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2019 – First Quarter Review

This review is a bit late. It is difficult to write this review in a cogent fashion when we seem to be in a handcuffed state with regard to trade negotiations and a flustered Brexit.

What a turn-around in the stock market from the 4th quarter last year. 4th quarter – the economy was strong, but likely peaked, and the stock market corrected. In the 1st quarter this year – the economy remains strong, but continues to show additional signs of being beyond its peak yet the stock market roared. This cannot be explained away by the alleged foresight of the stock market. It would difficult to run a correlation analysis, but it seems the movement of the stock market is closely tied to the progress (or lack thereof) in the trade battle/negotiations between the USA and China. In addition, the stock market was enticed by the Federal Reserve announcing a hold on interest rate increases.

In the first quarter a 100% stock portfolio with 20% invested in international returned 13.58% with dividends reinvested. Value stocks gained a lot of ground on Growth stocks in the 4th quarter last year, but with the strong rally in Q1 this year, growth stocks continued their dominance over value. We will cover macroeconomic information in this letter, but first we will put some focus on the surge in growth stock investments.

Growth stocks outgained value stocks in the first quarter by 4.56%. Therefore, value stocks trailed all stocks by 2.28%. **As a reminder, we are value stock investors for a few reasons. History shows that value outgains growth over the long term with less volatility (a smoother ride with superior return). In addition, value stocks are a better source of dividend income than growth stocks. This is important not only for our retirees seeking income from their portfolios, but also, it is a source of compound income return for those of us who are building our liquid assets for eventual retirement. Richard Young, former writer of the Intelligence Report, refers to compound income as the eighth wonder of the world. Lastly, it is nice to have an income component of return in stock market declines.**

From 1928 through 2015 Value beat Growth during -

- 15 Year periods: 97% of the time (For the statistically inclined, this corresponds to over two standard deviations.)
- 10 Year periods: 88% of the time
- 5 Year periods: 77% of the time
- 1 Year periods: 61% of the time

The outperformance of Value or Growth seems to come in lumps: Growth outperformed Value in the 1930s, 1990s, and 2010s. Value outperformed Growth in the 1920s, 1940s, 1950s, 1960s, 1970s, 1980s, and 2000s.

Highlighting Growth's recent decade in the spotlight, over the last 20 years Value beat Growth during -

- 15 year periods: 19 out of 20 periods. But Growth outperformed in the most recent 15 year period from 2004 through 2018.
- 10 year periods: 13 out of 20 periods. But Growth outperformed in the last seven 10 year periods.
- 5 year periods: 10 out of 20 periods. But Growth outperformed in 9 out of the last ten 5 year periods.
- 1 year periods: 9 out of 20 periods. But Growth outperformed in 8 out of the last ten 1 year periods.

Over the long term, Value stocks have outgained Growth stocks by over 1.75% annualized return. This recent run of success for Growth stock investments puts the outperformance (over 2% better than value) in rarified air of over a positive 2.5 standard deviations.

This level of extraordinary and unusual outperformance is reflected in valuations. At the end of the 1st quarter this year, price to book value of growth stocks stood at 7.06. This is 45.9% above the long term average of 4.83. Conversely, the price to book value for value stocks stood at 2.08, which is 2.5% above the long term average of 2.03.

In hind sight, the extended surge by growth stocks post the financial crisis may have been predictable. The Federal Reserve Bank not only orchestrated the availability of cheap money, they informed the public in advance that they were going to maintain the loose policy for an extended period of time.

By in large, DBFM has performed well against the spread of investment return between value stocks and the index during this period of success for growth stocks. This has been accomplished via success in the fixed income part of portfolios, as well as the use of mutual fund managers who attempt strategic shifts between value and growth stocks, and finally via the use of some so-called growth stocks that we found to be available at reasonable valuations.

There have been a lot of investment industry articles written recently around the topic of the Value premium – is it dead? The articles are subjective. We have not seen any data to support a shift in mankind or in the way the stock market or world functions to indicate that Growth has overcome gravity. The best effort was to point out that the economy is being driven by different industries than it used to be. Technology is the key industry; therefore winning with Growth is here to stay.

There are two problems with this line of thinking.

1. Based upon price to book value, in aggregate, the market has priced growth stocks 45.9% above the long term average for growth stocks. Over paying for anything usually doesn't work out well. Herd behavior overwhelms judgement and independent research. The 2019 SBBI (Stocks, Bonds, Bills, and Inflation) Yearbook quotes Robert Shiller from his 2005 book, Irrational Exuberance regarding ***herd behavior.*** "…people tend to follow other people and choose not to exercise their own judgment about the market; also, most people purchase stocks based on direct interpersonal communication instead of independent research". Valuations can reside outside the norm for long periods of time, but eventually, there is a reversion to the mean. The world will always go through changes, people will follow the herd, and eventually valuations will return to the average. We have seen this movie before.
2. Many leading technology companies have been around for decades now. Microsoft, Intel, Cisco, Oracle and Qualcomm (not to mention Dell, IBM, and Hewlett Packard) are notable examples of tech companies that still lead our economy. Newer leading tech companies include

Apple, Alphabet (Google), and Facebook. Not all of these companies pay dividends, but our independent research places them all on the Value side of the ledger.

Macroeconomics / U.S. Economy

In the first quarter, real GDP growth was a surprising 3.2%. This was an unexpected bump up from the 2018 rate of GDP growth of 2.8%. The first quarter result was aided by a growth in inventories and a reduction is the trade deficit. Estimates by business groups, the Federal Reserve and the IMF (International Money Fund) for USA GDP growth for 2019 range between 2.5% and 2.1%, while estimates of economic growth for 2020 center around 2%.

Eurozone GDP also rose a surprising 1.5% in the first quarter. Japan also surprised with a 2.1% increase in first quarter GDP.

China topped GDP expectations with 6.4% growth as compared to a 6.3% forecast.

The IMF recently lowered their forecast for worldwide GDP growth from 3.5% to 3.3%.

The impact of the U.S. – China trade negotiations is being felt in business investment numbers as well as Institute of Supply Management readings for manufacturing and services industry. While they remain healthy, they have declined. Numbers above 50 mean growth. Service numbers have gone from 60 to 58 late last year to 55.5 in April. Manufacturing numbers have gone from the upper 50s to 52.8 in April.

USA personal consumption declined in January, but rose in February, March, and April. It is up 4.42% from one year ago. Strength here is supported by continuing strength in employment. Initial claims for unemployment insurance remain at very low levels. This data points to continued growth in employment. The headline rate of unemployment has declined to 3.6%. The participation rate is rising and the underemployed/unemployed number is declining. That means more people are rejoining the employment force.

In spite of employment gains, the Federal Reserve is reporting inflation below their 2% target. This indicates that there is still some slack in employment. We also are seeing disability ranks decline, participation rates of the disabled increase, and as stated above participation rates increase.

Productivity rose in the first quarter this year to 3.6%. This is up from 2.4% last year. It is a welcome sign that pay levels can continue to rise without creating high inflation.

With modest wage growth (3%) and below target inflation, it can be safely assumed that maximum employment isn't here yet and there is no present need for the Federal Reserve to raise interest rates.

Automotive sales and the housing market have very likely peaked. Automotive sales have been running in the 17 to 17.5 million range for the last three years and are projected to come in at 16.9 million vehicles this year.

Existing home sales have declined for 14 straight months. The sources of the decline have been high prices, declining inventory, and rising mortgage rates. Mortgage rates have since been declining and inventory rising. Supply is still a low 4.2 months. A six month supply would be parity for buyers. The rate of price increases is slowing. Housing starts rose 5.7% in April from March and pending sales rose

4%. It is too early to tell if housing can improve from here. Greater supply is needed to improve pricing.

All said the economy is still in good shape. Business decision makers are generally on hold for an outcome on U.S. – China trade negotiations. A good outcome would release the animal spirits and a bad outcome would slow the world economy. As stated before, a trade war is a problem for both nations, but the biggest impact would be in Europe and then in Japan and other parts of Asia.

Further, Brexit remains a wild card. Like the U.S. – China trade negotiation, a lack of direction on Brexit is leading to a resistance to invest on the part of corporations.

As stated last quarter, China has a corporate debt problem; the USA, some European countries, and Japan each have a growing national debt issue. At best, if not addressed, it will lead to a "crowding out" issue where government debt crowds out economic growth.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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