Second Quarter 2018 Commentary and Outlook

Broad equity indices rose in the second quarter with the S&P 500 up 2.8%. As has been the case regularly in this historic bull market, a handful of technology stocks drove the advance. Amazon, which comprises 2.1% of the index's total market capitalization contributed 36% of the index's return. Not surprisingly, growth indices substantially outperformed value measures for the quarter. The Russell 1000 Growth Index gained 7% while the Russell 1000 Value Index fell 2%.

As we discussed in our first quarter letter, we believe earnings growth, not earnings multiples expansion, will be required for stocks to enjoy further gains. (Earnings multiples measure the ratio of companies' share prices to their earnings. For example, a company with a share price of $10 and earnings of $1/share has a price/earnings multiple of 10x.) Thus far in 2018 the aggregate price-to-earnings multiple of S&P 500 companies has contracted to 16.1x from 18.1x at the beginning of the year. We may see further multiple compression if interest rates rise, which would likely favor companies with strong earnings growth.

Economic Strength Today Masks Risk

The robust earnings growth experienced in the first quarter should come as no surprise. Strong fiscal stimulus in the form of the $1.5 trillion tax cut and $300 billion spending bill added fuel to an economy in full expansionary mode. Retail sales rose 4.7%, year over year, in June, unsurprising given that unemployment stands at its lowest level since the 1960s. Further, business investment in structures and equipment rose 16.2% and 5.8% (seasonally adjusted annual rate), respectively, in the first quarter.

That robust growth has masked risks that threaten the economic expansion. For example, the Fed is at risk of policy error as it proceeds down the path of gradual tightening even as, on a 12 month basis, inflation has yet to meet its 2% target and its trajectory is uncertain. Geopolitical risk remains with no shortage of bad actors (North Korea, Iran, etc.) presenting danger to global stability.

Other risks are distinct to the moment, including the potential for a trade war. President Trump's apparent willingness to abrogate deals like NAFTA and to pursue protectionist policies through the imposition of tariffs presents risks that are difficult to quantify. Supporters of these policies suggest that the risks of a trade war are low and even if one came to pass would be of little consequence given that U.S. exports and imports with China amount to just 1% and 3% of the U.S. economy, respectively. However, this view misses the broader knock-on effects. For example, businesses faced with uncertainty could curtail capital spending while consumers, faced with higher prices, reduce spending.

As noted in our first quarter letter, the Fed is in the process of unwinding an unprecedented $4 trillion balance sheet. While the outcome of that effort is uncertain, it stands to reason that if quantitative easing supported asset prices then quantitative tightening would have the opposite effect. Negative unintended consequences cannot be ruled out.

There is also risk of earnings moderating or declining moving into 2019. This could occur due to any of several factors. First, the positive impact of corporate tax reduction has likely peaked.

Second, share repurchases which have contributed 2-3% of S&P earnings growth per year since 2011 are likely to moderate because businesses may be constrained by balance sheets that, with the exception of some large companies, are quite leveraged. Third, in a full employment economy, rising wages may serve to compress profit margins. Finally, it is estimated that each 1% of GDP growth adds around $5 to the aggregate earnings of the companies in the S&P (current estimates for 2018 S&P earnings are around $160). With tightening monetary policy and in the absence of expansionary fiscal policy, broad economic growth will be more difficult to sustain.

Complacency and Uncertainty around Policy Response

While the risks to the economy and equity markets are manifold they are met largely with complacency. Equity valuations are high, currently trading at the 87th percentile of historical valuation relative to the past 40 years. Merger and acquisition activity has been buoyant, setting a record with over $3 trillion in deals in the first half of 2018. As for exogenous shocks, it appears most market observers are sanguine. In the July 6th issue of *Barrons*, the Wells Fargo Investment Institute predicted an "80% chance that the tariff tiff will swing back and forth in the headlines, but eventually end up with a good outcome." The magazine added that this is "an opinion shared widely in the markets." While the outcome is unknowable it appears markets are unprepared for a trade war with serious economic implications.

Historically, fiscal and monetary policy have been mobilized to buffer the severity of economic and market shocks and/or downturns. However, today both fiscal and monetary policy are overextended, limiting their ability to effectively address economic weakness should it come to pass, further accentuating the risks.

Portfolio Update

Being mindful of these risks allows us to maintain our vigilance and appropriately calibrate our judgment. As always, we seek and invest in discrete investments where we believe business-specific characteristics will allow for long-term value creation without unduly risking permanent impairment of capital. We are confident this approach will continue to serve our investors well over the long term.

Firm Update

There are no firm developments of note to report. We hope that you are enjoying your summer. As always should you have any thoughts or questions please don't hesitate to reach out to us.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

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