US Equities: The View From Here

It's easy to see why investors may have mixed emotions these days. After all, last year was the worst year for US equities since 2008 and yet, in its tenth year, the bull market marches on. Specializing in rising dividends strategies, Donald Taylor shares his insights on the bottom-up opportunities and themes shaping positive performance thus far in 2019.

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Q: With Q1 complete, what are your general thoughts on US equities?

Donald Taylor: Coming off the very sharp market drop that closed 2018, we've had an exceptionally strong start to the year. I expect we'll see the sharp sell-off, sharp rebound pattern repeat, although not necessarily anytime soon. It's the world we live in, shaped by a number of factors, particularly investor sentiment. Things turn very pessimistic with the whiff of a problem. Investors—especially those who experienced the 2008 financial crisis plus the sell-off in large cap companies after the tech bubble burst in the early 2000s—have some scars. They're understandably quick to worry about repeat scenarios. As a result, today's bouts of market concern move much faster than the actual underlying fundamentals. It doesn't take much for that kind of short view to recover and then you get the sharp move back up.

Q: Investors are hearing mixed messages about what's ahead for the US economy. What do you think?

Donald Taylor: There's a near universal belief that US economic growth this year will be less than 2018. Delving deeper into that assumption, viewpoints are generally divided into three camps. The first says we'll have a recession before the year's end. I don't share that view at all. The second camp believes the fiscal stimulus—that helped push 2018 GDP solidly above 3% and out of the muddling mode of the previous several years—is wearing off and we'll be back to 2% GDP and similar inflation. The third, and likely the smallest camp, says 2019 may be mathematically slower than 2018, but that performance will exceed general expectations. I lean towards this view.

From a market perspective, the near-term recession scenario would be the hardest on stocks. Markets would likely be fine with the second and third scenarios—unless with the third, where performance exceeds expectations, investors get concerned the US Federal Reserve Board (the Fed) might aggressively restart its tightening cycle, prompting fears that stronger than expected economic growth would soon fade.

Q: With that in mind, in March, the Fed put rate hikes on hold for the year. From where you sit, what does that mean?

Donald Taylor: For stable, predictable stocks with decent dividend and decent dividend growth, it's a good world. A while ago it appeared that 12 months down the road, the 10-year US government bond yield was going to be 4%. Now the 10-year yield in that same time frame is likely to be around 2.5%. Compare that to holding a stock with a 2.5% dividend yield plus dividend growth. The prospects look better today.

Despite the March announcement, the Fed watch will remain a sensitive point for markets. I expect that as long as the economy muddles along, the Fed will sit tight. If it's weaker, interest rate cuts will likely be on the table. Linking back to what I mentioned earlier, the interesting question is: What happens if the economy performs better than expected and inflation climbs beyond the 2% target? How high would inflation need to go and how long would

it need to hover above the target rate before the Fed introduces more increases? Or, would they tighten further solely on the basis of 3% real growth. It's an ongoing question and I believe the Fed faces a real conundrum.

Q: What are your thoughts on current valuations?

Donald Taylor: Broadly speaking, I think valuations are more or less where they should be.

Q: Where are you finding opportunities these days?

Donald Taylor: A key criteria for us is that a company grows its dividend around 10% a year. Microsoft Corporation is our largest position and it recently announced about a 10% dividend increase.[1] So did Honeywell International Inc., an industrial company with end markets that largely have nice secondary tailwinds behind them.[2] We expect that firm's growth rate to continue at a similar pace. Honeywell also presents less cyclical risk than other industrial names we could own. A smaller name in the portfolio, Albemarle Corporation, is a leading producer of lithium, a material vital to electric car batteries. It has posted a 10% dividend increase after slower dividend growth for a few years.[3] Albemarle operating results have been consistently healthy, but they've been investing a significant percentage of cash flow in building lithium production capacity as electric vehicle production skyrockets. In our view, their growth prospects are strong and it's been money well spent. Given the positive response to Albemarle's fourth quarter earnings report, we believe recent pessimism over the stock is lifting.

Q: Since your portfolio features multinational companies, how is slowing economic growth worldwide influencing performance?

Donald Taylor: Our holdings are affected in varying degrees by the slower economies in China, Japan, Europe and other emerging markets as a derivative of China. We focus on companies with end markets that have tailwinds behind them and try to avoid those end markets where we think there's a lot of risk. Generally speaking, I was happily surprised with fourth quarter earnings reports and guidance for 2019. Thus far, firms are managing through the current tempered environment.

It's not surprising that China figures in any conversation about the global economy. A lot of attention is dedicated to United States/China trade talks. However, I don't think there's enough attention paid to China's stimulus efforts, both in their fiscal and monetary policy. There's little said about its potential positive impact, both in China and as it filters into other countries' economic growth. I'll make the conceptual bet that China's stimulus works and we'll see growth accelerate somewhat.

Q: Global merger and acquisition (M&A) activity reached record highs in 2018; how might it affect your portfolio this year?

Donald Taylor: The companies we hold generally have very good cash flow and they'll put it to work growing and distributing dividends and repurchasing shares. A good number will also be involved in M&A activity, where the primary focus is on acquiring businesses that can enhance the overall organic growth rate of the company. They're generally adding important pieces rather than looking to massively expand the firm's size.

Interestingly, we're seeing more companies spin off businesses. For instance, there may be a business in a company that's fairly small relative to the whole organization and its value is underappreciated. Or, a new CEO arrives and decides parts of the business aren't core to the firm's future. So those parts are sold or spun off into their own enterprises. We've had some good experience keeping original firms and their spinoffs.

Q: What are your expectations as the year progresses?

Donald Taylor: At this point, we're up approximately 12% to 13% year to date and I expect we'll chart here for a little bit.[4] I don't see a big sell-off in the cards, but that said, more often than not, through the course of the year you have a 10% or more move down. As we're having this conversation, that has yet to happen. Frankly, I'll be happy if 2019 performance takes its cue from the first few months and delivers similar numbers throughout the year.

1. Calculations confirmed by FactSet Data as at November 14, 2018.
2. Calculations confirmed by FactSet Data as at November 15, 2018.
3. Calculations confirmed by FactSet Data as at March 14, 2019.
4. S&P 500 Index reference, Bloomberg Analytics Database as of March 31, 2019.