Financial Markets Review

If you blinked, you might have missed it. The constant daily drubbing to end 2018 is all but a distant memory. It has been well documented that the S&P 500 posted its worst December performance since the United States was in the midst of the Great Depression in 1931 – down 9.18%. The month to forget was quickly followed up by the month to remember, as the S&P 500 logged its best January since 1987 – up 7.87%.

You will recall that cash & cash equivalents were the only asset class to sport a positive return in 2018. At one time, Deutsche Bank reported that over 90% of the global asset classes they cover were down on the year. With a flip of the calendar, Deutsche Bank now reports that all major asset classes posted positive performance in local currency terms for the month of January. Just as 2018 was the worst year for global asset classes, January 2019 was the only month on record to have 100% of all major asset classes close higher.

So, what has changed from month to month? Truth be told, not all that much has changed since the end of November. It could easily be argued that the dramatic increase in January was just as unwarranted as the steep decline in December. For much of 2018, we wrote about the global economic slowdown and the performance divergence between global financial assets and our domestic equity markets. In addition, we focused much of our commentary on the inevitable corporate earnings growth deceleration in 2019 and the relative overvaluation of the market on most metrics other than earnings. The U.S. equity market began to price in all these concerns over the fourth quarter and in fact overshot the mark during the 3rd week of December. The S&P 500 has now made back everything it lost during that frightful third week and now here we stand. The market has discounted an economic and corporate earnings slowdown. Now, we are left with the $1,000,000 question – has the worst been discounted with growth to accelerate again or has this economic cycle finally exhausted itself? Only time will tell. But, for the first time in a long time, the U.S. equity market's risk/return profile is much closer to being balanced than it has been over the past couple of years.

Earnings Update

We are now almost half way through 2018 4th quarter earnings season with 46% of the S&P 500 having reported. As expected, the 4th quarter results have slowed down a little from the previous three quarters, but they are still very strong. According to Factset, revenues are on track to grow 6.6%, while earnings are on pace to grow 12.4%. Although the results have been pretty good, there have been a rather significant number of companies pre-announcing disappointing results due to margin contraction on the back of higher costs, waning global demand and uncertainty surrounding global trade.

The pre-announcements are not only specific to the 4th quarter, but instead the concerns are bleeding over into future expectations. Months ago, we warned that 2019 1st quarter earnings estimates were too optimistic. Corporate executive teams have been warning of higher costs and declining margins for some time. And once the corporate tax reform initial benefits lapsed a year, it was very difficult to see how earnings could grow at a faster pace than revenues. At the end of September, estimates for 2019 1st quarter revenue growth was 6.5% with 10.2% earnings growth. Three months later the revenue estimate of 6.5% growth remained steady, but earnings growth was more than cut in half and expected to grow at 4.6%. Today, 1st quarter revenue estimates have come down slightly to 5.7% and earnings are expected to not grow, but rather decline by -0.8%. The decline in earnings should not come as a shock, as it has been well telegraphed.

The wild card is not what happens solely for 1st quarter results, but how the rest of calendar year 2019 plays out. 2019 full-year earnings estimates have also been nearly cut in half over the past several months. In September, analysts were looking for 10.2% earnings growth for 2019 and right now estimates are for 5.4% growth. With 2019 revenues expected to grow at a similar clip to earnings, I suspect earnings expectations are still a little too high and need to come down in the face of declining margins.

Tandem Strategy Update

After a busy December, adding to our existing holdings and establishing new positions, we were much less active in January. Similar to our observation of the market being more in balance on the risk/return front, many of our core positions have moved toward fair valuation based on our quantitative model. As equity prices rebounded over the past few weeks, there have been far fewer opportunities to buy individual securities, but the rebound has not generally moved stocks back to being overvalued either.

The only transactions we made in January were in our Equity strategy. Within the first few days of 2019, Bristol-Myers Squibb (BMY) announced a deal to acquire Celgene (CELG) for $50/share in cash, one share of BMY and one Contingent Value Right (CVR) worth up to $9/share, based on specific milestones being met. Not factoring in the CVR, the deal has implied a $98 - $99/share take-out price for CELG shares. Throughout this past month, CELG has traded in the $86 - $88 range, which is roughly a 12% discount to the implied deal price. The current discount could imply a few things. The market may be saying that BMY's shares are overvalued and need to decline. It could be foreshadowing that CELG shareholders may vote the deal down. Or, the market could be implying the inability of BMY to get the deal done, considering they will have to take on a significant amount of debt. Either way, when the company being acquired is trading at this much of a discount to the implied deal price, there is always trepidation that the deal might fall apart. For this reason, we decided to sell 25% of our CELG position to lock-in the 35+% share price appreciation the stock experienced after the deal was announced on January 3rd.

Lastly, in our Equity strategy, we established a new position in Dominion Energy (D), which has been a long-time holding in our Large Cap Core strategy. D has operationally performed very well, but due to headline concerns over the past year, the shares have remained undervalued and range bound. The company was able to close on their Scana (SCG) acquisition at the beginning of this year, which is now one less distraction. The only headline risk now has to do with the timing and costs of building out the Atlantic Coast Pipeline. Once more clarity comes to this project, D should be in the clear. In the meantime, D has continued their commitment of increasing the dividend by 10% a year, which they announced on December 14th.

-Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson