our perception with "futbol fever", but it seems like the performance of stocks and bonds in the first half of the year was very reminiscent of the quadrennial sporting spectacular. Lots of noise, tons of excitement, tension, jubilation, disappointment, trash-talking Tweets…and in the end, very little change on the scoreboard. This is particularly true with the US markets which fared better than those overseas - which is ironic since our team didn't even qualify.

Stocks:

The stock market started out strongly for the first few weeks then in late January, 2018, the storm clouds of a potential trade war came twittering in.

From its peak on January 26, 2018, the S&P 500 fell nearly 12% in 10 trading days before bouncing off its long term support level. The downturn was quite a shock to the system for many who thought volatility had gone away. In 2017, there were a total of 4 days that saw prices drop by more than (-1%) with the worst being a drop of (-1.82%). In the month of February this year, there were 5 days that saw a drop of (-1%) or more, and the worst saw a decline of (-4.1%).

Investors had become so complacent that many were making "easy money" by betting that volatility would stay low. When this blew up, volatility begat volatility and the downturn was exacerbated by the necessary unwinding of that very crowded trade.

Since its lows in February, the market traded in a fairly narrow range. Fears of a trade war and higher interest rates the momentum to break out to fresh highs. Solid economic numbers and earnings growth have kept the market from breaking down below its long term trend line which provided a base several times during the period.

The key driver of return in the first half was earnings growth with little regard for almost anything else. The top 20 S&P 500 stocks ranked by long term projected earnings growth had an average return of 17%. Conversely, the 20 cheapest stocks ranked by P/E multiples returned an average of (-11%), the 20 top yielding stocks had an average return of (-6%). Being "big" helped a little, as the largest 20 stocks by market cap returned 4%.

Bonds:

Positive bond returns were tough to come by in the first half. As rates rose across the board, only bonds with high yields and variable rates were able to avoid price declines. The global bond market index ended the first half with a return of (-1.77%).

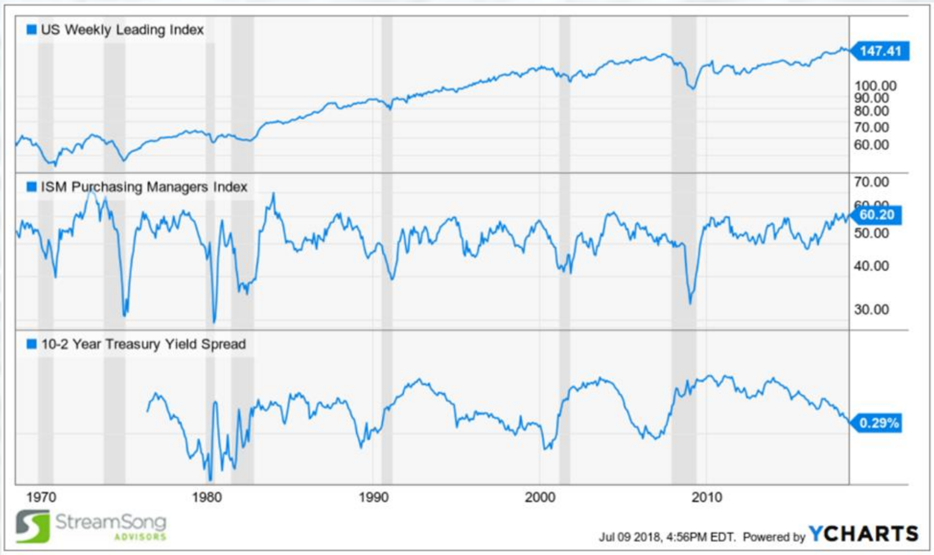
The Federal Reserve continued pushing overnight interest rates up by 0.5% to 1.75%. Their projections suggest they will continue this trend through next year with a likely stopping point around 3%. Concerns about an economic slowdown reflected in longer maturities as their rates increased by less. This has had the effect of flattening the yield curve, which as our devoted readers know, alerts our cautious senses to the potential of danger ahead.

Outlook:

The trident of analytical methods we use at StreamSong Advisors for individual securities can be applied to the markets as well.

First, we use Quantitative Analysis to identify good investments with solid characteristics. From a macro standpoint, the market's fundamentals are solid. The Federal Reserve Open Market Committee estimates 2.7% growth in 2018, 2.4% in 2019 and 2.0% in 2020. At the same time, they expect the labor market to remain strong and inflation to continue to run at or below their 2% target.

We also lean heavily on three other indicators the weekly Leading Economic Indicators, the ISM Purchasing Managers Index, and the slope of the U.S. Treasury Yield curve all have proven track records of gauging strength and foretelling danger. As evidenced by the chart below, two of the three are still giving the thumbs up. The third is causing some concern as the yield spread between the 10 year and 2 year maturities continues to shrink.



The narrowing of the yield curve is not necessarily a cause for alarm by itself. Its inversion, however, has almost always presaged a downturn in the economy and a significant pullback in stock prices. There will be those who argue that this should not be taken as seriously this time as we are in uncharted waters given the unprecedented level of influence that global central banks have exerted to stimulate their economies. That may well prove to be true, but our experience has been that there are no scarier words in the investment world than “it’s different this time”. It almost never is. In fact, the last 10 out of the last 11 inversions were followed by an economic recession within 12 to 18 months. While we have not moved to an overly defensive stance yet, should the 10 year yield fall below that of the 2 year, we will certainly move to a heightened level of security.

Once we are comfortable with the numerical strength of an investment or a market, we move deeper into Fundamental Analysis to get to know its true character and determine a fair valuation. We would currently classify the valuation of the stock market as “ok”. It got more attractive during the second quarter as stock prices went virtually nowhere, while earnings grew at a 20% annual clip.

There was some concern during the first half that as interest rates rose, stock valuations would have to contract. We put that theory to the test and found some rather interesting and counter-intuitive results. We compared the average Price to Earnings multiple of the S&P 500 with the prevailing 10 year Treasury yield to see if there was indeed a negative relationship. It turns out the answer is yes…but not until rates are much higher! In fact, stock multiples don’t start to compress below their current levels until rates rise above 6%. That makes the current gnashing of teeth over hitting 3% seem a bit premature.

Once we have identified a market or investment with solid fundamentals, calculated a reasonable valuation, we apply a third measure of analysis which many do not. Rather than blindly buying into downturns or being whipsawed by over-extended prices, we overlay a Technical Analysis before investing. This helps us complete the desired triumvirate by buying Good Investments at an Attractive Price at the Right Time.

As we discussed at the outset, the current price patterns of the US stock market still give us comfort as the long term uptrend is still in place. We would certainly like to see prices break out of their trading range with some conviction, but that simply suggests that a rising tide is not yet strong enough to lift all boats, and that discernment is critical in selecting individual investments. We welcome that environment.

We clearly can’t predict the tweets that will continue to move the markets, whether they be on trade wars, immigration policies or any other topic. What we can and will do is rely on our experience and the tools that have built over the last 30 years that have successfully interpreted what the market is telling us about its health and the foreseeable future. Right now, those guides are still saying it is prudent to invest in assets which show solid fundamentals, attractive valuations and positive technical patterns. We continue to do so where there is a conviction of upside and a margin of safety against potential downside.