ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
July 7, 2017

Dear Clients:

"Toto, I have the feeling we are not in Kansas anymore." --as spoken by Dorothy in the Wizard of Oz. We find ourselves and our clients frequently wondering in which "universe" we currently reside. One need look no further than the recent market euphoria over the FANG (Facebook, Amazon, Netflix, and Google) stock group and the acquisition Whole Foods Market by Amazon, followed by the resulting price markdowns of very profitable retailers such as Wal-Mart Stores, to witness the disconnect. Investors seem to value the speculative future far more than the known past, causing one client to ask if traditional valuation methodologies are no longer useful. Falling bond yields in reaction to the Federal Reserve Board's (Fed) efforts to raise short term interest rates and to reverse its Quantitative Easing experiment have many analysts shaking their collective heads in disbelief. Fiscal and monetary policy pronouncements seemingly in pursuit of a "weaker" dollar exchange rate and a 2% annual inflation rate contradict what might normally be in the best interests of a society's financial system transacted in a "faith-based" currency.

From our perspective, such anomalies have appeared repeatedly over the span of history. Today's high stock price to earnings multiples and minimal real yields on longer dated bonds are mirror images of the same mirage. Bond yields will remain low because future inflation is subdued by technological advances and economic globalization, while stock price multiples will remain high because cheap leverage and technology will allow creative enterprises to devour and displace the economic titans of the past. We are reminded of the relatively short tenure of the Roaring Twenties, the Nifty Fifty of the late Sixties, the Dot.com Boom, the Enron/WorldCom new world order, and other assorted market miss-fires. Neither have the disasters of depressions, wars and threats of wars, and banking/financial crises, and spend thrift governments (at least so far) caused lasting damage to a functioning capitalist system. We remain optimistic over the long term that market prices will settle at fair value with appropriate rewards for relative risk. We think history repeats rhythmically if not precisely, and contrarian actions in investment management generate the better outcome. Warren Buffett's advice "to be fearful when others are greedy and greedy when others are fearful" still sounds good to us, and our take is being greedy today has a high level of risk.

Investment Market Returns as of June 30, 2017

US equity markets ended the current quarter with a total return of about 3%, including a cash dividend of about 0.5%. Expectations for higher future earnings combined with a falling bond yield pushed the S&P500 P/E ratio to near 26x at quarter end from 25x at March 31, 2017 and 24x at year end 2016. Returns for smaller US stocks were slightly less robust but still positive around 2% for the quarter. For the twelve months ended June 30, 2017, US large company stocks returned just shy of 18% with a 2% dividend yield, while US small cap stocks had generally higher returns, as indicated by the 24.6% total return on the Russell 2000 Index.

Total returns on non-US stocks came in around 6% for the quarter, including a cash dividend of about 0.7%. Returns for the current quarter were similar across the developed and emerging countries. The USD returns benefitted from stronger non-USD currencies in the developed countries with over half of the quarterly return attributable to a weaker USD exchange rate. For the twelve month period, developed country stocks returned 20.3% in USD, while emerging country stocks returned 23.8%. Currency effects detracted from developed country stock returns but were additive to returns from emerging country stocks. Price to earnings multiples for non-US stocks remained lower than those of the US; however, the "risk-on" trade action resulted in a rising price multiple for such equities.

Total returns on fixed income assets (bonds) reflected the benefit of falling yields. Index returns for the current quarter for the US taxable, US tax-exempt, and non-US global majors investment grade bonds were 1.5%, 2.0%, and 2.7%, respectively. The income component of these returns was only about 0.50% for the quarter in the US and an even less impressive 0.20% for the non-US bond index. Price appreciation was the primary driver of bond returns in the quarter. By contrast, price declines drove the trailing twelve month returns to negative results, with the three primary indices delivering negative returns of -0.31%, -0.49%, and -6.66%, respectively. Suffice it to say, low yields fuel significant volatility in prices for bonds with mid to long effective durations.

Alternatives asset class generated unattractive returns as the intended hedge value of these assets was not realized with continued strong equity returns and compressed fixed income yields. With the exception of REIT assets, these assets are contrarian/low correlation positions that we expect to cushion the impact of market price adjustments to achieve more normal earnings multiples and bond yields. We continue to believe diversified portfolios will benefit from these allocations.

We encourage our clients to carefully review the return details included on pages 4 and 6-8 and the market indices shown on the next to last page of the quarterly report.

Valuation Signals and Other Sources of Confusion

The coincidence of rising price earnings multiples and falling bond yields would naturally occur as long as economic conditions are conducive to improving earnings with low inflation. This “just right” balance has been an elusive achievement over the last 80+ years as periods of deficit spending combined with rapid money creation have resulted in long term averages of 3% for annual inflation and 2.4% for real return on intermediate and long term bonds. Currently, the bond market is signaling an annual inflation rate (CPI) of about 1.7% and a real 10 year UST yield of 0.70%; these levels suggest a move to higher yields may be more likely than the current state. A sudden change in the yield on the 10 year zero UST note from 2.45% today to 4.45% would result in a 18% decline in the value of the bond, while the same yield change for a 30 year UST bond would result in a 43% price decline. Since the Fed is embarking on a path toward normalization of interest rates, we think keeping durations short and riding up the yield curve an appropriate portfolio strategy.

The recent behavior of stock prices offers even more conflicting signals - Amazon.com, Inc. and Wal-Mart Stores, Inc. are recent examples. Last month Amazon announced the purchase of Whole Foods Markets at a price premium of 29%; the market reaction was a 2+% increase in Amazon’s stock price and a nearly 5% decline in the price of Wal-Mart’s stock. Amazon’s market capitalization ($462 billion) is twice that of Wal-Mart’s despite Wal-Mart’s annual revenue advantage of $345 billion or 3.4 times that of Amazon, annual net income advantage of $11 billion or 5.7 times that of Amazon, and a dividend yield of 2.7% compared to 0% for Amazon. For the ten years ended 2016, Wal-Mart’s cumulative advantage in revenues and net income was $3.8 trillion and $143 billion, respectively, while generating a consistently higher return on invested capital. Now we fully understand that stock prices are all about the future and there is no disputing the magnitude of Amazon’s impact on the US retailing industry. Consider the proposition that Amazon’s annual net free cash flow is now about $9 billion and grows by 10% per year for thirty years; this results in $157 billion in annual free cash flow in 2047. Using a price earnings ratio of 20x, the terminal value would be $3 trillion nominally but only $360 billion discounted to the present at a cost of equity of 7.5%. If the cost of equity were 10%, the present value would fall to less than $200 billion. We consider these assumptions aggressive along with Amazon’s current market capitalization.

A prolonged period of extremely low bond yields may lead to an extremely low equity cost. However, as one of our clients recently pointed out, low bond yields accompanied by a flattening yield curve (rising short term rates) has historically presaged difficult economic conditions and less than robust revenue and earnings growth. We say investors beware of stock stories too good to last and thus to be true.

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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