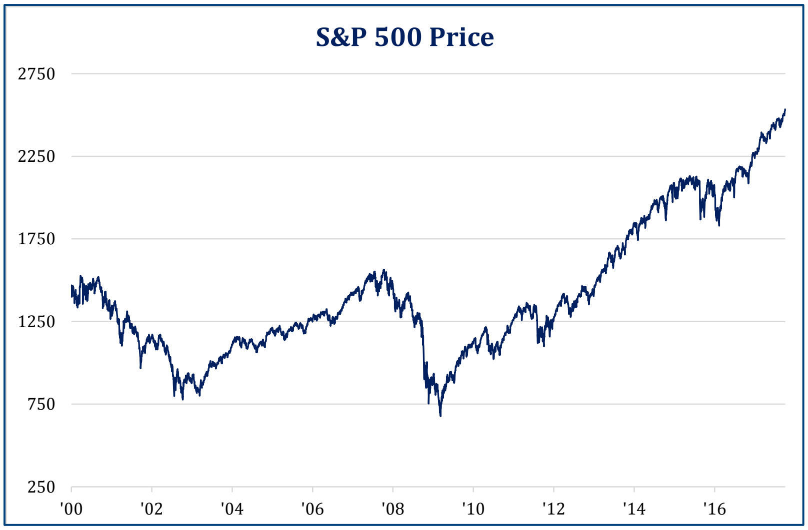
KINGS POINT CAPITAL MANAGEMENT LLC

# *If Old Age Doesn't Kill a Bull Market, What Does?*

Despite a great deal of investor nervousness, U.S. equity markets continue to move higher. Now in the eighth year of recovery from the financial crisis, investors are becoming increasingly worried that a severe correction or bear market may not be far off. While bull markets don't end from excessive longevity, the length of this cycle is certainly unusual (Chart I).

**Chart I**




*Source: Strategas*

This move seems to be supported by a number of factors. First, this economic recovery is unlike any seen in the past. U.S. GDP growth, hovering near 2%, is much softer than the 3% growth rate generally experienced during past economic recovery cycles. Therefore, economic pressures, such as full employment (which leads to rising wage growth) and peak capacity utilization in manufacturing have not reached the period of maximum stress on the economy. Additionally, despite very low interest rates, housing demand is good but not at a uniquely strong level (possibly the result of more stringent bank lending regulations). We also believe that cultural shifts partly due to the disruptive growth in social media platforms may have structurally impacted typical consumer spending patterns. Therefore, the usual signs of an impending bear market, such as a sharp rise in inflation and interest rates, an inverted yield curve, a decline in corporate profits, strong wage growth and higher commodity costs are not present at this time.

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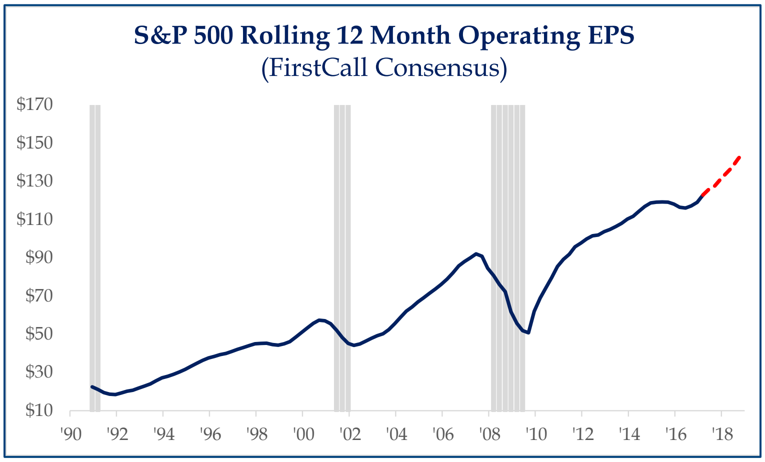
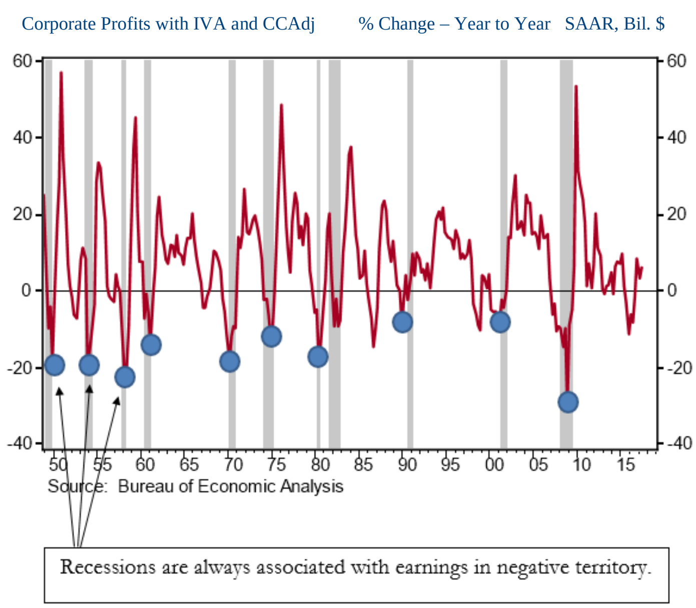
**<u>Chart II</u>**




*Source: Strategas*

Second, it is readily apparent that U.S. corporate profits are increasing after a period of sluggish growth (Chart II). Profits in European and emerging markets are also increasing which should bolster earnings for global multinational companies. Thus, we are in a period of synchronized global expansion. Statistically the U.S. economy does not experience a recession without a decline in corporate profits (Chart III).

**<u>Chart III</u>**




*Source: Strategas*

With corporate profitability growing on a worldwide basis, it is unlikely that U.S. based companies experience profit margin pressure while GDP growth accelerates in most global markets.

Lastly, the U.S. equity market is beginning to reflect the possibility of some tax reform in the intermediate term. If enacted, it would boost corporate profit growth in 2018 forward.

So, what are we watching that might give us pause about the current market (Chart IV)**?**

**Chart IV**

**Average Inflation, Treasury Yields, Valuation and Tax Rates by Decade**

| | CPI Y/Y % Change | S&P 500 Operating P/E | 10 Year Treasury Yield | Dividend Tax Rate | Capital Gains Tax Rate |
|---|---|---|---|---|---|
| 1950s | 2.1% | 12.6 | 3.0% | 91.0% | 25.0% |
| 1960s | 2.3% | 18.1 | 4.7% | 80.3% | 25.4% |
| 1970s | 7.0% | 12.5 | 7.5% | 70.2% | 36.0% |
| 1980s | 5.8% | 11.7 | 10.6% | 48.4% | 23.6% |
| 1990s | 3.1% | 19.5 | 6.7% | 37.0% | 26.0% |
| 2000s | 2.7% | 20.1 | 4.5% | 23.4% | 16.8% |
| 2010s | 1.5% | 17.1 | 2.4% | 20.0% | 20.0% |
| **Average** | **3.5%** | **16.X** | **5.6%** | **52.9%** | **24.7%** |
| **Current** | **1.9%** | **21.3x** | **2.3%** | **23.8%** | **23.8%** |

*Source: Strategas*

- Valuation – The U.S. equity market is trading at ~18x projected 2018 profits. As interest rates gradually increase, valuations could come under pressure. However, we believe that the 10-year Treasury would need to reach the 4% level to have a meaningful impact on valuations overall.
- Interest Rates & Inflation – Interest rates and inflation are generally lower than most economic forecasts. While we are not worried about a gradual rise in the U.S. 10-year Treasury yield from the current 2.3%, we would be more concerned if rates or inflation jumped **sharply** due to stronger than expected economic growth.
- Corporate Profits - Probably the single most important variable to equity market appreciation long term is the growth in corporate profits. As a result, we need an increase in corporate profitability in 2018 and into 2019 to see any meaningful advance in the overall market. Tax reform could play a decisive role in this variable.

As we enter the third quarter corporate earnings reporting period, we should get a good read on how companies view their near-term future. At this juncture, we expect a modest to moderately positive outlook for most companies. As a result, we remain cautiously positive on the market while realizing that current valuations are fully reflecting a generally positive trend in corporate profit growth.

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## Thematic Portfolio Trends – The Digital Future

During the normal course of business, we provide information regarding our overall investment themes as well as detailed research on certain companies within the portfolios. As we move into 2018, one area of continual interest for investment focuses on digital technology and mobility. However, prior to introducing this particular theme in more detail, we wanted to provide some basic information regarding our general thematic approach to security selection.

At KPCM, the fundamental approach to equity selection reflects our dedication to GARP (growth at a reasonable price) with our own unique focus on certain financial disciplines. Some of the essential financial criteria follows:

- Shareholder friendly management with a definable vision of growth
- Superior leadership and an industry leading position
- Positive free cash flow generation with returns on capital employed above its cost of capital
- Direct shareholder return through dividends, debt repayment and/or buybacks

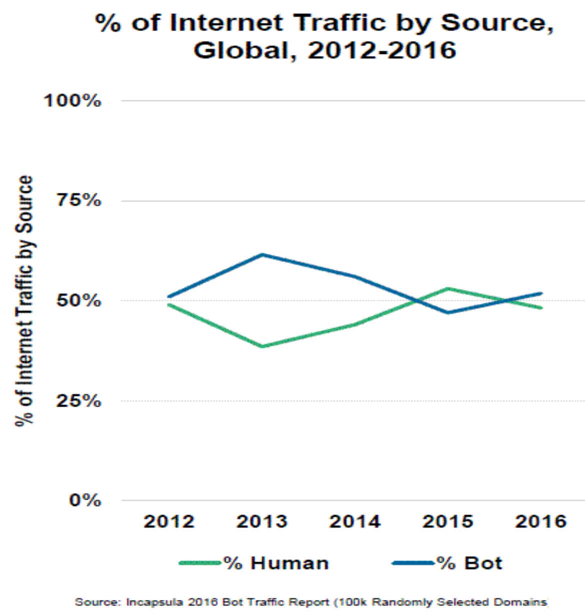
Needless to say, we have other selection criteria, but those listed represent the most important. In addition, we identify broad macro and industry themes that we believe will provide superior returns. As an example, in recent years, we have invested in many aerospace and defense companies like Boeing, Lockheed Martin and Raytheon. We observed that as sequestration ended, a trend toward an increase in defense spending was likely to occur. We have also thematically focused on service industries given the category dominance, strong cash flow and superior growth; Accenture, Intercontinental Exchange and AON are good examples of that investment theme.

While the digital revolution began over two decades ago, there is now a seemingly permanent generational shift toward exploring, buying and socially connecting through the online universe. This shift into the digital world has dramatically altered business practices and standards around the world. The last presidential election is a prime example, which was as much a social media event as a traditional political campaign.

But it is the visionary business expansion and ultimate profitability at Amazon that continues to drive our focus for how this digital revolution plays out in equity investments over the coming decades. Amazon is not only changing the retail landscape, but is also a critical piece of the worldwide web infrastructure. It recently expanded into media and grocery and threatens other traditional business models. As such, we believe we are still in the first inning (to borrow an often-used baseball analogy) of the digital age.

As Chart V indicates, humans are less than 50% of all current Internet traffic, while digital bots (computer generated traffic) represent the balance.

**Chart V**




This has significant implications as to how the business models for companies like Google and Facebook will evolve to capture more value-added Internet traffic. Aside from the obvious pressure on traditional retail store traffic, and possible hacking of personal or corporate protected data, the growth curve in digital is rapidly expanding into financial, media and corporate markets daily.

We have been positioning our portfolios to take advantage of these growth profiles with equities that are clear beneficiaries and some that are not as obvious. Some of the overt names include Amazon, Google and Apple. Amazon, more than any other company, has defined the systematic shift that the digital age brings to the world. With the launch of the *Alexa* product line, it has also formed a digital ecosystem that links its various marketing efforts. In many respects, Amazon is moving at a faster pace than Apple’s product ecosystem. Google has also branched out from its dominant position in online search and is in the formative stages of launching its own consumer-oriented ecosystem of media, communications and payments. Indeed, we believe the near future will see one or two dominant digital ecosystems become the basic interaction for the U.S. consumer. This has negative implications long term for the cable industry if they don’t find a way to stop the cord cutting.

Alibaba (a core position) has replicated the best of Amazon, Google and PayPal (another core position). We expect this company to not only dominate the emerging market countries, but ultimately compete on a worldwide basis within 5-10 years. We also target companies with a strong position in certain submarkets. These companies include LogMeIn (online security and corporate communication), Accenture (global business process outsourcing and consulting), Intel (software and hardware processing), Microsoft (consumer and business software) and Avery Dennison. This last company has the largest position in radio frequency tags that are instrumental in inventory control systems and a clear beneficiary of growth in online merchandise.

Lastly, we have also positioned portfolios with the two biggest cell tower companies in the United States: American Tower and Crown Castle. As 5G wireless speeds become the standard in the next decade, these companies should materially benefit from demand for more space on their cell sites.

Our portfolio investment themes are well defined and are a critical component to all our client portfolios. Moreover, we remain focused on profitable growth at reasonable valuations rather than growth for growth's sake. While this eliminates such companies as Netflix, we believe our financial discipline will serve our investors well over the next exciting years in the digital world.

Please contact our offices with any questions.

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