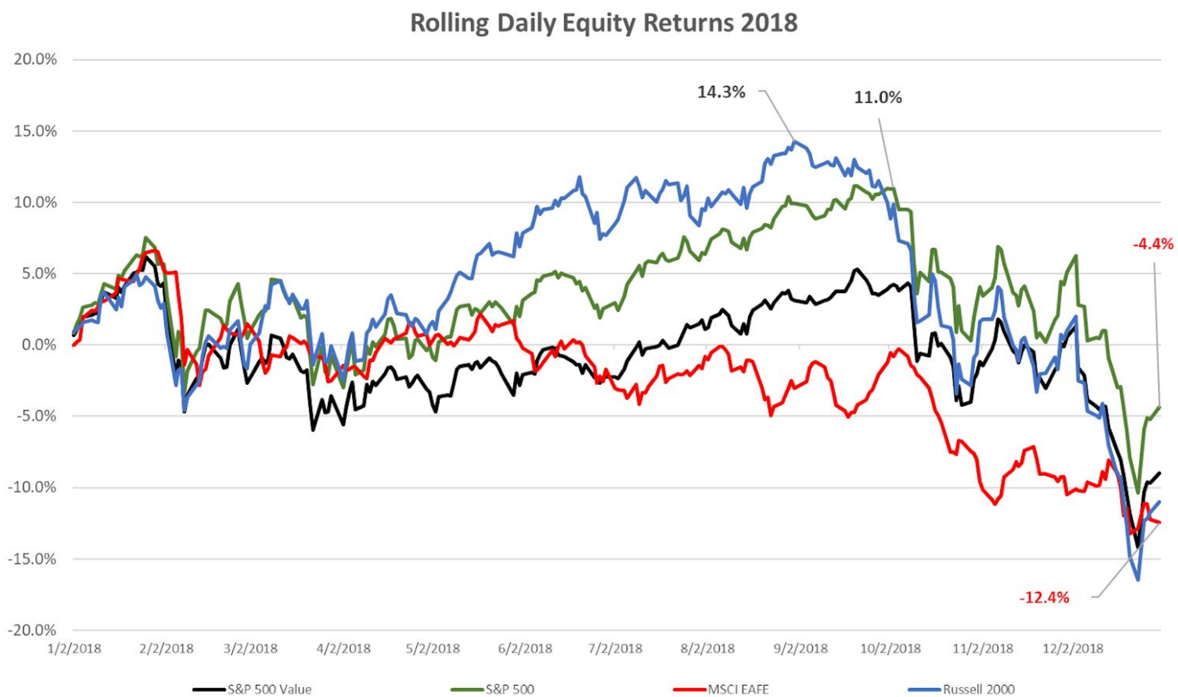
January 25th, 2019

Dear Turtle Creek Client,

2018 was a year in which literally nothing worked for investors. Every major asset class from stocks to bonds to commodities posted negative returns and the synchronized global economic growth that fueled investor optimism in the first months of the year decelerated noticeably. International markets posted significant losses, with the MSCI EAFE index declining nearly 13% during the year. Domestic stock market losses were mild by comparison, with the S&P 500 and Dow Jones Industrial Average declining 3% and 5% respectively. These U.S. figures are deceiving however given strong performance through the first nine months of 2018 followed by a steep collapse in market values. U.S. stocks entered a sudden and swift bear market during the final quarter of the year, losing nearly 20% of their value in a handful of months.



Source: Bloomberg

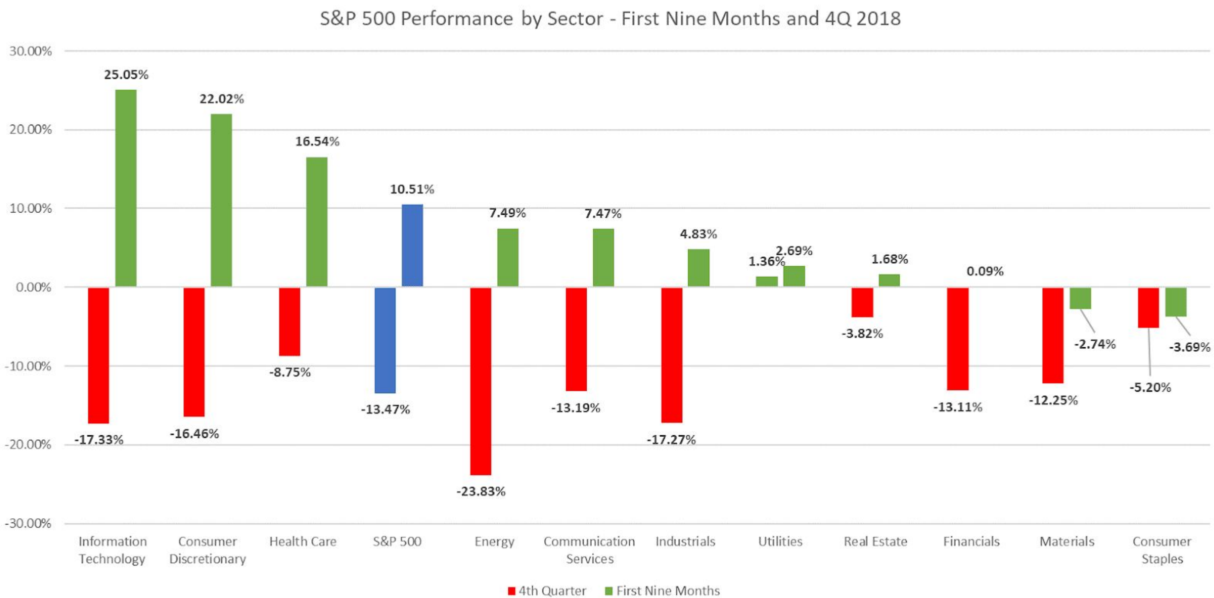
The fundamental risks that fueled global market declines were in most cases well-known. Federal Reserve tightening, an increasingly hostile trade stance by the U.S. Government, questions regarding sustainability of robust earnings and economic growth, and the usual geo-political risks were all well-diagnosed but offset in investors' minds by global economic expansion. As international economies reversed course and cracks began to appear in U.S. corporate performance, investors quickly re-assessed the downside of various market risks and sold equities across the board.

The key question entering 2019 is whether markets have overreacted regarding both the timing and magnitude of an economic slowdown. While earnings and economic indicators have cooled from above-average and likely unsustainable rates, most traditional recession indicators continue to signal economic growth and the credit or market excesses that historically lead to significant recessions are not visible.

Correction or Recession is the question.

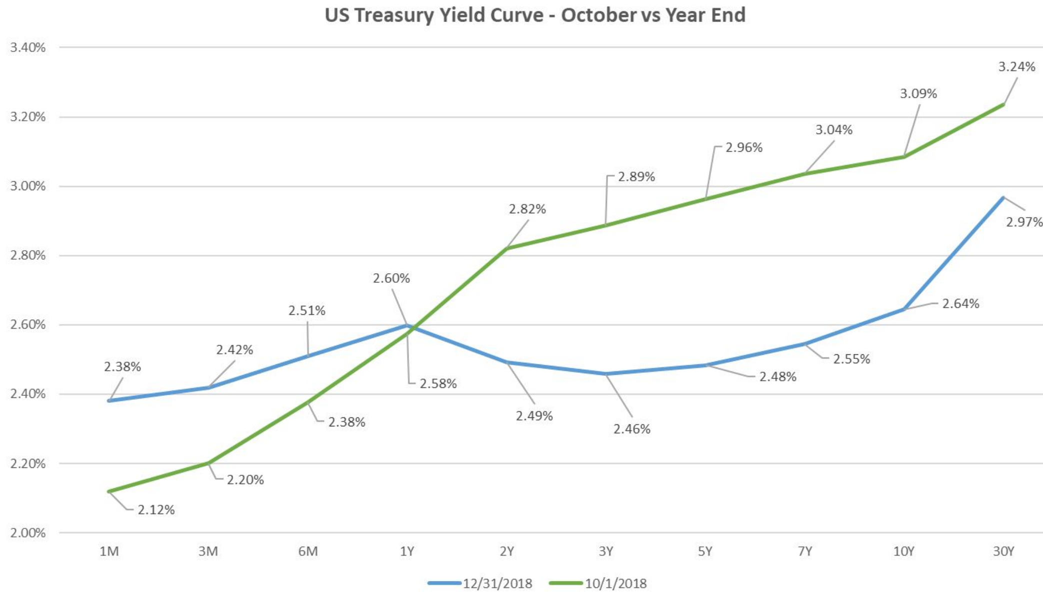
2018 Domestic Stock and Bond Market Performance

Through the first nine months of the year, the growth-oriented industries that have driven equity markets for a multi-year period extended their strong performance while defensive, safe-haven sectors posted flat results. This dynamic reversed itself in the last few months of the year as prior market leaders posted declines well in excess of the overall market and laggard groups such as consumer staples, real estate, and utilities held their value.



Source: Bloomberg

Bond markets also reversed course at year-end. The prospect of an accelerating economy had pushed up yields for most of 2018 but yields then dropped quickly through the last few months of the year. Sections of the U.S. Treasury Bond yield curve flattened and in certain cases inverted, an alarming sign as yield curve inversion historically foreshadows a recession.



Source: Bloomberg

<u>Quantifying Current Stock Market Expectations</u>

The humble price/earnings multiple is a powerful mechanism for gauging market signals. Financial expectations from sales to profit margins combine to form the market's expected earnings per share (The E) and investor's expectations regarding interest rates, inflation, and risk combine to determine the price investors are willing to pay for those earnings (the P).

At the end of 2018, market analysts were projecting S&P 500 companies to earn approximately $170 per share in earnings in the upcoming year. At the low-point of December's stock swoon, the market valued those expected earnings at only 14 times. This was a significant reduction from earnings multiples of near 20 times earnings at the beginning of the year. Markets were projecting 2019 corporate earnings growth well below Wall Street expectations, heightened risk aversion by investors in the form of lower valuation multiples, or some combination of both.

S&P 500 2019 Fiscal Year Projected Earnings

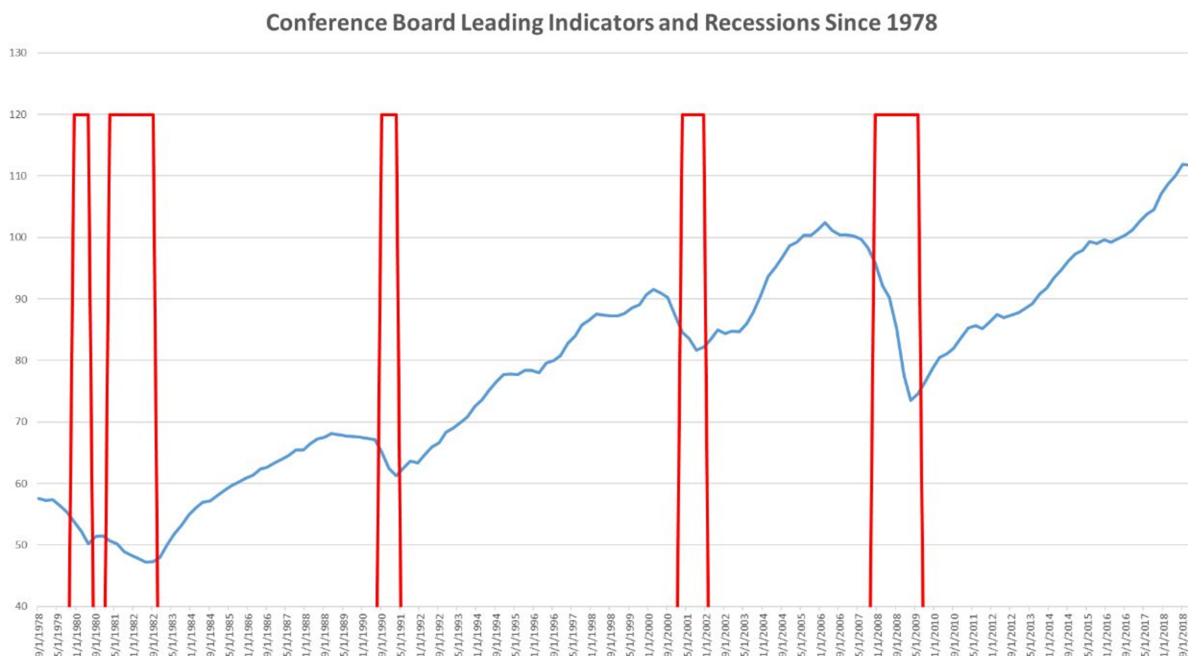
Earnings Multiple	$ 150.00	$ 155.00	$ 160.00	$ 165.00	$ 170.00	$ 175.00
11	1,650	1,705	1,760	1,815	1,870	1,925
12	1,800	1,860	1,920	1,980	2,040	2,100
13	1,950	2,015	2,080	2,145	2,210	**2,275**
14	2,100	2,170	**2,240**	**2,310**	**2,380**	**2,450**
15	2,250	**2,325**	**2,400**	**2,475**	**2,550**	**2,625**
16	**2,400**	**2,480**	**2,560**	**2,640**	**2,720**	2,800
17	**2,550**	**2,635**	2,720	2,805	2,890	2,975
18	**2,700**	2,790	2,880	2,970	3,060	3,150
19	2,850	2,945	3,040	3,135	3,230	3,325

<u>Is the Stock Market Speaking Too Soon?</u>

Equity market sell-offs have historically exhibited a fairly consistent pattern. The economy takes a negative turn and “smart” markets such as bonds or foreign exchange identify the trend and adjust accordingly. The stock market on the other hand has historically ignored negative sign-posts and continued to advance until finally waking up and collapsing into significant declines. Famed investor Jeremy Grantham described the stock market in the run up to the 2008 Credit Crisis as a “Brontosaurus that has been bitten on the tail and most of its body hasn’t noticed it yet, the signal is still working its way up the vertebrae.” Historical data supports his characterization. Stock markets have continued to appreciate for a nearly two-year period on average after economic indicators start to turn negative and post gains over 20% in the process. This market tendency to rally into the teeth of economic pain has traditionally been a powerful disincentive against trying to trade on the basis of economic indicators.

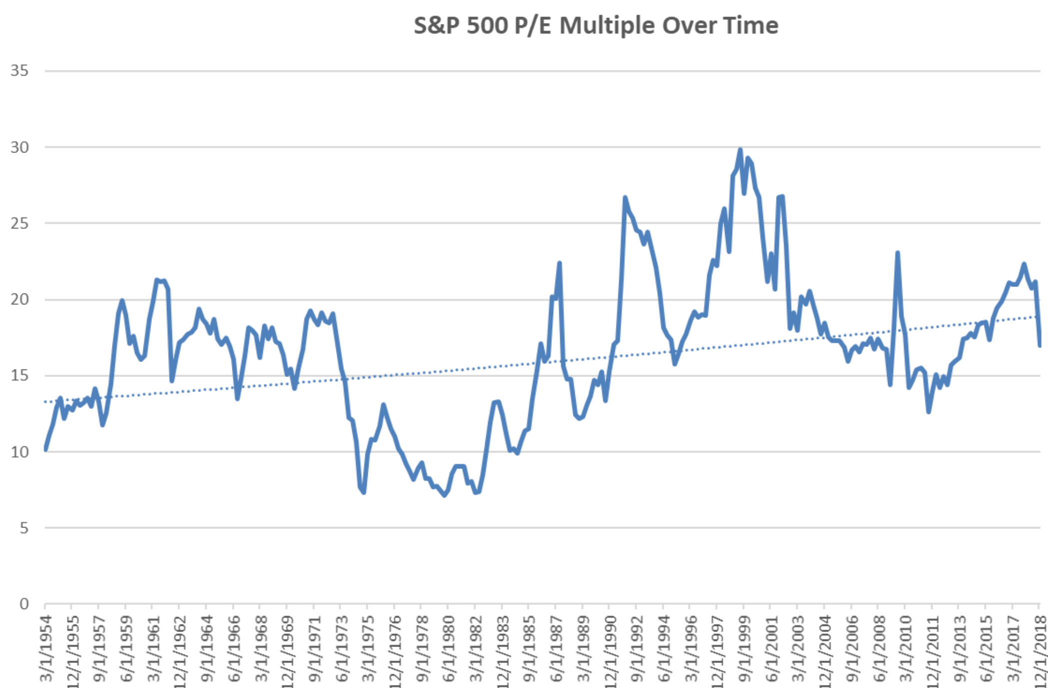
Given these historical patterns, recent market behavior seems odd. At the onset of the recent stock market plunge, popular economic sign-posts were all striking an optimistic tone. The yield curve was in healthy shape as late as early November and employment indicators continue to strengthen rather than weaken. Employee wages were finally increasing after a long period of stagnation, a trend that historically increases economic activity. Manufacturing activity maintained its positive trajectory, albeit at a slower pace with some volatility due to the ongoing trade spats.

The Conference Board U.S. Leading Indicators Index has turned clearly negative well in advance of the last five recessions. In the run-up to the Great Recession of 2007, its leading indicators turned negative in March of 2006. The S&P 500 continued trading upwards for another 20 months before finally catching wind of economic contraction. At the end of 2018, these same leading indicators were posting record positive results. If an economic slowdown is in the cards in the near future, traditionally reliable early indicators have yet to pick up on this trend.



Source: Bloomberg, NBER

Market valuation multiples have reached lower levels historically compared to today but only during times of severe economic distress. These times include the oil shocks and stagflation of the 1970s and the Global Credit Crisis of 2007.



Source: Bloomberg

With the overall economy providing a supportive backdrop for near-term earnings growth and valuation ranges sitting at the floor of most historical periods outside severe economic shocks, the prospect for ongoing market losses appear low. We would argue that we have experienced a market correction rather than the prelude to a more painful recession and further sustained market losses. There is plenty of historical precedent for similar sudden, sharp market drops that ultimately do not lead to recession. The Kennedy Slide of 1962, the 1987 Crash, and most recently the Growth scare of 2015 all entailed near-term economic volatility and market declines that ultimately resulted in ongoing economic growth.

Implications for your Portfolio

While we currently see the risk/reward ratio for stock markets as positive, we cannot ignore that both short and long-term risks remain and should be managed appropriately.

Government institutions ranging from the Federal Reserve to the White House continue to represent a threat to the economy. The Federal Reserve has pursued an overly-pedantic policy and could tighten financial conditions to the point of recession. The Trump administration continues to wage a potentially damaging trade war that if taken to an extreme will significantly impact both foreign demand for U.S. goods and pressure margins for U.S. companies. The latest government threat is a prolonged Federal Government shutdown. These are man-made problems, however, and can be quickly undone by more intelligent policy decisions. The Federal Reserve has already significantly dialed back its plan for future rate hikes and China and the U.S. have committed to resolving trade differences. Resolution to these problems would be a positive catalyst for equity markets.

A potential economic recession remains a longer-term risk but based on current data such a downturn does not seem to be imminent. The U.S Economy remains late into its economic cycle but has yet to signal a decline.

The best news for investors is that the stock market appears to have discounted these scenarios and much worse with its recent slide. Positive earnings and economic growth through 2019 should translate to market gains in the year ahead.

At the beginning of the year, we had speculated that the Great 30 Year bond bull market might have ended but the subsequent flattening of the yield curve indicates significant upward movement in interest rates is now much less likely. Our emphasis on high-quality and short maturity bonds remains the appropriate portfolio stance but the downside of longer-term bonds seems less severe.

Finally, we want to report to you that Kevin Hardage has left the firm effective as of January 15th, 2019. As you may know, he was one of the founders of Turtle Creek Management and has been with us since 2006. We wish him the best.

As always, we appreciate the trust and confidence you have placed in our firm. Please call should you have any questions or concerns regarding your portfolio.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA