

ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

January 7, 2020

Dear Clients:

As this piece goes to press, we find ourselves in a world of alternative universes. Based on the nightly news feeds from the major media complexes, one might rightly conclude our society is on the brink of apocalyptic collapse. On the one hand, Congressional partisans are about evenly divided between wanting to impeach the sitting President for his unorthodox statements and actions and cheering on his actions with regard to judicial appointments, income tax policy, regulatory restraint, and the use of lethal force by the military. In addition, the list of geopolitical hot spots outside the United States receive nightly updates if only to remind the viewing public of their existence – Korean peninsula, Iran, Russia, Hong Kong, Brexit, and widespread conflict in the Islamic world. Adding to this worrisome list of calamities is the impending doom to our civilization from rising temperatures and sea levels, not to mention the low probability event of a life altering collision with a “giant” meteor.

Now, a quick take on the economy and markets for publicly traded stocks and bonds suggests everything is peachy cool. Employment and wages in the US are rising nicely after a decade long hiatus following the financial crisis of 2007-08. Innovation in technology and health care continue to flourish largely in the business-friendly US environment. As if on cue, prices for publicly traded stocks and bonds broadly are up sharply, signaling a positive operating environment with continued earnings growth and favorably low interest and inflation rates. In fact, the year 2019 will go down as the first in nearly thirty years where all major asset classes – stocks, bonds, mortgages, utilities, and gold – generated positive returns with Sharpe ratios* greater than 1. Since we trust market actions far more than news feeds, we remain sanguine about the conditions of overall markets despite the news “noise,” but are attuned to events and signals that would necessitate actual adjustments to our clients’ portfolios.

Our number one concern with market stability today is the rapid growth in aggregate debt across the globe. Continued and unprecedented quantitative easing activities (aka money printing) by the world’s central banks has led to, in our opinion, an artificially low yield environment which in turn has led to an explosion of debt issuance by governments, businesses, and individuals with increasingly lax underwriting standards. This vulnerability will surface should any combination of materially higher interest rates and lower earnings lead to a decline in the ability of debtors to meet periodic debt repayment requirements. The early signs of this risk will show up in deteriorating stock prices of financial and other heavily leveraged companies and the major “story” stocks such as Netflix, Tesla, Uber/Lyft, and the like. We will also remain alert to poor performance by high yield bond funds and private equity funds, as both groups depend heavily on low interest rates and abundant credit to sustain positive returns.

*Sharpe ratio is defined as the difference between the asset return and “safe” return on the three month US Treasury Bill divided by the return volatility of the specific asset.

Investment Market Returns as of December 31, 2019

Total returns on stocks were strong with the CRSP US total stock market index returning 9.0% for the fourth quarter and 30.8% for the full year. As has been the case from the end of 2008, the S&P 500 Stock Index continued to experience the highest returns with 31.5% return for the twelve months ended 12/31/2019. Non-US domiciled stocks in the aggregate generated positive total returns for both the quarter and full year. Total returns for the FTSE Global All Cap exUS Index were 9.7% and 23.9%, respectively, for the quarter and full year. Positive earnings growth combined with an expanding earnings multiple drove the returns across the globe. Interestingly, the US dollar exchange rate fell slightly in 2019, adding a very minor boost to returns on non-US stocks.

The fixed income (bond) markets also generated favorable total returns as yields fell across the globe. In the US, the Bloomberg Barclays Aggregate bond index returned 0.2% for the quarter and 8.7% for the full year. At year end the annual yield on this index was around 2.3%, down from nearly 3.0% at the beginning of the year. The modest return for the fourth quarter reflected slight upward pressure on yield, a trend we hope continues. The comparable returns for the Bloomberg Barclays Global Majors exUS bond index were -0.5% and 4.6%, respectively. The negative total return for the current quarter hopefully represent the beginning of a trend away from negative yielding government bonds in Western Europe and Japan and a return to a more logical bond pricing environment.

Commodities generally and gold specifically generated positive returns for the two periods. The Bloomberg Commodity Index increased 4.4% and 7.7%, respectively, for the quarter and full year. The iShares Gold Trust etf increased 3.7% and 18.0%, respectively. The returns for these instruments indicate upward pressure on prices as well as a possible increase in geopolitical stresses.

Cash returns as indicated by the three month US Treasury Bill averaged 2.3% for the year, but declined slightly to 0.5% for the fourth quarter. Since we view the three month UST bill as a signal indicator for price inflation and safe haven demand, the near term result may be a contra signal for future disinflation and greater safe haven demand.

Our Look Forward

The general consensus among market forecasters for the major investment houses is for mid-single-digit equity returns and low-single-digit fixed income returns over the next ten years. Within the equity space, non-US equities, especially emerging markets stocks, are expected to outperform US equities. Returns on fixed income assets (bonds) are expected to be somewhat higher than the current yield curve but to remain below the returns on equities. These expectations reflect both a belief in mean reversion as well as a case based on a currently lower pricing multiple for non-US stocks. Two things are certain: (1) all forecasts will be wrong but no one knows either the magnitude or direction of the error and (2) unanticipated events/conditions will have the most profound impact on future results.

Our counsel going forward is to moderate portfolio risk by trimming assets with above average recent returns and adding assets with better forward return metrics. Given the likelihood of lower future returns, we will encourage our clients to manage portfolio withdrawals at a level consistent with the overall return opportunity and the goal of maintaining portfolio purchasing power.

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.

P. Michael Adkins, CFA
mikeadkins@ascm-llc.com

J. Richard Seale, CFA
dickseale@ascm-llc.com

Jay K. Binderim, CFA
jaybinderim@ascm-llc.com