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Large Cap Value Commentary

January, 2020

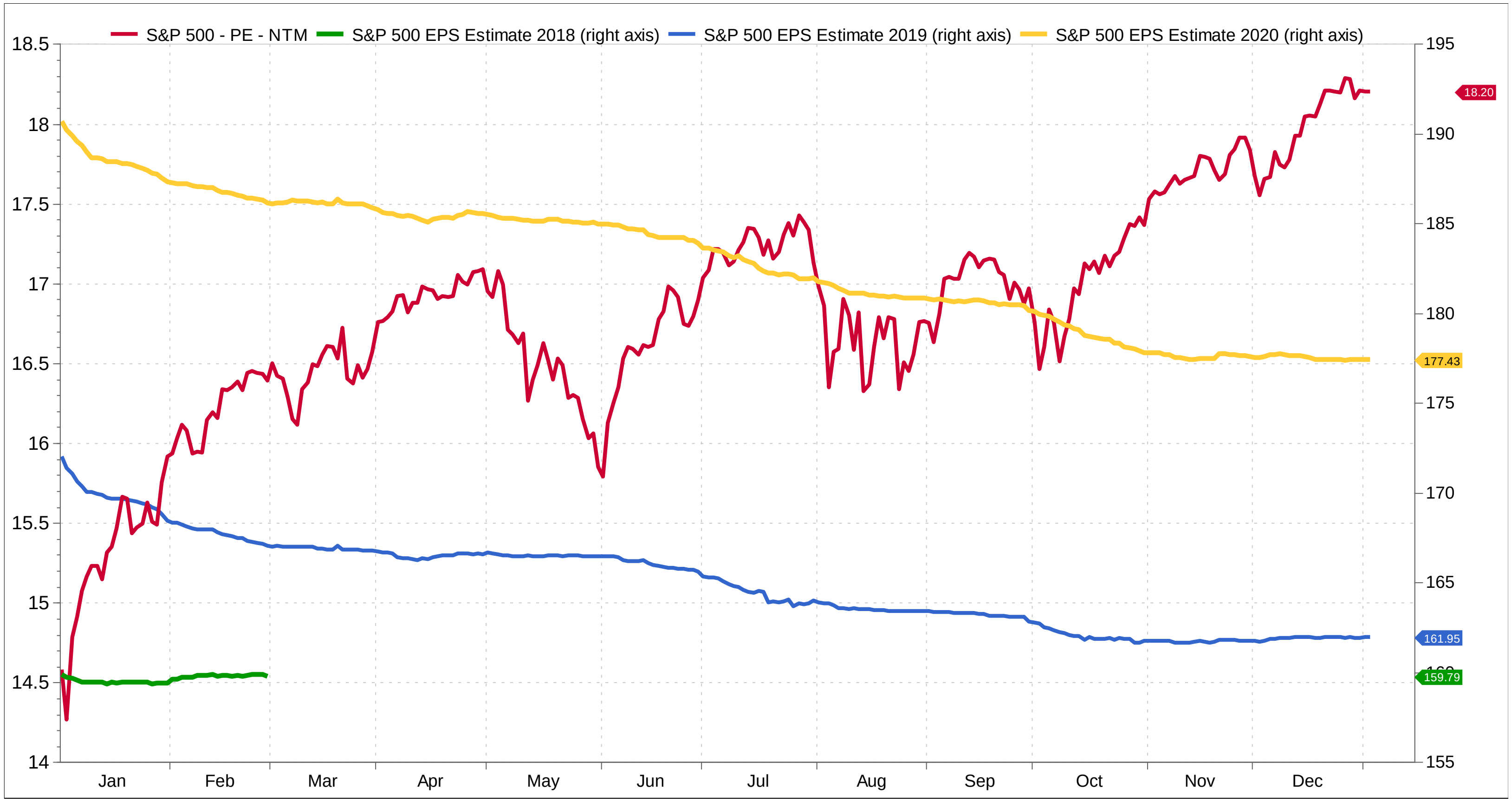
The 2019 market gains for large cap indices were driven mostly by higher valuations or multiple expansion, while expected earnings grew just 1%. The multiple expansion was largely the result of two policy shifts. The first from Fed Chairman Powell, the second from President Trump. One way of looking at the shift in monetary policy is to track the forward rate guidance provided by the FOMC. In December 2017, the median of the projections of FOMC participants pointed to three ¼ point interest rate increases in 2018. A year later, after four rate increases, the Fed Funds rate was 2.5% and projections indicated two more hikes would occur in 2019. That proved to be the high watermark for rates as they were lowered three times during 2019, as the "crosscurrents"[1] that Chairman Powell pointed to in his December 2018 press conference apparently became too strong for the Fed's liking. Today, the published projections from the December 2019 FOMC meeting call for what sounds like a hopeful ¼ point increase in 2020. Powell's tone has shifted as he said that he would like to see a significant and persistent move up in inflation before raising rates, and later adding that, "you've had quite a significant move in the direction of higher accommodation."[2]

While the current expansion is now the longest in history, it continues to be the slowest. While the duration of this expansion is noteworthy, growth did decelerate in 2019, specifically in the manufacturing or goods-producing side of our economy. In November, Industrial Production declined year-over-year for a third consecutive month. Similarly, non-defense capital goods orders rolled into negative territory in the second half of the year after growing roughly 10% in late 2017 and 5% in late 2018. Additionally, shipping activity in our West Coast ports fell in 2019 after several years of mid-single digit growth. It is easy to attribute most of this weakness to the worries caused by the trade negotiations with both Mexico and China. We have been of the view that there was no easy solution for the trade negotiations with China. In our opinion, this is Trump's highest conviction policy and the only initiative that had general support from both sides of the aisle. While China had nothing to gain from escalating the issue, substantive changes to their economic policy was unlikely. It appears that earlier this fall, both sides, but specifically the US, decided that reducing the collective pressure was in everyone's best interest, at least in the short term, hence a phase one trade deal or truce has been agreed to.

So, here we are at the beginning of a new calendar year and decade. Policy moves have alleviated a lot of the tensions that resulted in a down stock market in 2018 and triggered a substantial rally in 2019. Given the dramatic shifts in policy over the past year, an extra dose of humility for any market or economic forecaster looks appropriate. With that said, basic economic dynamics remain in place, so the lower inflationary and interest rate pressures have created a more conducive backdrop for rising confidence and activity in 2020, assuming future policy moves do not counteract these positives.

In terms of our strategic positioning, we had maintained a defensive posture for most of 2019, overweight sectors such as Utilities and REITs, and we also bought our first gold stock in years. This positioning has generally proved beneficial as interest rates fell and growth expectations were lowered over the course of the year. We did hold more cash than usual since we were uncomfortable owning the more cyclical stocks in the face of the slowing pace of growth. We have also shied away from the tech and financial sectors, which was a drag for most of the year and especially in the fourth quarter, as these were the two strongest performing sectors. During the fourth quarter, we exited several of our defensive positions in favor of stocks within the more cyclical sectors such as Financials, Energy, and Industrials.

We will introduce one of the newest positions, Franklin Resources (BEN), but we would be happy to share with you our thoughts on each and every holding in the portfolio. Asset managers have been out of favor for several years now, and BEN could be the poster child of the group. The industry has been pressured by higher regulatory costs, lower fees, and the bull market in both equities and fixed income has accelerated the move to passive management. This has resulted in negative net flow for most public managers over the past year. BEN has uniquely had poor equity fund performance partly as a result of their deep value philosophy, and a recent bad bet on Argentinian debt has added to problems for their global fixed income team. With that said, the stock is exceptionally inexpensive at a time when few disagree the broader market is expensive. BEN's cash balance is equal to 40% of its market value, and its dividend yield is 3.8%, or two times the yield on the 10 year Treasury. Most public managers are historically cheap on cash flow relative to the market and other financials, but BEN also trades at a big discount to peers when you consider the flexibility it has with its balance sheet. We are of the view that 2020 could be a tactically better year for BEN and its peers in general.



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[1] Transcript of Chairman Powell's Press Conference December 19, 2018

[2] Transcript of Chair Powell's Press Conference December 11, 2019