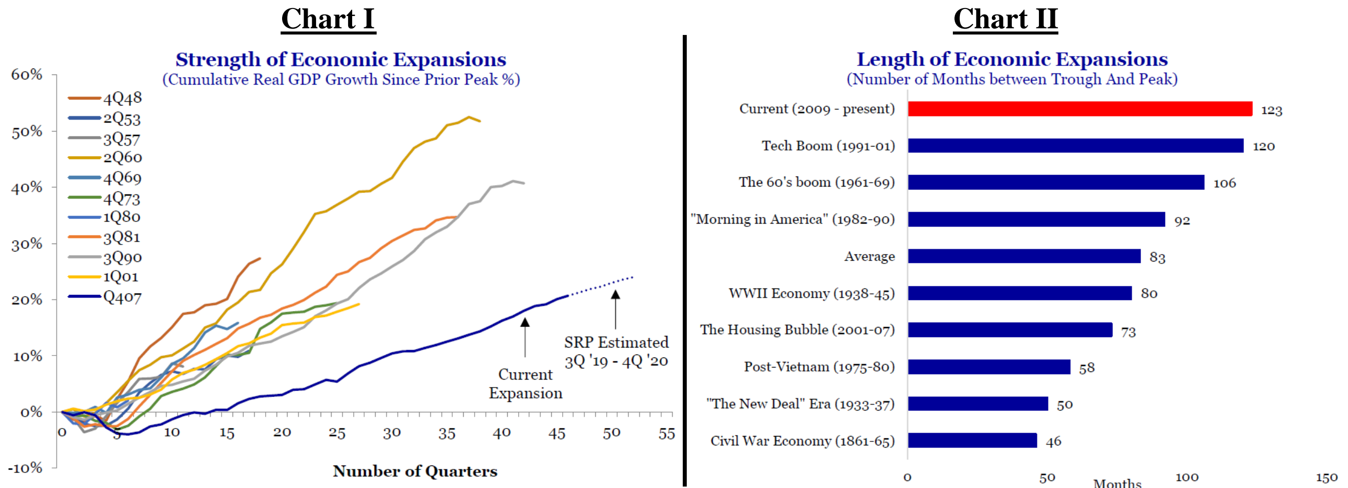
KINGS POINT
CAPITAL MANAGEMENT LLC

QUARTERLY REVIEW AND OUTLOOK
Economic Crosscurrents Create a Cloudy Outlook



Source: Strategas

The U.S. economy is now in its 123rd month of economic expansion (see Chart II), eclipsing the 120-month record that began in 1991 and ended with the "tech bubble" of 2001. What is different this time is the degree of economic growth. The current growth cycle is significantly slower than previous cycles (Chart I). Historically, the U.S. economy (GDP) has grown at 3% or more during most of the expansion phases. Our current expansion growth rate is closer to 2-2.5%. Indeed, most economists are expecting only 1.5-2.0% growth over the next 12-18 months. This slow growth economy is probably one reason why few economists see a recession anytime soon. Employment is strong; consumer spending is reasonable; corporate profits are still growing, and the global economic slowdown in Europe and Asia may be poised to begin recovery in the near future.

Slower growth in the U.S. also reflects more stringent regulations on bank lending toward consumers and for lower leverage in various financial products. On the positive side, these regulatory changes have resulted in stronger balance sheets for most of our major banks.

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Chart III

Net Flows into Mutual Funds + ETFs ($BN)						
	Domestic Equity		International Equity		Bond	Money Mkt
Year	MF	ETF	MF	ETF		
2009	(27.6)	30.9	29.6	39.6	417.2	(539.1)
2010	(81.1)	46.7	56.7	41.5	262.0	(525.1)
2011	(133.3)	47.3	4.1	24.3	163.7	(124.1)
2012	(159.1)	80.9	6.4	51.9	358.5	(0.2)
2013	18.1	104.1	141.4	62.8	(59.0)	15.0
2014	(60.2)	141.5	85.4	46.6	94.5	6.2
2015	(170.8)	65.4	93.9	109.7	29.4	21.5
2016	(235.4)	167.6	(24.5)	20.1	190.1	(30.3)
2017	(236.0)	186.0	76.7	159.8	381.1	106.9
2018	(253.2)	139.1	(7.3)	70.3	103.0	158.8
2019 YTD	(151.2)	50.4	(27.7)	(6.8)	280.9	300.0
TOTAL	(1489.7)	1059.8	434.7	619.7	2221.4	(610.5)

Source: Strategas

As Chart III demonstrates, we have seen a steady decline in equity investments in recent years as flows move to bonds and money market instruments. Concurrently, within equities, money has flowed to utilities, REITs and stocks with good dividend yields. The overall trend is astounding given the steady decline in interest rates in the same time period. It has been said many times over the last few years that this current bull market is the most unloved in history.

Chart IV

	Select Global Bond Yields (%)												
	6M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	20Y	30Y
Switzerland		-0.99	-0.98	-0.99	-0.97	-0.96	-0.96	-0.89	-0.86	-0.87	-0.82	-0.56	-0.43
Germany	-0.71	-0.72	-0.79	-0.84	-0.84	-0.80	-0.80	-0.76	-0.72	-0.65	-0.59	-0.32	-0.08
Japan	-0.28	-0.32	-0.33	-0.35	-0.35	-0.37	-0.37	-0.37	-0.35	-0.29	-0.20	0.18	0.34
Netherlands	-0.75		-0.78	-0.81	-0.79	-0.73	-0.73	-0.63	-0.56	-0.51	-0.45	-0.12	-0.09
Finland		-0.77	-0.76	-0.74	-0.71	-0.69	-0.69	-0.55	-0.45	-0.40	-0.33		0.16
France	-0.66	-0.65	-0.73	-0.75	-0.73	-0.65	-0.65	-0.51	-0.44	-0.38	-0.29	0.11	0.54
Sweden	-0.61		-0.68		-0.77	-0.73	-0.73		-0.57		-0.36	0.04	
Ireland		-0.61		-0.57	-0.55	-0.49	-0.49	-0.30		-0.15	-0.05	0.43	0.78
Spain	-0.50	-0.51	-0.54	-0.50	-0.37	-0.31	-0.31	-0.10	-0.02	0.06	0.13	0.56	1.02
Portugal	-0.49	-0.46	-0.65	-0.48	-0.32	-0.27	-0.27	-0.07	-0.01	0.08	0.14	0.70	1.04
Italy	-0.28	-0.28	-0.28	-0.11	0.00	0.21	0.21	0.50	0.59	0.64	0.82	1.57	1.93
U.K.	0.67	0.46	0.36	0.28	0.27	0.27	0.27	0.25	0.31	0.39	0.48	0.89	0.97
U.S.	1.65	1.59	1.38	1.34		1.35	1.35	1.46			1.54		2.05
China		2.56	2.68	2.76	2.76	2.95	2.96	3.16	3.17	3.14	3.13	N.A.	3.73
India		5.65	6.04	6.04	6.12	6.24	6.50		6.67	6.71	6.61	7.00	

Source: Wolfe Research Portfolio Strategy, Census Bureau,
Jay R. Ritter at the University of Florida Warrington College of Business and Bloomberg

One of our biggest concerns impacting our market view is the approximate $15 trillion in sovereign debt that is currently carrying a negative yield (see Chart IV). While economists do not seem

particularly worried by this unprecedented shift in financial flows, we believe this could be the "elephant in the room." Negative yields overseas are expected to bring down U.S. interest rates as foreign buyers seek better returns. This "cheap money" economy has created a huge increase in BBB rated investment grade corporate debt. This debt now represents about half of all investment grade corporate debt in the U.S. versus 25-30% historically. **Put another way, many companies with less than pristine balance sheets are borrowing at an accelerated pace given the low interest rates in the market.** Some of this debt may well fall below investment grade in the next economic recession. Thus, the seeds of an interest rate spike could flourish. At this juncture, we do not see this occurring. However, should the U.S. move into a recession, this part of the debt market needs to be monitored. Finally, we suspect the growing debt issues could be an even bigger dilemma in Europe, particularly since European banks are not as strong as their U.S. counterparts. We are not of the opinion that the Fed should continue to cut interest rates or act to support further quantitative easing. We believe the real benefits have already occurred and additional efforts to stimulate the economy using these programs may ultimately prove counterproductive.

At this juncture, we remain modestly bullish. The S&P 500 is selling at about 17 times projected earnings in 2020. If we exclude banks and energy, the market's P/E ratio is close to 18.5 times projected earnings. This is reasonable given the current low interest rate environment. Importantly, GDP growth of 2%, disproportionately low interest rates, full employment and slow growth in international markets suggest a recession scenario is not likely in the near to intermediate future. Overall, the market is at fair to full valuation at current levels. Thus, we expect the equity markets to reflect modest to moderate profit growth going forward without any additional expansion in valuation. If valuation expansion does occur, it is more likely to be in the value segment of the market. As a result, we remain modestly optimistic that the U.S. equity markets can move gradually upward through the first half of 2020. The market could well return 6% or more in 2020, if current economic trends remain stable.

PORTFOLIO INVESTMENT THEMES

Our Quantitative/Fundamental Approach - For us, cash flow is still king.

The core philosophy of our equity portfolio revolves around companies generating positive cash flow above the cost of capital. In a simplistic approach, we seek category dominant, well-managed companies that have consistently generated a superior return on capital over long periods of time. We measure valuation, cyclicity, competition, management practices and long-range goals, among other factors. We start with a regimented quantitative model that highlights leading candidates by industry subsets. We then shift to a fundamental approach to fully understand the prospects of each company in our portfolio.

Our disciplined approach highlights both positive and negative trends. Additionally, because we are tax sensitive and long-term oriented, sometimes our approach can be early in scaling into or out of a cashflow cycle. Two examples follow:

Positive Trend

We targeted the potentially massive positive impact that 5G technology could bring by the mid-2020s. This led us to increase our portfolio exposure to cell tower stocks, telecommunication equities and Internet providers well before 5G trends became apparent. Focusing on cash flow and strong return on capital, we slowly added a variety of names such as Google, Microsoft, Crown Castle and Cisco to name a few. Our clients are also well represented in the ever-expanding digital world, another targeted area for long-term investment that creates strong cash flow returns on capital.

Negative Trend

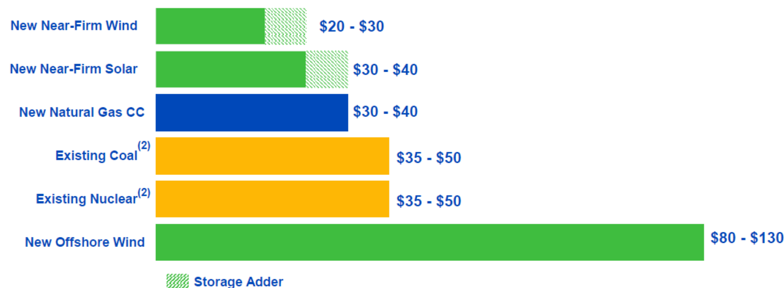
In recent years we have also reduced or eliminated companies in industries that we believe will ultimately suffer long-term pressure on cash flow. One such industry is tobacco. We eliminated all our exposure in this area in the last few years. Our concern is not just the possibility of cash flow growth slowing. We also dislike the areas of redeployment of current cash flow in the industry. Traditional tobacco consumption is in a secular decline. Worse, these companies are taking their current strong cash flow (benefiting from price increases) and redeploying much of it into cigarette-related products. These e-cigarettes and flavored vape smokers are still a health-related problem. The companies also have to price them aggressively to generate a good return on capital. We would have preferred to see this cash flow targeted for other non-controversial consumer products that lend themselves to sustainable cash flow growth. Since the tobacco industry is redirecting their cash flow back into “reduced risk” tobacco substitutes, we see little reason to own these equities. Should tobacco volume declines accelerate next year, cash flow may be under pressure.

A New Investment Frontier

We draw a similar conclusion in another industry which is far larger than tobacco. We believe that the global energy industry is at an inflection point. In the U.S., new solar and wind additions are lower in cost per megawatts (see Chart V) than new additions to natural gas, coal and nuclear energy. This means that future energy projects should see significant money invested into wind and solar at the expense of all other new energy alternatives. The driver of this reduced cost reflects significant technology breakthroughs in these alternative areas.

<u>Chart V</u>

<u>Estimated Costs of Generation Resources Post - 2023[1]</u>
($/MWh)



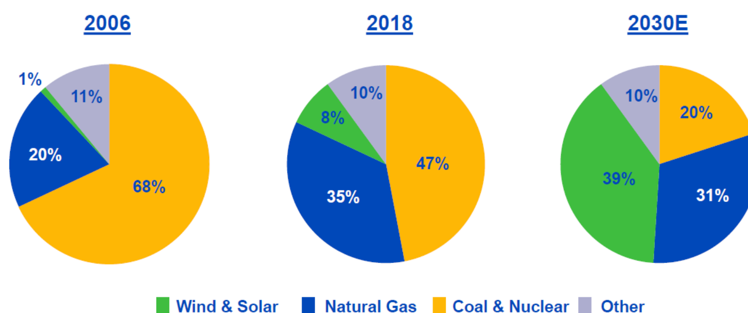
1) Energy Resources' estimate
2) Represents all-in cash operating cost per MWh including fuel and ongoing capital expenditures

Source: NextEra Energy Investor Presentation, June 2019

Most experts believe that natural gas will act as a transition energy as we move to more renewable alternatives. However, it is becoming clear that wind and solar are now competitive alternatives, even with eliminated subsidiaries in the near future. Thus, we believe that wind and solar are likely to see dramatically higher growth in the next 10 years.

<u>Chart VI</u>

<u>Electricity Production by Fuel Type[1]</u>



1) 2006 and 2018 source: U.S. Energy Information Administration; 2030 estimate source: National Renewable Energy Laboratory (NREL)

Source: NextEra Energy Investor Presentation, June 2019

As Chart VI demonstrates, estimates for electricity produced in the U.S. should shift dramatically toward wind and solar and away from natural gas, coal and nuclear in the next 10 years. We are seeking additional companies in the space to add to our NextEra investment. These new investments should meet or exceed our financial criteria and benefit from this shift toward renewable energy. Moreover, we are likely to avoid investments in oil, gas and other energy areas

as this shift begins to accelerate. We believe that oil is the energy subsector that is most at risk in the next 10-20 years. As is the case in tobacco, most oil companies continue to redeploy cash flow back into their industry. We believe that this money should be earmarked for renewables rather than exploration into existing oil prospects.

These broad-based investment themes are directly tied to our investment discipline of return on invested capital. While the equity markets may be less sensitive to these trends near term, we believe our clients are best served by our continued focus on tax efficient, long-term growth.

As always, should you have any questions, please reach out to us at your earliest convenience.

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