



Trade Tensions, Earnings Slowdown Driving Market Volatility

Financials, cyclical industrials, and energy sectors offer opportunities

July 2019

KEY INSIGHTS

- The deceleration in corporate earnings and renewed trade tensions were primary catalysts for the market's spring retrenchment.
- Our analysis has led us to see encouraging opportunities in the financials, industrial cyclicals, and energy sectors.
- Geopolitical developments amid a slowdown in the U.S. and global economies could pose headwinds to the market's ongoing recovery.



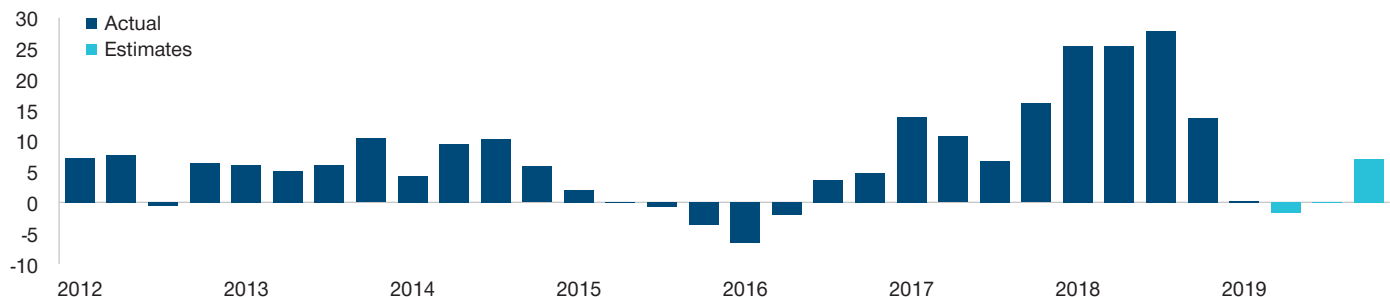
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After the virtual bear market in U.S. stocks toward the end of 2018, equities staged a remarkable rebound early this year—only to give a lot of it back this spring with a revival of trade tensions. While the market has recovered from that setback, it created some attractive opportunities, particularly in the financials, industrials, and energy sectors.

The main catalyst for the U.S. stock market's strong advance early this year was the 180-degree pivot by the Federal Reserve on rates. The year started with the expectation that the Fed would raise rates, and now the expectation is that it will cut rates this year—a dramatic shift. However, the expectation that trade tensions with China would be resolved faded

(Fig. 1) Slowing Growth in Corporate Earnings

S&P 500 Index quarterly earnings, year-over-year growth
As of June 30, 2019



Source: FactSet (see Additional Disclosures).

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and uncertainty on trade increased, prompting the market pullback this spring.

Some economists forecast a reduction in economic growth by seven-tenths of one percent due to trade tariffs, but amid such uncertainty, companies may cut back on capital investment and confidence is undermined. Volatility will likely persist until we get more clarity on the U.S.-China trade situation, and now possibly with Mexico as well. The trade issue could remain a headwind for some time. The market's early advance was propelled by price/earnings multiple expansion, but that's not likely to continue as long as trade concerns linger.

Another challenge has been the significant deceleration in corporate earnings and expectations due to rising labor costs and the fading benefits of the 2017 U.S. tax cuts. Earnings surged last year, boosted by tax reform and a strong economy. At the start of this year, earnings were estimated to rise about 10% to 11%. That estimate has been cut to about 4%, and I expect earnings to be flat or down 1% to 2% for the year. The estimate for 2021 is about 11%, which also seems optimistic. Eventually, the market is going to demand some progress on earnings and free cash flow growth.

With the market recovery, stock valuations are generally not cheap. Our strategy focuses primarily on steady growers with good earnings visibility and highly recurring revenue models. Those companies now are very expensive. However, the moderate retraction did provide opportunities in certain sectors.

Taking Advantage of the Market Retrenchment

With the sharp decline in oil prices, the energy sector has suffered, and we expect challenging supply/demand dynamics for energy to continue. But

there are appealing opportunities among low-cost oil and gas producers, mainly operating in the Permian Basin. Over half of the oil produced in the Permian Basin will be exported over time. We also expect to see much more consolidation among companies operating in the basin. The companies we own are potential takeout candidates over time. Overall, we are still underweight in energy, but the sector is more attractive than it has been.

We have also invested in industrial cyclicals that investors have shunned, such as Boeing, General Electric (GE), and some railroads. Boeing is suffering from the 737 MAX plane controversy, but that should eventually be resolved.

Information technology (IT) represents our largest absolute weighting but is our biggest underweight position, largely due to underweight positions in Apple. But recently, we have found opportunity in more cyclical parts of technology, such as Applied Materials and Micron Technology, a semiconductor company hit by a general slowdown in memory procurement and the trade controversy involving Huawei Technologies, the huge Chinese telecom company that is a significant customer for Micron.

In the IT sector, we generally favor companies with durable business models that address large and growing markets, including electronic payment processing businesses and providers of social connectivity. We also like companies benefiting from secular demand for public cloud computing services. Our largest exposure is to IT services through Visa, Fiserv, Accenture, and Fidelity National Industries.

Utilities, Financials, and Health Care Remain an Important Focus

In managing the strategy, we focus on high-quality companies with strong business models and management teams that have opportunities to increase their market share or have barriers to entry around their business that help

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them grow organically in a variety of market environments.

We have trimmed our exposure to financials over the past year and are modestly underweight the sector. Bank stocks are relatively cheap, but we are more cautious now as the credit cycle is about as good as it gets, and banks tend to do better in a rising rate environment, which we don't expect. Some of our top holdings include high-quality banks, including JPMorgan Chase, which we added to during the downturn, and US Bancorp.

We have focused on insurance brokers such as Marsh & McLennan and Willis Towers Watson, which have attractive business models, modest pricing power, and highly recurring revenue streams. The world has become riskier, certainly from a weather perspective, so there is increasing demand for property and casualty insurance products. We also added to our position in AIG and invested in Morgan Stanley at more attractive valuation levels.

One of our largest overweight positions is utilities, a sector that has performed well and usually benefits from a stable interest rate environment and economic uncertainty. Two utilities the portfolio has owned for several years are NextEra Energy, the largest renewable energy producer in North America, and American WaterWorks, the largest private water utility in the United States. We hold Sempra Energy, a strong utility in southern California that is among the leaders of liquid natural gas (LNG) exports from the United States. Cheap natural gas is cost-effective and carbon-efficient. Asia represents a big market opportunity as the region wants to reduce dependence on coal. Europe is another attractive market as the region wants to reduce dependence on Russia for natural gas. Sempra is one of the major companies investing in pipelines and converting gas to LNG and getting it to export markets. This business is just ramping up.

Health care is our second-largest sector and an overweight position. Although this sector has suffered from controversial political proposals, it provides the best combination of solid fundamentals and acceptable valuation. It also has a secular tailwind from an aging population. We invest in companies that could take advantage of long-term industry trends such as cost-saving distribution methods and highly innovative and effective therapies. Our primary exposure is in the health care equipment and supplies industry, where we have been long-term owners of Becton, Dickinson & Company; Danaher; and Medtronic. We also have modest exposure to pharmaceuticals through Johnson & Johnson and Pfizer, which has a very promising pipeline of new drugs that could drive future growth. We maintain a core holding in UnitedHealth Group, a well-diversified health care services company, but it could be susceptible to political rhetoric, which I expect to ramp up as the election cycle progresses.

Looking Ahead to 2020

As the presidential election campaigns gain momentum and controversial policy issues are debated, political headline risk may become more of a concern. All this comes against the backdrop of deceleration in the global economy and U.S. industrial production. Meanwhile, the yield curve has inverted with very short-term rates recently higher than 10-year Treasury rates. An inverted yield curve over a six-month period almost always is a harbinger of an economic slowdown. If the Fed cuts rates, that would help. But even if we don't get a slowdown, this may be signaling that something is wrong and stock multiples need to decline regardless. So investors should probably lower their expectations.

Despite these headwinds threatening the stock market's continued advance, we are confident our approach can provide investors with attractive risk-adjusted returns over time.

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