“Effective managers live in the present…….but concentrate on the future.”
JAMES L. HAYES

Third Quarter 2018 Review and Commentary

The recently completed third quarter was a good one for the U.S. equity markets characterized by reduced volatility and strong returns, propelled by a solid economic expansion and impressive corporate profit growth. Despite rising interest rates, more rhetoric about tariff wars and signs of slower worldwide growth, the U.S. GDP powered ahead 4.2% in the second quarter, corporate profits increased by 26 % and unemployment continued a slow decline to multi-year lows. In the fixed income arena, the two-year U.S Treasury note rose from 2.52 % at the end of June to 2.81 % at the end of September. Similarly the benchmark 10-year U.S. Treasury closed the quarter yielding 3.05%, up from 2.85% at the end of June.

After negative returns in the first quarter and modest gains in the second quarter, the S & P 500 Index produced a 7.7% total return in the third quarter, its largest gain since the fourth quarter of 2013. Many observers credit this rally to investor faith in the U.S. economy which has shown renewed strength this year while growth has cooled in the Eurozone and emerging markets. During the quarter, large cap stocks outperformed small cap stocks and growth, once again, outperformed value stocks although the margin was narrowed in the large cap universe. Health care stocks advanced 14.1% while Industrials gained 9.7 % and Information technology increased 8.5%. Interestingly, two stocks – Amazon and Apple - accounted for almost 25% of the S & P 500's quarterly return.

In light of the returns produced by the market indices, Metis Value Partners had a challenging quarter. The concentrated MVP Value strategy had a total return of -1.37 % while the Russell 1000 Value Index had a total return of 5.71 %. The concentrated MVP International strategy had a total return of 0.22 % compared with a total return of 1.35 % for the MSCI EAFE Index. Lastly, the MVP Dividend Income strategy had a total return of 1.29 % compared to the Dow Jones Global Select Dividend Index with a total return of 2.83 %. However, the year-to-date performance remains solid with MPV Value producing a total return of 10.40 % compared to the Russell 1000 Value Index with a return of 3.92 %. The MVP International Value had a total return of -3.63 % while the MSCI EAFE Index had a return of -1.43%. Lastly, the MVP Dividend Income had a total return of 4.82 % compared to the Dow Jones Global Select Dividend Index having a return of -1.34 %. It should be noted that MVP's strategies are not designed to consistently beat the popular averages. Instead, we allow our investment process to lead us to the best values at any given time with the expectation that MVP's results will add value over a full business cycle.

As investors turn their attention to the fourth quarter, their outlook is buoyed by the continuing strength in the U.S economy with every indication that GDP likely grew between 3.5 % and 4.0 % in the third quarter and corporate profits are estimated to rise about 19% for the S & P 500 companies. Consumer confidence is near an all-time high which should bode well for the all-important Holiday shopping season. Growth in the fourth quarter will probably slow somewhat from the torrid pace of the summer months and corporate profit growth may show signs of a slowdown.

Then, as 2019 unfolds, economic growth and corporate profit increases may moderate further as the favorable effects of the 2017 tax cuts begin to diminish. In light of the current conditions and the prospect for more modest economic and corporate profit growth in the coming year, it is important to take stock of where the markets are after a nine-year bull market.

The following table seeks to present various market valuation metrics that are widely used to assess market risk. While they are, by no means, the only measures used to evaluate risk, they have proven helpful in the past to identify periods when market risk is elevated. In this regard, it is clear that most commonly used metrics suggest the market is fully valued with the median metric in the 89 percentile in comparison to the most recent 40-year period. This begs the question……what's next for the equity markets?

S & P 500 Valuation Is Stretched Relative To History

Median valuation measure for S&P 500 is in 89th percentile vs. 40-year history

	Aggregate index		Median stock	
S&P 500 valuation metric	**Current**	**Historical %ile**	**Current**	**Historical %ile**
US market cap / GDP	185 %	**99 %**	NA	**NA**
EV / Sales	2.4 x	**97**	2.9 x	**99**
Cyclically adjusted P/E (CAPE)	28.7 x	**90**	NA	**NA**
Price / Book	3.5 x	**89**	3.5 x	**100**
EV / EBITDA	12.0 x	**89**	12.2 x	**97**
Cash flow yield (CFO)	7.1 %	**87**	6.8 %	**98**
Forward P/E	17.1 x	**83**	17.2 x	**87**
Free cash flow yield	4.1 %	**51**	3.9 %	**61**
S&P 500 yield gap	300 bp	**38**	NA	**NA**
Median metric		**89 %**		**98 %**

Source: FRB, FactSet, Compustat, and Goldman Sachs Global Investment Research

While few if anyone is willing to call an end to the current bull market, by some measures the longest in history as of August, it is wise to assess the headwinds that seem to be building within the U.S and global economies. Most are aware of the tariff wars, rising interest rates, the contentious mid-term elections, rising budget deficits, the slow-down in emerging markets, and concerns about Italy, Turkey and (always) the Middle East. The current slow-down in China could also be problematic. However, in addition to all these seemingly "ever-present" worries to give investors pause, some noteworthy observers believe that the next crisis that is likely to develop will emanate from the fixed income markets. While the U.S. Government debt climbs higher year after year with trillion dollar annual deficits projected for the next several years, it is the U.S. corporate debt situation that could be the next catalyst to tip over the apple cart.

With the Federal Reserve's policy of keeping near zero interest rates for much longer than some feel was necessary, corporate treasurers have taken advantage and issued more debt than at any time in recent memory. This increase in corporate debt is of little current concern given the exceptionally low interest rates that have existed for many years. However, the Federal Reserve has been raising short term rates over the last two years, actually eight 25 basis point increases, and has plans to raise rates one more time in 2018 and perhaps three more times in 2019. The latest figures released over the summer showed that U.S. corporate debt was close to ***$6.3 trillion***. While these figures are impressive, more troubling is that ***$1.3 trillion*** must be refinanced by the end of 2020 and ***$3.0 trillion*** is set to mature over the next five years. Should interest rates continue to rise over the next few years, the cost of refinancing this debt will be a much larger drain on corporate cash than at the present time. This problem is not limited to the U.S. Global nonfinancial corporate debt is up nearly 80% over the past ten years. All of us recall that U.S. households set themselves up for financial ruin in the run-up to the Great Recession by borrowing against the equity in their homes. Corporations are today's addicts and high debt levels makes them more vulnerable to any equity market correction.

To be sure, the increase in corporate debt has largely been used to repurchase common stock and enhance the cash dividend. While this sounds great at first blush, it is somewhat troubling that corporate managers are spending their precious capital at a time when stocks appear fully valued as shown in the previous table. To put some hard numbers on this corporate largess, according to Trim Tabs Investment Research, U.S. public corporations have announced $835 billion in stock buybacks so far this year, more than the previous annual record of $810 billion in 2007. It shouldn't be necessary to remind readers that 2007 was just before the top of the previous bull market. And, there is industry talk that buybacks in 2018 will top ***$1.0 trillion***. Interestingly, a recent look at insider buying by corporate executives reveals a completely different picture. Again, according to TrimTabs, corporate insiders sold $10.3 billion worth of stock in August 2018. Incidentally, that's the highest amount of selling in August over the last ten years. And, in September, insiders sold another $7.0 billion of company shares. By the way, the TrimTab database includes all Form 4 Securities and Exchange Commission filings that officers, directors and major shareholders must file.

While hard to believe, there is another aspect of corporate debt that is equally troubling. Although it hasn't attracted much attention, almost 50 % of all U.S. corporate debt is now rated BBB, one notch above junk bond levels. No one appears to care about this fact because investors, rating agencies and Wall Street marketers have been lulled into complacency by the strong economic recovery and surging corporate profits. As all are soothed by reassuring words from all quarters, no one seems to appreciate that a similar event occurred in the housing boom of the early 2000s when Wall Street took sub-prime mortgages and repackaged them into tranches that established rating agencies rewarded with a Aaa rating. After the meltdown, investors wondered how they could have been so stupid as to believe the rationale behind such securities.

Lastly, the extended period of near zero interest rates has fostered the existence of what Stanley Druckenmiller calls "zombie" U.S. corporations. Speaking at the Grant's Interest Rate

Conference in early October, he said that each rate increase by the Federal Reserve is like the removal of a brick in the game of Jenga. You never know which move will take down the tower but one eventually will. To be sure, when the economy turns down or perhaps long before a turndown, the fixed income markets may very well be the lynch pin in the house of cards. Inevitably, there are always investors who adhere to the belief that the economy will muddle through the problems one by one and their investments will be safe and secure. While most times that approach has worked out reasonably well, there is also a school of thought that states emphatically that stability leads inevitably to instability. Borrowing a theme from an earlier part of this commentary, as investors (both individual and institutional) become more and more confident that the economy is in great shape and there are no signs of excesses on the horizon, investors feel emboldened to take a “bit more risk” in the quest for just a “little more return”. Step by step, these seemingly small steps plant the seeds for trouble in the future. Unfortunately, the longer the stability lasts, the more risk an increasing number of investors will take until eventually an event occurs that triggers a collapse. No one knows when the sand will run out of the hour glass but all experienced investors should realize that “nothing lasts forever” and “trees don’t grow to the sky”.

By way of contrast, within MVP’s strategies we are seeing managements strengthening their balance sheets while making very conservative capital allocation decisions. For example, Carnival Cruise Line has reduced debt from $ 8.3 billion to less than $7 billion in the last two years while reducing their share count, boosting its cash flow and maintaining its market share in its industry. Similarly, we are seeing significant deleveraging in other companies including Chesapeake Energy and Barrick Gold. In essence, we favor good management teams that act as business owners while trying to minimize business risks.

After a bull market that some measures suggest became the longest in history in August 2018, it is certainly time to take stock of your asset allocation and equity exposure. As mentioned earlier in this commentary, growth oriented investments have outperformed value oriented investments for the better part of ten years. With such an extended period of outperformance, it is only natural for a ***regression to the mean***. In essence, the time for value oriented equities to have a resurgence is long overdue. At the very least, with extended valuations and excellent gains already realized from growth oriented equities, moving equity allocations from a growth to a value manager may be a wise decision. Such a move would enable an investor to continue exposure to the equity markets while lowering the risk profile of the portfolio. Warren Buffett famously stated: ***The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."*** On the other hand, growth investors always pay up for growth and history has proved them wrong time and time again. As Buffett has remarked: ***"You never know who's swimming naked until the tide goes out."***

Metis Value Partners offers three concentrated value strategies: Value, International Value and Dividend Income. One or a combination of these three portfolios will provide a well-structured portfolio of high quality companies that have been extensively researched and offer the very best investment ideas for the challenging times in which we live. As we often say, in all market environments, **"*know what you own*"** by focusing on balance sheet and income statement analysis. Remember, MVP thinks as a business owner and allows our investment process to guide us. As a result, we only put the very best ideas, with an adequate margin of safety, into our three concentrated strategies.

As always, we appreciate your support and stand ready to assist you in any way we can to help grow your AUM. Should you or your clients have any questions about the portfolios, the economy, or personal issues, please be assured that we are always available for consultation.

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