CAPITAL
ADVISORS

RESEARCH UPDATE
August 14, 2019

Key Points

- Multiple recent developments spanning geopolitics, economics and central bank monetary policy have triggered a spike in volatility in the financial markets.
- These market spasms have investors wondering if we are experiencing a "standard" short-term pull-back in risk assets, or the start of something more serious.
- Speaking specifically to the outlook for the stock market, deep declines of 20% or more have historically coincided with at least one of the following catalysts:

  1) Excessive monetary policy tightening
  2) Economic recession
  3) A major accident of some sort in the global financial markets

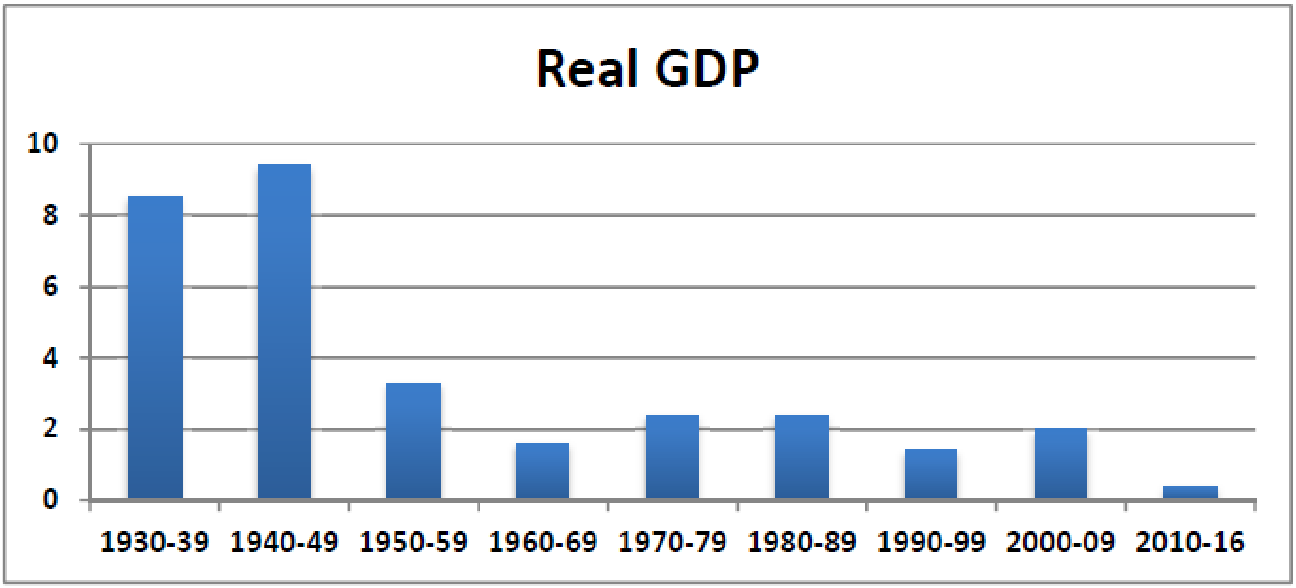
- When stocks pulled back sharply during the fourth quarter last year we believe the primary concern was item #1…Fear of a policy mistake from the U.S. Federal Reserve (Fed).
- That correction ended quickly in early January when the Fed signaled its intention to take a break from further interest rate increases.
- Today we suspect financial markets are wrestling with item #2…Fear of a potential recession.
- The deterioration in trade relations between the U.S. and China is undoubtedly contributing to market volatility, but tariffs and trade restrictions seem most likely to disrupt the profit margins of specific companies and industries, rather than drag the entire economy into recession.
- We have been managing the risk profile of our investment strategies lower for some time now (examples provided below) out of respect for the range of possible future outcomes implied by today's laundry list of macro uncertainties.
- However, for structural reasons we have outlined in previous commentaries (and revisit below), we retain the belief that the probability of a recession in the U.S. economy is relatively low.
- If we are wrong about this, it seems plausible to expect any downturn to be shallow due to the same structural forces that make the U.S. economy resilient to recession in the first place.
- This perspective supports a patient approach to portfolio design, where deliberate action is appropriate at the strategy level to manage risk, but a wholesale shift away from the stock market is not encouraged.
- Today's extremely low level of interest rates provides another argument for patience because ultra-low rates serve as a powerful force to support asset prices if/when investor confidence stabilizes.

Revisiting the Recession Outlook

(Note: portions of this section are reprinted from a market comment dated Dec. 10, 2018)

As of this morning the notorious 10-year to 2-year yield curve has inverted…a precursor to recession on several occasions historically. We do not take this signal lightly, but we also 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 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.

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

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) **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.

Investment Implications

We believe it is prudent to manage risk lower at the individual strategy level within a diversified portfolio, while resisting any temptation to abandon risk markets more broadly. We consider two primary factors to reach this conclusion. First, we suspect that *even if our relative optimism for the U.S. economy turns out to be misplaced, any downturn seems likely to be short and shallow for the reasons listed above.* It's hard to keep our economy down when its most important contributor by far – consumer spending – is supported by structural forces that encourage stability. Stocks would almost certainly turn lower in response to an economic recession, but if the downturn turns out to be relatively short and shallow, the damage to the stock market might be proportionately measured.

The second reason for patience is valuation. Accommodative monetary policy is currently reinforcing major structural forces like demographics, technological disruption and elevated debt ratios to induce historically low interest rates throughout the world. Importantly, it seems reasonable to expect low interest rates to persist for many years into the future because the forces driving them are equally persistent. Interest rates are the bedrock input for the valuation equation of all investment assets. Low rates support higher valuation multiples, and vice versa.

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

Steps We Have Already Taken to Manage Risk

Below we highlight a number of actions we have already taken within our investment strategies to manage the risk profile incrementally lower for these strategies. The general themes have been:

1) Shift higher in balance sheet quality for both stocks *and* bonds.
2) Identify companies that can take advantage of potential market weakness by expanding share or acquiring inexpensive assets.
3) Keep "dry powder" by not being aggressively invested and retaining the ability to take advantage of attractive opportunities if they arise.

Managed Equity Growth

- Diversified mega-cap technology exposure ("FAANG") into a more diverse set of attractive secular growth opportunities. Areas of diversification include:
  - Geopolitical Uncertainty – RTN
  - Robotics – ISRG, SYK
  - Genetic Biotechnology – DHR, TMO
  - Internet of Things – ACN, AMAT
  - E-Payments – PYPL, V
  - Consistent Complexity – ACN, INTU

ACN	Accenture	~$190	PYPL	PayPal	~$104
AMAT	Applied Materials	~$47	RTN	Raytheon	~$182
DHR	Danaher	~$139	SYK	Stryker	~$216
INTU	Intuit	~$273	TMO	Thermo Fisher Sci.	~$273
ISRG	Intuitive Surgical	~$510	V	Visa	~$176

- Sold American International Group (AIG: ~$54), Delta Airlines (DAL: ~$58) and TE Connectivity (TEL: ~$88) when these stocks reached our price objectives.
- Trimmed position in PayPal (PYPL: ~$104) prior to its earnings release to capitalize on recent strength in the stock price.
- Eliminated the volatility that comes with stocks in the energy exploration & production sector through the sale of Continental Resources (CLR: ~$29).
- Sold Albemarle (ALB: ~$65) to reduce the portfolio's allocation to its most aggressive category of stocks – "Emerging Franchises."

Managed Equity Dividend

- Deliberate migration toward stronger balance sheets and greater dividend coverage from earnings:
  - Sold Vodafone (VOD: ~$18), Pattern Energy (PEGI: ~$18), and Virtu Financial (VIRT: ~$18)
  - Added new positions in A-rated credits: BP (BP: ~$36), Eaton (ETN: ~$76) and Caterpillar (CAT: ~$116).
  - Increased position in Lockheed Martin (LMT: ~$373) to reflect geopolitical uncertainty.
  - Increased position in Cisco (CSCO: ~$51) to benefit from 5G telecomm rollout with solid balance sheet and dividend coverage.

- Added to Leggett & Platt (LEG: ~$38) to capitalize on management's "total shareholder return" philosophy and history of consistent execution through multiple economic cycles.
- New position in BCE (BCE: ~$46), the largest telecom provider in Canada, or stable, well covered dividend and participation in 5G technology rollout.
- New position in Oneok (OKE: ~$69) for above-average dividend yield during an attractive stage of the company's investment cycle.
- Swapped position in Invesco (IVZ: ~$15) for a new position in an alternative investment manager – Blackstone Group (BX: ~$46).

Tactical Dynamic Allocation

- Emerging market sector expected to come out of the portfolio this week.
- Natural resource sector likely to exit the portfolio next week based upon its current position relative to its moving average trend line.
- International equity and domestic equity sectors to be reviewed in early September.

Tactical Global Growth

- Over-weighted sectors – large cap growth, real estate and high-yield credit – have been the top-performing sectors within the strategy universe since the market top in late-July.[3]
- Under-weighted sectors – natural resources, international small-cap and domestic small-cap – have been among the weakest performers since the market top in late-July.[4]

Fixed Income

- It seems worth remembering the stabilizing benefit of high-quality bonds during times of maximum volatility in the equity markets.
- Our fixed income strategies have been well positioned for the events that have unfolded in 2019.

[3] Source: Bloomberg
[4] Source: Bloomberg

Disclosures

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"FAANG" is an acronym for the mega-cap technology companies, Facebook, Amazon.com, Apple, Netflix and Google.

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