BRAVE BOAT
Capital Advisors

The Brave Report

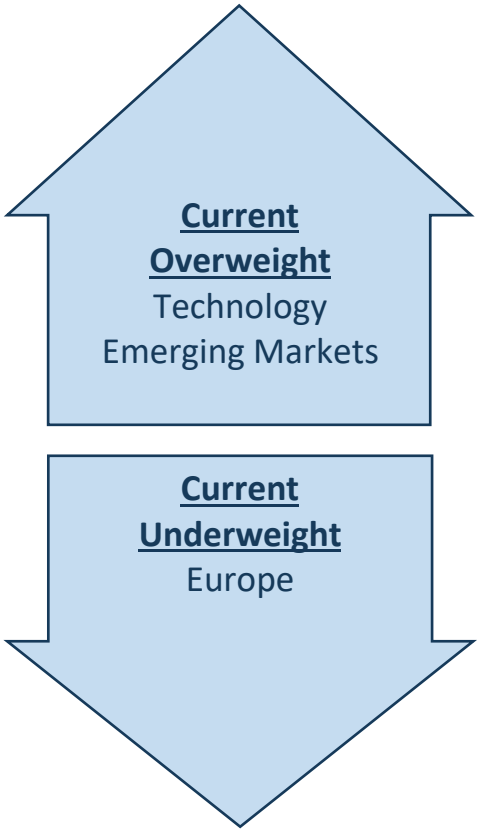
February 2019

And the train keeps rolling on…. The Dow and the S&P 500 just capped off their best start to the year since 1987 and logged their best two month run since 2010. What is up for debate now is whether this rebound has come too far too fast? History tells us that this kind of start to a year bodes well for the remaining 10 months. Of the last 27 times the S&P 500 has been up for each of the first 2 months of the year, 25 of those times the remaining 10 months of the year have also been positive. The average return in the circumstances is 12.1% versus a normal last 10-month average of 7.6%. This is pretty substantial outperformance and something that should give investors some optimism moving forward. I would also argue that most investors would be happy with just the average return over the next 10 months.

However, with this optimism should also come some caution, especially in the short-term. We rarely see continued follow through on these types of rallies without at least a little consolidation or pullback. Profit taking in these situations is normal and healthy and is often needed if the markets are going to make another leap higher.

Market Overview

The markets continued on their tear higher adding to the spectacular gains we saw in January. All three major indices gained more than three percent, with the NASDAQ gaining the most at around 3.8%. This puts all three indices up between 11% and 14% for the first two months of the year. This represents one of the best two month stretches we have seen in years and the best start to a year in decades. With some more clarity emerging around Fed policy and the potential of a trade deal with China there could be some catalysts to see some further follow-on to this rally. However, I would stress caution as well. When the markets move up this quickly we often see a reversal or some consolidation before another move higher.



With the stock markets continuing to march higher the fixed income complex has been relatively stable. After dropping sharply in November and December, rates have stabilized to start the year. We saw the 10-year treasury trade in a range between 2.63 and 2.72%. This was one of the tightest monthly ranges we have seen in quite some time. This can partly be attributed to some additional clarity coming from the Fed as it looks like rate decisions will be very data dependent and the pace of rate hikes seems to be slowing. If fears of a global slowdown do materialize over the next few year or two, I would not be surprised to see rates stay flat or even drop as global policymakers attempt to prevent a recession.

Trade Deal: Most signs coming out of Washington seem to point toward some real progress being made in the trade negotiations with China. Most notably, Trump again delayed the implementation of new tariffs on Chinese goods. This can only be a sign that the two sides are much closer to a framework for a deal than they have been for months. It benefits both countries greatly to come to some sort of positive agreement. The

prospects of and speculation around a trade war have cast a cloud over the entire global economy for almost a year now and helped to catalyze the major selloff we saw over the last few months of the year.

We have also started to see the impact of a potential trade war on the prospects for global growth as it has muted the earnings guidance for a number of companies. Without an agreement, it has seemed like most global companies have lowered their growth outlooks in an effort to hedge the potential risk of increased tariffs. Rather than speculate on the outcome most companies have been comfortable projecting more conservative results. If a deal gets done they can always raise guidance later but this prevents them from having to adjust down in the future. As we have seen from market performance for the last two months, most stocks have not been overly punished for these guidance adjustments.

I do still maintain a worry about the trade deal. As I discussed last month, I worry that the market has moved so far so fast that if/when a deal gets announced it will turn into a sell the news event in the short-run. The markets have run up on expectations that a deal will get done so unless the deal is viewed as perfect then we could see some profit taking. Now, I'm not saying the trade deal won't be a positive catalyst in the long-run but I would not be surprised to see some selling on the news.

Earnings: With earnings season drawing to a close, we finally have a clear picture of how companies actually performed in the 4th quarter and whether the doom and gloom feared near the end of the year was warranted. For the S&P 500, 69% of companies beat on earnings and 61% beat on revenue. This is slightly below the 5-year average beat rate for earnings but slightly above the average for revenue. Where these numbers did disappoint is in the magnitude of the positive surprises in both earnings and revenue, which both fell below the 1- and 5-year averages.

In terms of earnings growth, which is one of the metrics that many pundits were worried about, we saw a 13.1% growth rate. This is higher than the 12.1% estimated at the end of the year. This also marks the 5th straight quarter of double-digit earnings growth.

While this all seems like decent news, and most of it is, we did see 73 companies issue negative guidance for upcoming quarters and we saw analysts reduce their forward earnings estimates by 6.5%. This was the largest decrease since the 1st quarter of 2016. The big question moving forward will be whether this decrease in earnings estimates is due to an actual slowing in the global economy or if it can be attributed to the risk of a trade war. We should get a better picture of this if a trade agreement can be reached and analysts adjust their estimates accordingly.

Strategy Commentary

I have continued to add to equity positions but plan to take a pause on this approach as the markets seem a bit overheated in the short term. I am currently slightly overweight equities and am comfortable here even if there is some short term consolidation. With that said, I will also not hesitate to take some profits if the market pulls back in the short -term.

Domestically I have maintained my overweight to consumer discretionary, industrials, technology and healthcare. I am watching the healthcare sector closely as it outperformed in the 2nd half of last year but has been struggling to find footing as of late. This could be due to some profit taking or just a rotation into higher momentum stocks as the market has accelerated. If this continues I will be looking to reduce exposure.

I am still underweight European equities as growth prospects in the region seem to be muted. The risk of a recession is much higher there and there continues to be a long list of uncertainties that will hang over the region. I am maintaining my overweight to Emerging Markets. The recover there, especially in China has been pretty sharp. As I mentioned above, I am worried that a trade deal with China could turn into a sell the news event in the short-run as

investors capitalize on the run we have seen so far this year but I still like the risk/reward profile for the remainder of the year.

On the fixed income side, I am removing my underweight. I am not looking to rush in and start buying bonds with both hands but it seems that the upward pressure on rates is starting to be relieved. I will start to selectively add some positions, especially on the short end of the curve as long as rates seem to be range bound or trending lower. I am not moving to overweight at all but will look to bring the weighting up to a more neutral position as the data dictates over the next few months.

Please reach out to us directly if you have any additional questions or would like to arrange a free initial consultation to assess your needs and understand more about our services.

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