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Summer 2018

To be or not to be...

The first half of the year on the economic front, as we will outline, has been quite good. However, the continual banter related to tariffs being imposed (or threatened), retaliatory actions taken (or threatened), have provided constant volatility throughout the global markets. Prince Hamlet, were he around today, would surely have been inspired....Are things in good order, or not?....'That is the question.' We will allow others to discern the political banter, but we would however like to pass along three points provided to us from private money manager, Marshfield and Associates[1], as it relates to their opinion on the potential impact of a trade war, were it to progress:

First: Historically, markets tend to equilibrate. If China can't get its soy from the U.S., it will get it from someplace else, forcing the existing customers of their new suppliers to themselves find a new supplier such as...the U.S. This is precisely what happened in 1980 with President Carter's embargo on selling feed grain to Russia. In the wake of that embargo, global feed grain sourcing patterns abruptly changed, resulting in a surge in U.S.-sourced grain orders from countries that historically had bought their grain elsewhere.

Second: Companies adapt. Harley-Davidson moving some of its production to Europe is but one example. Is that optimally efficient? No, but it's a marginal change that helps dampen the impact on the company.

Third: Many companies have complex international supply chains that might suffer temporary disruption if the relative cost of some inputs in some locations rose sharply (as with steel in the U.S.), but they would likely adjust pretty well to any permanent shift. The better a company is at bailing any water they take on (through no fault of their own), the better their ability not only to stay afloat but to continue to move forward.

These three reasons, specifically the third, is why we rely heavily on the expertise from outside fund managers that can pinpoint companies with solid fundamentals such as growth in earnings and the generation of robust free cash flow, both in the United States and abroad.

"It was the best of times…

Hard to believe, words written nearly 160 years ago in Charles Dickens' "A Tale of Two Cities" could prove so true even today, specifically as it relates to the second quarter of the 2018 market and economy. We remain surprised, investors abroad, continue to shrug off numerous positive trends and undertones as it relates specifically to the U.S. economy. Robust Q2 earnings growth is widely expected in large part because of the tax cut package passed at the end of last year.

As you can clearly see on the chart below, in December of 2017 (the same time period in which the tax relief act was passed), corporate price to earning ratios took a nose dive. Typically when we are looking at charts referencing the markets or corporate profits we don't like to see them go down, but in this case, this is good...great news. The reduction in corporate taxes, basically over night, brought valuations back to similar levels we had not seen since early 2015, or a 20% decrease.

SP 500 Forward PE

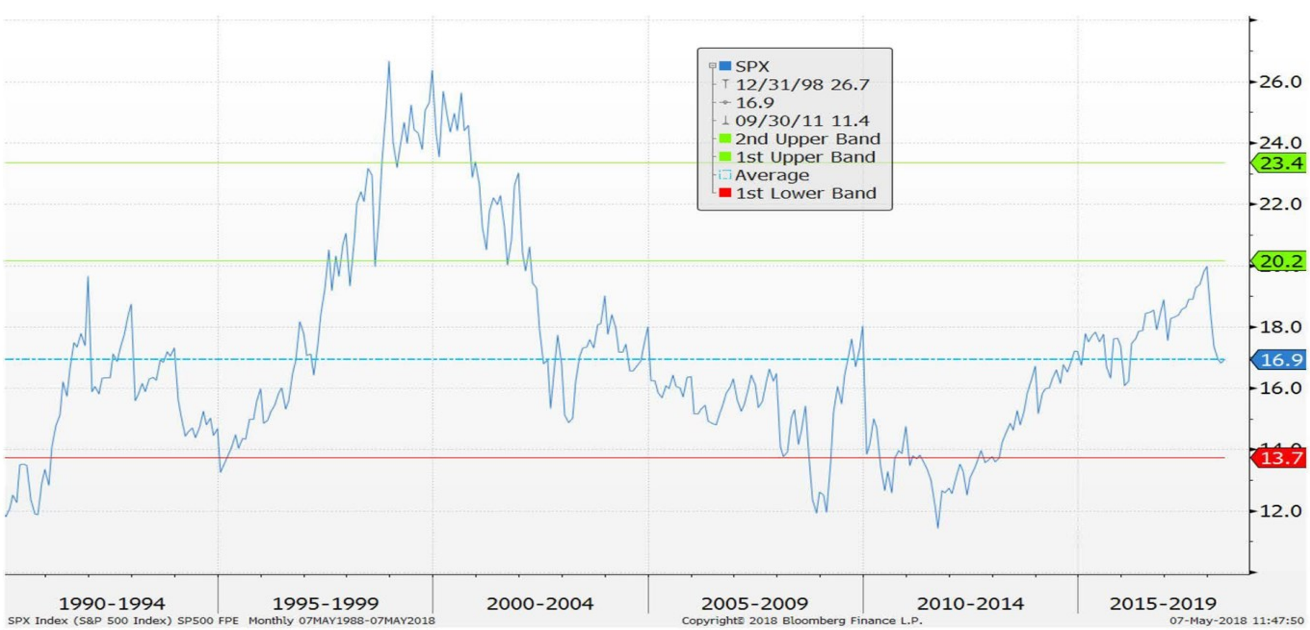


Chart Significance: The forward price to earnings ratio of the S&P 500 index is one way investor s use to determine if stocks are "fairly" priced.

A price to earnings ratio or P/E indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. If a company were currently trading at a multiple P/E of 20, for instance, the interpretation is that an investor is willing to pay $20 for $1 of current earnings.

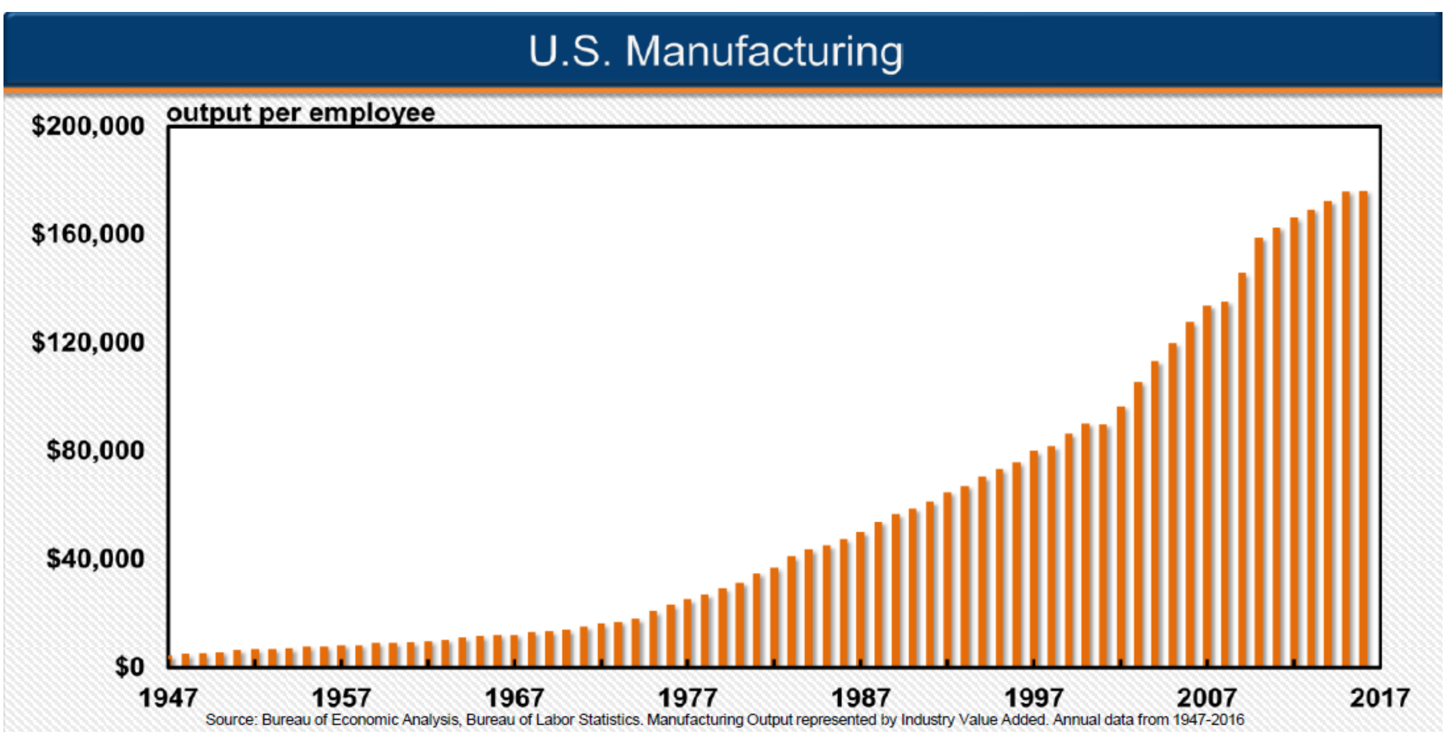
Example:

Were we to calculate the P/E ratio for Wal-Mart Stores Inc. (NYES: WMT), as of November 14, 2017 when the company's stock price closed at $91.09. The company's profit for the fiscal year ended January 31, 2017was $13.64 billion and its number of shares outstanding is 3.1 billion. Its EPS can be calculated as $13.64 billion / 3.1 billion = $4.40. Wal-Mart's P/E ratio, therefore, $91.09/ $4.40 = 20.70.[2]

In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. A low P/E can indicate either that a company may currently be undervalued or that the company is doing exceptionally well relative to its past trends.

We also feel full of energy after downing a bunch of pixie sticks! The bigger questions is whether this growth will prove sustainable. We believe it will. For instance, non-farm payrolls grew 223,000 in May and are up 2.4 million in the past year. Civilian employment, an alternative gauge of jobs that better measures small business start-ups, grew 293,000 in May and is up 2.3 million in the past year. Government jobs are up just 21,000 in the past year, while manufacturing payrolls are up 259,000 in the past year, the fastest twelve-month increase since 1998[3]. The number of jobs increasing in the economy is many times a solid measure as to the longer term strength of the economy, and we surely are showing good signs of that. But perhaps equally, if not more importantly than the number of jobs, is the output from those workers. As technology across multiple sectors of the economy continues to enhance, so too does the output from its workers. Below visually depicts how the U.S. Manufacturing worker has increased their productivity over time.

Our simplistic formula is this: More Workers + Doing More = Strong Economy



...It was the worst of times"

"Instead of complaining that the rose bush is full of thorns, be happy the thorn bush has roses."

- Proverb

Within months, the retail brick and mortar space has been rocked. Toys "R" Us closed all 735 stores after filing for bankruptcy in September 2017, Sears announced it was closing 39 Sears stores and 64 Kmart stores, Bon-Ton stores, the parent company to stores such as Younkers, announced it would be closing all 256 of its locations after 150 years in operation[4]. However (roses), retail sales grew for the fifth consecutive month, rising 0.5% in June. And the gains in June were broad-based, with eight of the 13 major categories showing rising sales, led by restaurants & bars, autos, as well as internet & mail order sales. Add in upward revisions for the month of May and retail sales are up a strong 6.6% from a year ago (and up an even stronger 7.1% excluding auto sales)[5].

The consumer today is demanding more. GPShopper and YouGov, performed a recent study on 1,200 U.S. adults asking them what innovations - both digital and physical - they want retailers to incorporate into stores. The survey found the following:

- *86 percent of shoppers like "experience stores," where they can test products in stores but buy on mobile or online, similar to the Samsung store concept.*
- *85 percent like the idea of product recommendations based on ratings, similar to what Amazon is doing with Amazon Books.*
- *80 percent like buying items online and picking purchases up in stores, as Wal-Mart and Target have been promoting.*
- *78 percent like stores that were first online and then developed physical storefronts, similar to Warby Parker.*

Today's consumer exists in a world that moves at an unparalleled pace. Retailers need to embrace change to remain competitive and employ experiential marketing initiatives to create an agile sore that keeps up with the needs of the consumer. Retail stores with online and in-store components can create an experience customers engage with and remember. All in all, stores that provide unique store experiences, in our opinion, will continue to thrive today and beyond.

Have a wonderful summer,

Randy, Trevor and Ashley

References

1. Established in 1989 and based in Washington, D.C., Marshfield Associates is a value equity money manager of approximately $2.286 billion as of June 30, 2018 in concentrated separately managed discretionary equity portfolios.
2. Investopedia
3. Jobs, Jobs, Jobs - Monday morning outlook - First Trust Portfolios
4. 24/7wallst.com
5. Data Watch, First Trust—June Retail Sales

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