Market Overview

The U.S. equity markets continued their yearlong rally into the fourth quarter with many indices and sectors closing at new highs.[i] Technology companies led the way with Microsoft and Apple both eclipsing the $1 trillion market cap level.[ii] The NASDAQ index, which is heavily technology focused, reached new highs, and had the best performance since 1999.[iii] Based on returns, equity markets appeared to overlook trade wars, Brexit, slowing global growth, earnings pressures, and finally impeachment. However, in the fourth quarter as markets looked ahead towards improving 2020 earnings and a better global economic environment, we observed a rotation to the more cyclical financial and industrial sectors. The only sector that significantly lagged was energy, despite the price of oil increasing to $60 per a barrel, up 30% from the start of the year.[iv]

U.S. Economy

We have more recently been asked if we are going to see a recession. We do not have a crystal ball – however, we have observed that with prior recessions there was an excessive level of speculative behavior and significant over investment in several sectors of the economy. Recall that Y2K was one justification for the optimism surrounding Technology in anticipation of the year 2000 and why prices and investment in housing driven by excessive debt, reached unsustainable levels. Today, despite individual examples, we see much more rational behavior and very little of the "irrational exuberance" that could signal an end to the current economic cycle as it enters a record 11 years. For example, We Work tried to go public at an initial valuation of $40 billion, but failed to go public at any price as the market became very skeptical of its questionable business model and significant governance and leadership deficiencies.[v]

The U.S. economy continues to be positive in the fourth quarter as employment numbers remained strong, consumer spending was robust, and housing numbers increased. The U.S. consumer, driving 70% of the GDP is helping with the expansion story.[vi] Manufacturing has been impacted by the U.S. and China trade war. This is evidenced by the Purchasing Managers Index (PMI) entering contraction territory in China and close to contraction in the U.S., which more recently has started to turn positive.[vii] It appears that the U.S. and China have reached a Phase One deal which prevents additional tariffs and helps facilitate some trade of agriculture products.[viii] U.S. CEO's have been uncertain about the trade talk progress and it is estimated that if the investment withheld in 2019 is invested in U.S. companies in 2020, it could add 0.5% to GDP growth.[ix]

The Fed and Interest Rates

Another positive development was that the U.S. Federal Reserve (Fed) cut interest rates for the third time in 2019 with the latest cut in October.[x] The interest rate yield curve had inverted in June, with the two-year yield higher than the ten-year yield, which often portends a future recession.[xi] To prevent a recession and slowing economy, the Fed quickly acted to cut rates.[xii] Currently, there are opposing expectations for another Fed rate cut or if the economy does improve, the potential to increase rates late next year. The Fed has also stepped into facilitate the repo market. In addition to buying short-term treasuries to ensure there is enough liquidity in the market, it is now increasing its balance sheet.[xiii]

Fixed Income

With fixed income yields so low and the spreads between corporate bonds and treasuries narrow, we view equities as being more attractive than bonds.[xiv] We are uncertain about the direction of interest rates, although we believe they could move a bit higher, but be relatively range-bound. In general, with Anchor balanced portfolios, we minimize our risk taking on bonds and use that as an opportunity on the equity side. We focus on high quality bonds that can have price appreciation and generate income while managing duration exposure.

Growth vs. Value

We are value investors in that we look to buy a stock at a valuation level that is relatively attractive and provides a margin of safety. We try not to become caught up in the growth versus value label, as you will find stocks in the value indices that have growth attributes. The popular press is making a big deal of the performance spread between the growth and value indices. In 2019, there was a 10% performance spread between the Russell 1000 Value and Russell 1000 Growth indices.[xv] We have not seen this wide of a spread between the factors since 2007 when value was significantly outperforming growth. Related to that is the valuation of the Russell 1000 Growth index is 21.5x 2020 earnings while the Russell 1000 Value index is 14.6x 2020 earnings, an almost 7 turns difference.[xvi] What we focus on more than classifications is whether we deem the company to be high quality, have attractive fundamentals, and be at a value price. To protect capital we continue to look for interesting companies that we can hold for long periods.

Valuations

As mentioned earlier we believe valuations are not stretched for the overall market. The S&P 500 index is trading around a turn higher than its average, the Russell Mid Cap index is trading about a half turn higher than its average and the Russell 2000 (small cap) index is trading around a turn and a half below its average.[xvii] Small caps in terms of valuation look attractive and that is primarily due to the higher weightings in financials and energy stocks, which have lagged until the last quarter.[xviii] There are individual stock valuations that are stretched and we pay attention to valuation in our portfolio holdings. We routinely take profits or sell out when we see a stock valuation becoming elevated.

Cash

Cash is a natural outcome of our investment process and is most often based on three outcomes: valuation levels, take-outs of portfolio holdings, and availability of attractive investments. When valuations are high, we are typically selling or trimming positions, and frequently we see at least a couple of take-outs in the portfolios each year - both of which result in higher cash levels. Cash levels may stay high if we do not find new stocks to buy at attractive valuations. This year we have uncovered a number of interesting new stocks to add to portfolios, therefore averaging out cash levels within our portfolios.

Conclusion

Despite the markets reaching new highs we continue to find interesting stock ideas. Our focus is steadfast to finding well run, standout companies that are leaders in their respective industries and are maximizing shareholder value for the long run. When valuations become too stretched we will start paring back and raising cash, but currently we still see opportunities at attractive valuations as we go into the new year.

STRATEGY DETAIL

Quarterly Attribution[xix]

Security Contribution (5 Highest)
Microsoft Corporation (MSFT)
Leidos Holdings, Inc. (LDOS)
Dow, Inc. (DOW)
PPL Corporation (PPL)
Eaton Corp. Plc (ETN)

Security Contribution (5 Lowest)
Hasbro, Inc. (HAS)
Cinemark Holdings, Inc. (CNK)
Hershey Company (HSY)
Occidental Petroleum Corporation (OXY)
Unilever NV ADR (UN)

Sector Contribution (3 Highest)
Financial Services
Materials & Processing
Producer Durables

Sector Contribution (3 Lowest)
Utilities
Energy
Consumer Discretionary

Quarterly Purchases

- NiSource Inc (NI).

Quarterly Sales

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Further Insight: Stock Position(s)

NiSource (NI)

Utilities have been difficult for us to buy given that they have been trading a premium to their history, so we have not been able to find real value. However, in the fourth quarter, NiSource's stock dropped 14%, which provided us an opportunity to buy a solid utility company.[xx] NiSource is the nation's largest fully regulated utility. It has 4 million natural gas and electric customers in 7 states under the Columbia Gas and NIPSCO brands.[xxi] For many years, NiSource traded at a premium to other electric utilities due to its long Capex runway, constructive regulatory treatment, and solid execution track record.[xxii] In September 2018, in the Greater Lawrence area of Massachusetts, Columbia Gas had a gas leak and explosion, which destroyed 40 homes.[xxiii] NiSource announced in October that the total cost of incident was $1.7 billion and the after-insurance cost was $600 million, which was better than expected.[xxiv] Concurrently, NiSource announced it would have a $500 to $700 million equity raise in 2020 to cover the out-of-pocket costs, which put an overhang on the stock.[xxv] We believe the situation had been ring fenced, appropriate safety measures put in place and the opportunity for stock to appreciate post the equity raise. NiSource is a defensive stock with over a 3% dividend yield at the time of purchase growing 5% to 7% per year.[xxvi]

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[i] FactSet financial data and analytics; Charting
[ii] Ibid.
[iii] Ibid.
[iv] Ibid.
[v] https://www.wsj.com/articles/2019-the-year-of-ipo-disappointment-11577615400?mod=searchresults&page=1&pos=8
[vi] https://www.usatoday.com/story/money/2019/08/29/gdp-up-2nd-quarter-consumer-spending-rises-us-economy-slows/2150057001/
[vii] https://tradingeconomics.com/united-states/manufacturing-pmi
[viii] https://www.wsj.com/articles/trump-says-he-will-sign-phase-one-trade-deal-with-china-on-jan-15-11577802332
[ix] Stiefel Research, Barry Bannister
[x] https://www.nytimes.com/2019/10/30/business/economy/federal-reserve-interest-rates.html
[xi] https://www.cnbc.com/2019/08/14/the-inverted-yield-curve-explained-and-what-it-means-for-your-money.html
[xii] https://www.nytimes.com/2019/10/30/business/economy/federal-reserve-interest-rates.html
[xiii] https://www.cnbc.com/2019/11/07/the-feds-monetary-juice-has-tied-directly-to-the-rise-in-stocks.html
[xiv] FactSet financial data and analytics; Charting
[xv] Ibid.
[xvi] Ibid.
[xvii] Ibid.
[xviii] Ibid.
[xix] FactSet financial data and analytics; Attribution

[xx] FactSet financial data and analytics; Charting
[xxi] https://www.nisource.com/investors
[xxii] Wells Fargo Research
[xxiii] https://www.cbsnews.com/news/lawrence-ma-fire-gas-explosion-suspected-2018-09-13-live-updates/
[xxiv] https://www.nisource.com/investors
[xxv] Ibid.
[xxvi] Ibid.

For a complete listing of all strategies contact Anchor Capital Advisors LLC (617) 338-3800.