ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
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Dear Clients:
Nearly eleven years after the height of the 2008 financial crisis, society's rush (through government) to prevent the recurrence of such disasters has pushed the markets to conditions that bear little resemblance to long observed metrics of investment risk/reward tradeoff. To wit, US nominal interest rates are at historical lows for long duration bonds with little or no net of inflation return opportunity. This condition exists alongside the stated goal of the US Federal Reserve Bank to "create" an annual price inflation of 2%+. On top of this economic contradiction, the ten year bond of a few foreign governments now trades at a negative nominal yield; that's right, an investor makes a loan to a foreign government in return for receiving around 95% of the loaned amount ten years into the future. This condition seemingly makes burying currency in the back yard a viable investment strategy. At the same time, the central banks of the world's developed countries, including the US Federal Reserve Bank and the European Central Bank, have instituted unprecedented money creation in hopes of forestalling economic corrections to the downside. A small circle of "modern day, so-called monetary economists" have coined a novel explanation for this strategy under the tagline of "modern monetary theory." According to this theory, a sovereign government with its own currency can issue unlimited debt in its own currency without adverse consequences, at least until adverse consequences appear at which time you go to an undefined Plan B. You cannot make this stuff up.

Coincident with the monetary stimulus experiment is the ongoing downward pressure on US wages and producer profits from the globalization of labor inputs and technology driven productivity improvements. This combination of influences is being played out on the current US presidential campaign trail with policy proposals to shield the public from economic reality through higher guaranteed wages, free college education, low cost health care, and loan forgiveness all to be paid for by higher taxes on individuals (not just the wealthy) and businesses. Business taxes are actually paid by the customers of businesses but no politician ever met an unseen tax he or she did not like.

As we contemplate the current economic/political situation, the concept of "moral hazard" keeps jumping out. Moral hazard is the condition where one or more well-intentioned programs/policies creates a negative outcome as bad or worse than the problem purported to be solved. Nobel laureate Friedrich Hayek's quote - "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design" is fair warning to investors that the good intentions of government officials, whether elected or appointed, often result in bad outcomes. Ben Bernanke, one of the authors of the US Federal Reserve Bank response to the 2008 financial crisis, warned "as we make the financial system safer, we must inevitably confront the problem of moral hazard."

Since none of us knows the timing of the moral hazard backlash, our focus as your investment adviser is twofold: to construct your portfolio in anticipation of the inevitable economic correction and to encourage our clients to develop the financial capacity to absorb these corrections without a major lifestyle disruption. Our approach to portfolio construction remains focused on broad diversification with a bias for limited leverage and sustainable profitability. We believe this approach has the best chance of producing sustainable positive returns albeit lower than historical norms. Our advice for creating sustainable financial capacity centers on maintaining a portfolio withdrawal rate at or below the expected net of inflation portfolio return and on the limited use of debt.

Investment Market Returns as of September 30, 2019
Investment returns continued to be quite volatile, toggling often dramatically between risk-on and risk-off psychologies. The broad US equity market returned 1.1% for the third quarter, compared to 20.0% for the year to date, and 2.9% for the trailing twelve months. The broad non-US equity market generated similar but lower returns, with -1.7%, 11.5%, and -1.7% for the same respective periods. Watching from the sidelines, an investor might imagine suffering neural whiplash. We attribute this yo-yo return pattern to investor uncertainty created by the historically

unusual monetary and fiscal policies being followed around the world and continued geo-political tensions between the old guard G-7 and rising economies in the developing world. We expect these conditions to persist with continued market volatility.

Fixed income returns remained robust by historical norms with the broad US investment grade bond index returning 2.3%, 8.5%, and 10.3%, respectively, for the three time periods above. The broad non-US bond index generated total returns of 0.2% for the recent quarter, 5.2% for the year to date, and 7.4% for the trailing twelve months. Beating equity returns with annual coupon interest yields of 2%+/- in the US and virtually 0% for the non-US bond index is testament to the positive return benefit of falling yields for long duration bonds. Investors should not lose sight of the certain negative impact of a yield reversal.

Our Look Forward

We believe both equity and fixed income markets are currently priced for low to mid-single digit annual returns for the next ten years. The probability for a substantial downside return experience seems higher than that for a positive double digit outcome. The forward annual earnings yield for US stocks is around 5% with an expected annual real growth rate of 2%, or say 7% total return best case. As described above, current bond yields in the US barely cover the expected annual inflation rate of 2%, while government bond yields in Europe and Japan are essentially zero. If not for the inevitable backlash from moral hazard, investment advisers would invest most of clients' portfolios in equities. However, future events such as a recession driven earnings decline or a material increase in bond yields could deflate current equity prices, resulting in lower or even negative returns on stocks. Bonds provide a portfolio ballast against equity risk, but with today's nearly flat yield spread between short and long duration bonds, we expect to maintain overall bond durations shorter than the market index. In short, the mix of the above portfolio ingredients suggests modest overall returns for the foreseeable future.

Some of you have asked why advisers continue to allocate equity assets to US mid and small cap stocks and to non-US stocks given the persistent out performance of US large cap stocks from 2010 through 2018. The simple answer is that we believe over the long haul investment asset class returns revert to the mean or to historical averages. Looking back to the decades since 1970, we find that US large cap equity outperformed the other asset classes in only one of the five decade periods but generated the second highest compound annual return for the entire 1970-2018 period. US mid and small cap stocks outperformed the other two classes in three of the five decade periods and was the top return for the entire period. The return ranks by decade for non-US stocks alternated quite nicely with that of US large cap stocks even though substantial under performance in the 2010-2018 period caused the long term return to come in third. In short, the longer term return patterns have generated diversification benefits from comparable returns and less than perfect correlations. Finally, earnings yields and expected earnings growth rates continue to favor US mid to small cap equities and non-US equities over that of US large cap equities, compensating for their higher volatility.

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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