CAPITAL ADVISORS

RESEARCH UPDATE
December 11, 2018

Key Points

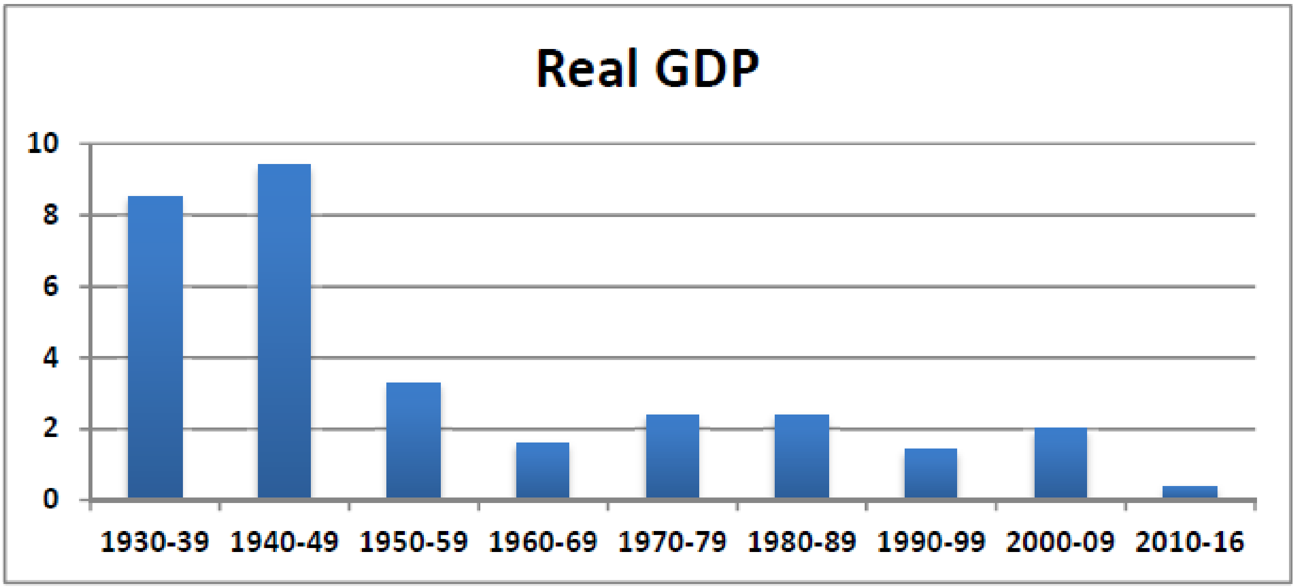
- We believe the U.S. stock market is currently experiencing a normal correction, not the beginning of a bear market (i.e. a decline of 20% or more from a recent high).
- For this to be the start of a bear market, we believe at least one of three things would need to occur:
    1) The economy enters a recession soon
    2) The Federal Reserve overdoes it on interest rate hikes
    3) A major accident of some sort flares up in the asset markets

- 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.
- We don't expect a financial accident either, but it can never be ruled out.
- 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.
- 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.

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.[1] 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.

[1] 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.[2] 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.

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.

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.

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.

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

Investment Implications

If our relative calm turns out to be misplaced, we suspect some kind of market malfunction 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*. 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.

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.[3] This puts the current valuation level of the stock market below its long-term average[4] 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.

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[3] Source: Bloomberg

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

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