

## INVESTMENT COMMENTARY & OUTLOOK

April 22, 2020

Our dividend growth and conservative growth stocks have rebounded impressively in the past four weeks. As we have said repeatedly, good stocks bounce right back and that is exactly what has happened since the late March lows. We expect to continue to sell selected stocks into strength as we concentrate on the crème de la crème and anticipate holding fewer stocks in the upcoming months due to the fact that the economic recovery is anticipated to be very narrow.

Looking forward, the U.S. economy is anticipated to have a U-shaped recovery, since states are reopening up at different paces. We are very fortunate in the U.S. that we can learn from Europe, which continues to gradually reopen as other countries follow Austria, the Czech Republic, Denmark, Germany, and Norway. As an example, Volkswagen announced that it would begin reopening its first German factories on April 20th, while its plants in Bratislava, Slovakia, Portugal, Spain, Russia, and the U.S. would resume operations on April 27th. Interestingly, 40% of Volkswagen's annual sales are attributable to its China factories, which resumed operations in February and were recently operating at 60% of capacity.

Since the U.S. is not as densely populated as Europe, we can space ourselves a bit better and hopefully reopen faster. The spontaneous protests across the U.S. to get back to work are a good sign that many Americans are eager to restart the U.S. economy. The summer heat and humidity may impede the spread of the coronavirus and naturally help reduce new cases. Fortunately, Gilead Sciences' drug remdesivir, which was first developed to fight Ebola, has been highly effective at fighting the coronavirus in Phase 3 clinical trials at the University of Chicago. So although a vaccine is not yet available for coronavirus—with several in expedited trials—at least there is some hope for fewer cases and treatment in the upcoming months.

You may have noticed that one of our former Large Cap Growth stocks, namely United Healthcare recently reported better-than-expected earnings. Most health insurance companies will be posting better-than-expected earnings during the coronavirus outbreak, since normal elective medical procedures (e.g., new hips, knees, stents, etc.) have been largely curtailed, which in turn, pads the profits of health insurance companies.

One of the outcomes of the coronavirus outbreak is that it is now severely hurting the profitability of most private hospitals and many doctors in the medical community. In the U.S., we do not normally ration healthcare, but that is exactly what has happened under the Centers for Disease Control's (CDC) coronavirus response as elective procedures were postponed; so it is imperative that the CDC restrictions be lifted, otherwise it is going to cause private healthcare companies to increase their costs to pay for all their fancy medical equipment and facilities, like MRI machines, hospitals, and outpatient surgery centers that are not being sufficiently utilized.

The politics of the coronavirus outbreak are simple. Each governor has their own opinion polls and will likely reopen their respective economies as their respective popularity peaks and the outcry to get back to work intensifies. When the April economic data is released, it is expected to be absolutely horrific, so many governors will be forced by public opinion to reopen their respective economies in May and June. Most Americans are naturally optimistic and eager to get back to normal or the "new normal" in New York City and other congested urban areas.

As you probably noticed, the stock market is anticipating a robust economic recovery. As an example, our average Large Cap Growth stock is characterized by 16.2% annual sales growth and 60.8% annual earnings growth. Frankly, we remain amazed that the analyst community continues to revise their consensus earnings estimates

higher and have revised them up by an average of 3.1% in the past three months for our average Large Cap Growth stock. Many companies are not issuing guidance moving forward, so the fact that our average Large Cap Growth stock remains characterized by positive guidance is very positive.

We anticipate that the U.S. economy will be in the midst of a robust economic recovery later this year, just in time for the upcoming Presidential election. Naturally, if there is a resurgence in coronavirus cases in the fall without a vaccine, all bets are off, since it would likely become a hotly-debated political issue, especially if key states re-impose economic restrictions and cancel essential services, like schools. Fortunately, Americans are naturally optimistic and like their freedoms, so hopefully the U.S. economy can resume growing and prospering under the new CDC guidelines.

## THE 0% INTEREST RATE ENVIRONMENT & DEFLATION

The International Monetary Fund (IMF) recently told 25 emerging market countries that it would provide grants to cover their IMF debt payments for six months. The G-20 subsequently announced that it supports a suspension of IMF debt payments to these 25 emerging market countries and encouraged private lenders to also suspend debt service payments for these countries.

Ironically, many countries in the G-20 can borrow at zero or negative interest rates, so they are a bit hypocritical on providing credit advice. I remain amazed that the Fed has “thrown in the kitchen sink” twice in recent months at the credit markets. The first drastic Fed action was to cut key interest rates to zero and to reactivate quantitative easing. The second shocking Fed action was to pledge an additional \$2.3 trillion to support the U.S. economy. This pledge included buying \$600 billion in small business administration (SBA) loans, \$850 billion in corporate bonds, and \$500 billion for municipal bonds. The biggest surprise is that the Fed is buying “fallen angels,” which are BBB investment grade corporate bonds that were recently downgraded to BB or junk status. This was truly a big surprise that got Wall Street excited, so many junk bonds have rallied impressively in recent weeks.

Right now, Corporate America has been very busy issuing new debt at ultralow rates to (1) add to corporate capital, (2) refinance existing debt, and (3) to build their coffers in case they decide to resume stock buy-backs. Eventually, this cheap money could re-ignite inflation, but for the time being, deflationary forces have enveloped the U.S. economy as key commodities like corn, chickens, and crude oil plunge in price due to lack of demand because of government-mandated shutdowns in many countries. As a result, wholesale prices based on the Producer Price Index (PPI) have declined every month in 2020, so deflationary forces are growing and enveloping more parts of the U.S. economy.

It is absolutely imperative that the Fed and other central banks strive to stimulate economic growth, since if deflationary forces persist, it would be a long-term disaster for central bankers, because consumers would likely postpone their purchases if they know prices will continue to decline. A good example is real estate in New York City and Long Island, which was soft before the coronavirus outbreak and will likely remain weak, since it is going to take a while for life to get back to normal. As a result, thanks to ultralow interest rates as well as quantitative easing, the Fed will be trying to stimulate multiple industries, like the automotive and housing markets, which are notorious for being interest-rate sensitive.

We must add that we remain impressed with how the Fed continues to control Treasury bond yields, which have recently continued to decline while the stock market has improved. The lower the 10-year Treasury bond yield, the stronger the foundation under the stock market. The demand for both high yield corporate bonds and high dividend yielding stocks remains robust, which is a good sign that investors are expecting economic growth to reaccelerate as many states prepare to reopen their respective economies.

Frankly, we are worried that the current ultralow interest rate environment may remain permanently. With crude oil under \$3 per barrel for May delivery—no, it's not a typo—there is no doubt that deflationary forces are spreading. The world used to use approximately 100 million barrels of crude oil per day, but now with worldwide demand down approximately 30%, barely 70 million barrels of crude oil per day are required. As a result, the OPEC+ (includes Mexico & Russia) cut of 9.7 million barrels per day is grossly insufficient. Even if Canada, the

U.S., and other non-OPEC+ countries cut crude oil production by 10 million barrels per day, that is still grossly insufficient, so the crude oil glut continues to grow.

In conclusion, if deflation becomes permanent, it could eventually become a threat to stock valuations. Fortunately, low commodity prices and ultralow interest rates are currently boosting dividend stocks. As an example, on the day that crude oil prices fell decisively below \$20 per barrel, most dividend stocks surged, including Chevron and Exxon, as yield hungry investors chased high dividend yields. In the case of both Chevron and Exxon, these companies can borrow in the credit markets to maintain their very healthy dividend payments, despite record low crude oil prices. However, now that crude oil prices have plunged below \$3 per barrel, obviously both Chevron and Exxon may not be able to sustain their current dividend payments.

There have been some high-profile dividend eliminations in recent months, like Boeing, Darden Restaurants, and Ford. But, as the first-quarter announcement season kicked off, Johnson & Johnson boosted its dividend and then Costco subsequently raised its dividend. Currently, the average stock in the S&P 500 yields 2.23% and all the dividend stocks in the S&P 500 yield 2.79%. Based on a 10-year Treasury bond yield of 0.62%, the S&P 500 yields 2.6 times, while the dividend stocks in the S&P 500 yield 3.5 times the 10-year Treasury bond!

As we have been saying repeatedly on podcasts, dividend stocks have been rallying impressively ever since the Fed seized control of Treasury bonds. Now that we are in the midst of the first-quarter announcement season, it is finally time for growth stocks to shine. Since our conservative growth stocks are characterized by strong sales growth, even more powerful earnings growth due to margin expansion, and positive analyst earnings revisions, we are anticipating another stunning earnings announcement season. Furthermore, our average Large Cap Growth stock has revised its dividend 40.6% higher in the past year, so we are expecting nothing less than a stunning announcement season!

As any stock market climbs higher, it typically becomes more narrow and that is exactly what we expect to be happening in the upcoming months. Of the 11 sectors in the S&P 500, only biotechnology is poised to possibly break out, probably due to Gilead Sciences' favorable Stage 3 FDA trial and the search for a coronavirus vaccine. Outside of biotechnology, we are not in a sector market, but instead a market where it will likely be "every stock for itself." Traditionally, our dividend growth and conservative growth stocks have represented a silver lining and critical path to follow. As a result, I expect that the crème de la crème will continue to break out this quarterly announcement season and the vast majority will be led by our Large Cap Growth stocks!

## SUMMARY

Our dividend growth and conservative growth stocks are poised to continue to break out relative to the overall stock market, which has been systematically been driven by (1) short covering, (2) bargain hunting in dividend stocks, and (3) a flight to quality. Short covering can fizzle, so we should not confuse strength in weak stocks for a sustainable rally. However, the dividend rally is real and sustainable, since the 0% interest rate environment may be permanent, so yield hungry investors will likely continue to propel high dividend stocks steadily higher. Finally, the first-quarter announcement season is time for our conservative growth stocks to shine and we expect that many will emerge as the crème de la crème in what we expect will be an increasingly narrow market environment.

We are expecting a U-shaped economic recovery that will likely boost fewer stocks than would prosper in a V-shaped and more robust economic recovery. Nonetheless, Americans are notoriously optimistic and the overall stock market reflects that optimism. The spontaneous protests across the U.S. to get back to work are a very good sign that many Americans are eager to restart the U.S. economy.

In the meantime, the central bank intervention and ultralow interest rate environment will help the auto and housing markets, which are notoriously interest rate sensitive. The Fed is also buying a lot of corporate bonds, which suppresses credit spreads and lets companies borrow at much cheaper rates.

We expect that dividend stocks will continue to improve and have set the stage for an explosive rally for our conservative growth stocks. In the wake of an impressive rebound since the late March lows, we are expecting a much more narrow, selective stock market where the crème de la crème perform the best. As a result, many of our

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portfolios will be shrinking in anticipation of an increasingly selective stock market. The good news is that our conservative growth stocks have superior fundamentals and should emerge as a silver lining and critical path that investors can follow.



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