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## For Quarter Ending September 30, 2018

## In This Issue



# Around the Firm

We are pleased to welcome Carole Hughes as our new office manager. Carole comes to Legacy with strong experience in office management and administration in both the private and public sector. A native of upstate New York and graduate of Ithaca College, she has made her home here in Houston for over the past 15 years.

We have also expanded our client support team with the addition of Cody Garrett. Cody has a bachelors degree from the University of Houston and is also a graduate of the Berklee School of Music. He is an accomplished musician and a Houston native. Cody is currently studying for his Certified Financial Planner designation at Rice University's CFP® Graduate Certificate Program and will be working as a client services representative while training as an associate planner under Jillian.

# Keep on Rolling

# Market Review

## "The Economy, Stupid!"

The quote above, coined by President Clinton's Chief Campaign Strategist, James Carvel in the 1992 presidential campaign which referred to the then prevailing recession, is a perfect description of what drove the markets higher, this past quarter. In August, the media went crazy, celebrating and reporting that the current bull market run "is now" the longest on record, stretching back to March 9, 2009, when the S&P 500 reached its low point of the financial crisis. The previous record was attributed to the amazing dot.com market run lasting from 1990 – 2000. According to Wilshire Associates, U.S. Equity values have increased by $27.8 trillion or 337%, since the March 2009 lows, proving that with all the panic ensuing in financial crisis in 2008 and 2009, investors willing to stick with their long-term investment strategy and continue to reinvest in equities as they fell, were richly rewarded.

Investors have become almost complacent and perhaps, entitled as 11 of the last 12 quarters have yielded positive returns even as the Fed continues to normalize interest rates (raising rates three times this year alone). In addition, the President has stepped-up pressure on China by announcing a list of tariffs on $200 billion in Chinese goods and a 25% tariff on all imported steel and a 10% tariff on aluminum. Even though President Trump successfully renegotiated NAFTA (North American Free Trade Agreement), there still remains significant trade risks that could be a headwind for the economy.

Nonetheless, investors ignored any issue that might slow the market's upward trajectory and chose instead to focus on the scorching economy. With the lowest unemployment rate in 49 years, higher salaries and rising minimum wage as catalysts, consumer confidence reached its highest level in 18 years, very close to an all-time high. Consumers indeed reacted with their wallets. Auto retail was up 18% in the quarter and was the best performing group of the Consumer Discretionary sector. Apparel, internet & direct marketing retail, consumer electronics, specialty retail and restaurants were all up double digits.

Companies were also optimistic. Key economic barometers from the Purchasing Managers Index, which measures the health of the manufacturing and service sectors, hit record levels in the quarter. As you would expect, the subgroups of the industrial base that benefit from increased spending and capital investment did well. Companies like Fluor and Jacobs Engineering, that provide construction and engineering expertise, returned 20+%, boding well for future economic growth. If companies are expanding, unemployment could continue to fall supporting additional spending. In addition, transportation, trading companies, distributors, construction machinery and aerospace and defense were all double-digit winners in the quarter.

Overall, major market indexes reached performance milestones in the quarter. The Dow was up 9% and led both the S&P 500 and the Nasdaq by 2%. The Dow's market leading performance is a rare occurrence due to its make-up of large cap, dividend-paying, blue chip stocks, representing all but two sectors of the economy, Utility and Real Estate. It has had a return of 9% or greater in only two of the last 20 quarters. Furthermore, the outperformance was very narrow as 11 of the 30 components of the Dow had a negative return. Apple, Microsoft, Nike and Visa were all up over 33%, while Merck, Cisco and Boeing jumped by more than 25%.

The S&P 500's 7.2% return represents its best quarter since 2013 and is less than 1% off its all-time high. Performance in the S&P was also narrow as the top 100 largest stocks (market cap) generated 75% of the return. The smallest 100 stocks added basically nothing. Although 3Q 2018 earnings growth is expected to slow relative to the previous quarter, valuations are near historic average, meaning the S&P could continue to move higher.

Earnings and economic growth were the main catalysts for the Nasdaq which was higher by 7%. 94 of the 100 stocks in the index reported earnings growth of 33%. The largest position in the index is Apple, which became the first stock to ever cross the mythical $1 trillion market cap level, becoming the most valuable company in the world. Right on its heels and about one month later, Amazon crossed the $1 trillion value and is the second largest company in the world. Both Apple and Amazon have been in the top three contributors to returns on the S&P 500 in six out of the last seven quarters.

## Market Internals

While Information Technology continued to outperform for the year and FAANG (Facebook, Apple, Amazon, Netflix and Alphabet's Google) stocks maintained their favored status, market leadership changed in the quarter as Healthcare stocks +14% became the best returning sector. Industrial +9%, Info Tech +8 and Consumer Discretionary +7.8% all were outperformers. In September, the S&P welcomed its 12th sector to the index, Consumer Services. This new sector combines the old Telecommunications group with select companies from Consumer Discretionary, mainly from the media industry group and from the Internet & Direct Marketing. Consumer Services represents about 12% of the S&P 500. For the quarter, 11 of 12 sectors had positive returns, with Materials the lone sector down modestly.

As you can probably surmise, growth did much better than value stocks, once again. In fact, large, high quality stocks with high valuations and no dividend were big winners. Overall, large cap stocks outperformed small stocks by more than 650 basis points (6.5%), while high quality companies (those with the highest return on equity) did better than low quality by over 400 basis points (4%). The most expensive stocks did better than cheaper stocks by 8%.

In other markets, the U.S. dollar continued upward momentum against a basket of 16 other currencies, rising +1.9% last quarter. It is higher by +4.3% year-to-date. A stronger dollar causes foreign sales of multinational companies to be more expensive and subject to currency fluctuations. Of the 98 companies in the S&P 500 that have provided 3Q projections, 76% have issued negative guidance and have blamed currency translation as one of the main reasons. Brent crude, the global benchmark for oil, jumped 4.1% for the quarter and 24% for the year. However, domestic oil measured by West Texas Intermediate crude fell in the quarter -1.2%, due to pipeline bottlenecks and scheduled maintenance.

International markets, defined as the EAFE (Europe, Australasia and the Far East) Index which measures the equity market performance of developed markets outside the U.S. and Canada, managed to eke out its first quarter of positive returns of +1.3% in 2018 and continuing to significantly trail U.S. by 5.9%, its widest spread since 2013. Emerging markets also continued their slide in the quarter, falling an additional 1% and bringing their yearly underperformance to -9%. Emerging markets are those located primarily in Southeast Asia but can include South Africa, Brazil, Russia, Turkey and Indonesia. Equity prices and yields in these regions are typically negatively correlated to the U.S. dollar and oil prices. So as both the dollar and oil rise, earnings of companies operating in these regions slow.

# Looking Forward

## The Great Liquidity Experiment

The most popular question asked is - where are rates going, and how will they effect stocks? The answer is uncertain because this cycle of tightening monetary policy is truly different from a historical standpoint, and the implication could be far different from previous periods.

What makes this so interesting is we are in the early stages of reversing one of the biggest liquidity experiments in history, following the financial crisis, when the Fed lowered interest rates to 0% and initiated Quantitative Easing (QE)  QE is a program where the Fed ultimately bought trillions of dollars of government bonds and mortgage-backed securities. Buying bonds simulated rising demand which pushed bond prices higher and kept rates artificially low (as bond prices rise, yields fall).

Through QE intervention, money was essentially free. Corporations, consumers and investors could borrow money at basically no cost, invest it and earn higher rates of return. This easy money policy created what I commonly referred to in previous newsletters as the TINA (There Is No Alternative) effect. This acronym describes the artificial environment of low rates where income needy investors would have to increase risk by buying stocks that paid high dividends, to compensate for low bond interest. Bond income was significantly inferior to both dividend income and potential return characteristics of stocks. Greater demand for stocks was one of the main reason equity prices rose.

Why is this relevant? Since December of 2015, the Fed has been slowly reversing this liquidity experiment. Last fall, the Fed announced not only would it continue to pursue its campaign of normalizing (raising) interest rates, but also shrinking its balance sheet by letting $50 billion of bonds per month mature and roll off. This tightening or taking money out of the economy serves as a double whammy to anyone looking to borrow for investment or capital spending. However, the bigger looming question is how will the rising rate environment effect the most levered economy of all times, where over half of the 6 trillion dollar market for investment grade corporate bonds (those rated BBB or higher) is scheduled to refinance in less than three years? Providing these issuers will have to refinance their debt, they will have to pay higher coupons or interest for the first time since the financial crisis, according to *Barron's Magazine*.

## Rolling Cycles

It makes perfect sense to raise rates during economic boom times, like we have seen over the past 12 months. However, the biggest challenge for the Fed is to not overextend the tightening to where it sends the economy into a recession. That will not only effect consumer confidence and corporate spending but also throw the federal budget deficit further into the red as it depends on growth to offset last year's tax cut plan. Higher national debt could also cause rates to rise, exacerbating the effect of a potential recession.

As we look out over the next few quarters, we believe the economy will lose a bit of steam as it moves from peak to late cycle, causing investors to adjust return expectations due to higher rates, rising costs due to tariffs and slowing earnings growth. Companies are already warning of higher cost due to tariffs. Soon they will have to contend with the double whammy of rising rates and higher cost of capital. Corporations will then have to make a strategic decision to either pass along higher cost to consumers in order to maintain profitability or take a hit to margins as higher costs fall to the bottom line. Either scenario will likely cause stocks to reprice as investors adjust future valuations.

Keep in mind, market returns during late cycles are historically below-average, but not necessarily negative. Therefore, investors should not run away from stocks. Portfolio management through asset allocation, sector exposure and position weighting can reduce risk and minimize volatility that can destroy account returns.

Rising rates affect various asset classes in different ways. Bonds and bond-like assets (Utility and Real Estate) whose prices fall when yields rise, tend to lag in these market conditions. Banks and cyclical stocks generally do better than defensive stocks in a rising rate environment, so long as the economy continues to expand. The same goes for Energy, Material and Industrial stocks, as they tend to increase in value with economic growth.

Although the economy appears to be humming along at the present time, we are beginning to position our portfolios to be more defensive as we see an economic slow-down in in the first-half of 2019. We believe sectors like Utility, Real Estate, Consumer Staples and Healthcare that provide high dividend income, compensating for the lack of earnings growth, could also provide some return benefit from falling long-term rates.

# The Portfolio

## Additions & Subtractions

For the first time in eight quarters, we added our first new name from the Energy Sector to the portfolio. We initiated a position in **Halliburton (HAL)** after watching its stock price decline 26% over a 10-week period-due to a combination of weak industry supply and demand fundamentals, a slowdown in new project formation in the Permian Basin in West Texas and a second-quarter earnings report where management lowered future earnings expectations. While there were clearly many reasons for the decline, investors were primarily focused on bottlenecks due to pipeline shortages in the key fracking region of the Permian basin.

Halliburton is the leading service provider in the Permian, and pipeline constraints could hurt production, which in turn negatively impacts HAL's earnings. However, we believe these fears are overplayed and the reality of oil and gas fundamentals have become short-term drivers on stock price. For example, new pipelines are expected to resolve the bottleneck issue by the second half of 2019. Even with these transportation issues, producers continue to move forward with large projects and are ordering more equipment. More importantly, crude prices which closed the quarter at multi-year high, is up 21% year-to-date. Higher crude prices lead to more oil exploration, which benefits oilfield services companies like Halliburton, which sell equipment and provide maintenance for a subsequently increasing number of rigs.

Financially, HAL is in good shape thanks to strong financial discipline during the tough years of 2015 and 2016 and has positive cash flow after paying dividends and considering capital investment. While debt is a bit higher than most, the company has been successful in reducing the absolute level of debt by over $1.5 billion. The company is cheap, both on an absolute and relative basis as it has the lowest price/earnings ratio of any of its peer group. With a backdrop of higher oil prices, improving industry supply/demand fundamentals and an agreement where Europe has agreed to buy more American liquified natural gas (LNG), HAL's valuation is attractive and its operations will likely benefit from these positive industry developments driving profitability and improving long-term outlook.

The evolution of video gaming from a monolithic platform where individuals play a single computer to a dynamic ecosystem where gamers compete against other gamers in a non-programmable or open environment could offer significant return possibilities for investors. Recognizing and accepting the validity of potential global growth from these battle royale games (games where players compete in a live, real-time format, searching for weapons and armor to eliminate opponents) like the cultural phenomenon Fortnite has caused us to add Activision Blizzard (ATVI) to the portfolio.

ATVI is the largest video game manufacturer in the U.S. by market cap. They publish Call of Duty, one of the most popular video game series of the last two decades, and other very popular titles like Overwatch and World of Warcraft. They own Major League Gaming, a professional eSports league that hosts tournaments which are broadcasted online and on television. Activision also owns King, the maker of hit mobile games like Candy Crush Saga.

We believe ATVI has value on three levels. First, the market for video games is growing exponentially. Twitch, a subsidiary of Amazon, is a live-streaming service were people play video games for others to watch - think YouTube for video games. Back in January, Twitch had over 1 million average daily viewers, slightly lower than those that watch Fox News, but higher than those watching MSNBC & CNN.

Secondly, ATVI has developed and promoted Major League Gaming, the premier name in competitive gaming with interests in local and national gaming tournaments. In July, Activision signed a deal with ESPN to broadcast its Overwatch eSports league on television. Overwatch has over 40 million players worldwide, and the league finals that aired on ESPN was watched by over 200,000 households. Activision is best positioned to take advantage of the eSports phenomenon based on its ownerships of gaming leagues and many of its games can be played competitively, unlike its closest competitors Electronic Arts and Take-Two Interactive. Finally, in October, Activision will release new versions of their popular game Call of Duty; pre-sale numbers are exceeding expectations.

Surprisingly, Activision has an attractive valuation relative to its peer group, very strong financial position and significant cash flow. While ATVI might seem like an obvious alpha (short-term) holding for quick momentum gains, we believe it could eventually become the next long-term, blue-chip company attracting consumers' discretionary dollars.

We also added to three current positions in the healthcare sector this past quarter: **AbbVie (ABBV)**, **Medtronic (MDT)** and **Quest Diagnostic (DGX)**. Each of the three companies represents a different industry within the Healthcare Sector. AbbVie is a biotech stock with therapies that address autoimmune diseases, oncology and hepatitis C. Medtronic is a health care equipment firm that provides technology and solutions for cardiac and vascular disease, minimally invasive therapies and patient monitoring. Most know of Quest Diagnostic if they have had to go to one of their facilities or labs to draw blood or other diagnostic testing. All three companies have growing revenue and earnings, attractive valuations, a strong cash flow to support operations and capital investment. Bottomline, we wanted to increase our exposure to the sector and these companies.

Finally, we sold **Limited Brands (LB)** after 2 consecutive quarters of poor execution, falling profit margins and earnings, as well as a lack of a viable plan to turn around its flagship property, Victoria's Secret. While Bath & Body works continues to meet expectations, management continues to drop the ball when it comes to merchandise mix, quality and inventory management. In addition, LB has yet to successfully develop and implement a coherent online strategy to combat Amazon's introduction of sports bras and other basic lingerie items. Therefore, we believe there are more attractive return opportunities elsewhere.