Tuesday, November 20, 2018

PUTTING IT IN NEUTRAL

- We are beginning to favor Value stocks a bit more than we have.
- For nearly a decade we've been overweight Growth stocks. We continue to prefer Growth on a long-term basis.
- We are not shifting portfolios totally to Value, just putting it in Neutral.

For the last nine years, except for a few defensive shifts here and there, we've very much so leaned toward Growth over Value. But we've been shifting more toward Neutral recently. We actually continue to prefer Growth over Value on a long-term basis; this tilt toward Neutral is more tactical.

We've mostly stayed away from heavy Value exposure recently because the biggest Value sector, Financials, had underperformed. We're not necessarily overly excited about the prospects of Financial stocks in 2019, but we've become more neutral on Financials as well (which is an upgrade from our concerns for the sector). But that just changes things at the margin. The larger forces at play are interest rates and earnings.

Rising interest costs will eat into corporate margins in 2019. Interest expense has been rising as companies either refinance at higher rates or are subject to adjustable rates. There was a lot of cash repatriated from overseas this year, and a lot of that went to paying down debt, but not enough to offset the cost of rising rates. The aggregate per share interest expense of S&P 500 companies has climbed to $24.68, up 38% in four years to the highest level since Q2 2009. That's actually quite a bit less than the $55 reached prior to the Financial Crisis, so it's not disastrous by itself. But the issue at hand is that Growth companies carry greater indebtedness than Value companies.

Not that anything at all is wrong with debt. The availability of capital financing is the life blood of the economy. But you can see how higher interest rates will take a bigger bite out of the earnings of Growth companies.

But, honestly, normally, I'd just say, "who cares?" Not that financing is what I'd really consider leverage, but it kind of is. Financing allows for growth. The problem is that we're struggling to find the source of margin expansion in 2019. Not that we think economic or sales growth will be bad; we actually think both will be quite good next year. We expect that companies of both the Growth and Value variety will see top-line growth. But the bottom-line growth will be tight as companies struggle to find improved productivity given that the labor market is extremely tight with unemployment at a nearly half-century low. Each new hirer is less productive, and they will be more expensive as labor costs have been creeping up. This will affect both Growth and Value companies, but it's the coupling with higher interest expense that is putting us in Neutral.

Bottom Line: We remain constructive on the US stock market and will continue to until we see increasing signs of recession (which we've been arguing for a long time is expected in 2020-2022). Our shift to Neutral, from Growth, is tactical in nature and does not currently reflect our longer-term bias toward Growth.