

APR  
2018

# Woodmont Market Commentary

## March Madness: In More Ways than One

The annual NCAA men's basketball tournament, aptly referred to as "March Madness," began with a bang this year. For the first time in tournament history, a number one seed lost to a sixteen seed. Specifically, the University of Maryland, Baltimore County Retrievers beat the top-ranked University of Virginia (UVA) Cavaliers by an astounding 20 points. The Retrievers' victory was as



improbable as the Cavaliers scoring five points in 0.9 seconds to beat University of Louisville just a few weeks prior. While a sad night for Woodmont's resident UVA alumnus, and the 27% of all participating bracketologists who picked UVA to go all the way, it made for an exciting start to the tournament.

The basketball hysteria soon gave way to a different sort of "March Madness" – a brisk Wall Street sell-off. Even so the 8% correction from the March highs to lows, and four consecutive days of 2% or more swings, was rather mild by historical standards. The average intra-year peak to trough in the S&P 500 is 16%. And from late January to early February the S&P tumbled 12%. Investors, however, entered the year having grown accustomed to the limited volatility. It was also the first time in several years the F.A.N.G. (Facebook,

Amazon, Netflix, and Google) stocks looked vulnerable, particularly as the scrutiny around Facebook data privacy intensified. With many retail and a surprising number of institutional investors (active and passive) having grown convinced that four stocks equalled a portfolio, the group's rapid reversal had an outsized effect.

## Stocks Decline: First Time Since the Third Quarter of 2015

With the February and March declines, the S&P 500 gave up its big gains from January to finish the first quarter of 2018 down 0.8%. Indicative of how impressive the markets' rally has been, this was the first quarterly decline for the S&P since the third quarter of 2015. Developed international markets declined 2% in the quarter. Emerging markets continued their winning streak up 1%, adding slightly to the 38% gain in 2017. Rising interest rates pressured bond prices. While prices firmed later in the quarter as investors sought safety, the Barclays Aggregate Bond index still fell 1.5% in the quarter.

The first quarter was a reminder of the risk of a rate-fueled sell-off where both stocks and bonds decline. It also highlighted the strong linkage of certain equity sectors to interest rates. We've discussed this correlation in several commentaries, but this was the real deal in terms of duration and impact. For instance, the relatively higher yielding S&P Real Estate, Utilities, and Consumer Staples sectors declined 6%, 4%, and 8% in the quarter. The dividend-heavy energy sector declined 7%, despite oil prices climbing 7% in the quarter and up 28% from this time last year. These sector declines posed a meaningful performance drag relative to the S&P for dividend-focused investors. It also highlighted the S&P 500's performance dependency on the broader tech sector and F.A.N.G. stocks. Excluding these stocks, the S&P was down 1.5%. With tech comprising 25% of the index, and just five high profile "tech" stocks representing 14%, this performance dependency is easy to understand.

**"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." –Mark Twain**

Heading into the second quarter there is plenty of “Madness” to go around. Further escalating trade tensions, new tech regulations, uncertainty around November’s mid-term elections, rising interest rates, North Korea, and now diplomatic chess with Russia, could all qualify on the investment front.

How much angst the market has already anticipated is always difficult to determine. No doubt there is at least some, especially considering that the business model of today’s media incents rapid-fire dissemination and exaggeration in an effort to drive viewer traffic. There will be, of course, unanticipated developments, or new twists on old news, that will surprise investors. To prepare, we remain focused on the long-term and continue to stay diversified. We also will seek to increase exposure to sectors or asset classes where some short-term market technical phenomena, or possibly even the media, has helped skew the expected return versus the risk of an investment in our favor. On the pages that follow we’ll discuss some of those market developments, look back ten years, and touch on some secular trends with potential market implications.



## Ten Years Later: Older Yes, But Wiser?

2018 marks the ten year anniversary of the onset of the financial crisis and “great recession” of 2008/09. The investor angst and widespread economic suffering the crisis inflicted is still etched in the memories of all but the most nascent of market participants. Lots has changed in the past ten years.

Changes Since the Financial Crisis		
	2008	2018
S&P 500 Index	903	2,641
MSCI All-World Ex-US	177	300
U.S. Unemployment Rate	9.9%	4.1%
U.S. National Debt	\$10 trillion	\$21 trillion
U.S. Homeowners' Equity	\$6 trillion	\$14 trillion
U.S. Mortgage Delinquency Rate	13.0%	4.0%
Student Debt	\$600 billion	\$1.4 trillion
Auto Loans	\$800 billion	\$1.2 trillion
Triple-B Corporate Debt	\$700 billion	\$2.5 trillion
Large Bank Tier 1 Capital Ratio	7%	15%
Passive Investing (% of Assets)	5%	25%

Sources & Notes: Bloomberg, FactSet, Wall Street Journal, U.S. Government Statistics. S&P 500 and the MSCI All-World Indices' prices are as of 3/31/2018 and 12/31/2008. Unemployment and Mortgage Delinquency Rate data in 2008 column are from 2010 which reflects the peak of the fallout from the 2008-2009 crisis.

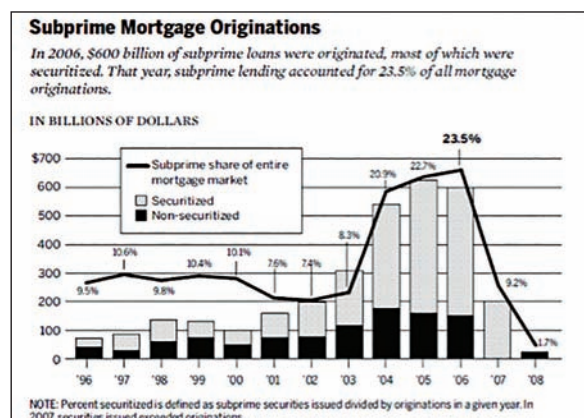
The table below highlights a few of the more interesting developments.

We are often asked if the economy and markets are setting up for another crisis like we experienced in 2008/09. Our response is generally three-fold. First, it is safe to assume there will be some sort of crisis and significant market reaction. Stock market volatility is in part a product of human emotion, and collectively we’re prone to get too high and too low. Unfortunately, getting the timing, magnitude, and ultimate source is impossible. It feasibly could be next week or a decade from now. What applies today, however, is not to invest money in stocks that you need near-term and to limit exposure to levels at which you could accept a significant

decline in value. After all, as Peter Lynch reminds us, if you are invested in stocks “the secret to making money is not to get scared out of them.”

Second, the average bear market decline is 32%. The S&P 500 fell 57% from 2007 highs to March 2009 lows. Only the fallout from the Great Depression had been more severe. Some vehemently argue that in an effort to postpone and mute the impact of economic cycles, we are only adding to the size of the next correction. Others highlight the historical rarity of the 2008/09 downturn, particularly because of its deep roots in the banking sector and the ensuing credit crisis. Both sides make compelling arguments, which makes the first response above all the more relevant.

Third, some of the more acute excesses of today are different than ten years ago. Student debt (from \$600 billion to \$1.4 trillion), auto loans (\$800 billion



to \$1.2 trillion), and certain real estate, corporate debt, and other investment themes fueled by a prolonged period of historically low interest rates, are all significant and lurking issues. Yet while the big banks are still big with the ten largest holding around 55% of all banking assets, bank balance sheets are much improved. It is also difficult to identify a subprime and jumbo mortgage equivalent in terms of assets, breadth of participants, and negligence. This is somewhat comforting. Then again, it's more likely the dangers we can't see that bite us.

## The Low-Vol Blow Up

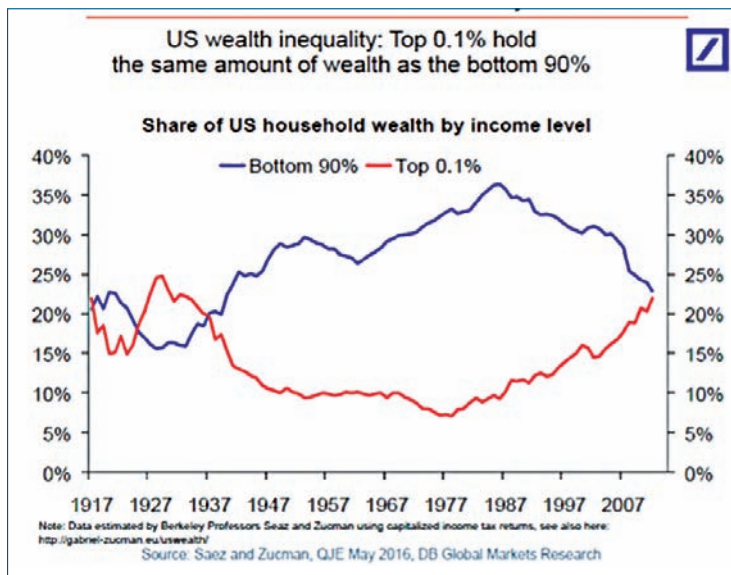
In January, we commented that the historically low market volatility in 2017 had been rather perplexing, especially given a slew of seemingly market-moving headlines. Volatility's extended hibernation caused some investors to conclude markets had entered a new paradigm. The theory was passive investment vehicles and algorithmic trading, which can comprise 60% of trading activity on any given day, had changed the rules for volatility. Believers, and some who just follow the trends, bought exchange traded funds that bet limited volatility was here to stay. The investments did extremely well for a long time. Then, in early February, the low-vol streak (e.g., 405 trading days without at least a 5% pullback in the S&P) ended in such a stark fashion that it wiped out practically overnight many of these inverse-vol funds.



Billions of investor money was lost in the course of a few hours. Sadly many of these investors had limited understanding of these investment products and their inherent risks. It proved a tough lesson for those investors, and an important reminder for those of us watching. That is, derivatives, leverage, and a supposed new paradigm, can represent a dangerous investment combination.

## Life Is Good in the C-Suite. Will It Filter Down?

Duke University's first quarter business survey recorded the highest levels of optimism among Chief Financial Officers (CFOs) in its 22 year history. Specifically, 53% of CFO's were more optimistic about the U.S. economy than the previous quarter. Only 16% were less optimistic. This compares to just 33% more optimistic and 29% less as recently as the third quarter of 2017. Contributing to the



enthusiasm among public company executives, were corporate tax reform and still relatively easy credit. Big stock market gains, which have inflated the almost universally generous executive compensation packages of public company executives, have also been good for the executives' psyche. Historically, a high level of CFO optimism has been a predictor of economic growth, which bodes well for 2018 economic data and potentially corporate earnings.

For economic activity to accelerate beyond the 2.7% forecasts, this C-Suite enthusiasm and improved financial condition will have to reach the rank and file. The pace and extent of recovery for this segment of workers have lagged in this recovery. The good news is the U.S. firms surveyed expect to increase employment numbers by a median of 3% during 2018. This demand for workers is also why 45% of firms surveyed list

attracting and retaining talent as a top 4 concern (another Duke survey all-time high). These employer needs in an already tight labor market has resulted in wages, adjusted for inflation, finally rising after ten years of going nowhere.

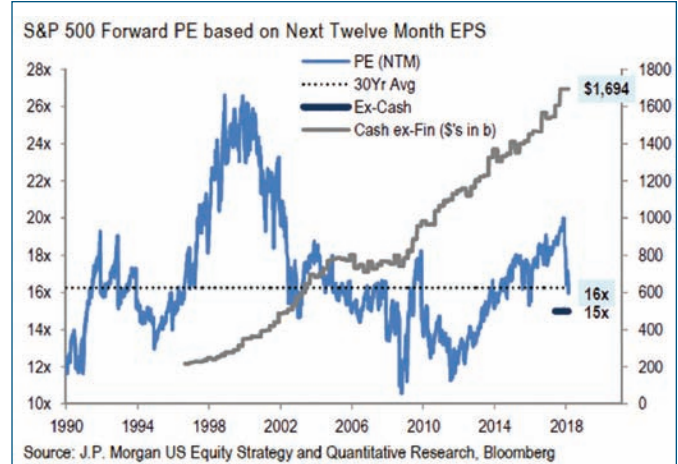
As we've discussed in previous commentaries, the types of jobs and the skills workers will need to participate, let alone, flourish will remain fluid. The CEO of Oracle (ORCL) reminded us of this increasing workplace dynamism on the company's fourth quarter conference call, when he noted "humans cost a lot of money." And, as a result, we are finding ways to "automate them out of the system."



## Stock and Bond Prices: Much Has Changed in Recent Months

In January, U.S. and international stocks soared as Wall Street earnings estimates moved higher. Incorporating the lower corporate tax rate and an improved economic outlook, the 2018 Wall Street consensus earnings estimate for the S&P 500 has jumped 7%. According to J.P. Morgan, S&P earnings are now expected to increase 30% from 2017 to 2019. The estimates are obviously sensitive to any change in the economic outlook, or pressure for companies to share more of the tax savings in the form of higher wages or lower prices for consumers. The earnings jump, coupled with the February and March stock price declines, however, have reduced the S&P price to earnings ratio (the non GAAP version) to nearly 16X 2018 estimates compared to almost 20X as recent as late last year. Arguably at the later stages of this economic cycle, the combination of higher earnings and lower prices has brought the ratio in-line with the thirty year average at a time when interest rates are still historically low, limiting the attractiveness of many fixed-income alternatives.

International markets continue to trade at a discount to U.S. markets at 13X 2018 earnings. The developed market discount is attractive, although it is worth noting that European companies get about half of their revenues from outside the EU leaving them slightly more exposed to a global trade war. Of course, as we discussed in January, U.S. markets have grown increasingly tech centric. Add AMZN and NFLX to the list of tech stocks within the S&P 500 and it represents 28% of the index. While we're relatively underweight these stocks, we are keenly interested in the upcoming political and regulatory debate around data privacy, competition within the sector, and how tariffs could impact these increasingly global companies. Any broader market fall-out could present an attractive opportunity to increase equity exposures in general and potentially among growth stocks in particular.

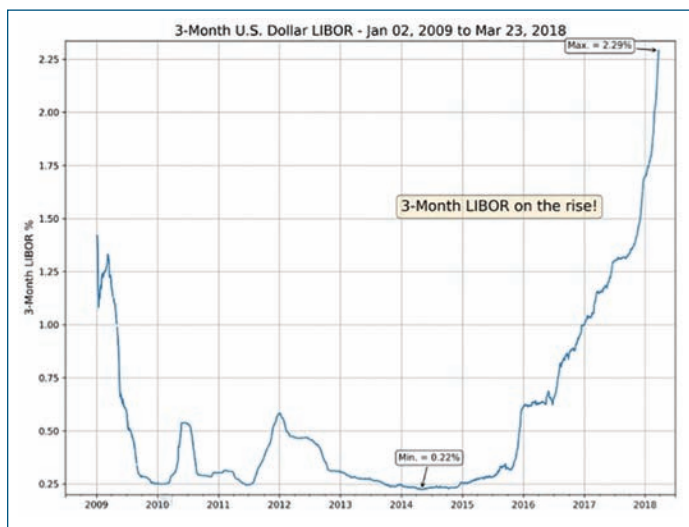


### **“There are only two forces that unite men—fear and interest.” –Napolean Bonaparte**

As dynamic as equity valuations have been in recent months, the U.S. bond market has proven even more interesting. Long-term rates have barely budged, but short-term rates have risen dramatically. The 2-year U.S. Treasury has climbed to 2.3%, which is up from 1.3% last fall and 1.9% to start the year. The Ten-Year peaked during the quarter at 2.9% but is currently at 2.7%. This compares to 1.4% as recent as July 2016 and the 4% 25-year average.

This flattening of the yield curve has been the source of considerable debate and consternation. Whether reflective of temporary supply and demand imbalances within the short-term Treasury market, or an impending economic slowdown, remains to be seen. Either way, higher short-term rates have greatly enhanced cash and cash equivalent options for our clients without the need to take on additional credit or principal risks if rates move even higher. This opportunity to earn a return on one's cash versus just a return of one's cash is welcome and long overdue. Market volatility and European investors' desire to arbitrage our relatively more

attractive yield environment may cap near-term rates. Although the newly minted Federal Reserve Chair Powell seems committed to at least two additional rate hikes this year. The Chairman's effort represents an important step to replenish the Federal Reserve's arsenal of options in the event of a future economic downturn, and certainly a welcome one for savers and investors holding cash.

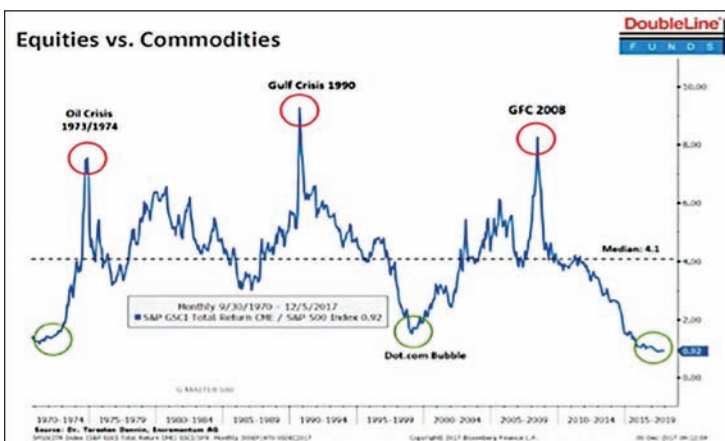


Another interesting development for interest rates is the increase in the interbank lending rate, LIBOR. It is at 2.3% after staying below 0.5% for years. Companies with LIBOR-based loans will have to overcome higher interest costs. Considering many private equity companies have debt levels six to seven times greater than their annual cash flows even before capital expenditures, this higher cost of capital is likely to have a negative impact on growth prospects and valuations for many in the sector.

The impact of higher rates, especially when coupled with a shift in investor confidence, can impact high profile public companies as well. The most recent poster child for how quickly things can turn on the credit front is Tesla (TSLA). After raising almost \$2 billion of high-yield debt in August, some operational missteps and a credit ratings downgrade have caused its debt to trade down ten percent, pushing yields up to 7%. For a company that is not yet profitable and doesn't plan to generate free cash flow until 2020, this higher cost of capital will prove challenging. Tesla is not alone. According to Morgan Stanley and the Wall Street Journal, the issuance of corporate bonds rated triple-B, which is just above junk bond status, has reached \$2.5 trillion versus \$1.3 trillion five years ago. A strong economy and low rates have contributed to investors' comfort with financial leverage. Further increases in interest rates and/or a softening economy will test this market and the companies which have relied on it for funding.



**“Buy straw hats in the winter. Summer Will Surely Come.” –Bernard Baruch**



Things are rarely cheap when everyone wants them. Thus, we're always on the lookout for the forgotten stock or asset class. One out of favor asset class these days is commodities (e.g., oil, grains, metals, and natural gas). All the rage in the mid-2000s and for a brief period in 2011, the asset class is as cheap relative to other opportunities as it has been in decades. We appreciate the fact that certain commodities face secular headwinds and, in some instances, obsolescence years down the road. Yet the asset class looks like an attractive complement to a diversified portfolio given global economic expansion, “green shoots” of inflation, and its cyclical low valuations.

## Spring Cleaning – The Financial Version

Any time of year is a good time to get your financial house in order. One way we are helping clients with this is by constructing a long-range financial plan. We've mentioned this regularly since investing in the software that assists us in this endeavor a couple of years ago. It's included in how we serve clients, and many of you have taken us up on the offer to prepare a plan. If you haven't yet, and are interested, please let us know. We'll warn you though. The analysis has its limitations. It won't identify the next Bear market or help you with your next NCAA bracket. For the Bear market, long-term investors have to accept some level of inevitability, and certainly their unpredictability with regards to timing. This is why we don't reach for all the returns we can when it seems times are good and investor complacency may be running high. As for your bracket, just be careful concluding that sixteen seeds beating one seeds is now the trend.

Thank you for your continued confidence. We look forward to answering any questions you may have and potentially assisting you with that financial spring cleaning.