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CAPITAL MANAGEMENT

Equity Investment Outlook
October 2017

During the third quarter, the economy continued its slow, low inflationary expansion and the equity market continued to gain ground. Real Gross Domestic Product (GDP) expanded by an estimated 2.5%, and inflation hovered around 2.0%. Corporate earnings grew by an estimated 2.8% and the S&P 500 Index (S&P 500) tacked on another 4.5%. At this point eight years into an economic expansion and bull market, we think there are four critical questions that investors ought to be asking:

- Can the economic expansion continue?
- Can inflation remain quiescent?
- Will the Federal Reserve (the Fed) be measured in tightening monetary policy?
- Are equity valuations too high?

In a nutshell, we believe that the slow growth, low inflation trajectory will continue a while longer and, as a result, the Fed can maintain a very measured pace unwinding its unprecedented monetary ease. Typically, economic expansions do not die of old age but rather begin to suffer from excesses and an inflationary build up that then cause the Fed to slam on the monetary brakes. At the moment, we do not see evidence of excesses nor do we see the kind of inflationary acceleration that would alarm the Fed.

We should note, however, that the U.S. economic expansion has been joined by expansions around the world. Such synchronized global economic growth has the potential to cause commodity prices to surge and thereby tilt the inflationary curve upwards. Add to this the possibility that Janet Yellen could be replaced with a more hawkish Fed chairperson who would advocate for a more rapid and forceful Fed tightening. In other words, if we are wrong about a continued low inflation, moderate interest rate environment, it would likely be because inflation ramps higher and the Fed responds with more aggressive tightening.

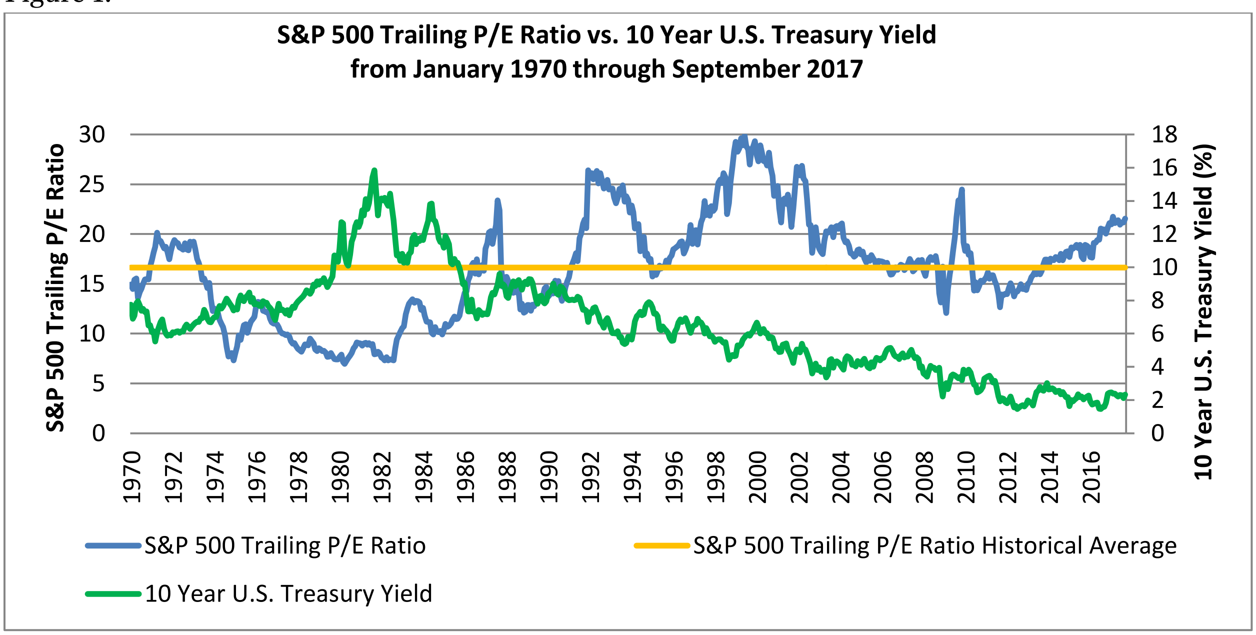
As we wrote in last quarter's Investment Outlook, the combination of globalization and the digital revolution has created structural shifts in the economy that have significantly dampened inflation. Globalization allows companies to source labor where it is cheapest and the digital revolution enables companies to drive down costs. To recapitulate what we detailed last quarter, the digital revolution has led to significant re-ordering of the economy.

First, the internet has given consumers an unprecedented ability to compare prices, thereby limiting retailers' abilities to charge higher prices. Second, the digital revolution has enabled businesses to streamline their processes, thereby driving down costs. This affects not only manufacturing and services but also the extraction and production of commodities such as oil and gas from shale formations and even the production of power from wind and solar. For example, by 2020 wind and solar are estimated to be the lowest cost sources of energy <u>without</u> subsidies. Third, the digital revolution has undermined labor's ability to demand higher wages. Workers in the "gig" economy are often part-time and rarely unionized. Workers in more traditional industrial roles can be replaced with robots and others with artificial intelligence.

All this is not to say that inflation can never heat up – because, of course, it will at some point – but that there are new structural impediments that are working to postpone higher inflation. At some point, tight labor markets will lead to wage gains. Short-term supply/demand imbalances can still cause commodity prices to fluctuate. The weather will affect food production and hence prices. At the moment, though, inflationary pressures remain tame. Should this change, we will change our tune.

Next there is the question of equity valuations. Simply put, equity prices are above average, equating to a 21.6x P/E multiple for the S&P 500. So what? Academic studies have shown that when equity prices are above average, equity returns over the next decade fall below average and vice versa; when equity valuations are below average, returns are likely to be above average over the next 10 years. But these studies say nothing about the next 1-3 years. In other words, equity valuations are lousy indicators of short-term (1-3 year) market direction. High prices can go higher and low prices can go lower. The chart below illustrates this. Equity valuations can remain above or below average for long periods of time. With interest rates as low as they currently are (10-year Treasury at roughly 2.3%), and not likely to rise dramatically over the next year or two, equity valuations may very well remain above average and could even climb higher.

Figure 1:



Source: Bloomberg

With all this in mind, we remain constructive on the stock market. In building portfolios we are focused on three key investment themes: First, we believe that more and more industries favor dominant companies. This allows them to gain market share and out-compete their peers. Second, we like companies with high, growing dividends. Such firms are often mispriced by the market, which tends to view them as boring income stocks, while we often see them more as growth stocks potentially deserving of higher multiples. And third, we are always on the lookout for companies with unrecognized earnings acceleration stemming either from industry conditions or from company specific causes such as a restructuring, new management, new product cycle, etc.

As we discussed earlier, there are risks to our rather sanguine outlook. We are carefully monitoring these risks. Should they become imminent or actual, as opposed to merely possible, we would alter our view and make adjustments accordingly. If you have any questions or concerns, please let us know.

Sincerely,

John

John Osterweis

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Price-to-Earnings (P/E) ratio is the ratio of the stock price to the trailing 12 months diluted EPS.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance. One cannot invest directly in an index.

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