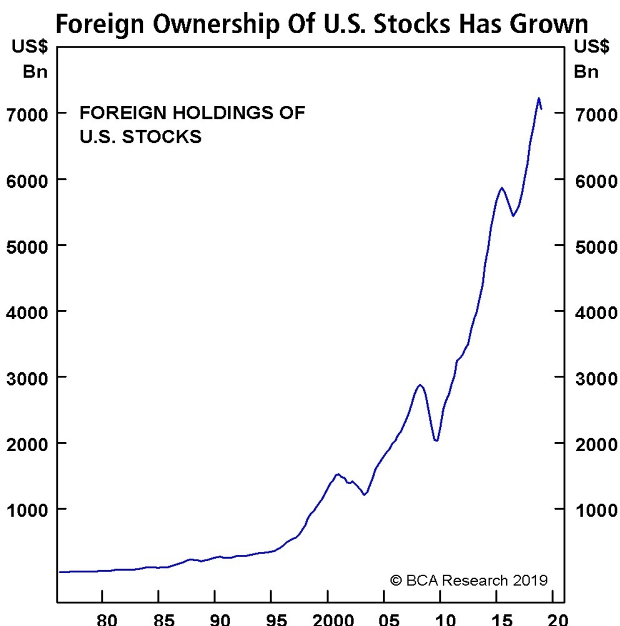
NOTES FROM THE NORTH: MARKET OUTLOOK

April, 2019

The IMF has once again reduced estimates of worldwide growth for 2019. Despite this U.S. stocks continue their climb and have nearly erased fourth quarter declines. No doubt, foreign buying of U.S. stocks (see Chart 1, right) has provided a prevailing tailwind. Perhaps additional credit belongs to the skill of U.S. corporate management teams. In any environment, but especially in an uncertain and dynamically changing one, the best companies take matters into their own hands and seek to improve their long term prospects.

For example, Apple, Disney and Chevron, three mature, blue chip-quality companies already considered to have strong competitive positions, have each taken decisive steps to further improve strategic positioning and long term growth prospects. Apple is launching a news and magazine subscription service, a credit card (Apple Card) and a gaming service. These moves are designed to reduce the firm's reliance on its cell phone (hardware) sales and increase the amount of revenue generated by more dependable service revenues.

Chart 1



Disney, which recently acquired the majority of Fox's film and TV studio and library assets (21st Century Fox, FX Network, National Geographic channels, etc.) along with certain international distribution networks and rights, plans to roll out a new streaming service ("Disney+") which could potentially capture between 60 and 90 million subscribers by 2024.

Chevron has been expanding its ownership of shale oil deposits in the U.S. and last week announced a plan to acquire Anadarko Petroleum, which will enhance its position in shale, tight gas, and liquefied natural gas.

This last example is particularly interesting. While the markets have not favored energy stocks since 2014, when oil prices fell from the $100/barrel level, Chevron must be seeing strategic value in energy companies that the market has not (yet?) appreciated.

In 2014, energy stocks represented 10% of the S&P 500 Index. Today, in a market that is 150% larger, energy's representation has shrunken by half. Could there be well-founded reasons for renewed optimism? In addition to Chevron's active bet, JP Morgan recently mentioned energy as a pocket of value, citing the following list of developments that may bode well for energy stocks prospectively. Of note:

1. Global oil supply/demand is normalizing. OPEC continues to restrain its production while Venezuelan exports have plummeted. Oil prices are expected to increase to an average of $65 per barrel in 2019.

2. Valuation of the energy group is at a multi-decade low. This is illustrated by Chart 2 (over) which shows the price-to-book value ratio of S&P energy stocks compared to that of the S&P 500 Index.

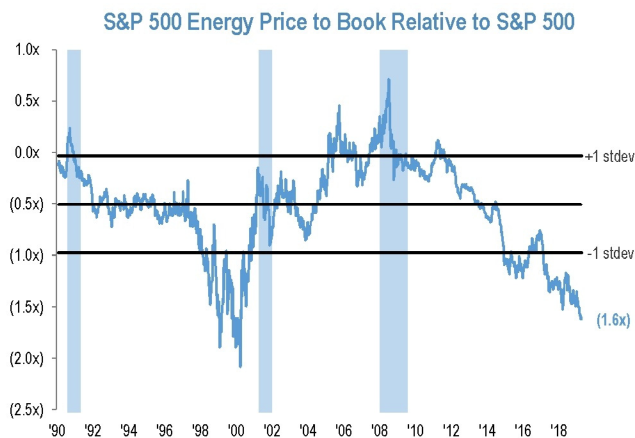
3. Energy firms are ramping up share repurchases (as shown in Chart 3).

4. Investor positioning and interest in energy stocks remains extremely low. Short interest in energy is the highest of all sectors (whereas it was the lowest in 2013).
5. Insiders at energy firms are increasing their purchases of their own shares.
6. Energy would be a key beneficiary of a positive outcome to the U.S. trade negotiations with China.

Oftentimes, stocks that get "left behind" in a bull market are left behind for good reason. Their business models are under challenge, they mis-allocated capital (made a poor acquisition or paid too much for a good acquisition, etc.), their competitive position was undermined….There are any number of reasons that a cheap stock can actually be a value trap. The tectonic shift in the oil markets driven by U.S. shale production and the 2014 fall in oil prices were good reasons for energy stocks to be left behind in this market and it did not pay to be "early". These are the areas, however, where a shift in prospects or just a shift in Wall Street sentiment can unlock the value and reward early investors. As we continually seek candidates for the process of rotating from investments that are highly-appreciated by the market to ones that are unloved and, possibly, undervalued, the energy sector is one place to consider.

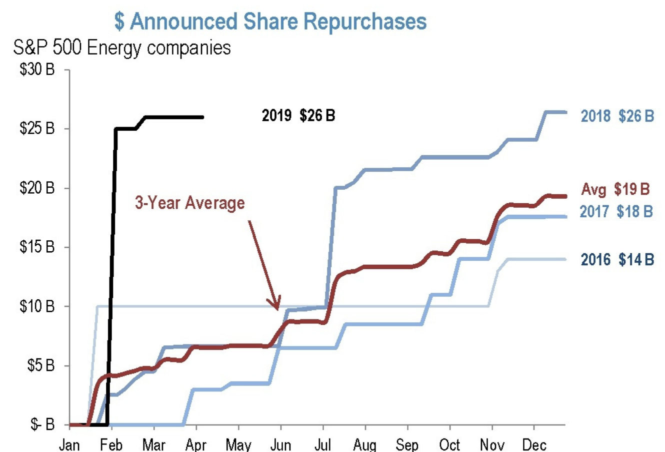
In an ever-evolving and dynamic world, management vision is an important factor in sustaining the long-term health of companies. History is strewn with examples of once powerful enterprises that failed to adapt and faded. In a market where few stones have been left unturned, however, it is worth considering where unpopular stocks or sectors or even asset classes intersect with agile management teams, sturdy financial footings, and reasonable operating plans.

Chart 2



Source: J.P. Morgan US Equity Strategy and Quantitative Research, Bloomberg

Chart 3



Source: J.P. Morgan US Equity Strategy & Global Quantitative Research, Bloomberg

Martha Cottrill, CFA — *President*

Carl Erickson — *Principal*

Edmund R. Taylor, CFA — *Chief Investment Officer*

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Taylor, Cottrill, Erickson & Associates* P.O. Box 7 * 224 Main Street * New London, NH * 03257 * 603-526-7400
800-526-4860