ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
April 3, 2019

Dear Clients:
As this letter goes to print, the market signals of the previous year have reversed, leaving your humble servants with a new round of "head scratching" in our efforts to make sense of the pricing for both stocks and bonds. Last year, stock prices declined sharply in the fourth quarter in concert with a meaningful rise in bond yields after September. We found comfort in this signal given our long held belief that unsustainably low bond yields had driven stock prices to unattractively high prices. Today, stock prices have recovered most of the decline of the previous quarter, while bond yields have fallen to levels only slightly above the level of expected annual inflation.

We continue to believe bond yields constitute the foundation for the return components for all other investment classes. If true, then what are investors to conclude from the essentially flat yield structure from the one year US T-Bill to the ten year US T-Note? We think this condition signals either very stable inflation and debt market conditions or the onset of a material slowdown in economic activity. The stock market behavior clearly suggests the former conclusion. Low yields in the absence of economic distress support low hurdle rates for equity securities. Today's bond yields suggest a plausible equity hurdle rate of 9%+/- versus the long term average of 12%+/-. This "favorable" interest rate foundation is further enhanced with the traditionally optimistic earnings forecast from the sell side of Wall Street firms. Currently, consensus expectations for earnings growth of the constituent companies in the S&P 500 Index for 2019 and 2020 is +17% and +13%, respectively. While such stellar earnings growth may be realized over the next two years, investors should not lose sight of the "fact" that the compound average annual growth of earnings over the last thirty years and since 1925 clocks in at 6%. Given the current market signal for inflation, we see a sustainable earnings growth rate of 4-5% as best case. Even with a lower earnings growth assumption, today's lower return environment, if durable, would support price to earnings multiples in excess of 20x. So what's to worry about?

First, we are skeptical of the leap of faith that inflation and thus interest rates will stay low and stable in the absence of economic stress. The US Federal Reserve Bank gets credit for its policy recipes to generate full employment while maintaining stable prices (aka US dollar). However, these policies have encouraged greater use of debt across the globe and a corresponding reduction in the use of equity capital. In addition, the reversal of experiments in Quantitative Easing and Zero Interest Rate Policy have yet to be fully tested - with unknown consequences. Count us as skeptics of the "Modern Monetary Theory" that money creation through central bank purchase of debt issued by its sovereign government has no adverse consequences or even effective limits. Equities are very long duration assets, and equity prices are very sensitive to changes in interest rates on long duration assets. Investors should keep in mind that the present value of one dollar earned 30 years in the future with a 2% interest rate is worth $0.55 today, compared to only $0.23 and $0.13, respectively, with interest rates of 5% and 7%.

Second, earnings of US public companies have not experienced a serious decline since 2008, a streak of about 11 years versus a typical cycle length of around 7 years. With profit margins at historical highs, inklings of upward wage pressure, and limited pricing power, headwinds for continued strong earnings growth are strengthening. On top of these factors, the helpful 2018 decrease in the corporate income tax rate is fully imbedded in today's earnings outlook while continuing to be a target for repeal by a revenue-hungry Congress. Investors should expect an earnings reversal as a normal consequence of competitive pressures in a market oriented environment.

The bottom line for investors and their investment advisers is to maintain a clear-eyed focus on capital protection with a reasonable but controlled exposure to long duration assets. In our view, stock and bond prices have captured a fair amount of the forward good news in rates and earnings and thus exposed to a higher than normal exposure to downward adjustments.

Investment Market Returns as of March 31, 2019

Equity market returns were broadly positive for the first quarter of 2019 with the US again generating the most attractive returns. The total return on the broad equity index for the US and non-US markets was 14.1% and 10.2%, respectively. These returns were essentially mirror images of the previous quarter as investors apparently became convinced of the continuation of low interest rates, robust economic activity, and the diminished exposure to adverse geo-political events. Perhaps our embellishment is over the top but how else can these returns be explained? On a twelve month basis, the broad US equity market returned 8.8%, while the broad market for non-US equities absorbed a -4.8% negative return. Obviously, not all investors in all markets were as comfortable as the typical US investor.

Price appreciation brought on by falling interest rates drove fixed income returns for the quarter and twelve months ended March 31, 2019. The broad US investment grade bond index had total returns of 2.9% and 4.5%, respectively, for the quarter and twelve month periods. With the average coupon well below both returns, the power of falling interest rates was quite evident. Investors should not ignore the even greater power of an interest rate movement in the opposite direction. The markets for non-US bonds was a mixed bag with a positive 1.3% for the recent quarter, in contrast to a -4.0% negative return for the twelve month period. Unfavorable currency affects and the re-establishment of above zero interest rates on government debt issued by countries such as Germany, Japan, and Switzerland were the principal sources of the negative twelve month returns in USD terms. Investors should note that the below zero yields on the aforementioned foreign debt are now back in vogue, having the provided the primary fuel for the positive return in the recent quarter.

Returns on Alternative Assets were a mixed bag again, with REIT stocks other than timber stocks performing well versus lackluster results from hedge strategies and commodities. Hedge strategies generated positive single digit returns for the quarter but were generally negative for the twelve month period. Actively managed quantitative strategies have underperformed due, in our opinion, to the apparent disconnect between quoted market prices and traditional valuation methods. We have decided to trim part of the allocation to tactical asset allocation in response to this observation. Furthermore, we have changed our internal benchmark index for hedge strategies to a 50/50 blend of the S&P 500 Index and the 3 month US T-Bill from a 6% absolute return index. The blended index gives a better indication of the benefit and cost of hedge strategies. REIT stocks broadly performed well with the continued low interest rate environment supporting income producing investments. Commodity strategies are destined to lag as long as inflation and geo-political stresses remain contained.

Summary performance of your aggregate portfolio is included on page 3 of your quarterly report. Detailed performance of asset classes, class subdivisions, and individual holdings are included starting on page 5.

Our Look Forward

In short, we remain cautious about the “Goldilocks/Wizard of Oz” mentality underlying market prices for stocks and bonds. Your portfolios will be managed with a less than normal tilt to both equity exposure and longer duration fixed income until such time as either we develop a conviction of the sustainability of current earnings and yield factors or such factors revert to norms which we think we understand.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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