May 7th, 2018

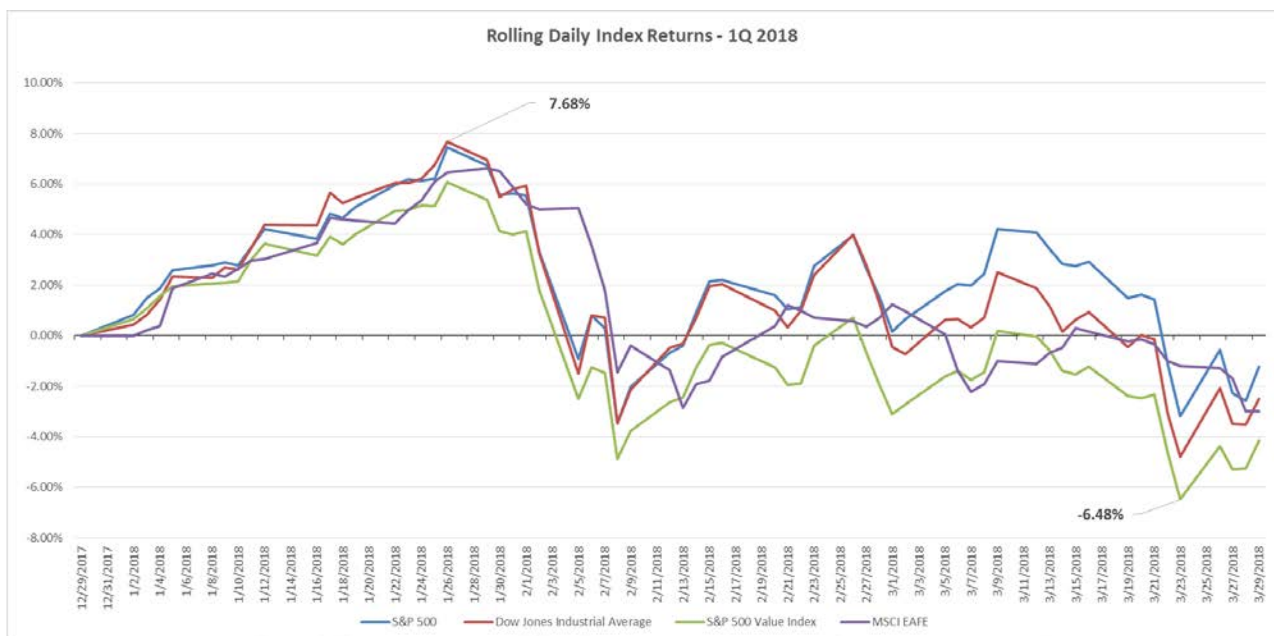
Dear Turtle Creek Client,

The first quarter of 2018 featured volatile results in both equities and fixed income markets, marking an abrupt reversal to the serene and positive trends that characterized the prior market year. We had pondered in recent letters the sustainability of market behavior that ignored so many historical worries. Investors in aggregate seemed to come to our view of things in dramatic fashion.

The stock market telegraphed contradictory and often incoherent signals during the quarter, resulting in highly-variable returns on individual securities and economic sectors from week to week. Also worth noting was the historically abnormal day-to-day market volatility. Market swings were in certain cases unprecedented in their scope. Despite these steep peaks and valleys, equity indices finished only slightly lower for the quarter. Fixed Income markets also posted losses during the quarter, reflecting the measured increase in short term interest rates driven by Federal Reserve bank rate hikes.

It was difficult to ascertain a precise message from the stock market's highs and lows. The euphoric start to January reflected investor belief that the strengthening global economy would accelerate even further. The subsequent and steep decline in February represented angst over accelerating inflation and the potential for faster-than-forecast Federal Reserve rate hikes. Markets then see-sawed back and forth responding to a variety of events ranging from political concerns to weaker-than expected GDP growth to trade spats between the US and key trading partners

In contrast to the stock market's jitters, the healthy medium-term outlook for corporate profits and global economic growth remained largely unchanged. Earnings growth estimates remain robust and macro-economic concerns such as above-trend inflation are not yet detectable in economic reports.



Source: Bloomberg

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com

Modern Markets and Time Varying Risk Premia

By almost every measure, first quarter volatility was abnormal. The S&P 500 declined more than then two percent five times, something that did not occur at all during 2017 and occurred only eight times in the preceding five years. This atypical volatility begs several questions including what is driving such swings and whether you as an investor should be concerned.

The primary suspect behind recent market sell-offs was the technology that underpins today's modern markets. Stocks no longer exchange hands between suit-wearing traders wandering exchange floors. An ever-increasing percentage of daily market volume is now the product of computers trading amongst themselves based on relatively crude decision rules. These computerized traders take several forms ranging from quantitative trading strategies to passive investing vehicles such as exchange traded funds.

Many benefits have accrued through the move to computerized markets but one undeniable negative is the diminishing lack of human nuance and fundamental price discovery in daily trading. A computer is told to sell if the market goes down, and it keeps selling no matter the longer-term rationale of such a choice. Analyzing market debacles ranging from the Crash of 1987 to the Flash Crash of 2010 shows a consistent pattern of machine-based trading causing significant dislocations that lack fundamental justification. Market watchers trying to make sense of this quarter's swings have found similar patterns at work.

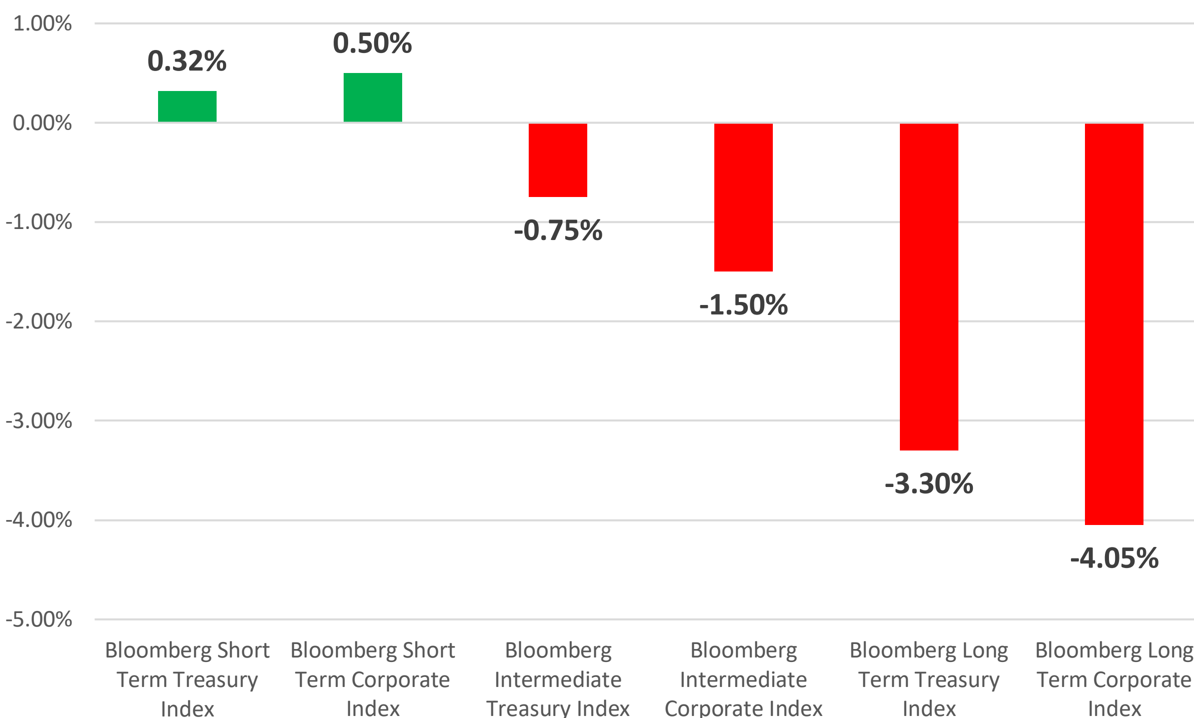
Another consideration is an overdue normalization in risk appetites. Investors understand that risk is inherent in equity investing and therefore ask for additional return over and above safer investment choices such as bonds. This additional compensation is called the "equity risk premium" and economists have labored mightily to understand and gauge this mysterious figure.

Researchers initially assumed financial markets were rational, efficient, and oracular in their ability to signal future risks and returns. If the market was concerned, you should be as well. As more thorough data has been gathered, however, these professors now view markets as moody and inconsistent. The official term for this concept is "Time Varying Risk Premia", which in plain English states that an investor's risk appetite swings between optimism to pessimism in hard-to-predict and often illogical ways, severely limiting the predictive value of market behavior over the short-term. Investors appeared unnaturally calm during 2017 despite a litany of potential risks. Security prices now show a much greater degree of caution. The significance of either of these risk appetites is limited however.

Fixed Income Markets – Continued Normalization

The bond market also posted negative returns due to rising Federal Reserve borrowing rates and greater caution regarding riskier bond issues. As we have discussed in previous notes, rising rates are a negative for the market price of your bond holdings. As the Federal Reserve pushed forward with well-signaled rate hikes, the 10 Year Treasury Bond saw its yield rise over 30 basis points (0.3%) during the quarter. At the same time the spread, or additional compensation, investors asked from lower quality borrowers also jumped.

The losses investors experienced were commensurate with their degree of risk. Turtle Creek has hammered home the "Short-Duration/High Credit Quality" bond strategy the last several years and this approach was insulated from recent losses. Looking at various bond indices sorted by maturity and credit quality, short-term Treasury and Corporate bonds maintained their value during the quarter while bond strategies of longer maturities and greater embedded risk posted increasingly steeper losses depending on your exposure to those two factors.



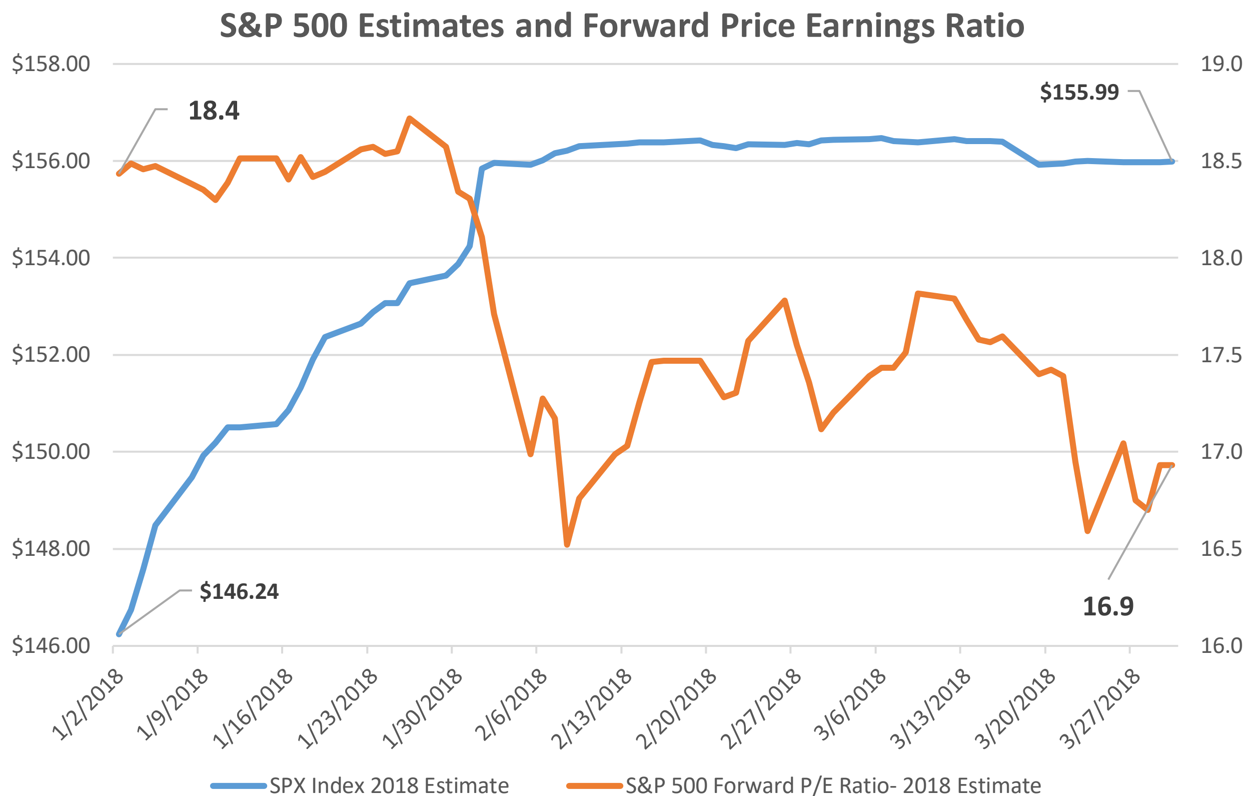
Source: Bloomberg Barclays Indices

The Signal-To-Noise Ratio and Interpreting Quarterly Results

To advance their trade, investment analysts borrow liberally from the world of science. One of the more useful appropriated concepts is the signal-to-noise ratio. Used by engineers to check if a device is emitting a proper transmission or reflecting unwanted background noise, analysts apply the same logic to gauge if a security price reflects significant information or irrelevant noise. Engineers apply filters to screen out unwanted noise and investment analysts are obligated to do the same. Computer-induced volatility and shifting risk appetites are certainly noise. Value-added signals are better found in hard numbers like near-term corporate forecasts, valuation multiples, and dividend yields.

Earnings estimates for corporate America ratcheted upwards another 8% during the quarter despite the market's gyrations. This escalating profit outlook during a period of stagnant market returns mitigated one of the clearest equity risks we have highlighted in recent notes, the historically rich valuation multiples reflected in broad market indices. The forward P/E multiple for the S&P 500 index, which started the year at a premium level of nearly 18.5x the index's expected 2018 earnings, sank to 16.9x which is roughly in line with the 30-year average for the index. Other market concerns such as the onset of above-trend inflation or slowing economic growth also cannot be detected in the data.

The improving fundamental outlook for corporate America is a positive signal for equities over the near-term, no matter what the noise of short-term trading might indicate to the contrary.



Portfolio Strategy

Looking forward, the Federal Reserve-driven upward normalization in interest rates should persist over the next 12-18 months absent material change in the inflation and growth outlook. In this scenario, our short duration/high-credit quality bond strategy remains the appropriate approach. At some future date rates will climb to levels that satisfy central bankers and fit better with historical norms. Until then the risks featured in longer-dated bonds with more speculative credit quality outweigh the meager rewards.

The near-term growth outlook provides a supportive backdrop for the stock market. Longer-term risks ranging from a potential negative turn in the business cycle to reversion to the mean in abnormally high corporate profits remain relevant however. While declining market valuations better discount these potential outcomes, individual security selection of stocks that provide the best margin of safety for all future scenarios, both fair and foul, remains paramount.

We appreciate the continued trust and confidence you have placed in our firm. Please call or write with any questions.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA

Turtle Creek Management, LLC | 3838 Oak Lawn Ave | Suite 1650 | Dallas, Texas 75204 | 214-468-0100 | 214-468-0106 fax |
turtlecreekdallas.com