WELLS TRECASO FINANCIAL GROUP

Portfolio Talk

Quarter Two 2018

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"There's always somebody who is paid too much and taxed too little…and it's always somebody else."
–Cullen Hightower

Bull markets are often viewed through the lens of "a rising tide lifts all boats!" However, this is not always the case! Let's first take a look at past Bull & Bear Markets dating back to 1926.

The average Bull Market period lasted 9.1 years with an average cumulative return of 476%. The average Bear Market period lasted only 1.4 years with an average cumulative loss of -41%. Sounds like the cards are stacked in favor of the Bulls right? Not always the case. Take for example the last five (5) Bull Markets: 1974-1980, 1982-1987, 1988-2000, 2002-2008 & 2009 to present time. During these Bull Runs there were time periods where a very small group of companies contributed a substantial portion of the total return of the market (as measured by the S&P 500). In the bull market of 1974-1980 the group of companies were called the "Nifty Fifty" led by such companies as Coca Cola, Polaroid, Eastman Kodak, etc…Then in 1982-1987 they were the "Take Over" companies such as Beatrice Foods, RJ Reynolds, Philip Morris, Enron, etc…And of course the run in 1988-2000 was ruled by Technology ending with the "Tech Bubble". Companies like Cisco, Microsoft, Oracle, and Intel moved the markets substantially as the internet came into being! The current run is also following suit with a group so affectionately known as the FAANG; Facebook, Amazon, Apple, Netflix & Google. According to Investor's Business Daily, dated 3/30/2018, "the FAANG + Microsoft are now 28% of the S&P 500…their outsized influence in the markets is starting to play out."[i] Just imagine, Apple's size being equal to 106 of the smallest companies in the index! That means if Apple is down 1%, 106 of the bottom companies have to each be up 1% just to offset the decline. Taking it a step further, according to Commonfund, dated March 2, 2018, FAANG was nearly 50% of the S&P 500 total return in 2017.[ii]

So what is the message in pointing out these narrowly traded markets? First, what goes up can also come down! Take a look at the Nifty Fifty in the 1970's, many are no longer the companies they once were. The takeover companies of the 1980's became subsidiaries of larger companies or gone. And when we look at the Tech companies of the 1990's, many are just getting back to where they were (Cisco was at $80 in 2000 and now trades at $42). Will the FAANG follow the same course or will it be different this time? Apple, Google & Facebook are actually trading at a reasonable if not attractive price/earnings ratio with earning accelerating. Amazon and Netflix on the other hand are reminiscent of the companies in past bubbles trading with price/earnings ratios of 240x and 288x respectively! Secondly, it tells us that when looking at these narrowly traded high multiple growth companies we tend to overlook the larger companies that like the tortoise slowly grind out earning, increase dividends and continue to grow their operating base. These are called large cap value companies. Their values are often suppressed during times when the large growth companies are moving aggressively. Here in lies the opportunity if we have patience. In the past, over longer periods of time, the two components of the Russell 1000 Index, Growth and Value, have very similar returns. Sometimes one out performs the other, they then flip-flop and the underperformer out performs the other. See the chart below.

Rate of Return as of 7/9/2018

	YTD	**1 YR**	**3 YR Cumulative**
Russell 1000 Growth	9.31%	25.74%	54.06%
Russell 1000 Value	-.42%	8.66%	28.53%

JP Morgan Weekly Market Recap DTD 7/9/2018

Over the past three years the Growth component has doubled the return of the Value, so rotating from growth to value has not paid off yet. However, as illustrated in an analysis conducted by John Hancock, the flip may be close at hand. The report goes on to say "Historically, performance leadership has shifted between growth and value, and in several instances one style has maintained an edge for several years before the situation reversed. We are now in one such period, as the Russell 1000 Growth Index has outperformed its Value counterpart in 7 of the past 11 years. In 2017, Growth's outperformance was unusually strong, as the Russell 1000 Growth Index returned 30.2%, versus 13.7% for the Russell 1000 Value Index. Growth's leadership extended into early 2018, as the Growth index posted a 9.7% total return through June 11, versus 0.6% for its Value counterpart. However, Growth's outperformance in recent years followed a long stretch of leadership for Value, which outperformed for seven years in a row. That run started in 2000, as the tech bubble that had inflated the prices of many growth stocks began to burst; it ended in 2007, prior to the financial crisis that began in 2008."[iii] What will be the catalyst that causes the flip? Only time will tell. Often times the outperformance comes when the Growth side declines substantially; i.e. the Nifty Fifty deflating, Tech Bubble bursting, take overs crashed, etc... Will the FAANG be de-FAANGED? Possibly if history repeats itself! Just know that tops are hard to call and can stay over valued for long periods of time. Flipping to Growth would be a mistake at this time. Value will rule again, but having a balance (like our portfolio) between the two makes the most sense.

Portfolio

The Tax Cuts and Jobs Act of 2017 has given the economy a boost that is driving GDP to 3% plus, something we haven't seen since 2005! Even with the "Trade War" or "Trade Negotiation", 2018 and into 2019 is showing signs of an economy that is absorbing new workers at a record pace. Wages are starting to inflate, albeit at a slow rate, due to the labor participation rate expanding from a low of 62.8%, still well below the record high of 67.3% set in January 2000.[iv] Earnings are estimated to increase approximately 24% (consensus), substantially higher than last year's 5%+.

In the June NABE (National Association of Business Economics) Outlook Survey "panelists are slightly less optimistic about the U.S. economy in 2018 than they were three months ago, said NABE Vice President Kevin Swift, CBE, chief economist, American Chemistry Council. However, they are much more positive about the prospects for industrial production – anticipating 3.8% average growth in 2018, up from 3.3% gain forecasted in March and significantly from the 2.3% forecasted in the December survey."[v] All looks good, right? Maybe, but a flattening yield curve is of concern in many economic reports these days. The typical spread between the 30 year Treasury Bond and the 10 year Treasury Note is approximately 2 – 2 ½%, meaning a 3% 10 year should have a 30 year at approximately 5 – 5 ½%. Currently the 10 year is trading at 2.85% and the 30 year at 2.96%. What does it mean? Not sure with rates at close to record lows. Historically, when rates were higher, a flat to inverted yield curve (10 year yields more than the 30 year) has been a warning sign of a coming recession. We're not anticipating a recession. With rates so low we believe the economy is in good shape through 2019. However, we're watching things closely.

Our current thinking is to stick with a blend of Growth and Value allocation. We're also looking for opportunities in any companies that fall out for unfounded reasons due to the noise about a trade war!

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[i] Investor's Business Daily: Is FANG Stock Trade Dead as Facebook, Amazon, Netflix, Google Lead Tech Weakness? By Alissa Coram DTD 3/30/2018

[ii] Commonfund: Baring Their Teeth – FAANGS Take a Bite out of the Equity Market, by Mark J.P. Anson – Mark Bennett DTD 3/2/2018

[iii] John Hancock Investments: What's a growth stock? A Value stock? Equity Market style explained DTD June 13, 2018

[iv] Trading Economics: tradingeconomics.com/united-states/labor-force-participation-rate DTD 7/17/18

[v] NABE: NABE Outlook Survey – June 2018

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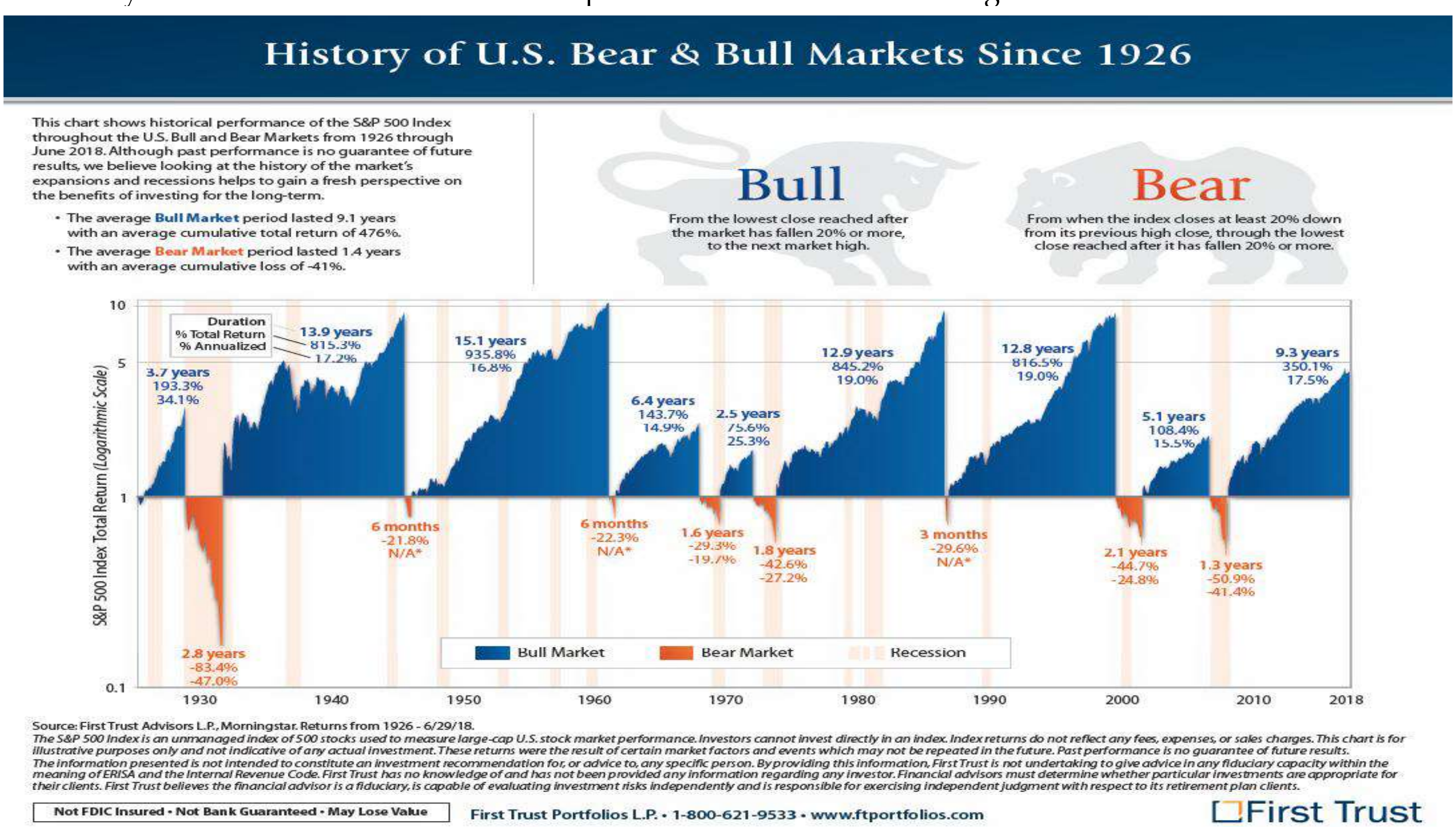

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