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Investment Review and Outlook

What a year 2019 turned out to be! Going into 2019, market participants were in a state of near panic, as fears of global slowdown due to the simmering trade wars were prevalent. The inverted yield curve in the U.S. added to expectations of a potential recession. But as trade war rhetoric began to slowly abate, the stock market found its footing and moved meaningfully higher through the year.

One of the most interesting aspects of this rally was that it seems to have been due primarily to a change in investor sentiment rather than actual earnings growth, which was essentially non-existent in 2019. At the end of 2018, the average price-to-earnings multiple was around 15 times. With the strong rally in the market, the average price-to-earnings ratio is currently closer to 19 times. In Wall Street parlance, what we witnessed was a phenomenon called "multiple expansion." It is another way of saying that investors breathed a big sigh of relief and were once again more comfortable with taking risk.

As we look toward 2020 and beyond, we view the stock market's overall opportunities and risks as fairly balanced. With an election coming in November, we do not believe that the Federal Reserve will raise interest rates this year. With the signing of Phase 1 of a trade deal with China imminent, the chances of a recession in 2020 has declined substantially. We believe the greatest challenge for the stock market is that multiple expansion has reached its limit. Thus, we see earnings growth as the key driver for higher stock prices going forward. With an expected recovery in earnings of companies negatively impacted by the trade wars, we expect earnings growth to be much improved versus 2019.

While the stock market is not necessarily priced for perfection, many stocks trade at the higher end of historical valuations. We will be focused on sectors of the market and stocks that trade at more modest valuation than the average valuation in the stock market overall.

Don't Hide Under the Apple Tree with Such an Elevated PE

After reviewing some of our stock recommendations over the past decade, we found two prescient calls on the stock of Apple Inc. (AAPL $309.63), the largest company in the U.S. based on market capitalization. In April 2012, we penned a piece titled "Sell Apple Now!" which questioned the near universal bullishness surrounding the stock at the time. A little over one year later, the stock had lost about one third of its value and we changed our tune with a screed entitled: "The Apple of our Eye." We pointed to the stock's much improved valuation and the management's continued success in introducing products and services that consumers coveted. That turned out to be a great call: since that time the stock has risen about 340% while the S&P 500 index has risen about 100%.

We remain great admirers of the company, its management, and its continued success in monetizing on its remarkably consistent innovation. But we are not as bullish looking forward because of its current elevated valuation. The stock now trades at over 20 times next fiscal year's average earnings estimates. The company has also been spending down its massive cash hoard by aggressively repurchasing shares, which undoubtedly has helped drive stock performance in recent years. There is also the law of large numbers: the company's large size will likely make it very difficult to innovate such that earnings growth will likely decelerate in coming years. Thus, we recommend waiting on the sidelines until the valuation becomes more compelling.