

November 2018: Thoughts on October's Selloff

October was a difficult month for U.S. and global investors across all asset classes. On a global basis (from foreign equity to fixed income markets), 89% of assets posted a negative return during the month, which is the highest percentage dating back to 1901.¹ The S&P 500 was no outlier and declined 6.94%. At its lowest point on October 29, the S&P 500 was down over 10% from its September highs. The 6.94% decline masks the severity of October's selloff in many individual securities. By month-end, nearly 50% of S&P 500 constituents were down more than 20% from their 52-week highs.² With both U.S. Treasuries and corporate bonds declining as well, this was a painful month to have any risk exposure whatsoever.³ Despite the sharp pullback in markets, we don't fear an imminent recession or material sell-off from current levels. However, we do expect volatility to remain elevated.

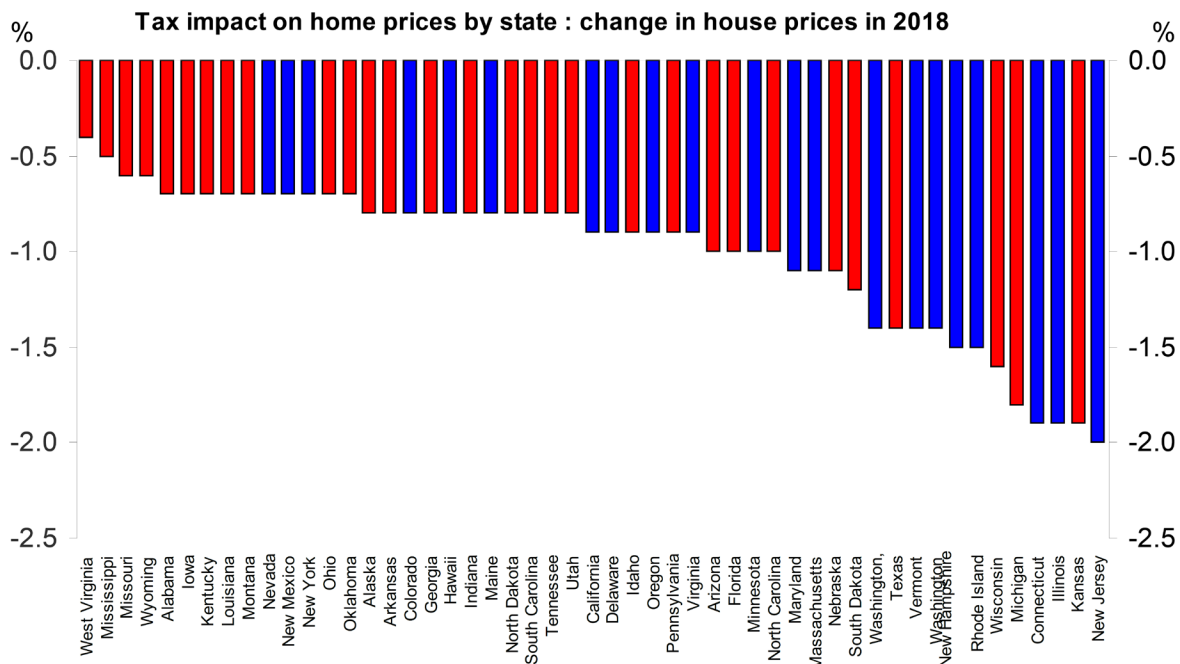
While we don't have a single explanation for October's pullback, we think the following were all contributing factors:

- Federal Reserve Chairman Jerome Powell's comment on October 3rd that: "we're a long way from neutral [interest rates] at this point, probably."⁴ By which, Mr. Powell meant that interest rates may have to rise materially before they begin restricting economic growth.
- The 20-basis point jump in 10-year U.S. Treasury yields from the end of September through October 5th, peaking at a 7-year high of 3.26%. Higher interest rates generally exert downward pressure on stock valuations, particularly for long-dated assets (such as growth companies) whose valuations are largely predicated on the present value of future cash flows.
- Geopolitical turmoil ranging from concerns over Italy's budget to the killing of Saudi journalist and U.S. resident Jamal Khashoggi (allegedly at the direction of Saudi Crown Prince Mohammed bin Salman) during Mr. Khashoggi's visit to Saudi Arabi's consulate in Istanbul, Turkey.
- Continued deterioration in the U.S.-China trade relationship.
- Weak U.S. monthly housing sales and new home construction data. Existing home sales declined 3.4% from September and new home construction fell 5.3%.⁵
- Notable earnings "misses" and sales guidance that came in below analyst expectations from large-cap technology firms including Amazon and Alphabet.
- Company earnings releases and management commentary on earnings calls suggesting that earnings growth may have peaked for this economic cycle and that rising labor costs and input costs (ranging from metals to materials) may cut into profit margins.
- Concerns that U.S. GDP growth, which has ranged from 3-4% this year, will moderate in 2019 as the stimulus from tax cuts wears off and trade uncertainty leads to a slowdown in business investment.

- The combination of inflation and a slowdown in growth has some worried about a return to stagflation of the 1970s.

These factors caused investors to quickly re-assess risk and led to a wave of selling and increased volatility that begat more selling, likely due to large-scale position unwinding from various institutional strategies (ranging from hedge funds, to risk parity funds to systematic trading funds). In our view, none of these factors justified the extent of the market selloff last month, nor were any of these factors much of a surprise (other than the Khashoggi murder). The two major threats for U.S. investors to watch out for are overly extended valuations and the odds of entering a recession. Starting with recession concerns, though growth is likely to slow down next year, no economic data other than housing suggest that the U.S. is close to seeing the economy contract. As to housing, we think the culprits for the slowdown are two-fold: (1) higher interest rates make financing home purchases costlier and (2) the newly instituted \$10,000 cap on state and local tax (“SALT”) deductions diminish some benefits of home ownership, particularly in states with high property taxes (see below chart).⁶

SALT impact on home prices

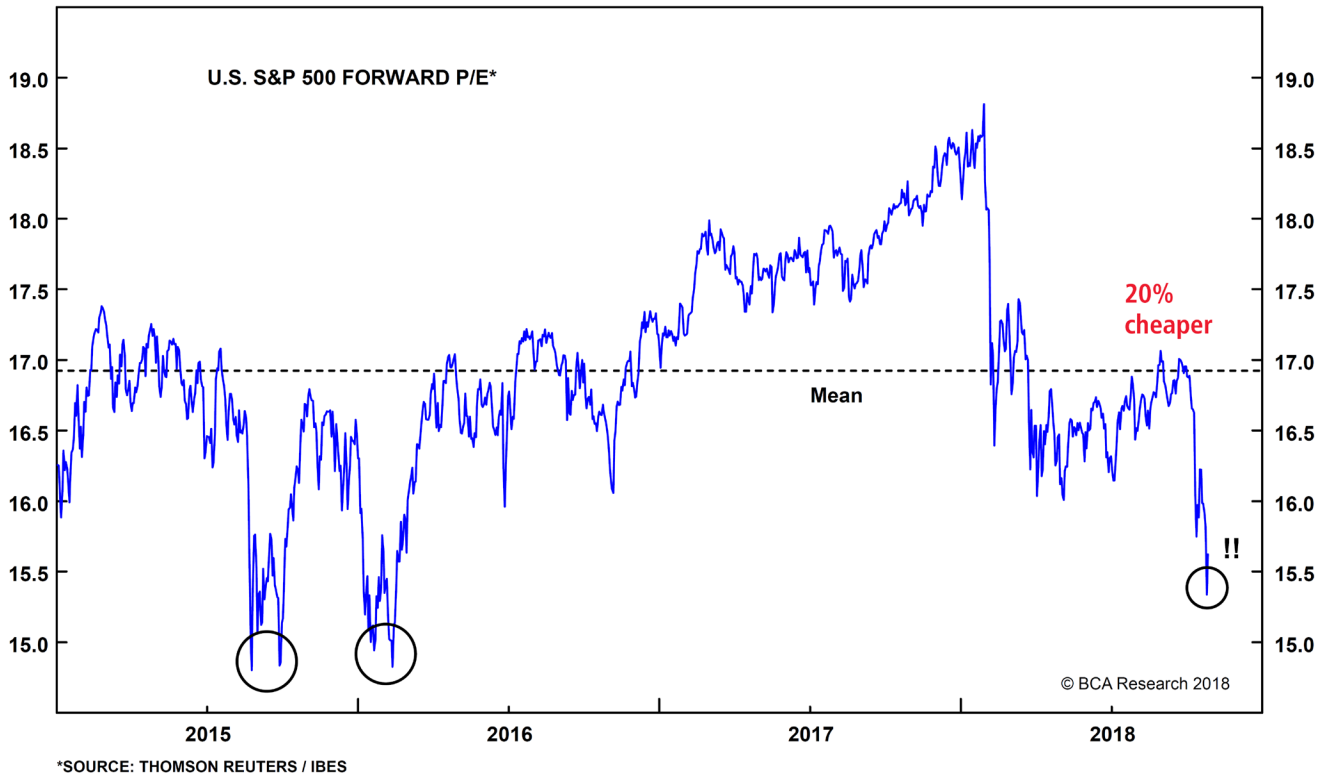


Note: Red = states that voted for Trump in 2016

Source: National Association for Realtors (NAR), DB Global Research

Given that the U.S. economy continues to otherwise perform well and that company earnings are still expected to grow in 2019 (perhaps in the high single digit range rather than double digits), we are inclined to take advantage of the recent selloff. As shown in the chart below, the combination of earnings growth and last month’s decline in stock prices, has brought valuations down close to their bottom range over the last three years (based on stock prices to next year’s expected earnings).⁷

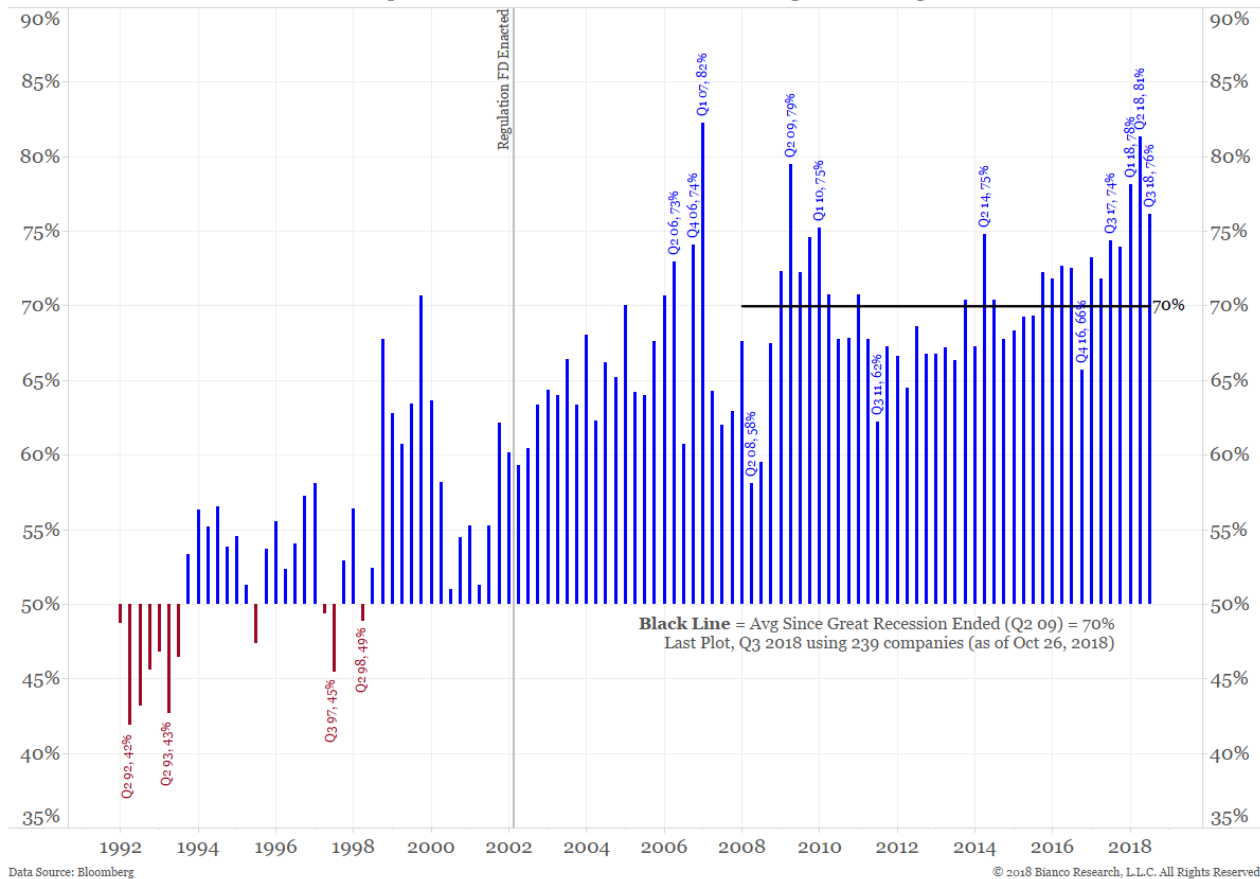
Wholesale Liquidation Should Bring Out Bargain Hunters



With many quality stocks down over 20%, the universe of opportunities to deploy cash at reasonable valuations is perhaps its broadest since the 2015-16 market correction. We think there are particularly compelling opportunities in the technology, biotechnology, industrials, materials and energy sectors, along with select foreign markets (such as Argentina). Of course, any of the risks highlighted above could materialize into something more severe (particularly on the trade front), but there is rarely a “goldilocks” environment without worries in which to invest. We think what in large part makes this year’s volatility seem so jarring is that it is coming on the heels of 2017, during which markets were as close as one can get to a goldilocks investment environment. The fresh memory of low volatility and consistent price appreciation is a stark contrast to daily price swings exceeding 1%. However, as we have encouraged everyone to remember during other bouts of volatility, markets and individual stocks over time follow the trajectory of earnings. That trajectory may not always be smooth, but so long as earnings continue to grow, we expect gains for investors.

Per the below chart, at halfway through the S&P 500 third quarter earnings season, 76% of companies have exceeded analyst earnings expectations.⁸ While forward sales and earnings guidance have been less robust than in prior quarters, the majority of companies are still offering positive outlooks.⁹ This suggests a slow-down in growth from what was likely an unsustainably high level (exceeding 20%), not a contraction. Investors can still do quite well in an environment where earnings are growing up to 10%. Particularly if invested in stocks whose valuations do not fully reflect their growth potential or cash flow stability.

Percent Of The S&P 500 That Beat Quarterly Earnings Expectations
(Compared To The Last Median Estimate According to Bloomberg)



Last month was a painful experience that we hope not to repeat any time soon. Unfortunately, volatility comes with investing and as the U.S. economy adjusts to higher interest rates and potentially slower economic growth, volatility is likely to persist. However, a volatile market does not mean a bear market. For those who can handle the volatility and have excess cash available, we would welcome having a conversation on compelling opportunities to invest in. For those who can't stomach the volatility, we are happy to discuss ways to de-risk your portfolio. And for all, in light of the selloff and approaching year-end, we are reviewing ways to limit potential 2018 tax liabilities by recognizing losses in positions with limited potential for price recovery. We continue to pay close attention to both economic and company earnings data. If we see a material degradation in either we will proactively advise to limit risk. For now, though, we think the outlook for investors remains positive. As always, please let us know if you would like to discuss any of the ideas in this letter or your overall portfolio. Many thanks.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

¹ Deutsche Bank Research, *October Performance Review* (Nov. 1, 2018). Returns are in U.S. Dollar terms. In local currency terms, 64% of global assets had a negative return during October.

² Morgan Stanley Research, *US Equity Strategy* (Oct. 29, 2018).

³ Bloomberg. During October, the Bloomberg Barclay's U.S. Treasury Index declined by 0.48% and the Bloomberg Barclays U.S. Corporate Bond Index declined by 1.46%.

⁴ Jerome Powell, Comments at The Atlantic Festival (Oct. 3, 2018).

⁵ Wall Street Journal Economic Data from October 17 and 19, 2018.

⁶ Deutsche Bank Research, *Global Markets, November 2018* (Oct. 26, 2018).

⁷ BCA Research, *U.S. Equity Strategy, Critical Reset* (Oct. 29, 2018).

⁸ Bianco Research (Oct. 29, 2018).

⁹ Bianco Research (Oct. 29, 2018). Based on Bianco Company Offered Guidance Index.

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