COMSTOCK®

Paul Comstock Partners ®

Your Partner in Investment Decision Making

1ST QUARTER 2018

Market Commentary

As trees grow taller, increasing leaf water stress due to gravity and path length resistance may ultimately limit leaf expansion and photosynthesis for further height growth
–The Limits to Tree Height, Nature (April 22, 2004)

Volatility returned to equity markets during the first quarter. From its peak on January 26, the S&P 500 declined by just over 10% during the first week of February - barely meeting the definition of what stock market lore terms a 'correction' (it takes a 20% decline to meet the equally arbitrary threshold of a 'bear market'). The return of volatility felt as more of a shock due to the fact that, during steady appreciation of the market last year, the level of daily price fluctuations in the S&P 500 hit an all-time low of 5%, compared to a historical average of over 15%.

Scientists estimate the maximum height of a tree at around 400 feet. Initially, the taller a tree gets, the greater its growth potential, as increased height allows the leaves access to unblocked sunlight and obstructs that light for its shorter neighbors. Eventually, however, the energy required to transport water from the roots up to its leaves exceeds the energy generated from photosynthesis and the tree will no longer grow. Similarly, once a company obtains a sustainable competitive advantage in its industry, it can quickly outgrow its competitors and its size delivers economies of scale. However, gains in market share cannot continue forever and dominant companies attract competitors, regulators and risk the ire of the public if they misstep. Investors tend to become overconfident in continued outperformance of the company's stock, projecting past high returns beyond a reasonable limit.

Although Technology and Consumer Discretionary (where Amazon.com abides) outperformed and remained the only sectors with positive performance during the first quarter, cracks began to appear in the enthusiasm for large Internet / tech stocks. Apple, Amazon, Alphabet (Google), Microsoft and Facebook comprised approximately 14% of the S&P 500 at quarter end. For the three year period ending March 2018, these five stocks, on average, delivered more than four times the return of the S&P 500 and accounted for just over 25% of the return of the index. Facebook's user data scandal, President Trump's threats to Amazon.com and fears of slower growth at Apple and Google may sour investor confidence in these stocks. Approximately 25% of global advertising spending goes to Google and Facebook. These two companies account for 61% of online advertising, which in turn now commands over half of all advertising. Global advertising spending is cyclical and grows in line with the global economy – about 4% a year. Online advertising will not gain 100% market share, nor will Google and Facebook ever completely dominate this market. At some point, technology may allow for traditional pay-TV providers to offer targeted advertising similar to what the Internet offers (imagine a Super Bowl where viewers see different commercials depending on the demographics of their household), perhaps competing ad dollars away from online.

It is part of the nature of growth stocks to fall out of favor at some point. We do not pretend to know how or when this might happen, just that at some point it will. Comstock's large cap growth managers participated in the gains from these stocks and continue to own them. Nonetheless, we think it prudent to recommend rebalancing portfolios that have become overweight large cap growth stocks. For taxable portfolios, this year's higher volatility may also offer more options for loss harvesting to offset any gains realized by this rebalancing.

Over the past several years, investing in the Russell 2000 Small Cap Index through Exchange Traded Funds (ETFs) has grown to the point where ETFs own nearly 6% of the index. At the same time, the number of publicly traded companies in the US declined from over 8,000 in the 1990s to around 4,300 today. Consolidation, increased regulatory burden and growth of the private equity industry all contributed to this decline. Flows into small cap index funds and ETFs tend to impact the prices of the more thinly traded stocks in the index, disproportionately bidding up the prices when funds flow in, and reducing them when funds flow out. With the easy support of the ETF's guaranteed bid and lax lending standards, the credit quality of small cap stocks has declined. Currently we estimate that just over 19% of US small cap companies, by market cap, cannot cover interest expense with their earnings. The only time in the past 10 years this has been a higher percentage was in 2009, reflecting depressed earnings from the 2008 Financial Crisis. Contrarily, the past twelve months experienced some of the best business conditions for small business this decade.

Concerns over the risk of a trade war with China or our NAFTA partners continue to ignite volatility. The President recently announced tariffs on an additional $100 billion in Chinese goods, on top of the $50 billion already announced. This adds uncertainty to an otherwise robust picture for the US economy. Considering that the US last year imported $506 billion in goods and exported $130 billion with China, this represents nearly a third of Chinese imports. The problem is China is not nearly as dependent on US exports as it was a decade ago, giving them room to retaliate.

The first quarter began with an encouraging 10% rally in MLPs which evaporated with the return of volatility in February. The Federal Energy Regulatory Committee (FERC) then provided another hit to already exhausted MLP investors with its announcement that it would remove tax allowances from its rate calculation for certain pipelines using an older 'cost-of-service' formula. This relatively arcane ruling impacts only federally regulated interstate pipelines, which represent about 8% of the assets within the Alerian MLP Index. It does not cover assets with privately negotiated contracts or intrastate pipelines. Likewise, the change does not affect regulated interstate pipelines owned by C-Corps such as ONEOK. The large MLPs – Enterprise, Energy Transfer, Magellan, Williams and MPLX quickly issued press releases stating the potential impact on revenues and distributions would not be material. Despite the limited, and in most cases, immaterial impact of the ruling, MLP investors are understandably tired and this news proved to be the final straw for many.

While it is too early to call it a trend, the fading luster of big cap tech has correlated with some renewed interest in the Energy sector and MLPs. The Alerian MLP Index has outperformed the S&P 500 since March 15. Furthermore, April and May have historically been good months for MLPs. Signs point to continued fundamental performance of these companies, and this quarter should see healthy distribution growth.

The volatility over the past few weeks is actually about at average historical levels. Over the past few years, we experienced an abnormally low level of stock market fluctuation. The key point, more important than details about trade policy, is that we are in the later stages of this economic cycle. The underlying US and global economy, by all available data, continues to perform well and this will support the market as long as it continues. However, over the next few years, something will cause the next recession. It may be a trade war, or it may be some factor yet unknown. The only real protection is to own high quality companies that can weather potential downturns.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer