QUARTERLY INVESTMENT LETTER
SECOND QUARTER 2019

July 2019

THE BIG PICTURE

As we just saw in June (when the S&P 500® Index posted its best June return since 1955), a lot of strange market activity can happen during the last month of a quarter with low volume and low liquidity. That is a great environment for short-term traders to push their positions. But you can't change the fact that Bloomberg's year-over-year consensus earnings estimates for the just-ended second quarter are -29% for the tech sector and -25% for the S&P 500® Index. Apparently that's next month's concern. Myopia is a common problem in bull markets, and we certainly saw it at the 2000 and 2007 bull markets peaks — before they went over a cliff.

Symons Capital focuses on macro and fundamentals research, because we believe they're what matter over the long term. Right now, both macro and fundamentals data are weak and trending worse. We stand a pretty good chance of seeing an earnings recession (two quarters in a row of negative year-over-year earnings growth) this year. Meanwhile, after the longest streak of U.S. economic growth in history, it looks like even the optimists see a slowdown coming.

So does that mean we need to prepare for Armageddon? Not really. What it does mean is that the ability for growth sectors like tech, industrials, and financials to outperform is likely to be deeply impaired. We believe our odds are much better in safer stocks like utilities, REITs, and staples, and that looks likely to be true for quite a while. That may not turn out to be true over the next month, but it's the odds-on bet going forward.

Will the market never go down again? Of course not. What will make it go down? That is always a hard question. While the answer seems to be different every time, often it involves a change in investor expectations from speculation to risk aversion. Rather than trying to figure out what will cause the next market drop, we tend to look at year-over-year data to warn us of future probabilities. In hindsight, the generic cause of a market downturn usually turns out to be investors having an unforeseen (to them) realization that their expectations were too high. In our judgment, that's what happened in 2000 and 2008. In 2000, tech stocks were going to recreate the future, and nothing else mattered. In 2008, aggressive financing ran into an economic slowdown. In both cases, investors developed these larger and larger expectations of what could happen, and inevitably those expectations got too high. Then macro and fundamentals reality set in.

Currently, it would seem that there is sufficient weak macro and fundamentals data that, by now, we should have seen an expectations reset. So, it can be somewhat frustrating. Then again, 2000 and 2008 were also frustrating. Patience and discipline always help. When will people admit to the pretty obvious problems of weakening economic and corporate data? We couldn't tell you that in 2000 or 2008, and we can't say now. Does it have to happen now? Once again, of course not. At this point all we can really do is recognize the problem, recognize that the next event is on the horizon, and prepare for what can happen next. Short-term games can get played in the market, but at this point we don't see how the market can avoid disappointment.

THE ECONOMY AND INVESTMENT MARKETS

With the S&P 500® Index near an all-time high, investors are inclined to have a positive, risk-on outlook and fail to consider or anticipate the possibility of a market downturn. At the same time, the 10-year U.S. treasury yield is again around 2%. While that raises bond prices, it also suggests economic weakness ahead. The global Purchasing Managers Index has dropped below 50, indicating economic contraction — not just economic slowing. It appears that vulnerabilities are increasing — declining levels of economic activity and corporate earnings, increasing debt levels, increasing trade tensions, and historically high stock valuations. The realities of economic data are giving us warnings.

The stock market's short-term direction appears to be dependent on constant hope for dovish Fed (and other central banks') monetary policy — lower interest rates (ZIRP) and more quantitative easing (QE), and for a resolution of trade disputes with China. Unfortunately, a steady stream of Fed interest rate cuts didn't matter in either the 2000 or 2008 market downturns, and the chances of a game-changing trade deal with China are slight.

We expect both interest rates and inflation to remain modest for at least the immediate future. Weak organic economic growth should keep interest rates in check, and inflation should remain modest until people become concerned that the ever growing federal spending deficits are unsustainable and cannot be repaid without inflating away those debts.

Finally, particularly for passive investors, the current combination of low fixed income yields and high equity valuations creates material risks. For Symons Capital that suggests the need to tilt portfolios toward high quality, defensive stocks that should have less downside risk.

EQUITY STRATEGIES AND PORTFOLIO MANAGEMENT

For now, we see weak economic activity, modest inflation and modest interest rates. When that is coupled with high stock valuations and slowing corporate earnings, it makes sense to tilt our portfolios toward utilities, staples and REITS as we seek to provide less downside volatility along with relatively attractive performance and risk patterns. In short, we already have aligned our portfolios in accordance with what we see as prevailing risks and sensible opportunities.

There is one more point of note. The current market is the only time in this century we can remember where it looks like every single lever of corporate earnings is likely to turn down. In our investment research process there are four principal levers that can impact earnings — sales, profit margins, cost of capital, and asset efficiency. Right now, due in part to tariff implications, year-over-year sales comparables are broadly quite tough and look extremely likely to decline, not to mention the more basic problem of overall consumer demand. Profit margins are getting hit from everywhere — lower sales revenue, higher labor costs, and higher import costs. Usually, cost of capital and asset efficiency tend not to move fast, but even they look bad. After years of lower cost of capital, it seems to have gone as low as it can, and now seems to have nowhere to go but up. Asset efficiency is also taking a hit, as companies stockpiled materials and inventory to deal with trade war fallout.

Once again, none of this means that stocks have to decline tomorrow. What it does mean is that after a very long run in growth stocks (largely deserved in direction, if not magnitude), it's hard to see how it isn't the turn of defensive stocks to have the ball. Is there one last hope — will a friendly trade war resolution fix that? We think it could change the magnitude of the drop, but not the direction. As happens at the end of long bull markets, growth stocks have certainly put up a valiant fight, but it's hard to see how they're not running out of oxygen here.

CONCLUSION

It can be good not to be part of the herd. As a boutique investment manager, Symons Capital has the power to choose to be different. Our concentrated portfolios cannot be copied by large asset managers because our portfolios cannot accommodate the scale of portfolios the large asset managers are after. We can avoid such saturated strategies.

Rather than fearing down markets, it is important to understand what down markets can offer boutique investors. If we can preserve purchasing power through intelligent risk management, then we have an opportunity to buy sound companies at attractive prices. Both sector rotation and the economic/market cycle can create those opportunities. Overall, our job is to make money for clients when markets are rising and avoid substantial losses when the cycle inevitably turns.

In our judgment, the investment markets are continuing to tempt investors into risky speculation. We are holding purposely cautious portfolios, and are continuing to do what we have always done — engage in intelligent risk management for our clients to try to help them build durable wealth and economic security. To do that, we have put portfolios on a different path from the market. We determine the path by managing the risk/reward equation with both macro and fundamentals research. That investment process generates our distinctive risk metrics such as downside protection, beta, standard deviation and active share. While no one can time the market short-term because of investor psychology, we can be prepared for the long-term probabilities. We believe we have tilted the long-term odds in our favor with the predominately defensive, high quality stocks that we currently hold.

Yours sincerely,

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Chairman & Founder	Chief Investment Officer