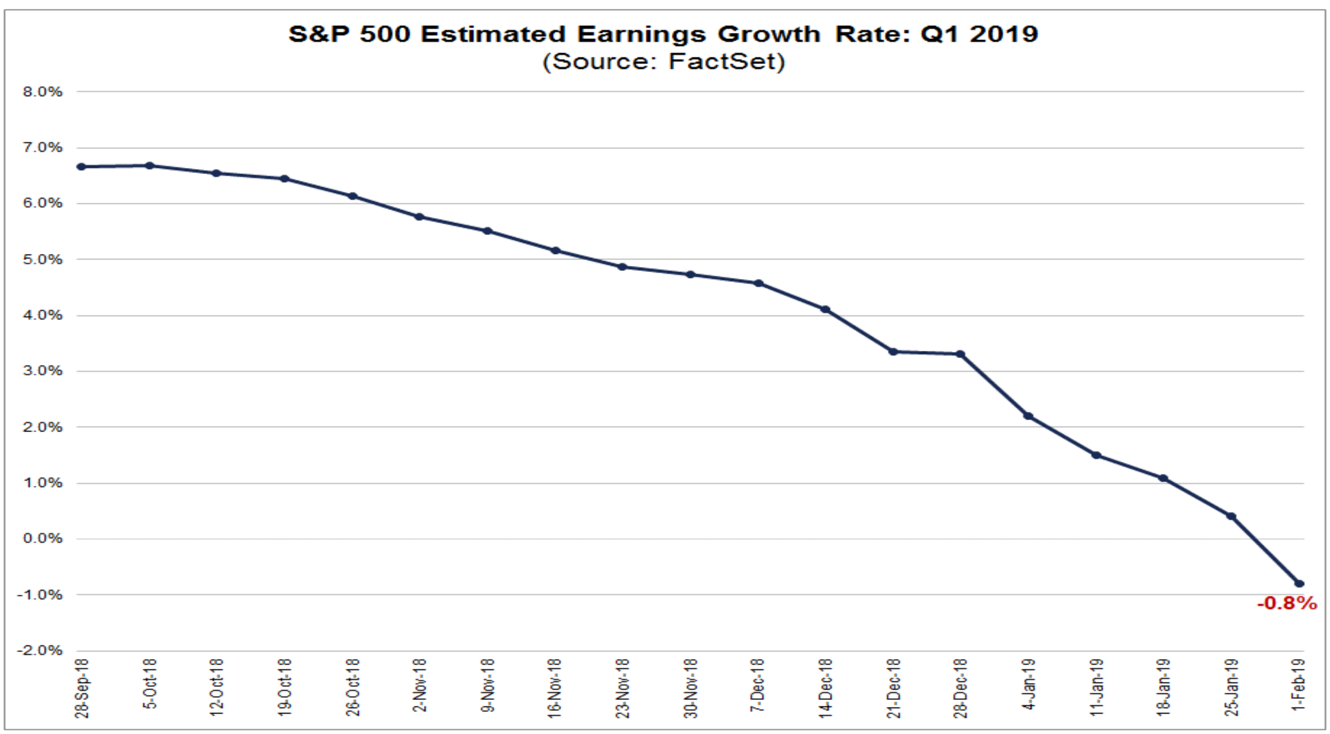
HCM WEALTH ADVISORS

Feb 18, 2019

Market Insights for Week Ending Feb 15, 2019

"Tug of War"

A friend of mine recently approached me about starting an investment club. These groups have become popular over the past few years as markets have rallied. The general idea of an investment club is to get a group of investors together to share ideas and resources, ultimately creating a group portfolio. This isn't the first time someone has asked me to be involved in such a venture. Most of the time I find that people aren't prepared to do the work and high-level analysis that is required. They simply want to buy Apple because they think the company will sell a lot of iPhones. While I don't participate in these groups, I often offer research exercises so members can get a different perspective of their process. The goal is to help them uncover potential behavioral biases that may exist in their process, or in some cases their lack of process. One of my favorite exercises is to ask the group to choose a small cap stock that they have never heard of before, research everything they can about the company, then make a buy/sell recommendation. I also put in a twist...they must do all of this without looking at any charts or price information. The purpose of this exercise isn't to teach someone to create discounted cash flow models. It is to help them understand how much price movements can affect our interpretation of data.



The chart above displays the projected Q1 2019 earnings growth rate for the S&P 500 at different points in 2018. The dates listed on the bottom show how the earnings estimates were revised down as 2018 progressed. For example, back on Sept 28, 2018, analysts expected earnings to grow in the first quarter of 2019 by around 6.7%. Fast forward to the beginning of February 2019 and that number has been revised down all the way to negative 0.8%. If those numbers hold, it would be the first quarter of negative earnings growth since 3Q 2016 and would also break the current streak of 5 consecutive quarters of double-digit earnings growth for the S&P 500.

Why Do We Care?

As the market has continued to recover from its December lows, many commentators have declared that the bull market has resumed. We are the first to acknowledge that it may have, it is just too early to know. Since our responsibility is to manage our client's "forever-retirement money" we take additional precautions to help avoid risks that could damage HCM Clients' portfolios.

This brings me back to the experiment that I mentioned in the first paragraph. Are the commentators who are offering quick opinions looking at the data and offering an objective decision about how to best manage risk, or are they looking at short term price movements and molding their interpretation of the data around that? Even worse, are they completely ignoring the fundamental data and just using price movements for their rationale?

Since anticipated earnings growth is the most fundamental driver of stock prices it is easy to appreciate that the last five quarters of double-digit earnings growth supported equity prices. It is unlikely that we will sustain higher profits if growth rates begin to fall. Put another way, if strong earnings growth trends drive equity prices higher, then weak earnings *should* put stock prices in jeopardy.

According to *FactSet Earnings Insight*, the growth rates for Q2 and Q3 2019 are expected to be 1% and 2.4% respectively. As we can see in the chart above, those numbers are subject to negative revisions as time passes. A poor retail sales report last week raised the caution flag regarding the U.S. consumer. The consumer drives approximately 70% of U.S. GDP growth. So with the risk that retail sales may be slowing, the prospects for economic growth are diminished.

If growth is doubtful, why is the market doing well? That is a good question that not enough people are asking. As we wrote last week, the Fed has certainly made people forget about fundamental data. In fact, things are so "interesting" in the Eurozone right now that the European Central Bank announced the possibility of restarting their version of quantitative easing (free money). Remember, these are supposed to be the emergency measures of monetary policy, reserved for, you guessed it, emergencies. While the ECB hasn't re-started these measures yet, the mere mention that they are back on the table is enough to get investors excited.

HCM remains committed to being objective in our analysis of market data. We don't want to let the price action distort our interpretation of the data or take our attention away from the underlying drivers of long-term performance. The recovery we have seen over the past 6 weeks has brought the emotional aspect of investing back to the forefront for many investors with the common lament "Did we miss out?". Even though we remain somewhat cautious, our models have participated in the recovery from the December lows.

Our modest defensive positioning remains in place because of the risks we see in the economy. The recent dovish comments by the Fed and ECB have placed duct tape over these concerns, but the tape will not hold forever. We would like to see a resolution in the Chinese tariff situation and a reacceleration in growth expectations to alleviate our concerns.

Unless fundamentals improve, the market will remain in a battle between investor's faith in Fed policy and the headwinds of slowing growth. The Fed has the upper hand for now, but the economic data is starting to pull a little harder.

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Weekly Focus – Think About It

“Blessed are those who can give without remembering and take without forgetting.”

-Anonymous

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 2.71%
- Developed Foreign Markets (EFA) – Gain of 2.58%
- Emerging Markets (EEM) – Gain of -.04%
- Fixed Income (AGG) – Loss of -.17%

(Note: performance is based on the change in price plus dividends)

Last Week’s Headlines

-Global stocks gained on hopes for a deal in the ongoing US-China trade talks.

-Companies representing two-thirds of the global stock market value have reported earnings, with single-digit annual growth in profit and sales.

-US economic data sent mixed messages with December core CPI coming in at 2.2% while retail sales recorded their sharpest decline in more than nine years.

Eye on the Week Ahead

-January FOMC minutes may shed more light on what the central bank’s recently adopted “patient” approach to monetary policy means. Any hint the Fed may be looking to raise rates in coming months could spook the market.

If you have questions about the recent price volatility please contact a member of HCM’s Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

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