SYMONS® CAPITAL MANAGEMENT

QUARTERLY INVESTMENT LETTER
FIRST QUARTER 2019

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THE BIG PICTURE

Substantially everything we expected to happen in the first quarter did happen. We expected a weaker economy and weaker corporate earnings and we got both. But the stock market continued to rise. Why? We'd tend to point to Howard Marks' ideas on market cycles as a process.[1] What we believe he would say is that people have spent the last ten years being rewarded for risk-taking. Those people still have that success in their rearview mirrors, so it's not too surprising that the ten-year bull market seems slow to change course. The same basic process has happened in the past. The year 2000 wasn't really that bad a year for the broad market. The real trouble in the broad market didn't start until 2001. (In our judgment, we'd say the trouble started with CSCO earnings in October 2000.) Likewise, there were obvious problems in the summer of 2007, but most people danced right off the cliff with Chuck Prince, CEO of Citigroup, who famously said "as long as the music is playing, you've got to get up and dance."[2]

Trying to time the exact point where people give up or are carted off tends to be a bit too white-knuckle of an investment process for us. It's obvious there are numerous economic, fiscal and monetary problems worldwide, even if people choose to believe that Trump and the Fed will make it all OK, despite historical signs that that's a bad investment management idea.

After the 19% market drop in December 2018 (at which point our Chief Investment Officer wrote a blog titled *Don't Panic)*, the idea of a bounce in January seemed reasonable to us. But the idea that we'd have the best quarterly performance in a decade, despite weak earnings, weak earnings forecasts, and poor macro news, was beyond our range of reasonable outcomes. Guess it shows what can happen when the risk-takers have the ball.

We would not be surprised if the risk-takers get carted out over the course of the next year, probably in stages. First, we have earnings season coming up in April-May. That should be the second bad quarterly earnings season in a row. That will hurt, but already commentators are saying it's a one-off (despite it being a two-off) due to the trade war. People can try to ignore the weakening worldwide data, but the upcoming quarterly reports are likely to be even worse than last quarter, and people aren't obviously prepared for that. There are plenty of investors and companies talking up a second half recovery, despite the fact that earnings comps versus the last year or three are tough and there isn't a whisper of a sign of improvement in the economy.

We believe that July earnings could be even more interesting. Right now it looks like high expectations will meet harsh reality. That should hurt. That is what often happens, though. After a bull market, people regain reason slowly, one at a time.

THE ECONOMY AND INVESTMENT MARKETS

We see weaker economic data and risky markets. Since December 2015 the Federal Reserve has raised the Federal Funds rate from 0.25% to 2.50%. At this point the Federal Funds rate is about the same as the yield on the 10-Year Treasury. A flat yield curve is a brutal environment for banks. Interest rate sensitive areas such as autos and, to some extent, housing have slowed. Consumer demand is weak, as shown by retail sales coming in below expectations. First quarter U.S. auto sales were down 5% from a year ago, and 9% of U.S. mall space is vacant. Both the IMF and the World Bank have again cut their global GDP expectations for the next two years. The Fed has reduced its U.S. GDP expectations. At the same time, government deficits keep growing, which tend to grow even faster as a weaker economy brings slowing tax revenues and increasing social services expenditures. It is hard to see a pathway to a growing economy.

The increasing evidence of economic weakness also caused the Fed to indicate that it will be changing its monetary policy plans, indicating no more Federal Funds rate hikes in 2019 and ending the QT (Quantitative Tightening) process in September 2019, earlier than planned.

Looking at the financial markets, stock valuations are currently at about 30 times trailing 10-year earnings. By historical standards that is very high. It is similar to 1929, above 2008, and below only the 2000 market P/Es. Current market valuations do not match up well with weakening corporate earnings.

Nevertheless, investors seem to continue to have great faith that the Fed can protect financial asset values. After ten years of unprecedented central bank interventions, investor expectations have changed. People seem to have more confidence in the central banks than in real economic data when making investment decisions. Investors seem to trust that the Fed will keep everything OK, even though there are economic warnings signs all around. Can the Fed do it? People have high expectations, but we don't think they are warranted. Why is that?

First, the last 10 years indicate that the Fed is largely powerless in moving consumer salaries and wages higher, which is critical to real economic

growth. Seventy percent of GDP is consumer spending. Over the past decade, debt has been the key driver of increasing consumer spending. Can consumers continue to add more debt to pay for the rising costs of health care, education, housing, child care, etc.?

Second, historically the Fed tries to turn the economy around by dropping interest rates. But it is hard to do that today, with already historically low interest rates. The Fed faces additional difficulties with historically high debt burdens for consumers, corporations and governments, an aging population with modest workforce growth, and weak foreign economies. What else can or might the Fed do? Resume QE asset purchases and more money printing to buy those assets? Encourage more debt across the board? Over the past decade both actions propped up the financial markets, but did nothing to restart organic economic growth, rather than debt-based growth. Borrowing $2 million to generate $1 million of GDP growth is not a sustainable strategy.

EQUITY STRATEGIES AND PORTFOLIO MANAGEMENT

In the first quarter, we did well, just not as well as the market. We certainly had a few individual stocks that disappointed, but nothing that seems like a broad trend. Investor psychology continued to be dominated by risk indifference rather than risk aversion. The stocks we're invested in are generally unpopular, with their modest earnings growth rates, but they have very durable businesses that should largely continue to do well as the economy sags. With stable revenue and earnings, along with continuing free cash flow, we view them as high quality stocks.

Stock markets are fairly efficient over time, but short-term investor psychology can cause people to pile into certain stocks and sectors, and sell out of others that are currently out of favor. Many investors never get past the "out of favor" categorization of the unpopular stocks. And that is what can create opportunity. If a company is a viable business it has to be worth something, and that something may be more than what the market has priced it at as an unpopular stock. If a company is financially sound, competitive and generates stable earnings, it can be an attractive risk-reward buying opportunity. Unpopular stocks are not scary. They can skew the odds in our favor in terms of capital preservation and building durable wealth.

While in the first quarter the popular "growth stocks hare" jumped ahead again, we think our "turtle investments" should do well in what could be tough times ahead. On the one hand, investing in currently unpopular stocks (particularly consumer staples and REITS) can be psychologically unpleasant. We thought there'd be more give-up on growth and momentum, given the broadly weakening economic and corporate data — first foreign and then U.S. On the other hand, for all the moderate unpleasantness, this market progression is still within the range of a normal market top. Have you ever had the experience where you know that, based on past experience, someone might do something crazy, but you still feel surprised when it actually happens? Here we are.

At this point we generally like the high quality, dependable revenue and free cash flow names in staples and REITS, as well as in utilities (which are no longer quite as unpopular as they were a year ago). Health care can be attractive, but it's hard to find stocks that are worth the risk of potential government political interventions — so we want bargains. For banks, the flat yield curve is a curse. Tech stocks are complicated. While some appear to have particularly difficult earnings comps going forward, there may be a few attractive opportunities in tech. In every case we are both playing the odds and looking for exceptions. This broad outline of risk-reward sector probabilities is reflected in our portfolios.

Investors, like people in general, tend to expect tomorrow to be the same as today. But change happens and with change comes disorder. With disorder comes opportunity. While our macro research doesn't uncover a lot of specifics looking forward, it does enable us to judge trends and ranges, and that is sufficient to help us make our macro judgments and portfolio sector tilts.

CONCLUSION

It's pretty clear that many investors are still chasing growth. We expect that love affair with growth to end sadly, as earnings comps become more difficult each quarter. Investors generally were gentle with January earnings disappointments. To us it looks like investors want to believe that the Fed will somehow save them. As the economy slows, stable revenue and free cash flow become more important. That is where we are, and that is where we believe more investors will want to be in the future.

The data and the trends tell us to put caution and capital protection first. We want to preserve client assets when it is most important, and we want to invest in such a way that we are materially (even though we can never be totally) in charge of the path our portfolio takes. One major down market can seriously alter a portfolio's path, and that is why avoiding big downturns greatly matters in building durable wealth. That also is why we don't choose the passive index path, because that puts you on the path to the large losses. No path is without risk, but risk can be managed.

Yours sincerely,

Ed Symons, JD — Chairman & Founder

Colin Symons, CFA — Chief Investment Officer

[1]Howard Marks, *Mastering the Market Cycle*

[2] Financial Times, July 10, 2007, *Citigroup's Chuck Prince wants to keep dancing, and can you really blame him?*

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