CAPITAL ADVISORS

RESEARCH UPDATE
December 21, 2018

Key Points

- This note is designed to provide a brief update on the commentary we issued 11 days ago.

- The format is unusual…the entire commentary from December 11th is reprinted below with updated thoughts inserted in red.

- We encourage readers to interpret both commentaries as an expression of what clients can expect from us in the near-term – i.e. we cannot tell you what the stock market will do next week, but we can describe our interpretation of current events and preview our potential investment actions.

- The Research Team at Capital Advisors recognizes that our collective voice is just one of millions trying to navigate the current minefield of uncertainties in the economy and financial markets.

- Not everyone will agree with our interpretation of events, or plan of action.

- If you disagree with our view of the world please don't hesitate to let us know…it's your money.

  Note: The color red was selected for ease of reading, not to signal alarm!

Key Points (Reprinted from December 11, 2018)

- We believe the U.S. stock market is currently experiencing a normal correction, not the beginning of a bear market (i.e. a decline of 20% or more from a recent high).
  This is shaping up to be more wrong than right. As of the close on December 20th, the *S&P 500 Index* was down approximately 16% from its high, while common benchmarks for international equities, emerging markets and domestic small caps have already crossed the 20% threshold of a bear market.[1] However, whatever this pullback turns out to be, we continue to believe it can be relatively short and shallow by the standards of historical bear markets.
- For this to be the start of a bear market, we believe at least one of three things would need to occur:
  1) The economy enters a recession soon – We continue to view this as unlikely.
  2) The Federal Reserve overdoes it on interest rate hikes - A flubbed press conference by Fed Chair, Jerome Powell on December 19th shook the confidence of many investors, including us. That said, the Fed has already moved its interest rate intentions *in the direction* of investors' wishes, and we do not expect inflationary pressures to prevent the Fed from walking back further if incoming economic data justifies it.
  3) A major accident of some sort flares up in the asset markets – Further disruption in the global asset markets since December 11th hasn't helped our confidence on this front, but nothing obvious has emerged to date.
- Historically, bear markets don't happen without one of these three catalysts present.
- For reasons we will describe, we consider the first two outcomes to be highly unlikely for the foreseeable future.
  It seems fair to downgrade this statement to "unlikely" rather than "highly unlikely." If the U.S. economy does experience a recession, we suspect it might be largely attributable to excessive tightening from the Fed. Thus, if the Fed backs off in the coming days/weeks we might return the recession forecast to "highly unlikely."
- We don't expect a financial accident either, but it can never be ruled out.
  The challenge with a financial accident is that it is the hardest threat to predict, but it might have the highest impact within a short timeframe. For instance, credit spreads[2] have widened further over the past 11 days, which is somewhat troubling. At this point spreads remain within the historical range that can be considered "normal," but we are watching this carefully.

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[1] Source: Bloomberg

[2] "Credit Spread" refers to the difference in yield between corporate bonds and U.S. government bonds. When the yield differential between corporate bonds and U.S. Treasuries widens out it can be a sign of economic stress. This has been particularly true for sub-investment grade bonds, or "junk bonds" historically.

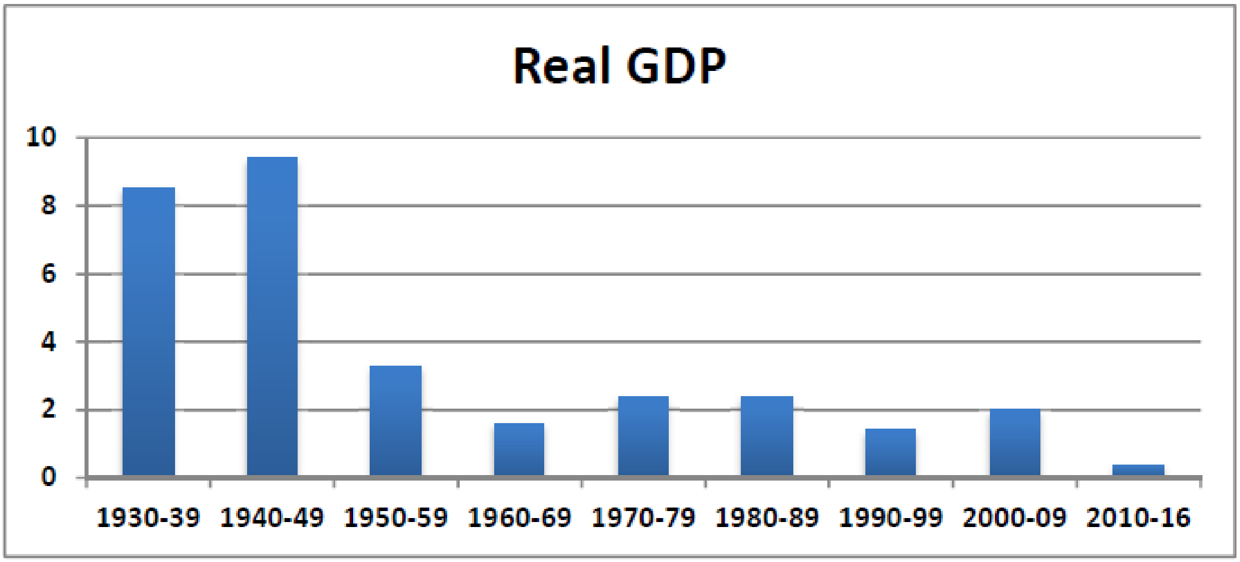
- Fortunately, the recovery period from market malfunctions can be relatively swift, like the aftermath of the "Black Monday" stock market crash in 1987, or the recovery following the collapse of hedge fund, *Long Term Capital Management* in 1998.
- This dynamic supports a positive bias, in our view, because if our optimism turns out to be misplaced due to a market disruption of some kind, there might be a silver lining in the form of relatively swift recovery.
  We would add another reason for a positive bias now that stocks have declined another 6.4% since the first note was written. With major stock market benchmarks already down roughly 16% - 25% from their highs, the risk-reward tradeoff for many stocks is looking increasingly attractive.
- Valuation provides another argument for patience with the stock market…The recent combination of strong earnings growth and falling stock prices produced a dramatic improvement in the valuation level of many stocks.
- We believe investors should resist any temptation to bail out of good stocks, including many of the platform technology companies that have been the tip of the spear in the recent pull-back.
- Beyond patience with existing positions, we believe it is time to begin searching for new opportunities as well.
- This is our current focus at Capital Advisors.
  This is still our focus, but we have moved slowly so far. We added a new position in **Raytheon (RTN: ~$154)** to the *Managed Equity Growth* strategy on December 11th, and we added to an existing position in **General Mills (GIS: ~$39)** in the *Managed Equity Dividend* strategy on December 20th.

  We are cognizant of the risk that any new investments we make in the near-term might continue lower if the broader market remains under pressure. Please know that we view these decisions as a tradeoff between estimated downside risk and potential *long-term* reward.

Bear Market Risk #1 – Recession

We believe major structural changes within the U.S. economy over many decades have made it far more resilient to shocks. Consider the graphic below, and the explanations that follow:

Decade by Decade Standard Deviation
U.S. Gross Domestic Product (GDP) Net of Inflation
Jan. 1, 1930 to Dec. 31 2016



Source: Strategic Economic Decisions, Inc.; BEA

The message in this graph is remarkable, but it is rarely discussed in the financial media. The data basically says that economic risk has collapsed in the U.S. over the past 80 years. This particular graph depicts the volatility of economic output net of inflation, or "Real GDP," but we could show similar charts for a diverse mix of economic indicators, and the message would be the same. The volatility of our economy has declined substantially over time.

Importantly, there are structural reasons for this outcome that suggest it is sustainable, in our opinion (We will limit our discussion in this report to bullet points, but we are happy to provide details in a follow up with anyone who is interested). We believe the following four structural developments are important contributors to the increasing resilience of the U.S. economy:

1) **Rise of the Service Sector** – Approximately 83% of private sector incomes are currently generated by service sector jobs.[3] This supports a material reduction in the influence of inventory cycles on the economy, as well as the threat from trade related frictions due to the non-tradeable nature of many services, like haircuts, education and medical care.
2) **Two-Income Households –** The percentage of U.S. households supported by more than one income has risen steadily over the decades, resulting in greater stability for the largest contributor to economic output by far – household consumption.

[3] Source: BLS; Strategic Economic Decisions www.sedinc

3) **Proactive Social and Fiscal Policies –** It is easy to forget that social programs like unemployment insurance and disability payments were not always part of the economic landscape. Proactive fiscal and monetary policies have also evolved productively over the decades to help counter economic headwinds when they arise.
4) **Global Supply Chains –** The input/output matrix for the global economy has exploded in size, while becoming increasingly sparse. For example, the inputs required to produce a battery might come from eight countries today, instead of one or two.[4] Moreover, each input is likely to be more specialized and require less labor for its production due to automation within the manufacturing process. As a consequence, the amount of *household income* tied to any given unit of production is much smaller than it used to be, creating resilience for the system as a whole.

The net result of these structural changes (among others) is an economy that is very difficult to push into a sustained contraction. This is not to say that individual *industries* cannot experience periods of severe weakness – witness the energy sector just a few years ago. Yet the downturn in energy helps to prove the point of resilience for the economy as a whole. The global energy sector experienced an outright *depression* between 2014 and 2016, yet the U.S. economy barely missed a beat.

The only thing to add here is that if we are wrong about a recession in 2019 or 2020, the dynamics described above should support a relatively short and shallow contraction. We note as well that interest rates remain very low by historical standards. Global equity markets would almost certainly overreact to an economic contraction – they always do – but we believe the market damage from a short and shallow recession should be bought, not sold.

Bear Market Risk #2 – Fed Policy Mistake

Federal Reserve chairman, Jerome Powell signaled a softening in the committee's plans for interest rate increases during a public speech last week. Several other Fed governors have trumpeted the same message in various speeches and media appearances before and after Mr. Powell's comments.
These dovish signals from the Fed prior to the policy announcement on December 19th probably contributed to the sense of surprise reflected in the stock market's swift and steep decline within seconds of Powell's comments during the press conference.

More importantly, inflation has remained low and stable for many years, and the next move for inflation seems likely to be downward as the recent collapse in the price of oil filters through the economy. Historically, when the Fed has killed the economy with interest rate hikes they had no choice because they were fighting stubborn inflationary pressures. That is not the case today. Still true.

[4] Source: Strategic Economic Decisions, Inc. www.sedinc.com

Bear Market Risk #3 – Asset Market Malfunction

There is a lot of debt in the world. Unexpected things happen all the time. This creates an ever-present risk of an asset market malfunction of one kind or another somewhere in the world.

The good news on this front is that there does not appear to be an obvious bubble in need of bursting among the major asset markets today. Whereas the last two economic contractions in the U.S. were triggered by the bursting of an asset market bubble – technology stocks in 2000, and housing in 2007 – nothing seems similarly frothy today. Still true, but we are watching credit spreads and other indicators of market risk very carefully.

Investment Implications

If our relative calm turns out to be misplaced, we suspect some kind of market malfunction (or an overzealous Fed) will be the culprit. For example, one could argue that government bond yields near zero throughout Europe and Japan might represent an asset bubble of historic proportions. We are less alarmed because low government bond yields are a function of monetary policy, rather than a mania among investors. In addition, the U.S. economy has demonstrated the possibility of successfully transitioning away from a zero-percent interest rate policy, at least *so far* (reiterate "so far"…Powell's comments on the 19th were not confidence inspiring). Perhaps the same can be achieved elsewhere in the world?

We encourage investors to look past the risk of an asset market accident for two reasons. First, these events are nearly impossible to predict. Second, the recovery period from market malfunctions tends to be relatively swift unless the disruption is deeply intertwined with the broader economy – like housing in 2008. The relative stability of credit spreads throughout the current correction in the stock market leads us to believe there is nothing cracking beneath the surface of the global economy as of yet. We may change our thinking if the encouraging signal from the credit market deteriorates. The continued widening of spreads since this was written has us feeling a bit more cautious.

A more important reason to be hopeful is valuation. Falling stock prices have coincided with a healthy jump in corporate profits in 2018, leading to a dramatic improvement in the valuation level of the U.S. stock market, as measured by the price-to-earnings ratio (P/E). As of the close on December 10th the *S&P 500 Index* was trading at a forward P/E of just 14.8 using the consensus earnings estimate for 2019 as the "E" in the ratio.[5] The forward P/E was down to 14.6 as of December 20th. This puts the current valuation level of the stock market below its long-term average[6] at a time when an *above-average* multiple could be justified by the current environment of stable inflation, low interest rates and healthy corporate profit margins. If stocks drop another 10% from here, sufficient to qualify the current pullback as a bear market, the valuation level would look that much more compelling.

[5] Source: Bloomberg

[6] Source: Bloomberg; Standard & Poor's; The average forward 12-month P/E since 1989 has been 15.3

<u>Bottom Line:</u> There are plenty of worries in the world right now. Uncertainty around global trade, falling commodity prices, fluttering asset markets, the President's Twitter account, and slowing growth in China and the Eurozone have all contributed to the material decline that has already occurred in global equity markets. Unfortunately, this backdrop made Wednesday's commentary from the Fed feel particularly toxic. The last thing the world needs right now is an out-of-touch Fed.

Yet our intentions remain the same – we plan to search for attractive entry points into good investment opportunities, and take action when we find them. We feel this way because the Fed should not *need* to overdo it with inflation under control. We don't believe they will, despite Powell's guffaw on Wednesday. If we're wrong, structural forces at work in the economy should limit the damage to a relatively short and shallow contraction by historical standards.

We remain mindful of the possibility for a financial accident of some kind. We are watching credit spreads, credit default swaps, currencies and other fundamental indicators to identify warning signals. These indicators might encourage us to slow down, or even reverse course if they start flashing red. Otherwise, we are looking to put capital to work for the long-term.

Lastly, we seek to frame all of our investment decisions within a total portfolio context. We believe the risk market capital within a diversified asset allocation should take prudent risks. This is our plan.

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