

The New Environment For U.S. Equities

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April 2018

2017 extended the domestic equities bull market to nine years. Over this span, equities were able to continuously ascend through a litany of worries and slow earnings growth because of low valuations, low interest rates, low inflation, and an accommodative Federal Reserve. Over time these variables slowly shifted, and now as we enter the second quarter of 2018, there is a new environment for U.S. equities. What is this new environment? What does it mean for U.S. equities? And what portfolio shifts should be made to defend against it?

The table below succinctly summarizes the environment for U.S. equities over the last five years, and shows a clear depiction of how the environment has recently changed. First, a review of each column in the table is helpful. From left to right, we show the year; the forward Price/Earnings ratio at the start of the year (valuation); the forward Price/Earnings ratio at the end of the year (valuation); the earnings growth for that year (earnings); the 10-year U.S. Treasury bond yield at the start of the year (interest rates), the start of year CPI (inflation); PCE (inflation); and finally the Federal Reserve bias (interest rates).

YEAR	START YEAR FORWARD P/E	END YEAR FORWARD P/E	YEAR EARNINGS GROWTH	START 10 YR U.S. T-BOND	START YEAR CPI	START YEAR PCE	FED RESERVE BIAS
2013	13	15	5%	1.75%	1.6	1.7	EASY
2014	15	16	7%	3.02%	1.5	1.5	NEUTRAL
2015	16	16	0%	2.17%	0.8	1.5	NEUTRAL
2016	16	17	0%	2.27%	0.7	1.3	TIGHT
2017	17	18	11%	2.44%	2.0	1.9	TIGHT
2018	18		20% EST	2.41%	2.1	1.5	TIGHT
3/31/2018	17		20% EST	2.74%			TIGHT

Source: OPCM

Per the table, 2013-2015 was an amazing environment for U.S. equities. The combination of low valuation (13-16x P/Es), record low interest rates, tame inflation, and an “easy” Fed enabled the S&P 500 to rise over 45% during that period...even with annualized earnings growth of under 4%. After 2015, the variables began to shift.

First, the Federal Reserve shifted to a tightening monetary stance – the Fed Funds rate would no longer troll near 0%. Next in 2017, inflation started to normalize. Plus, for the first time in over ten years, the whispers of high wage growth worries began to surface. By the time 2018 started, valuations had reached higher levels in the S&P 500, and bubble-like levels in small and microcap companies. The final variable to turn occurred when interest rates quickly rose in the first quarter of 2018. After a quick 12% correction and subsequent rally, we enter April with the environment flipped toward spiking earnings growth and



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rising interest rates, rising inflation, and an actively tightening Fed. So what does this new environment mean for U.S. equities?

Generally, U.S. equities should be a more difficult and volatile asset class. There will be an increasing battle between market participants believing the economy will expand for a few years – buy financials, industrials, materials, energy; and those who believe the economy is peaking and a recession is on the horizon – buy consumer staples, defensive parts of healthcare, utilities, telecom service. Meanwhile, the high growth, high valuation areas, FANG for example, have and will show increased volatility. As a firm, we are mainly finding more “value in value” equities, and continue to believe the major underperformance of defensive sectors will likely continue for now. In the meantime, what portfolio shifts provide a higher probability of improved risk-adjusted returns?

There are three portfolio shifts the OPCM investment team has made over the past year. These shifts will likely persist over time. First, equities outside the U.S. generally have not seen the same variable shifts as the U.S. There continues to be a meaningful valuation discount versus the U.S., global central banks are presently not as aggressive as the U.S., inflation is in check, and earnings growth is strong. Second, natural resources has been the worst performing asset class over the past ten years. After being underweight for many years, we began to increase our exposure a few years ago – first in industrial metals, then natural gas, and more recently in agriculture. As the U.S. monetary policy tightens, usually the dollar peaks. As this occurs, we enter the sweet spot for natural resources, which are priced in dollars, and experience a tailwind from strong global economies. Plus, many of the oversupply issues from the last boom/bust have been corrected. Third, there may be a time within the next year when fixed income will be capable of driving both portfolio income growth and appreciation with a risk reduction component. As the Fed completes the interest rate cycle increases, fixed income (and other income related securities) will potentially outperform after a lengthy period of underperformance.

In conclusion, the main reason multi-asset class and active investing succeeds over time is because asset classes become over/undervalued due to the variables that affect them. In this case, after a lengthy period of outperformance, U.S. equities may see relative underperformance versus other asset classes. Our portfolios will always gradually shift to dampen the effects of these asset class shifts.

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