ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

January 3, 2019

Dear Clients:

Some of you may have attended or watched some bowl games the past few weeks. Shreveport hosted the 43rd edition of the Independence Bowl on December 27th where Chef John Folse set a Guinness World Record for the largest pot of gumbo ever made at over 6,800 pounds! According to reports in The Shreveport Times, the list of ingredients included 983 lbs. of shrimp, 590 lbs. of catfish, 299 lbs. of crab, 262 lbs. of alligator, 33 lbs. of crawfish and 111 lbs. of oyster. These are classic ingredients to making "Louisiana" gumbo and the portions needed to generate the right texture and flavor. Equity and bond markets are no different. The inputs needed to generate rational market returns are bound by ranges. If these ranges are exceeded, which can be due to a number of factors, the markets may not be reasonably priced, and hence, the "market" gumbo may not taste right. Over the last decade, market risk premiums or "ingredients" such as the risk-free rate and premium factors for duration risk, credit risk, and equity risk have all been compressed. Central banks have enhanced returns through their artificial flavoring (expansionary monetary policies), and the results have been pretty satisfactory for risk-taking investors. The fourth quarter of 2018 appeared to be a "taste test" which showed the effects of central banks changing the monetary policy cookbook.

The right Ingredients and portions are certainly the start to making the gumbo, but the recipe requires additional processes to follow that build consistency. We observe several market metrics critical to the recipe for rational price discovery. One of the most important metrics is the expectation for enterprise earnings. Based on data provided by Howard Silverblatt at S&P Global Indices, the current trailing twelve month index equivalent earnings for the S&P 500 constituent companies is about 130 or an earnings yield of about 5.8% (price/earnings ratio of 18.8x). Since the long-term average for these metrics are 6.4% and 15.7x, respectively, we believe equity prices are moving toward a more normal posture but with more downside adjustment likely. Bear in mind that 2018 earnings show an annual growth rate of over 20% from 2017 on the strength of a 10% revenue increase, rising and all time high profit margins helped by the lower income tax rate, and a boost from share repurchases. Considering the earnings strength in recent years with the current direction of stock prices and interest rates, investors might rightly expect level earnings for a couple of years unless a recession leads to even lower results.

Additionally, as fans tasted this gumbo, they may have compared it to other "Louisiana" gumbos eaten in the past. We are not immune to using this same method when evaluating our assumptions on the markets. History tells us the US economy has grown at an average annual rate of 6% nominal and 3% real over the last 90+ years. As is the case with the cyclical nature of investment returns, observed growth rates above long-term averages will likely be followed by growth rates below long-term trend and vice versa. In light of the above trend growth in earnings since 2008, a period of below trend growth going forward seems a good bet. With the US Treasury yield curve nearly flat at around 2.5%, our estimate of the required annual return on the S&P 500 Index is around 10% which, given our expectation for more modest earnings growth over the next few years, leads us to a current equilibrium price of around 2200 compared to a current level of 2450. Our view places a higher weighting on the signals from the bond market which are flashing slower growth and stable inflation.

In any event, recent declines in equity (stock) prices are at a heathy and long overdue adjustment and lay the foundation for reasonable future returns from stocks. We will be leaning toward increasing equity allocations as prices approach our equilibrium estimate.

Investment Market Returns as of December 31, 2018

US equity market returns finished the year with modest negative total returns brought on by near "bear market" price trends in the fourth quarter. The total return on the S&P 500 Index was a negative -4.4% for the year, reflecting the negative -13.5% return for the fourth quarter. Investment result for smaller US companies was even worse with the Russell 2000 experiencing a negative -11.0% return for the year and a negative -20.2% return for the quarter. Based on the price action in the top 20 holdings (representing nearly 32% of the index market capitalization) of the S&P 500 Index, investor preferences switched from companies with high growth / low current earnings to those with slow growth / more predictable earnings. Growth darlings in both the large and smaller cap spaces showed the biggest declines for the quarter even though the same names had the leading returns for the full year, a testament to the extreme price action stocks such as Amazon experienced during the period.

Returns from non-US stocks were also negative for both the quarter and year and continued to lag the broad US stock market. Currency effects were stable in the fourth quarter but negative for the full year. Given the generally lower price multiples for non-US stocks, the observed price action is probably a harbinger for relative out-performance by non-US stocks over the next couple of years.

Fixed income assets were generally stable for 2018. The US Aggregate Bond index returned essentially 0% for the year as price declines offset the average coupon of around 2.5%. The returns on the broad non-US bond index showed more price weakness and lower total returns primarily as the result of a rise in yields from near zero levels. A big "fly in the ointment" for fixed income assets was the reversal to lower yields in the fourth quarter both in the US and abroad, indicating a potential slowdown in global growth. Such a trend portends worsening conditions for lower quality bonds.

Hedge strategies and real estate lagged significantly for the full year but did show some diversification benefit in the fourth quarter. Hedge strategies are expected to provide downside benefit during periods of excess price exuberance; as equity prices move to a lower equilibrium level, the need for these strategies will diminish. Real estate has been hit by rising interest rates and concerns for excessive rents in the face of a possible economic slowdown. Further price declines in real estate assets will likely lead to higher portfolio allocations to this segment.

Cash was "king" in 2018 after a nearly 10 year exile into the land of ZIRP (zero interest rate policy). Currently, the one year and shorter US T-Bill provides a return sufficient to maintain purchasing power of short term reserves (ignoring income taxes?). Going forward, cash may provide the most efficient hedge instrument but it will remain a temporary portfolio holding.

Our Look Forward

The outlook for investing at higher returns is improving as equity prices decline and interest rates rise. We remain concerned by the headwind risks from reduced global economic growth and worsening geo-political tensions. Clients can expect us to be deliberate in our actions to add equity exposure and fixed income duration to our portfolios. Current conditions remain volatile and place continued emphasis on the importance of investing in relative quality. Pursuing opportunities as they arise while maintaining an emphasis on capital preservation remains our mantra.

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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