Aviance Capital Partners
Investing for Generations

INVESTMENT COMMENTARY

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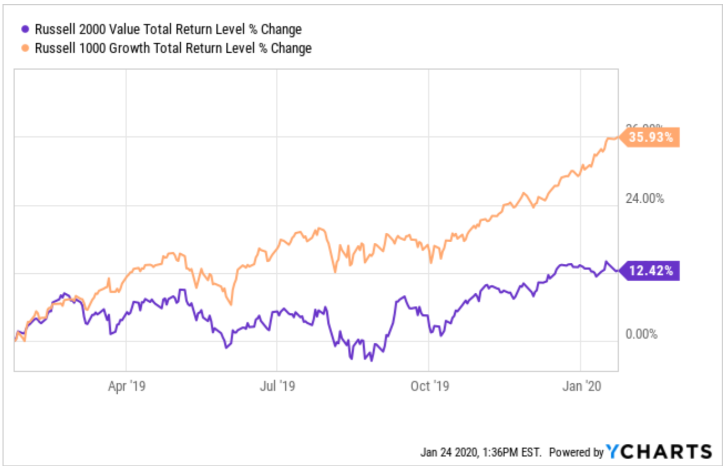
Continued Price Leadership from Large Growth Stocks

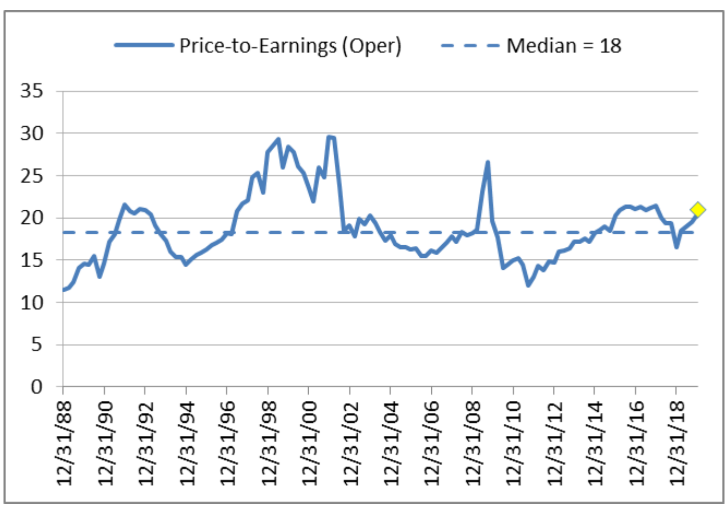
Led by large, fast growing businesses, the stock market continues to make strong gains through January 2020. At the time of this writing, large-cap growth companies rallied a stunning 36% over the past year. On the other hand, small-cap value stocks, the opposite end of the stock market "style" spectrum, did well in absolute terms (+12%), but weak on a relative basis. Given the 3x performance advantage of Large Growth over Small Value, we expect Large Growth to continue to do well since many investors tend to chase strong results.



Stock Market Valuation Still Reasonable

The stock market as measured by the S&P 500 appears slightly overvalued on some metrics, such as the price-to-earnings ratios (P/E). At the end of a poor 2018, the P/E ratio was below its long-term median. However, by the end of 2019, the market appears to be above that threshold (from 17x to 21x in the chart below). In any case, the current level is within a reasonable P/E range from our perspective.

The market is fairly valued, maybe just a bit expensive.

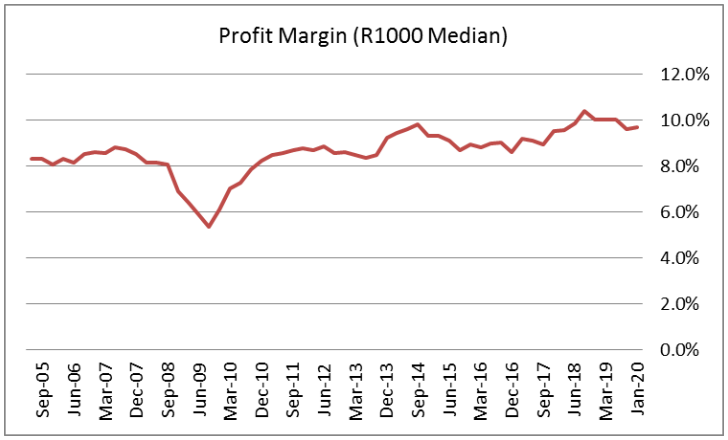


Source: Standard & Poor's.

Another favorable aspect of stocks is that corporate profit margins remain healthy. Since 2016, margins improved after corporate income taxes were slashed from the highest levels in the developed world to a competitive 21%.

Profit Margins remain strong.

(Median profit margin for companies in the Russell 1000)



Source: YCharts.

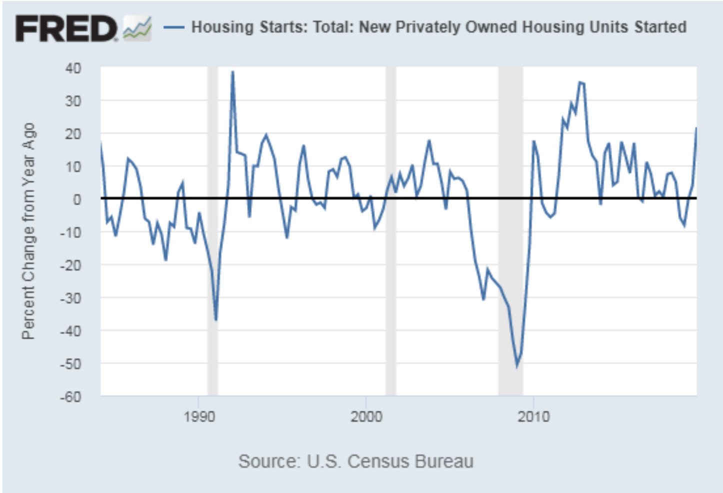
Despite healthy margins, there was plenty of concern in regards to business growth in 2019 including business confidence, the Purchasing Managers' Index, shipping tonnage, and heavy truck sales. Further, the yield curve was "negative" for a short while - meaning long-term interest rates were lower than short-term interest rates; seen by many as a bad harbinger for the economy.

A Favorable Economic Climate

Recently, the mood has swung back favorably for the economy and business. This is showing up in some of the data as well. For example, the amount of new houses being built has spiked.

Recent pickup in Housing Starts

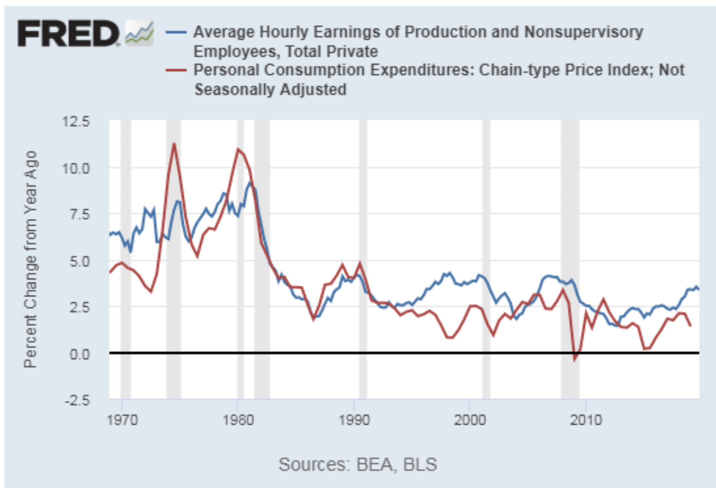
(notice the spike on the far right)



In 2019, our view was cautious as well, however, we landed on the side of continued economic growth given the strength of the typical consumer. The themes we've identified in prior commentary have stressed a strong and growing labor market with growing wages. This has been augmented by fiscal conservatism in your typical U.S. household as evidenced by a declining 'household liability to net worth' ratio and a variety of other measures.

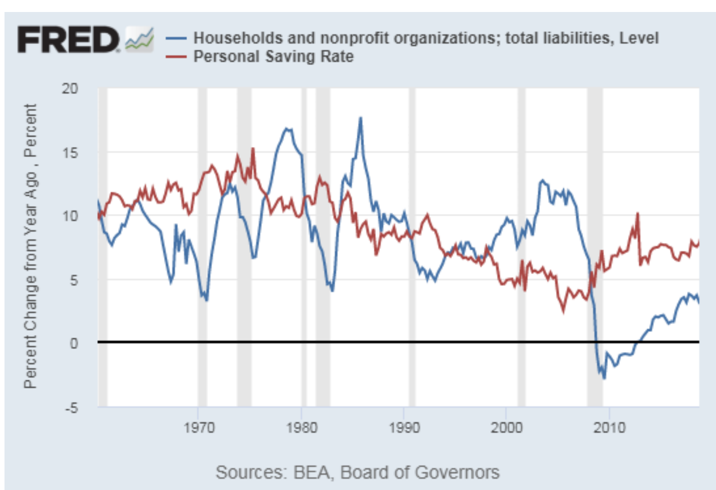
These themes remain in play and to lead us to conclude that continued economic growth will exist in 2020. For example, the chart below shows us the average hourly earnings are growing at a rate higher than inflation – making it easier for consumers to pay down debt and save money.

Wage growth (blue line) is comfortably beating inflation (red line).



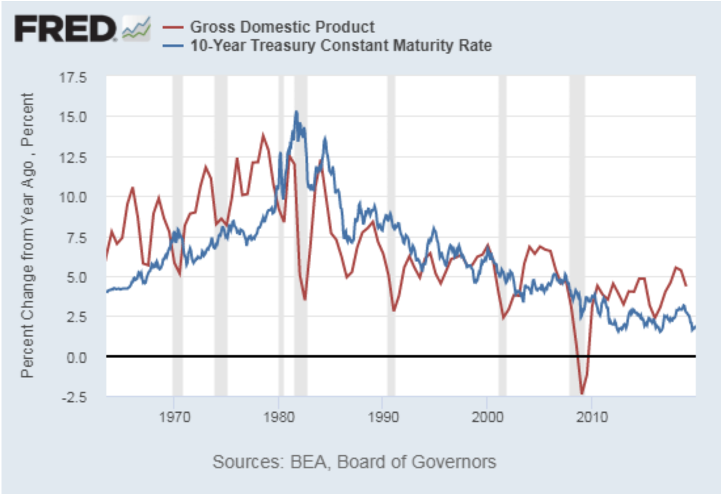
In fact, households are setting aside approximately 7% of their income which is considerably higher than the amount of new debt they are taking on at approximately 4%. Higher income, savings, and lower debt means the economy will have better shock absorbers the next time a recession strikes.

Consumer savings rate (red line) is higher than consumer liability growth (blue line).



Turning towards interest rates, inflation has been mild, long-term economic growth expectations have been low, and the world is full of negative rates. Given these factors, we see historically low rates in U.S. Treasuries. At 1.7%, the 10-year Treasury bond remains close to the lowest levels in our nation's history. While it would surprise us to see meaningfully higher rates in 2020, a sustained nominal economic growth rate (includes inflation) consistent with current levels would likely mean interest rates would climb – as the chart below hints.

Continued nominal GDP growth (includes inflation) in the 4-5% range could lead to higher rates.



Beware of the Growing Corporate Debt Pile

The top risk we see on the horizon is high overall corporate debt levels. Low rates are the candy that attracts businesses to debt, and debt service is the stomachache that follows. Today, corporate liabilities, as a percentage of economy, are as high as we've seen in decades. When companies have to eventually refinance a much bigger pile of debt or pay back principal, problems tend to emerge. More debt means more interest and more principal. Servicing these types of obligations is non-discretionary and become more difficult when business slows. This tends to lead to sacrifices such as reducing new hires or passing on new projects.

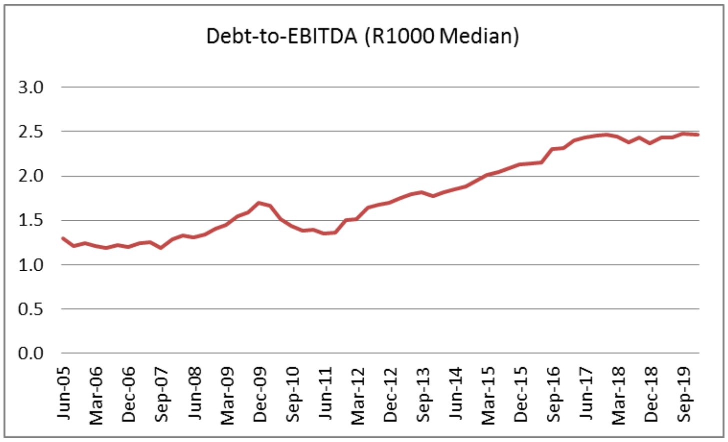
A slowdown in business also means both liquidity and interest-coverage metrics decline, and consequently, credit ratings fall for companies with too much debt. Easy money is followed by hard money.

For now, however, corporate rates are low. Specifically, note the deviation in the blue line from the red line in the chart below. The blue line is debt-to-GDP and shows the growth and amount of corporate debt has been immense. The red line is the extra yield of high-yield corporate bonds over U.S. Treasury Bonds. When the market gets nervous, high-yield bonds are sold, and the yield goes up relative to treasuries. Right now, the market is quite comfortable with large corporate debt levels.

Debt levels are high for overall corporate America (blue line).
Fortunately, the corporate bond market is confident, for now (red line).

While the former chart shows us broad economic data, below we see a similar story emerge when looking at companies in the Russell 1000 Index, the largest 1,000 U.S. stocks.

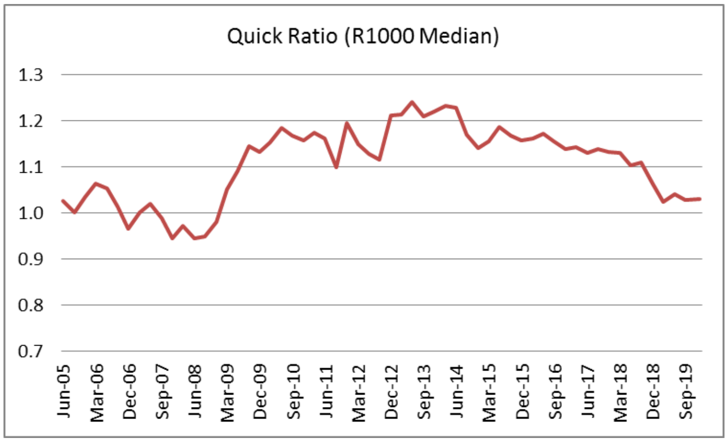
Climbing debt levels for Russell 1000 Index companies.



Source: YCharts.

So when should investors begin to get nervous? It is not yet an issue and hard to say when it will be. However, when liquidity falls enough, many businesses will have difficulty servicing debt. The chart below shows that the liquidity for the typical company in the Russell 1000 is less liquid than it had been during its peak levels in 2013. We will continue to watch liquidity, initial jobless claims, and corporate bond prices.

Declining liquidity measures may become a problem at some point.



Source: YCharts.
The Quick Ratio measures the ability of a business to pay its short-term liabilities by having assets that are readily convertible to cash. Source: Corporate Finance Institute.

Conclusion

Despite high and rising corporate debt levels, we remain positive on the economy and the market for 2020. The consumer is responsible for approximately two-thirds of economic activity and is currently in good shape. Businesses remain somewhat nervous, but positive data seems to be arguing for continued growth. Stock prices are not too expensive, and large-cap growth stocks, we believe, will continue to lead the way to a positive 2020.

Interest rates will remain low for now but may turn higher if the economy stays strong. Investors should stay on their long-term path with a thoughtful and personalized strategic balance between conservative and appreciation-oriented assets. We do not feel it's time to tactically take risk off the table but are keeping an eye on jobs, the corporate bond market, and liquidity for clues that storm clouds may be forming.