Market Newsletter & Opinion

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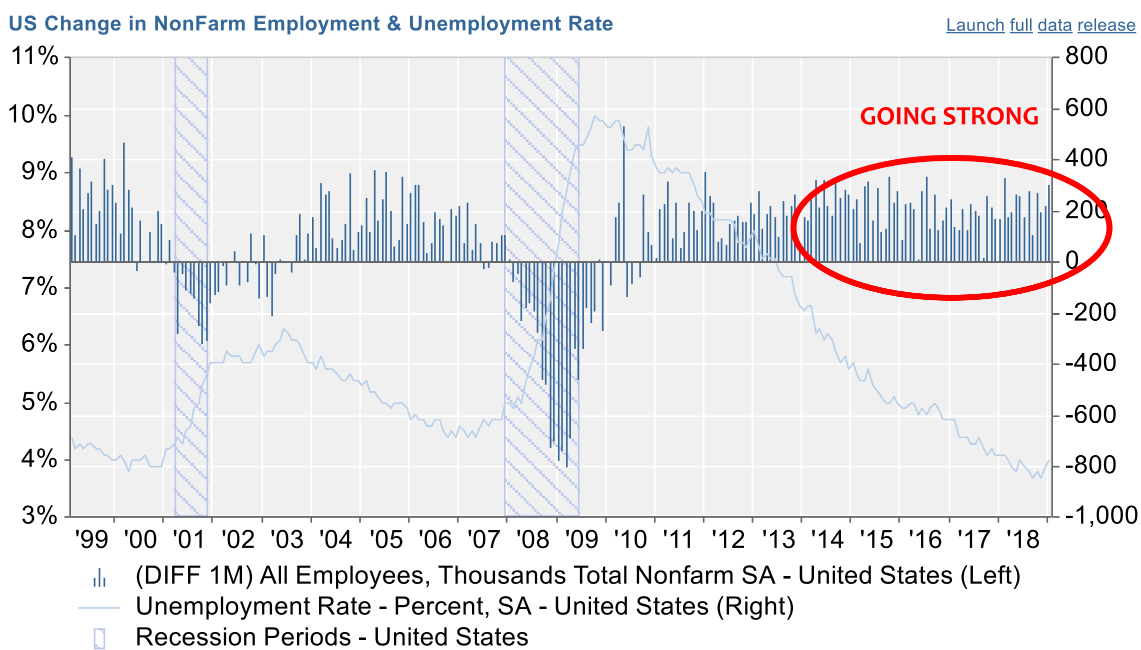
After Recession Scare, Bull Market Remains

Summary: Big rebound in stocks to start 2019 leaves professional worriers behind. Stocks tanked in the last quarter of 2018. Essentially, many investors had become convinced that a recession was on the horizon and competed with each other to sell stocks ahead of the expected bad corporate and economic news. Why were investors convinced that things were turning south? The most significant factor (but not the only one) was the Federal Reserve's insistence on tightening monetary policy and apparent lack of sensitivity to markets. Unfortunately for those who sold positions, the Fed subsequently completely changed its posturing and adopted a friendlier stance for stocks. Simultaneously, economic data remained fairly robust, thus spurring a 12% rise in the S&P500 to start 2019

Employment is the Most Important Factor for Consumer Spending

And consumer spending is 2/3 of U.S. economic activity. Despite pervasive fear among professional investors, a stock market decline, political rancor including the longest-ever government shutdown, softening housing metrics, slowing growth abroad, trade disputes between the two largest economies in the world and Brexit, the U.S. economy continues to add new jobs and bring more individuals into the workforce. Given all the excuses we just annotated, the job growth speaks to the underlying strength of the economy, in our opinion. Further, more jobs usually leads to more spending and more economic activity for a consumer-spending based economy like the U.S. This is an over-simplification. However, we find that focusing on jobs and the consumer helps us to avoid getting caught up in media-related panics and to stay in stocks for the right reasons. See Figure 1 below for the change monthly jobs (the vertical blue bars) and the U.S. unemployment rate with shaded columns representing recession.

Figure 1.



Economic Cycles Don't Die of Old Age

In five months, the current U.S. economic expansion will become the longest ever. This should be a cause for celebration, but instead many investors will look on it as a negative. These investors believe in the cyclical nature of the economy. Accordingly, an exceptionally long expansion can only mean that stocks are past their purchase-by date and a recession must be coming soon, according to this thinking. Our view, on the contrary, is that the length of the economic cycle has no fixed duration. We also don't see signs of things of some of the conditions that have created recessions in the recent past including a reduced availability of credit (such as occurred after the housing crisis in 2008-2009) or the Federal Reserve raising rates too quickly (which precipitated the dot-com bust in 2001). Accordingly, while we are always cautious, we currently believe the near-term outlook for the balance of 2019 is attractive.

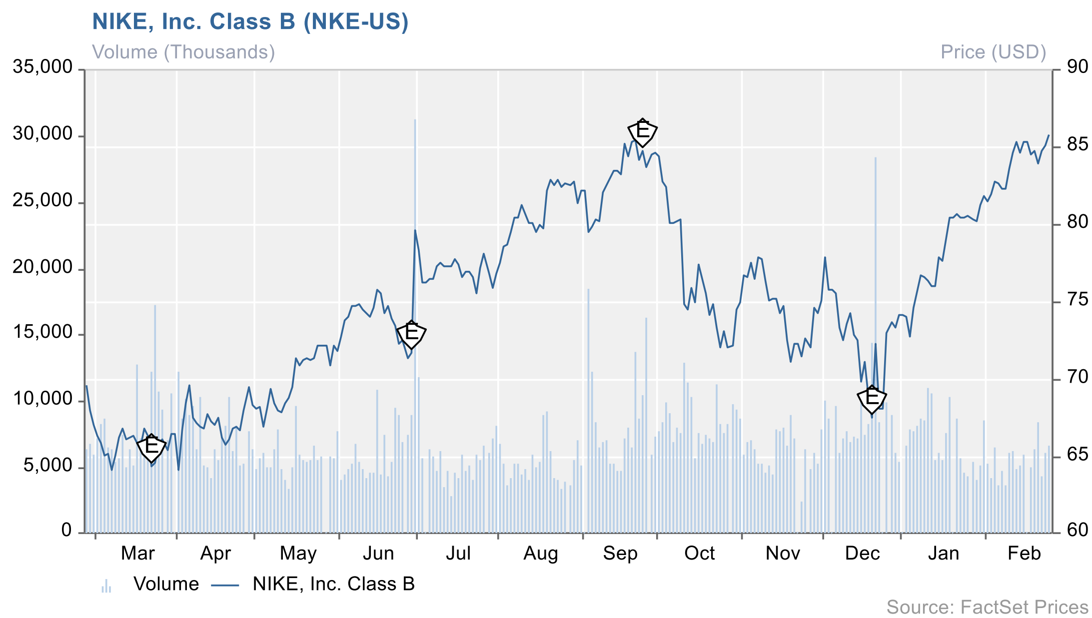
How We are Managing Our and Client Money:

Our assumption is that our ability to forecast the overall market and macroeconomic conditions is highly limited. Accordingly, while we try to understand current conditions and trends, we try to make investment selections based on a long-term view and look for companies we can own throughout the economic cycle. The stocks of the best companies will still go down in a recession but these businesses oftentimes benefit from challenging economic conditions as weaker competitors fail and cede share.

Selection from our model portfolio: Our approach is to own high-quality companies, bought opportunistically, and own them long-term with the intention to minimize trading costs and taxes. Our portfolio is concentrated (~20 positions) and generally we are favorably inclined towards companies we *know* or at least find easy to understand.

Nike, Inc. (NKE): Fans and marketing executives alike were horrified last week when Duke Star Zion Williamson's Nike shoe essentially spilt open at the onset of a game vs. rival UNC, sending him out of the rest of the game, which had just started. Nike shares fell about 1% on the news, before recovering and are hitting a new all-time high as we write. Shouldn't exploding shoes be a bigger deal and cause for concern? Essentially, we believe the market shrugged this off because NKE totally dominates the U.S. basketball shoe market with some sources estimating a share of > 90% when taking together Converse (owned by NKE), Brand Jordan and Nike. Basically, there is no viable alternative. We like Nike for this theme of total market dominance. We also view Nike as one of the best-run and most complete global consumer branded companies. Nearly 55% of Nike's revenues come from outside the U.S., its marketing strategy of aligning with the very best talent in each respective sport has served to elevate the brand, and the company generates very strong cash flows which are in turn used to augment financial returns for shareholders. Beyond these considerations, and consistent with an investment theme we have discussed in previous newsletters, NKE is a leader in using technology to connect with its consumers. The company has developed and is in the process of developing new shopping apps to sell directly to consumers and, in part, bypass 1,000s of retail stores operated by its wholesale partners. Nike is able to make this happen because, as we mentioned above, its brand power and market dominance brings consumers to the company. Further, as you might imagine, selling directly to consumers is much more profitable for Nike than selling via third-party retailers. Summing up, we see the company continuing to grow and dominate its markets globally, generate excess cash flows and experience rising margins over time which should support ongoing outperformance for the shares. Please see the NKE chart below.

Figure 2.



This month I am traveling back to Shanghai, China. I am attending an investor event hosted by YUM China (NASDAQ: YUMC) which is an independent company and was spun off in 2017 from YUM Brands. You may not know the corporate name of YUM Brands which is based in Louisville, KY but you know the brands it owns, operates and franchises including KFC, Pizza Hut, and Taco Bell. Yum China owns the rights to these brands in China and is the largest restaurant operator in China with approximately 8,000 locations. My visit to Shanghai is primarily motivated by researching this company but I will also be trying to learn as much as possible about the Chinese outposts of other U.S. companies and China in general during my second visit in the past year.

If you or someone you know is looking for help investing in the markets, please get in touch to discuss whether our equity portfolio is appropriate. An archive of our past newsletters can be found on our website by clicking this link .

Yours,

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The analyst who is the author of this report has a long position in Nike, Inc. (NKE). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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