

Summer 2018

The turmoil and volatility of the stock market in the first quarter of 2018 gave way to a somewhat calmer environment in the second quarter. While the issues of trade restrictions, tariffs and protectionism still provide daily challenges to stocks, a focus on the ever improving economy and the potential for significant earnings growth seems to have won the day for now.

The potential impact of restrictions on global trade was not lost on stocks in the second quarter however, as many industrial and export oriented companies suffered declines. Many global consumer staples stocks such as McDonalds and Procter & Gamble also declined. The year to date gain of 2.6% in the S&P 500 was due primarily to substantial gains in a few technology stocks. In a recent CNBC report it was noted that Amazon and Netflix were responsible for over 50% of the total gain in the S&P 500 for 2018. If you add in Microsoft, Apple, Google and Facebook, those 6 companies account for almost 100% of the gain. This is not to imply that these stocks are necessarily overvalued but that there are plenty of good companies that may have declined to attractive levels.

Foreign developed and emerging markets also suffered declines during the first half of 2018. The Vanguard Emerging Markets exchange traded fund (ETF) declined 7.4% year to date while the Vanguard Developed Market ETF declined 2.9%. According the Credit Suisse, the global synchronized economic recovery has given way to more divergence in growth rates. Re-emerging concerns about Europe and in particular, Italy, during the second quarter have troubled investors. Argus Research cites the difference in the yield on the S&P 500 of 2.0% versus a yield of 3.6% on European stocks as one measure of both the relative performance and valuations of U.S versus foreign stocks. Argus also points out the trailing Price/Earnings (P/E) ratio on the S&P 500 of 21.3X versus a global average trailing P/E of 16.7X as a measure of relative value.

The U.S. economy certainly seems to be enjoying continued growth in spite of the rather advanced age of the recovery. Credit Suisse expects GDP growth of 2.9% in 2018 versus 2.3% in 2017. The significant growth in jobs and resultant increase in consumer confidence coupled with corporate tax cuts could prove to be a powerful boost to corporate earnings for the rest of 2018. Many analysts are calling for share earnings growth of over 20% versus 2017 levels. This earnings growth could lead to a more widespread advance in stocks for the balance of the year as other sectors of the market recover.

A recent investment industry presentation (1) highlighted the positive impact of corporate tax cuts and the repatriation of cash from overseas earnings on the U.S. economy and on the technology, health care and financial services sectors in particular. Discussions on the repatriation of overseas cash have often focused on technology companies, specifically Apple, because of the amount of cash held by these companies on a per share measure. This repatriated cash can be used to invest in new employees, expand existing operations, increase dividends and share buy backs or buy other companies.

According to the presentation, health care companies also have a significant overseas cash position. Hence, the same positive repatriation effects attributed to U.S. technology companies are present in the health care group. The challenges facing the health care industry are significant but there are good opportunities as well. Advances in biotechnology, surgical innovations and the efficient and cost effective delivery of health care services are all very positive trends. It was also noted that the relative forward P/E ratio of the health care sector to the rest of the market is well below historical averages. Favorable demographic trends worldwide also benefit the healthcare sector.

Corporate tax cuts impact most companies but the financial services sector may be a particular beneficiary as tax rates for these companies has been relatively high. The banking sector should benefit from a more favorable regulatory climate, stronger capital positions and a rising interest rate environment. Many bank and other financial services stocks have had a difficult first half of the year but they may be poised for a recovery in the second half and into next year.

Technology companies stand to benefit not only from the reduction in their corporate tax rates and the repatriation of their own overseas cash but from spending by other companies of their own cash windfall on upgrading their technology. Spending on information technology across hardware, software and other upgrades should increase significantly across virtually all economic sectors. A more confident and prosperous consumer will also provide a boost to technology spending.

Technology companies may also use a portion of the tax cut or repatriated cash to initiate or increase dividends on their stock. Over the last 20 years, according to the presentation, the dividend yield on the technology sector of the S&P 500 has gone from 0.2% in 1998 to over 2.0% today. Obviously valuations in the sector in 1998 were far higher but it is a measure of how many technology companies, like Apple and Microsoft, have grown and matured to the point of being reliable dividend growth stocks. Perhaps companies like Alphabet (Google) and Facebook will follow suit and consider dividends in the near future.

Another interesting observation about the technology sector in the presentation is the measure of Enterprise Value to Free Cash Flow of the sector. Basically this measures the value of a company versus cash flow from operations minus capital expenditures. At the height of the technology bubble in 1999 this measure was approximately 140X. It is now at roughly 20X. Couple that with yield of over 2.0% and it is hard to argue, with a few exceptions, that the technology sector is significantly overvalued.

While focusing on the positive aspects of both the economy and stock market we are mindful of the many risks. An escalation in the trade disputes, geopolitical worries, a rapid increase in inflation and/or interest rates or even an ill-advised tweet all pose threats to the markets. Many of these or similar macro risks seem to be swirling around the markets perpetually although the tweet threat is a new phenomenon. Regardless of these very real obstacles it appears that the economy is growing and the stock market seems reasonably valued. We believe there are opportunities in the current stock market and that the economic expansion will continue.

As always we appreciate your confidence in our firm and wish you the best for the summer of 2018.

John C. Knox CFA

John C. Downing CFA

The views expressed here are those of Knox & Downing Advisors and not necessarily those of the Advisory Services Network, LLC. This material is for informational purposes only. This is neither a solicitation nor a recommendation to purchase or sell an investment and should not be relied upon as such. All information contained herein is derived from sources deemed to be reliable but cannot be guaranteed. All the economic and performance data is historical and not indicative of future results. Indexes are unmanaged and do not incur management fees, costs and expenses. It is not possible to invest directly in an index.

Footnotes

1. Fidelity Sector and ETF Outlook Q2 2018 Fidelity Institutional Asset Management