Multiples Expand, Margin Pressure is a Concern

While Q4 was especially favorable for equities, most stock and bond investors enjoyed a bumper year. Cash, the top performer in 2018, lagged in 2019 as central banks changed course and the S&P 500 rose to record highs. Over the past two years, however, cumulative gains have been more modest – particularly among foreign equities - as investors tried to gauge the impacts of higher interest rates and bruising trade war rhetoric. Concurrent monetary and fiscal support, mostly absent since the 2017 tax cuts, did not reappear until the second half of 2019 after several rate cuts, some Fed balance sheet expansion and, finally, demonstrable trade progress between the U.S. and China. Overall, stimulus is more in tune globally and investors seem pleased.

"Fed Chair Powell left no ambiguity after this month's meeting, when he indicated that the Central Bank wants to see inflation 'materially and persistently rise' before tightening again."

Strategas Research, Dec. 24, 2019

Index	4th Quarter Return	Year-to-Date Return	Cumulative Two Year Return
MSCI Emerging Markets Index	11.8%	18.4%	1.2%
Russell 2000 Index	9.9%	25.5%	11.7%
S&P 500® Index	9.1%	31.5%	25.7%
MSCI All Country World ex USA	8.9%	21.5%	4.3%
Barclays Bberg U.S. Agg Index	0.2%	8.7%	8.7%

Source: FactSet

From a factor perspective, quality and value outperformed momentum, minimum volatility *and* the S&P 500 this quarter, though we note investor preference for quality shares (and bonds) persisted throughout most of the year amid substantial geopolitical uncertainty. We commented on the relative attractiveness of Value in our Q2 letter, and subsequently addressed our underweight to the factor. Looking ahead to 2020, we would not be surprised to see the U.S. Dollar weaken a bit as ambitious campaign promises get made and the effects of rather coordinated global policy support start to lift animal spirits outside the U.S. The International Monetary Fund now expects the global economy to grow 3.3% next year, up from 2.9% in 2019, a 10-year low. We are therefore currently considering incremental allocations to international equities for their inherent cyclicality and positive correlation to U.S. Dollar weakness.

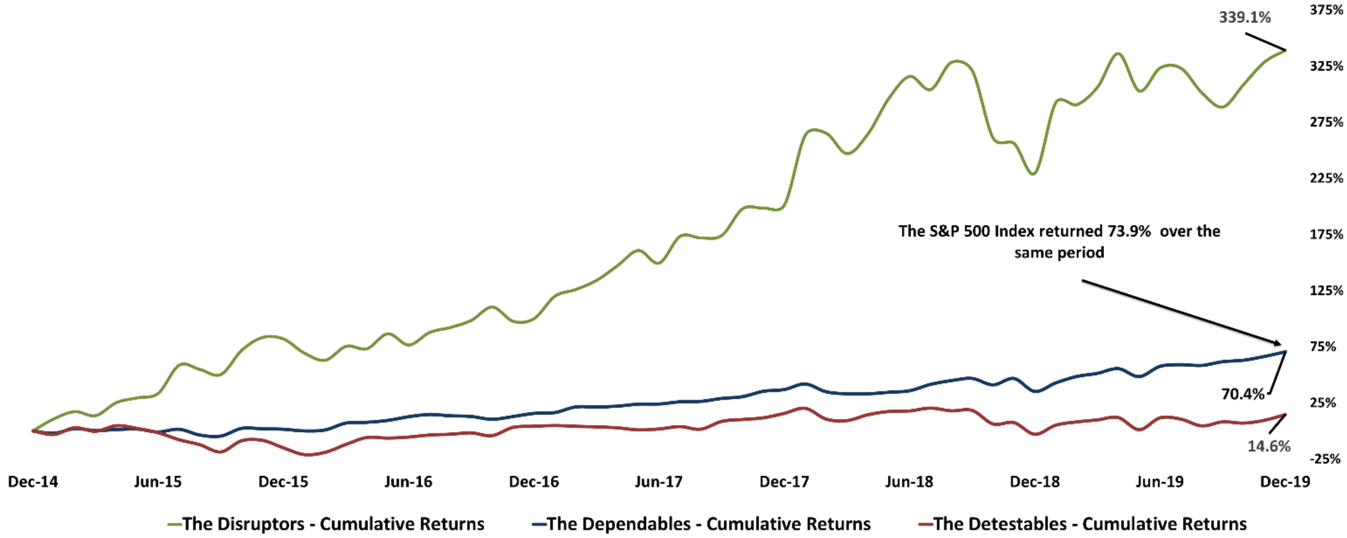
We think the recent performance of more cyclical shares and regions, while inflation expectations remain "anchored," could be noteworthy.

As we mentioned last quarter, global equities staged an impressive expansion of multiples this year – even as profits moderated in the U.S. and contracted elsewhere. Anticipation of both higher economic and earnings growth and subdued inflation expectations are key supports for such rallies, but here we inject a note of caution against overconfidence. Not only are profit margins demonstrably mean-reverting, but for many companies they are now quite high relative to history. Technological disruption notwithstanding, the historic commodity collapse of mid-2014 sharply deflated costs, delayed the QE exit plans of many central banks, and probably widened the gap between winners and losers in the following graph.

Corporate margins, essentially the percentage of sales that a company turns into profits, are high relative to history.

Stocks That Have Defined The Last 5 Years

As of 12/31/2014 -12/31/2019



We wish to avoid any complacency about the durability of profit margins that may have developed since 2014 due to low and exceptionally stable input costs. To illustrate, we have grouped the returns of three types of companies in the chart above: 1) *Disruptors*, shown in green, have enjoyed record profit margins and huge outperformance. Most FANG stocks are included here and, though narrow leadership is not atypical, the performance gap is striking; 2) *Dependables*, shown in blue, have been steady performers with consistently high margins relative to their long histories. In this group we include high dividend payers and stocks that exhibit low price volatility; and 3) *Detestables*, a basket of inflation-sensitive cyclical companies shown in red that have fared the worst, with fairly flat or declining margins. Many of these companies have experienced episodic earnings recessions since 2014.

Earnings and credit models that fail to contemplate rising input costs, or are overly dependent on high asset values, could experience a swift and surprising rotation or reversal.

We ask ourselves which kinds of companies in the graph above will prosper should input costs rise? Many within the red line, heretofore known as *Detestables*, are geared to make more money if the economy picks up steam and prices for raw materials go up. Judging by their declining share of equity indexes in recent years, they are under-owned. Will the shine come off "secular growers" (FANGs) if global growth picks up as expected and investors find cheaper ways to access expanding margins? It may not take much inflation to make today's momentum investors, many of whom are effectively short inflation (i.e. some of their favorite stocks may suffer as costs rise), realize they should be adding exposure to cyclicals. In addition, we can see that policy-makers on both sides of the aisle are beginning to understand how intractable current demographic headwinds are, and how disruptive new technologies can be. As politicians try to engineer change on behalf of their constituents, it's likely their efforts will not be deflationary. Our recent actions taken to rebalance client portfolios underweight the Value factor, and our deliberations about raising foreign equity weights, are efforts to keep client assets diversified against the possibility of changes in market leadership ahead.

Some think the relative trajectories of growth and value stocks have been permanently reset. We would not bet the farm on that.

Robert G. Scott
Chairman & CEO

Fraser J. McLean
Chief Investment Officer

Endnotes

Sources of graphs and data not specifically cited: NAM Corp, FactSet, Strategas Research, MSCI and Blackrock. Referenced indexes in U.S. Dollars, unless otherwise stated. All equity returns include reinvestment of dividends. The MSCI Factor Indexes are rules based indexes that capture the returns of systematic factors such as low volatility. All return data through December 31, 2019, unless otherwise stated.

Chart: Our proxy for "The Disruptors," consists of a equally weighted basket of Facebook, Amazon, Google and Netflix. The disruptors can be volatile, often have little debt, and record or little to no profit margins. *Low volatility and dividend stocks,* shown by "The Dependables" have steady month-to-month performance and often record profit margins. The *Low volatility and dividend stocks* are represented by an equally weighted return composite of the iShares Edge MSCI Min Vol USA ETF, iShares Core High Dividend ETF and iShares Core Dividend Growth ETF. *Hi-beta and cyclical securities*, shown by "The Detestables" generally have been out of favor since 2008, in a profits recession since 2014 (energy, industrial metals, and shipping stocks). "The Detestables" are represented by a equally weighted return composite proxy of Materials Select Sector SPDR Fund and S&P Energy Select Sector Index. The Detestables are heavily disrupted, or victimized by a strong U.S. Dollar (emerging markets).

All data is in USD, and Total Return represents the sum of the dividend, changes in earnings and multiple estimates for each ETF. Investors cannot invest directly in an index, nor is an index subject to fees and expenses associated with investment funds or accounts.

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