Investment Strategy
July 2019

The S&P 500 Index is back at all-time highs after a furious rally to start the year. This renewed optimism is being spurred by the prospect of the Federal Reserve cutting interest rates and the potential for a trade deal between the U.S. and China. In the current environment, several technology-focused initial public offerings (IPOs) have come to the market, reminiscent of the late 1990s tech bubble. Most of these companies will fail to meet expectations as their valuations are at sky high levels. While equity markets remain buoyant, there are several other asset markets sending potentially conflicting signals. Most notably, bond yields have fallen sharply and gold prices have surged to the highest level in five years.

As you can see above, the S&P 500 Index recently posted a new all-time high which slightly exceeds the level reached previously on three separate occasions. We included this graph because most investors would be surprised to learn the market has only made marginal gains over the past 18 months. Given the lack of progress, it is interesting to compare the economic conditions in January 2018 and today. In January of last year, the global economy was enjoying a period of synchronized expansion as all the major economies in the world were growing in unison. Additionally, the U.S. had recently passed a large tax cut that primarily benefited corporate America. This new law allowed companies to reduce taxes on U.S. profits as well as “bring home” overseas profits at a much lower tax rate. It was believed this would spur a large increase in corporate investment, leading to faster economic growth and rising employee wages. Additionally, these changes increased the share of profits going to shareholders, making stock valuations appear more attractive.

The global economic outlook has darkened over the past 18 months. The economies in Europe and Asia have clearly slowed and are likely headed toward recessions. The U.S. economy has remained resilient, but the boost provided by the tax cut seems to have worn off. Unfortunately, the tax cut did not boost capital spending as most of the repatriated foreign profits were plowed into stock repurchases. In fact, during 2018 and the 1st quarter of 2019, U.S. corporations spent slightly more than $1 trillion buying back stock! As one can imagine, this provided a considerable tailwind for the market during this period.

Despite the worsening global economic outlook, the strong stock market has allowed Wall Street to bring public a string of "hot" tech companies this year. Unlike in the late 1990s, today's tech firms are relatively mature because of the amount of funding they were able to secure as private companies. Despite this maturity, the majority still fail to generate profits. Here is a chart with the most notable new offerings over the past few months, along with their revenue and negative cash flow figures. We compared this selection of better-known companies with the average company in the S&P 500 Index.

Company Name	**Market Cap**	**Revenue 2018**	**Cash Flow 2018**	**Price/Sales**
Beyond Meat	$9.2 B	$87.9 MM	$-61 MM	104.67
Uber Technologies, Inc.	$75.1 B	$11.3 B	$-2.1 B	6.65
Lyft	$18 B	$2.2 B	$-349.3 MM	8.18
Slack	$26.4 B	$400 MM	$-98.1 MM	66
Pinterest, Inc.	$14.5 B	$755.9 MM	$-82.56 MM	19.18
S&P 500 Index Avg.*	$22.1 B	$10.1 B	$936.50 MM	2.19

*Median Values Data from FactSet database

As you can review in the chart, certain segments of the stock market are showing signs of euphoria as investors project overly optimistic scenarios far into the future. The same holds true in the bond market as many of these companies have also accumulated a sizable amount of cheap debt. There is no way to know how long this period will last, but it is wise to steer clear of companies built on hype (revenue growth) above substance (profits).

While the U.S. stock market shows signs of un-bridled optimism, the global bond markets have been on a sharply different path in 2019. Since late last year, interest rates have been moving lower around the world. In the U.S., the interest rate on a 10-year Treasury bond is down from 3.25% to only 2%. In Europe and Japan, interest rates have once again submerged below 0% with an estimated $12 trillion in bonds currently offering negative rates. To be clear, investors are paying governments to hold their money rather than receiving interest.

As a result of these impressive interest rate movements, the U.S. yield curve is now "inverted". This means that short-term interest rates are higher than medium and longer-term rates. An inverted yield curve is often viewed by investors as an impending recession signal because the market is anticipating the central bank will lower short-term interest rates in response to an economic slowdown. In Europe and Japan, where interest rates are already below zero, investors believe the central banks will return to buying assets directly from the market in what is known as "quantitative easing." Typically, central banks do not ease monetary policy until real pain is felt in their respective economies. In today's world of hyper-aggressive central banking, there is discussion they will attempt to forgo a slowdown by preemptively easing policy. If the central banks choose this path, there is a real possibility they will trigger asset bubbles to form, potentially in the stock market.

In addition to bearish signals from the bond market, gold prices have made a notable move in the past few weeks. The price of gold had traded in a relatively tight range over the past five years between $1,050 - $1,350 per ounce. This long-term trend was finally broken as gold surged to over $1,400. Surprisingly, the price of gold broke this trend as stocks were charging to new highs rather than during a period of market upheaval. Investors are often drawn to the perceived staying power of the yellow metal during times of stress. However, with no yield from bonds, other investors prefer to hold gold which similarly yields nothing. Across client portfolios, we've built large positions in one of the largest gold miners in the world, Barrick Gold. Barrick is trading for an attractive valuation and the stock has recently been responding strongly to rising gold prices. We believe gold will continue to move higher if investor anxiety increases or higher inflation catches the market off-guard.

While conflicting signals from the markets may trouble short-term traders, long-term investors should stay on a course of reducing risk. At some point in the foreseeable future, the current credit cycle will conclude and a certain amount of "froth" will need to be purged from the asset markets. This froth comes in the form of bonds issued to weak creditors, hot tech stocks with dubious businesses prospects, and plenty of securities peddled by Wall Street that have hidden risks. Investors should reduce risk by shifting their holdings toward high-quality companies trading at a discount to the market. We also believe that U.S. Treasuries and exposure to the price of gold serve an important purpose in a portfolio. We continue to manage portfolios in this manner knowing the overly aggressive central banking regimes in place today could easily trigger higher stock valuations. It seems many investors are making this bet. However, we believe their ability to lift corporate earnings has eroded as the effectiveness of their policies diminish over time. In summary, the potential gains from more aggressively investing client funds is easily outweighed by the hidden risks lurking under the surface.

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