

What's the difference between a horse race and the stock market? You do your research - look at all past data, analyze the trends, comb over all the competitors. You found a winner, so you make a bet...*on a horse? on a stock?* The process is very similar indeed, and in fact there is only one major difference: a bet on a stock is **owning** a share of an operating business; a bet on a horse is an exchange between counterparties dependent on an outcome. Nuanced? For sure, but this simple change of wording completely changes the perspective. Instead of just betting on a horse for one race, imagine if you **owned** a share of that horse. No longer is your focus on the winnings (returns) of one particular race, but all races, showings, and breeding. **We call this duration.** And if you owned a share of a horse, you also would want it to have a good pedigree, right? A good staff of trainers, doctors, and jockeys would be needed too. Yes, a horse that has all the right tools to compete - good genes, good health, good team. **We call this low risk.** Lastly, this would all be at a loss if there weren't good results. A horse that wins one race and finishes 12th in all the rest is not very attractive. What if a horse finished in the top five 80% of the time? **We call this consistent returns.** So a horse has a long duration, carries low risk, and provides consistent returns - would you own a share in it? *We would.* What about a business that has a long duration (through business cycles), carries low risk (good management & business advantages), and provides consistent returns (return on capital > cost of capital)? *Us too.* At Doxa Capital, this defines how we view our portfolio - **long duration, low risk, consistent returns.** Stock speculators are horse bettors (research from MIT even shows there isn't really a difference [here](#)), while stock investors are horse owners. While betting can be fun, adrenaline charged, and very lucrative - at the end of the day we just prefer to own the horse.

Before diving into our thoughts on the market, I want to hit one more *crucial* point in our philosophy stemming from a question we are frequently asked:

- Q. "Why even bother owning any particular business, just own all of them. Everyone knows that everyone knows stocks only go up over time. No need to do any analytical work, no need to write any notes. Just buy an index and solicit more prospects."**
- A:** Time. Every client has a different time horizon, meaning every client's portfolio should be different - ultimately matching their specific needs. It's very true and well-documented that stock markets have gone up over time. If your needs are on a 30+ year time frame, we created [Doxa Genesis](#) for this exact purpose! Stocks go up 'over time' - **but does 'over time' fit your time?** What if you were ready to retire in 2000 with a nest egg looking great thanks to the 90's boom - and no one told you to get defensive? Stocks went sharply down the next few years and were ultimately flat from 2000-2013. You would be nearly 80 by the time your portfolio turned a gain...but stocks always go up, right? 724,268 people retired¹

¹ According to ssa.gov - new retirees that enrolled for SS benefits.

in the year 2000, making that a hard reality for many who depended on their investments. In fact, the S&P 500 was flat from 1966–1983 as well, 15 years. Also 1926-1945, nearly two decades. Stocks aren't on your timeline, they are on their own.²

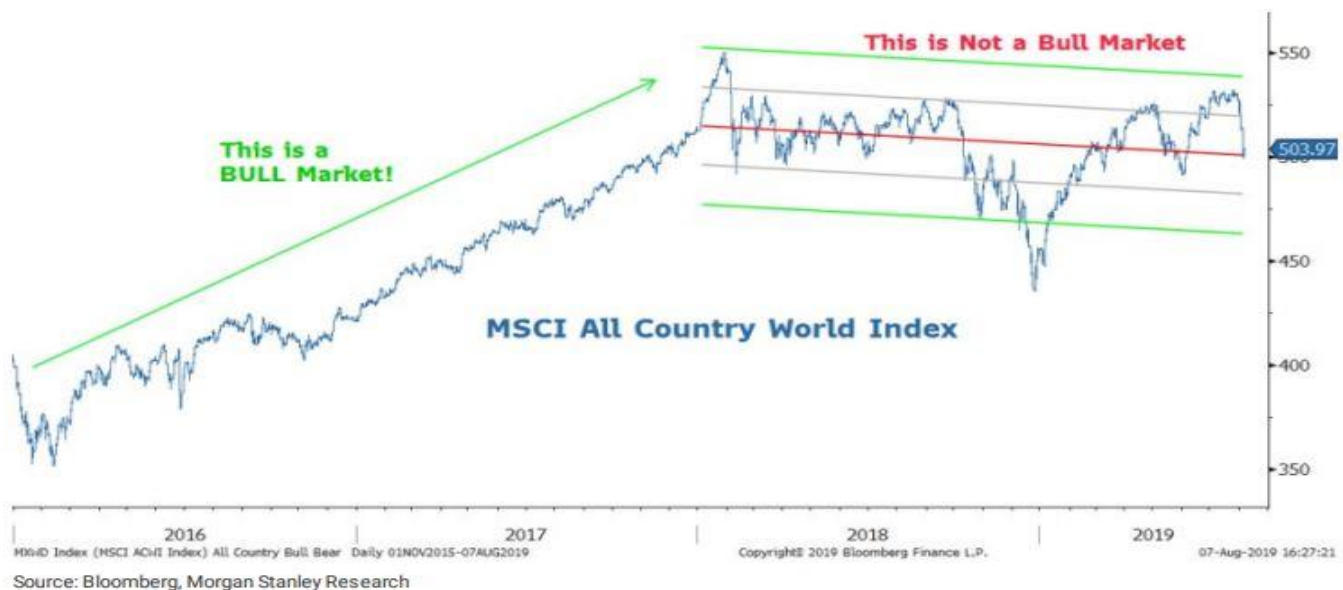
You've been saving for 17 years and finally your child is ready to head off to college next year. Stocks go up over time and you've methodically invested the whole way. The year is 2008. Now 30% of your funds are lost and you're paying for five years of college but only getting four. 7,794,323 kids³ were enrolled in college in 2009. Stocks aren't on your timeline, they are on their own.

Markets generally go up, that's why we all invest. However, markets don't care about your needs, and **that's why we plan.** Financial planning is at the core of what we do because we believe that your portfolio needs to be on your time, not its own. Which leads us to the most important question in all of investing: **is it a time to be aggressive or a time to be defensive?**⁴ That's why we do the analytical work. That's why we write all the notes. That's why we just prefer to own the horse.

Where are we? **Still defensive, but getting (cautiously) aggressive in areas.**

On December 15, 2017, we published our [2018 Macro Outlook](#) as we do every year. The first paragraph read:

"Our take: 2017 saw acceleration across nearly all global economies and this trend has been extrapolated forward by the markets. We see most of these trends normalizing or reversing course, neither of which seem to be properly discounted by market prices. In other words, everything went right under 2017 factors – why will everything continue to go just right under different 2018 ones?"



² Of course these are arbitrary points in time I've picked out – but this is the point really. Portfolio needs may be completely independent of market cycles. Maybe it works out perfectly, maybe it doesn't.

³ Total full-time undergraduates enrolled in 4yr institutions, according to nces.ed.gov.

⁴ Howard Marks is accredited here, consistently asking this question across all of his Oaktree memos.

Although written a while back, that paragraph is still hanging in there. Investor optimism coming out of 2017 hasn't been topped since, nor have most markets. Some technology and a few US indices made some new highs along the way, only to fall right back into the range we've been in. Nearly all large markets outside of the US are lower by 10% or more. Of the G7 countries, Germany is as close to a technical recession as it gets with Japan right behind it. And we've had *at least 94* trade headlines since then. In the December 2017 note we were opining to be defensive. Now 20 months later, we revisit that important question: **is it a time to get more aggressive or a time to get more defensive?**

Differences between January 2018 and now:

1. Corporate profit cycle is worse. Tax gains have filtered through, now late cycle costs are crippling. 75% of sectors are seeing negative earnings growth this year. Small/Mid cap companies are seeing profits down 6-7%.ⁱ
2. Business investment is worse + outlook is worse. Global growth in general is much lower.ⁱⁱ
3. Global + US yield curves are all inverted. Inverted curves slow down credit growth all else equal, making it really hard to be incrementally constructive.ⁱⁱⁱ
4. People are cautious, yet the labor market and the US consumer have stayed strong. This is undoubtedly our pillar of strength. Is it cracking? Probably a little, but not enough to start something deep.^{iv}

Before we unpack these variables, I'll skip right to the conclusion: **We still want to be defensive, especially in the US.** Utilities, staples, & secular growth names are particularly crowded. **However, we are getting cautiously aggressive in areas outside of the US and in some cyclicals.** While the picture is less rosy than a year prior, some asset prices are also much lower – **telling us the weakness is probably more than priced in.** These weaknesses present opportunities to invest in some good businesses at low prices.

Lower valuations = lower risk, good capital management = consistent returns, solid business through a cycle = long duration.

Cohort	1Q19 / 1Q18 Sales Y/Y Change	1Q19 / 1Q18 EPS Y/Y Change	2Q19 / 2Q18 Sales Y/Y Change	2Q19 / 2Q18 EPS Y/Y Change
Large Caps (S&P 500)	5.11%	-0.3%	3.9%	-1.0%
Mid Caps (S&P 400)	3.21%	-7.9%	1.9%	-7.9%
Small Caps (S&P 600)	3.24%	-16.2%	2.9%	-9.2%

Source: FactSet, Morgan Stanley Research.

Scenario	Probability	2018 EPS	2019e EPS	2020e EPS	Fwd. P/E	Y. E. 2019 Target
Bull	15%	\$162	\$168	\$182	17.0x	3,100
Growth			3.7%	8.3%		
Base	45%	\$162	\$165	\$160	17.0x	2,720
Growth		+\$10 for Tax Adj.	1.9%	-3.0%		
Bear	40%	\$162	\$160	\$153	16.0x	2,500
Growth			-1.2%	-4.4%		
Consensus		\$162	\$167	\$182	17.0x	3,100
Growth			3.1%	9.0%		

All numbers adjusted for comparison to consensus

Source: Doxa Research, Bloomberg

1. Corporate profits have a lot of headwinds.

We've mentioned corporate margin pressure in every note over the past two years, being the single biggest factor we've seen pushing back against corporate earnings. The corporate tax cut of 2018 hid this pressure, at least in the mainstream – but 2019 isn't being so kind. Last December, we [wrote](#), “...***we see margins falling from peak, whereas current consensus estimates see margin expansion continuing. We feel very confident consensus estimates will come down...***”. Note the two tables on the previous page. In the top one produced by Morgan Stanley, you see sales growth decelerating throughout the first two quarters, albeit still positive. However, profit growth has been outright negative. **This is margin contraction.**

As for estimates, the bottom chart shows our earnings forecasts against the consensus forecast (blue shade). Consensus estimates for 2020 have fallen nearly \$20 from \$200/shr. since the beginning of the year⁵, just as we expected last December. Even our estimates seemed to be a little too high at the time by a few dollars. Put simply, earnings have been much weaker than expected. It is not a coincidence that small caps are marginally weaker as labor and input costs have a greater effect to their bottom lines than the multi-nationals. However, the large caps are not immune, especially the longer these pressures persist.

The chart below maps S&P 1000 sales and profit estimates for the coming year. Consensus assumes the margin expansion story will resume next year. We remain cautious and think these are still too optimistic.⁶ In other words, **we think profit pressures seen in the first half of this year will continue through 2020** – leading us to believe that material upside at the index level will be hard to come by unless the profit picture turns around.⁷



⁵ Per Bloomberg S&P 500 Consensus Estimates.

⁶ While it is commonplace for forward estimates to always be optimistic, the magnitude of revisions is abnormally large.

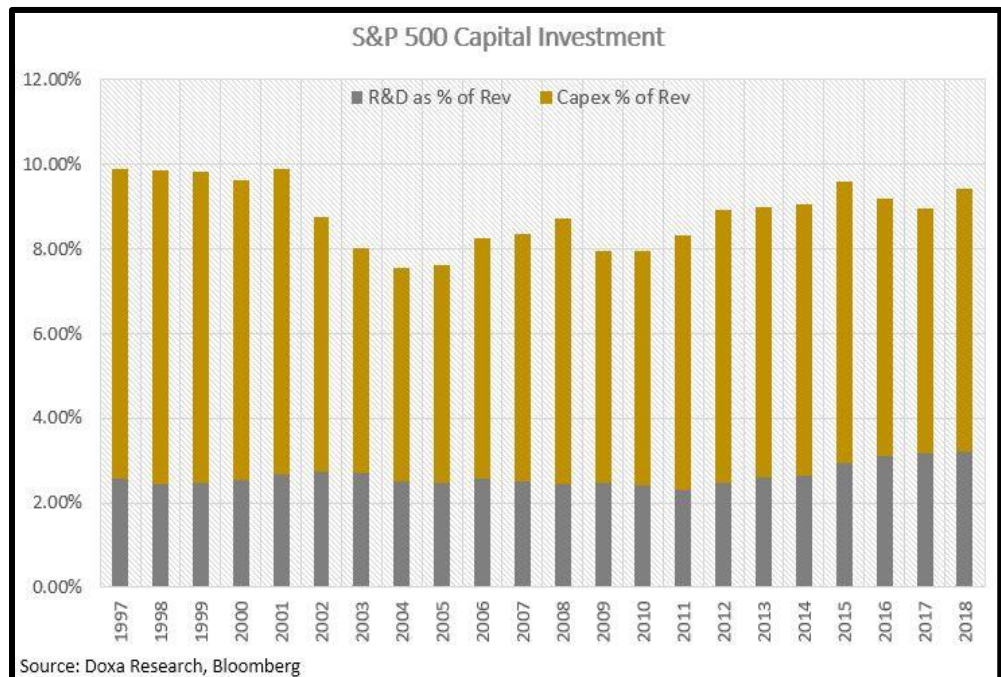
⁷ Note that 2018 encompasses corporate tax cuts, boosting profit margins.



Source: Bureau of Economic Analysis, FactSet, Morgan Stanley Research.

2. Business Outlook

Future earnings are largely driven by current investment. This is our prime reason for not believing a profit boom is imminent. **However – this same reasoning is exactly why we don’t foresee a deep recession.** How does this play both ways? From above, “future earnings are largely driven by current investment.” Put simply – the economy can’t have a future profit (& productivity) boom without an increased level of current investment. **And without a boom, there cannot be a bust.** Growth spurts and slowdowns will come and go – but a true boom/bust cycle never forms. The chart below shows the net capital investment (e.g. new production plants + R&D) of the 500 biggest firms in the US.⁸ Not only can you see a slow and tepid recovery from 2000 & 2008, but the composition is changing as well. Less dollars are building buildings (capex) and more dollars are building software (R&D). This distinction is important as it defines where 1) excesses have been, and 2) where recoveries have not.



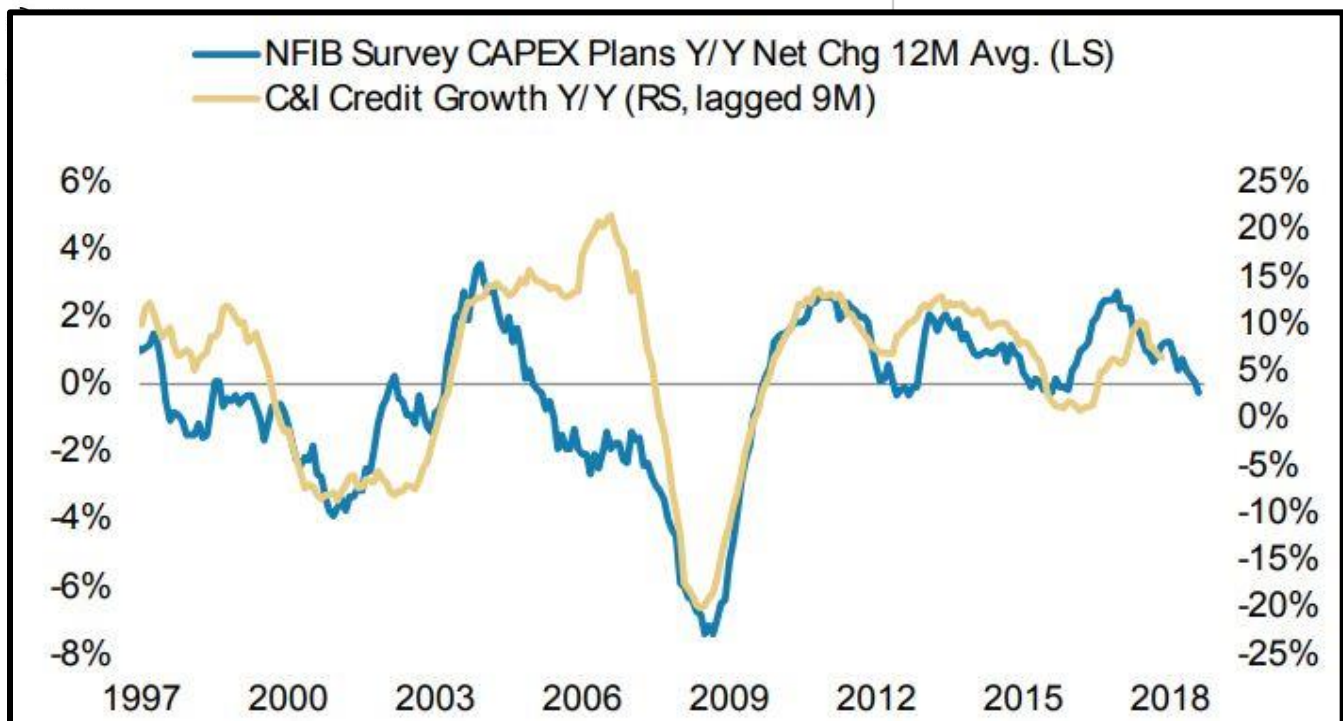
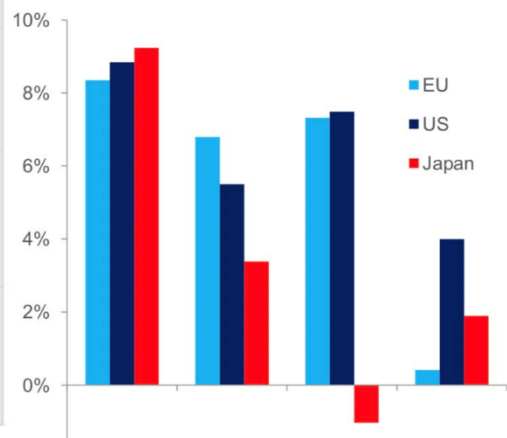
⁸ This understates the housing investment boom as it uses the S&P 500 Index.

Where is investment headed? This is where our baseline for a growth slowdown resides. A recent survey from the [Business Roundtable](#) shows Q/Q deterioration in capital spending plans, as does the NFIB. New orders, [ISM / PMI](#) surveys, and other leading indicators show the same caution in the business community.^v **Without business confidence in future growth, we don't see profits exploding higher near term.** C&I credit growth, also shown below, is another indicator rolling over – but hasn't really been robust since 2007. Credit is usually called upon for investment, so again another data point showing a lackluster decade.

Summary: coming out of the growth slowdown of 2015/16, business activity picked up. Fiscal stimulus helped the US in 2018 while the rest of the world began deflating. This year, we are all deflating together in a broad global slowdown. Will it be a deep recession? We never really got our 'boom', so we don't really expect a big 'bust'. Is it almost over? It doesn't appear so in most countries, but we are closer to the end than the beginning.

CEO Survey Results & Sub-Indices	2019 Q2				2019 Q3				Quarter-Quarter Change in Sub-Index
	Increase	No Change	Decrease	Sub-Index	Increase	No Change	Decrease	Sub-Index	
How do you expect your company's sales to change in the next six months?	65%	26%	9%	105.1	61%	19%	20%	91.6	-13.5
How do you expect your company's U.S. capital spending to change in the next six months?	48%	43%	10%	88.1	36%	50%	13%	73.4	-14.7
How do you expect your company's U.S. employment to change in the next six months?	41%	43%	16%	75.2	43%	36%	20%	72.6	-2.6

Reduced growth in bank lending
Average annual change in bank loans outstanding

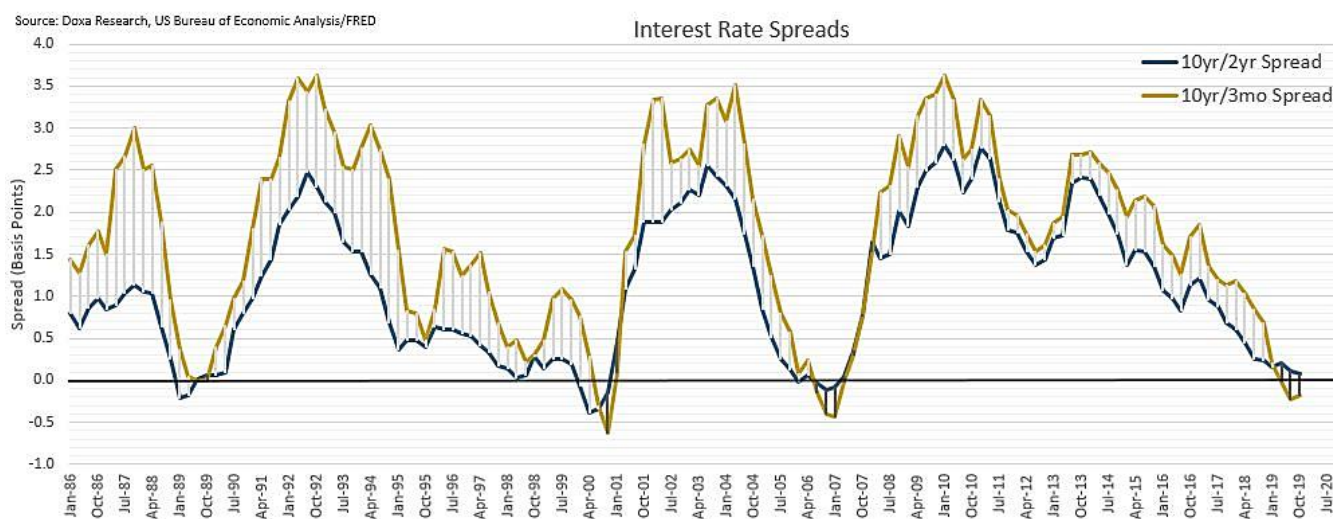


3. Yield curves and Confidence

Honestly this could be 2(b) because it is closely related to our previous point. The most frequent question we received this past summer was: “**can we talk ourselves into a recession?**” **Absolutely!** Nearly all of economics is behavioral at some level, and confidence reigns supreme. If someone mentions to someone else that mentions to you about how business isn't great – or they see a downturn coming – you may think twice about a big future investment. By delaying your purchase of a new John Deere tractor for example, the John Deere salesman sees sales slow and relays to someone how business isn't great. This is the theory of reflexivity and it can be very real (*especially for business investment as shown in the example. Consumers are more nuanced*). As you can imagine, this plays into all the confidence & investment points from above.

Which brings us to the ‘inverted yield curve’ scare making a lot of news this summer. An inverted curve, or when short term rates are higher than long term rates, can mean a few things:

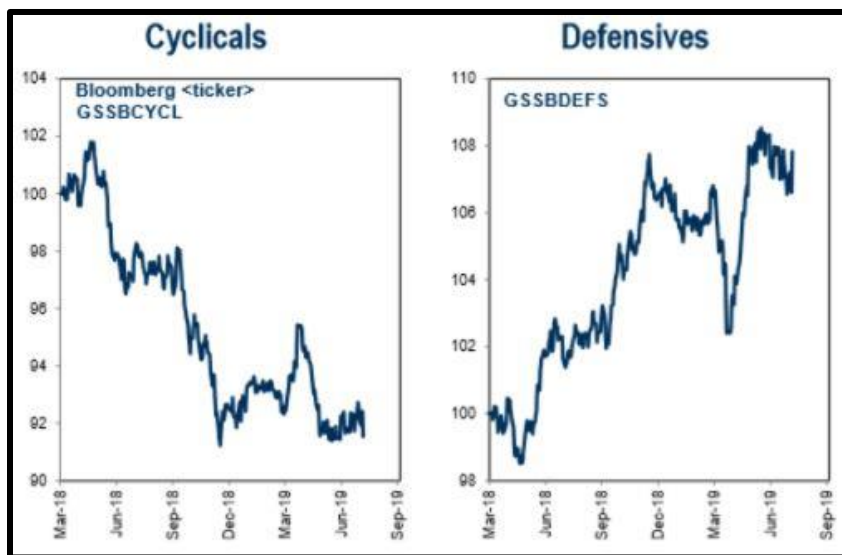
- 1) Banks tend to make less money (pay deposit rates at short term, lend at lower long term) → therefore lending gets tighter.
- 2) Future growth isn't perceived as great.
- 3) Future inflation isn't perceived as great.
- 4) Recessions follow/coincide.



A few frequent pushbacks: inversion don't matter anymore because quantitative easing and all the global stimulus distorts this relationship. It's too early an indicator. Or yields are already low so it doesn't matter. We think these points, valid or not, miss the most important fact – **an inverted curve can adversely affect psychology**. Today in the information age, those 4 points mentioned above aren't secret finance code. They are everywhere and available to all who are looking.

Psychology can be negatively affected by an inverted curve or other narratives (incl. asset prices), which can affect investment patterns, which affect business conditions, which provokes more caution, which can cause a growth slowdown.

Bingo, and here we are.



Last point on psychology:

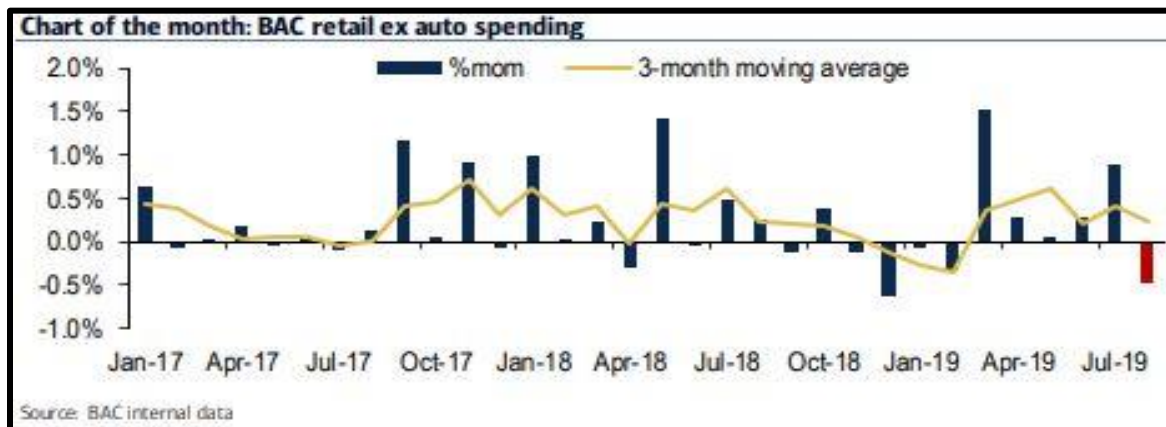
You may have heard “markets operate 6 months in the future” – not always true, but in this case we are seeing certain sectors discount a steep slowdown. This is where we are getting cautiously aggressive. While the picture is less rosy than a year prior, some asset prices are also much lower – **telling us weakness may be more than priced in.** These weaknesses present opportunities to invest in some good businesses at low prices.

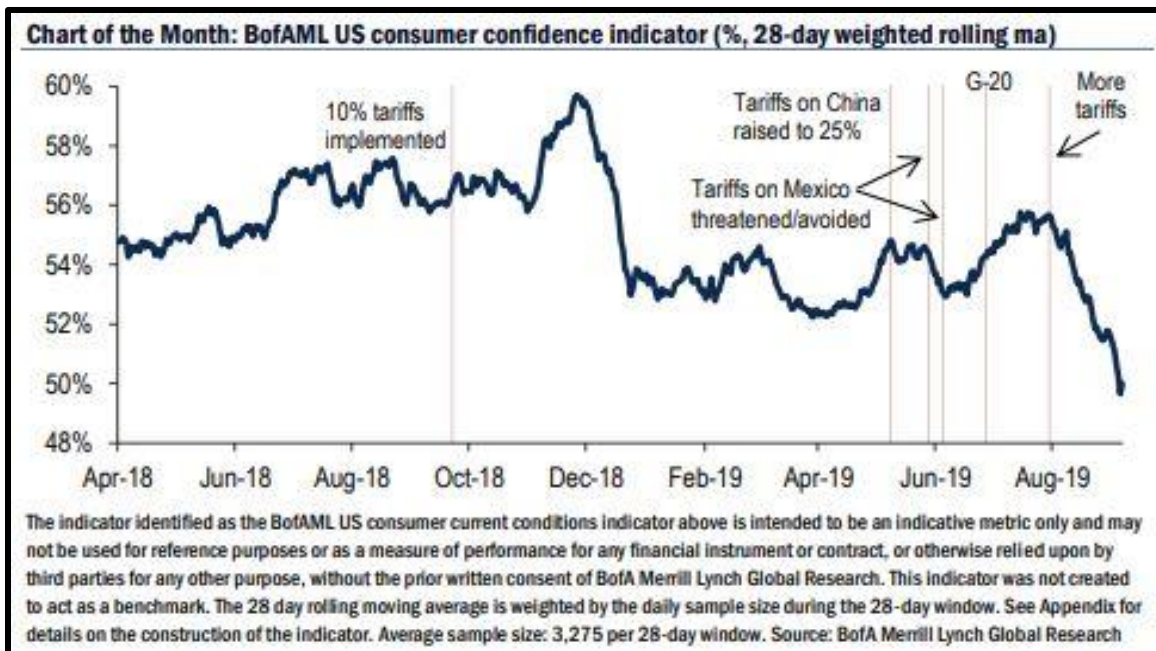
4. Is the Consumer Cracking?

Business investment is declining + business confidence is eroding + margins are getting tighter = low future investment = lower future growth. The global slowdown is in full swing, but the lack of any systematic excesses will prevent a big bust. Ok, got it. *And the technical term for our current environment?* **Blah.** So what’s the kicker? How does this change?

Consumer spending and jobs.

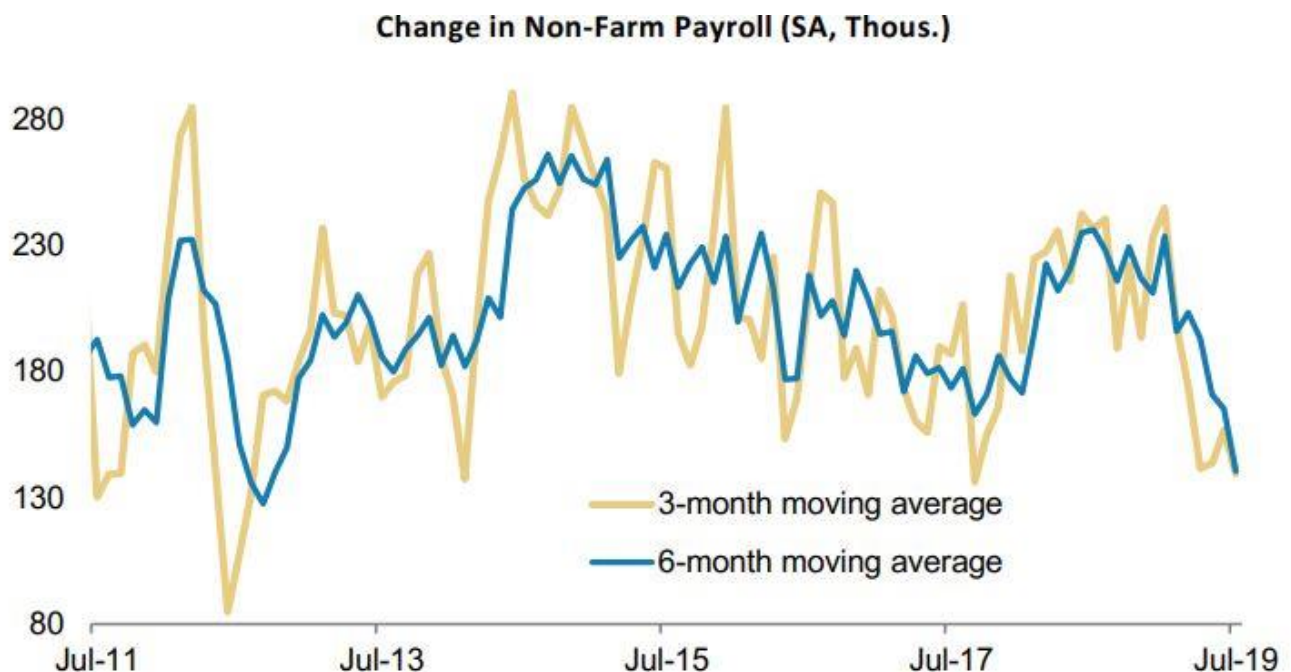
G.O.A.T., otherwise known as the ‘greatest of all time’, is unrivaled in the US consumer. At nearly 70% of total GDP, the economy goes as the consumer goes. Since 2008 the consumer has generally been fine, some hot years, some cold years. This year spending is in the middle with some sectors doing better than others. To understand if the current slowdown will transform into an economic recession – in other words ‘the magnitude of this slowdown’ – then we have to understand what’s going on with the consumer. The following charts from Bank of America Merrill Lynch paint a decent picture of the consumer so far this year with their BofA spending and confidence data.





A slight deterioration has been seen recently, but nothing to provoke outright concern yet. Unpacking this more: US consumers will generally spend as long as they have income, i.e. a job. As we've written in many prior notes, the current job market is very tight.^{vi} Job offers are plentiful and unemployment is very low. The trick here is that employment is the last indicator to fall, as employers often cut elsewhere before resorting to layoffs. The biggest question we face right now:

Will the current manufacturing/energy/global slowdown be enough to prompt job losses in the broader economy?



Source: Haver, MS Global Economics Research

The answer here isn't obvious, hence why we have a market. Nevertheless, our thoughts:

1. **Employment has definitely slowed this year**, from both little supply across some sectors and low demand in others. Manufacturing and energy employment has been particularly weak, same as it was in the *manufacturing recession of 2015/2016*. Fact is, these sectors aren't a large enough piece to drag down everyone else. **However, the longer they remain weak, the higher the chance the weakness spreads.**^{vii}
2. As business confidence and investment are drifting lower, it wouldn't be surprising to see an uptick in unemployed persons. However, shifting demographics should limit this drawdown in our view. We would not expect any future job losses to be extreme.
3. Knock on effects? The two charts below from Deutsche Bank paint a similar picture, showing the consumer is getting a little frisky in paying their debt and are cautious about big ticket purchases. We would note that household balance sheets are on much better ground than they were pre-2008, so again we expect resiliency to win out.

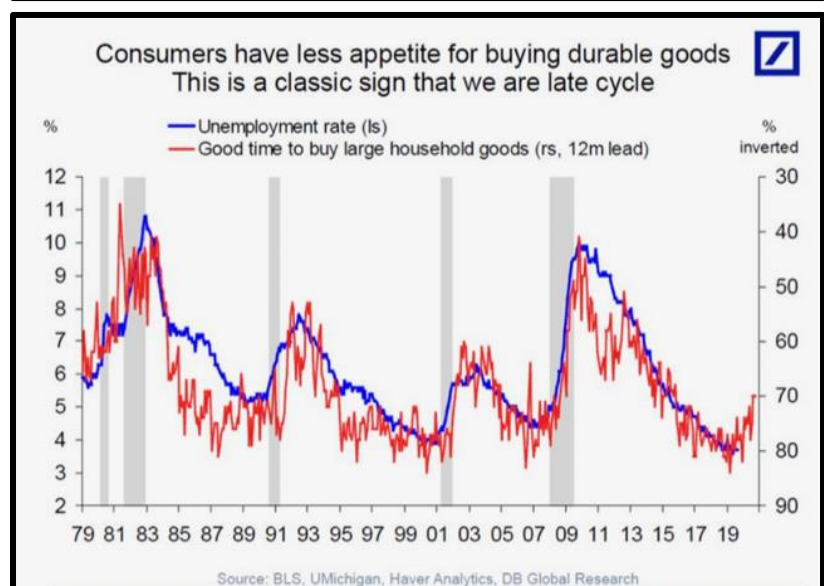
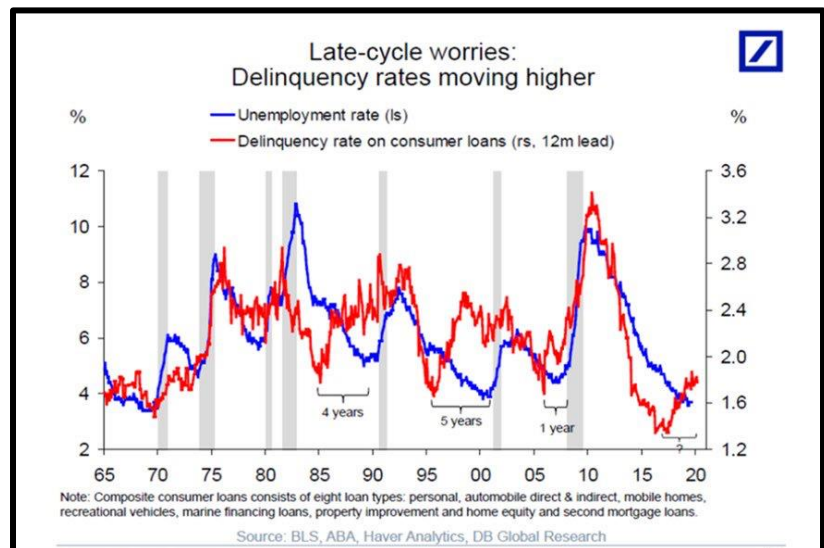
Doxa's Takeaway:

We remind investors constantly to remember that things are never black and white. Every point mentioned in this note could be countered with 'it's a one-time thing' or 'this is just because of X'. **But the most important observation?**

These points are all happening at the same time. One chart may represent a chapter, but all of them together tell a full story.

Confidence is not so good. *It's just the trade war*. Investment is low. *It'll come back*. Manufacturing is weak. *It's too small to matter*. Yields are low and the curve is inverted. *It's different this time*. We can be quick to dismiss one point as noise, but we caution dismissing all of them simultaneously. The more stress on businesses = more stress on profits = more stress on markets.

Is it time to be more defensive or more aggressive? We are sticking with our defensive stance.



Bonus: How are we positioned defensively? Where are we getting cautiously aggressive? As you have come to expect – we have plenty more data and charts on this in a presentation form. Please reach out to us if you are interested.

I would probably block out at least 45 minutes though.....

Chase Lee

Director of Research

David Mucciario

Director of Financial Planning

ⁱ S&P, Bloomberg, Morgan Stanley Research

ⁱⁱ ISM & PMI Surveys, Morgan Stanley Research, Bank of America Merrill Lynch Research, Business Round Table, Duke Fuqua CFO Surveys, Conference Board CEO surveys

ⁱⁱⁱ <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2019> , [https://www.ecb.europa.eu/stats/financial markets and interest rates/euro area yield curves/html/index.en.html](https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_area_yield_curves/html/index.en.html)

^{iv} Weekly Warm Up: Falling Demand & Confidence; Lower Rates Higher Multiples; SPX > NDX, Defensives > Growth, Michael Wilson & Morgan Stanley Research, Sept 3, 2019

^v <https://www.prnewswire.com/news-releases/nmi-at-52-6-september-non-manufacturing-ism-report-on-business-300929995.html> , <https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm?SSO=1>

^{vi} <https://www.federalreserve.gov/newsevents/pressreleases/monetary20190918a.htm>

^{vii} Recession Probability: Defining the Debate, Michael Wilson & Morgan Stanley Research, Sept 23, 2019

2019 Copyright, Doxa Capital, LLC, All rights reserved. Charts are property of Morgan Stanley, Bank of America Merrill Lynch, & Deutsche Bank where indicated. All other material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Doxa Capital, LLC. It is delivered on an 'as is' basis without warranty.

IMPORTANT INFORMATION

Analysts and/or strategists of Doxa Capital, LLC hereby certify that their views about the financial markets are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report. Analysts and/or strategists of Doxa Capital, LLC receive compensation based upon various factors, including quality of research, client feedback, competitive factors, and overall firm revenue.

The views in this report are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns. Keep in mind, like all investing, that multi-asset investing does not assure a profit or protect against loss.

Doxa Capital, LLC makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss. Certain of Doxa's strategies involve advanced investments that can be illiquid and are subject to a substantial risk of loss and are not suitable for many investors. Options are not for everyone. Where an investment is denominated in a currency other than the investor's currency, changes in rates of exchange may have an adverse effect on the value, price of, or income derived from the investment.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Doxa Capital, LLC believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or underweighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals. Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Investment in Global, International or Emerging markets, directly or indirectly, may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets, directly or indirectly, can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to subprime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities, directly or indirectly, is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

Please contact any representative of Doxa Capital for definitions of any terms used within.