# Market Letter

Market Perspective Third Quarter 2018

## KEEPING AN EYE ON THE BALL

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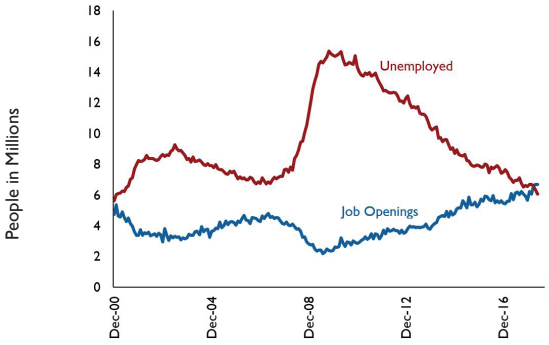
**IN THIS PUBLICATION**



Concerns about U.S. trade policy, the potential for later-cycle inflation and higher interest rates have combined to blunt the delivery of robust corporate earnings. Accordingly, blue-chip equities have struggled to gain ground so far this year. In contrast, small-cap stocks have rallied amid lower U.S. tax rates, a recently resurgent dollar and the threat of tariffs.

### Extremely Tight Labor Market

More Than One Job for Every Person Unemployed




*Source: Bureau of Labor Statistics*

We tip our hat to the domestic drivers of this small-cap trade; indeed, the U.S. economy looks like a fat pitch to us. As evidenced by the accompanying chart, unfilled jobs domestically now outnumber those unemployed for the first time since this record-keeping began. Plentiful jobs and the personal income they produce should continue to power U.S. consumption and the broader economy, to the extent we could see what has become a relatively rare 4 percent-plus GDP growth number reported for the second quarter.

While the labor market is tight, wage inflation remains muted and with tax reform providing an attractive window of 100 percent capital spending write-offs for the next five years, companies are incented to invest in the type of productivity-enhancing software and equipment that can help keep the overall price level in check. Two-percent core inflation is finally at the Fed's target, and with a pragmatic chairman at the helm, we see a central bank less likely to overtighten amid the currently constructive backdrop.

Long-term interest rates have risen this year, but barring an unexpected inflation surge, we don't foresee benchmark 10-year U.S. Treasury rates moving dramatically above 3 percent. Bond prices have declined year-to-date, but if past is prologue, what we foresee as a rare year of modestly negative fixed income returns is unlikely to be repeated.

Regardless of the political outcome, equity returns have proven to be back-end loaded in mid-term election years, and with valuations having moderated amid 20 percent-plus expected earnings growth in 2018, we foresee the same kind of outcome this year. Accordingly, we remain constructive on equities while favoring international stocks therein and maintain our underweight to the fixed income asset class.

Founded in 1975, Ferguson Wellman is a privately owned registered investment advisory firm, established in the Pacific Northwest. As of January 1, 2018, the firm manages over $5.1 billion for more than 790 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and endowments and foundations with portfolios of $3 million or more. West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at $750,000.

**INVESTMENT EXCELLENCE**
**LIFELONG RELATIONSHIPS**

*Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius*

## FRED SANFORD AND THE GREAT EQUITY SHRINK

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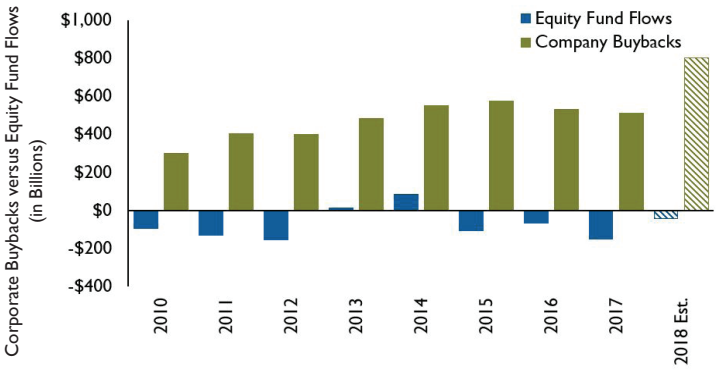
*"Oh, this is the Big One! You hear that, Elizabeth?! I'm comin' to join you, honey!"* —Fred Sanford, aka the comedian Redd Foxx in the NBC Sitcom, "Sanford and Son" circa 1972-1977

Still smarting from two 50-percent declines in the first decade of this millennium, individual investors have largely sat out one of the greatest bull markets in history. This is true for individual investors in general but is even more prevalent amongst younger investors. According to a new Gallup poll, only 38 percent of adults under the age of 35 have investments in public companies. This is down from 52 percent before the 2008 financial crisis. This decline in ownership occurred regardless of gender, household income or education.[1]

For those of a certain age, one can't help but think of TV's most famous junk dealer, Fred Sanford, who, whenever faced with adversity would feign his trademark mock heart attack — gripping his chest, looking skyward and calling out in vain to his late wife, Elizabeth. As an investor class, individuals are perhaps unwittingly channeling Mr. Sanford, perennially on the lookout for … "*the next big one*." That is, the next stock meltdown that seemingly never comes.

This behavior has not been solely the provenance of individual investors. By way of example, over the last 15 years the average foundation/endowment fund has gone from 50 percent invested in publicly-traded equities to only 36 percent today.[1] Astonishingly, despite a fourfold increase in share prices, virtually every investor class, both institutional and individual alike, owns fewer publicly-traded equities than they did a decade ago.[2] This is, *the most hated bull market of all time*. For those invested and still bullish, this is perhaps good news. The euphoria that normally accompanies the end of a bull market is still, thankfully, largely absent. Two contemporary bear markets have precipitated profound changes in both the *pool of available publicly-traded equities and the shareholder constituents who choose to own them*. What's more, there are now *more indices that track stocks than there are listed stocks*.

### Corporations Have Been Massive Buyers of their Own Shares for a Decade




*Sources: ICI and Goldman Sachs*

There has been a precipitous decline in the number of listed stocks in the U.S. since 1996. This is in contrast to the prior two decades where there was a steady rise in listings. The Wilshire 5000 Total Market Index now has only 3,816 stocks in its universe, and there are now fewer companies listed on an exchange today than in 1976. This despite the fact that U.S. output (GDP) is three times larger than it was back then.[2]

Curiously, this has been a phenomenon largely confined to the U.S. While new listings declined by more than 50 percent in the U.S. from 1996 through 2016, they actually rose by nearly 50 percent in other developed countries. There is now a "listings gap" of about 5,800 companies between the U.S. and the rest of the world. This occurred even though the U.S. equity market represents 53 percent of the global stock market. Models that measure how many companies should be listed (based upon GDP

*Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius*

growth, population growth and measures of corporate governance) suggest that the U.S. should now have in excess of 9,500 listings. Yet the number of companies eligible to list continues to grow, now about 600,000. What's more, the reported "propensity to list" has declined dramatically. This is largely a function of the costs associated with listing, and perhaps much more significantly, the onerous additional regulatory burdens that come with operating as a public company.[2]

While there are many reasons for this sea change, the near parabolic rise in the amount of investment capital resident in private equity firms has been perhaps the most significant. There now exists a significant imbalance between the number of companies leaving the public markets due to mergers and acquisitions (M&A) and new ones entering via initial public offerings (IPOs). M&A activity has flourished, while IPOs have been largely stagnant. These patterns are the same for both the NYSE and the NASDAQ. In 1980 there were only 24 private equity firms in the U.S. and annual deal volume was about $1 billion. Today the number is about 4,000, 95 percent reside in the U.S. and deal volume is about $825 billion annually. This figure is 10 times what it was in 1996. The two largest private equity firms, The Carlyle Group and KKR & Co., collectively employ nearly 1.5 million people via their portfolio companies, which is *more than any other listed company except for Walmart*.[1,2]

But if individual and institutional investors have been on balance net sellers of public equity for nearly a decade, and if these investors are collectively the *de facto owners of virtually all publicly-traded equity*, who then … *has been the marginal buyer*? Over the last decade, American companies have repurchased nearly $5 trillion worth of their own common equity.[3] This trend seems to show no signs of abating either. It appears that 2018 will be a record year for this activity. This is largely the result of the large tax cuts U.S. corporations will enjoy this year, coupled with many trillions that will return home due to the greatly reduced taxation of repatriated profits earned abroad. It is also of paramount importance to note that … *almost universally, these repurchased shares are retired*. That is, the shareholder base is reduced, resulting in more earnings, cashflows - and dividends flowing to - and spread amongst fewer shareholders. This cycle is indeed virtuous, and a very good thing for shareholders.

These two themes are important for investors to understand and consider in our view — and will undoubtedly continue to impact the investing landscape both now and in the future. While there are a variety of takeaways, the principal consequences are these: industries in public markets are now more highly concentrated, and the average listed stock is bigger, older, more profitable and much more likely to dispense cash to shareholders.[2] Also, the propensity for U.S. companies to use both excess cash and cashflows to repurchase their own equity continues apace. Both of these trends would seem to provide very strong underpinnings for the owners of equity and would explain the upward trend in prices we have enjoyed for some time.

It is unfortunate that a generation of investors have largely missed what has been by any measure … *a spectacular, decades long bull-run*. It is also not at all unreasonable for investors to fear the return of Fred Sanford's "heart attack." But at least by our lights, that day would seem to be a long way off.

*Weapons of Reason* Footnotes and Sources:

1. Jason DeSena Trennert, "The Future of Public Equities (Millennials are Underinvested)," *Strategas Research Partners*, May 25, 2018.

2. Michael J. Mauboussin, Dan Callahan, Darius Majd, "The Incredible Shrinking Universe of Stocks: the Causes and Consequences of Fewer U.S. Equities," *Credit Suisse*, March 22, 2017.

3. M. Diver, I. Jenkins, A. Harmsworth, S. McCarthy, et al., "European Equity Strategy: Conclusions from Corporate Cash Use," *A | B Bernstein*, February 20, 2017.

4. Jason DeSena Trennert, "Requiem for The New Normal: A Real Business Cycle Emerges," *Investment Strategy Outlook, Strategas Research Partners*, June 2018.

## BOND BEAR MARKET

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Executive Vice President of Research

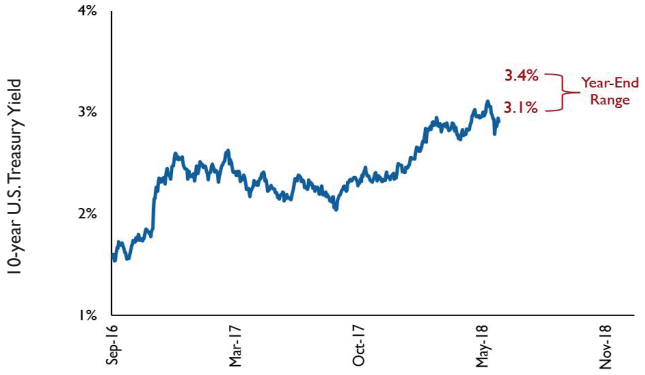
Investors may notice that the returns for their fixed income assets are negative for the year with most bond indexes down approximately 2 percent. Interest rates and bond prices move inversely to each other so when interest rates rise like they have this year, the prices of bonds fall. The silver lining of rising interest rates is that the declines in bond prices are temporary as investors will get their money back at maturity. In addition, investors then have the opportunity to reinvest at higher interest rates which will increase the portfolio income.

Unlike bear stock markets, bond bear markets are not that scary. The rising interest rates we have been experiencing have created a bear market in bonds – but it is more of a *teddy bear* rather than a *grizzly bear*. Looking at the history of bond bear markets one has to dig in the data to find them. In the 42 years of the existence of Barclays Aggregate Index, which is a broad proxy for the bond market, there have only been three negative years. The worst annual negative year was 1994 when the index returned -2.9 percent. Historically, there has never been two consecutive negative years in the bond market.

Bonds have been disappointing this year with negative returns; however, it is critical to remember why it is important for investors to have an allocation to bonds. We view fixed income as cheap insurance for market downturns. Bonds and stocks are normally inversely correlated so that when stocks decline in value, bonds appreciate as investors rush to the relative safety of fixed income.

We do think that interest rates will rise this year, but not enough to choke off the economic expansion. While we do believe the Federal Reserve will increase short-term interest rates another two times this year, we don't see a reason for the Fed to be more aggressive. While short-term interest rates are set by the Federal Reserve, long-term interest rates are set by the market. We don't see enough current or perspective inflation in the economy that would drive longer-term interest rates much higher.

### Expect Rates to Go Up, but Not Dramatically




*Source: Bloomberg*

## Communication and Education

*We have moved our communication and education section of Market Letter to our website. To access this online feature and to see our industry definitions, please visit www.fergusonwellman.com/investment-terms.*

*If you would like a printed copy of our Glossary of Investment Terms reference guide, please email info@fergwell.com and we will send it to you in the mail.*

*Our logo features a bronze coin of Marcus Aurelius Antonius, Emperor of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of meditations that reveal a mind of great humanity, natural humility and wisdom.*