HORAN CAPITAL ADVISORS
Investor Letter
Summer 2018
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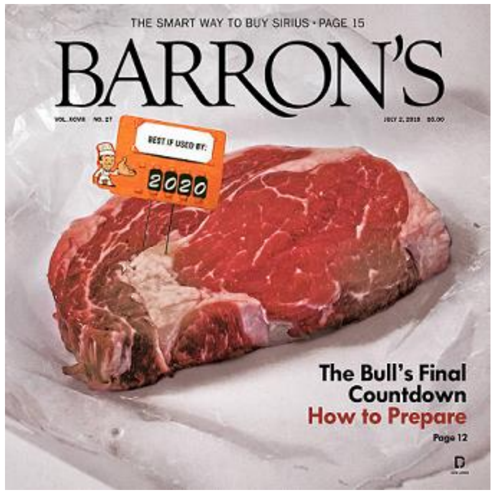
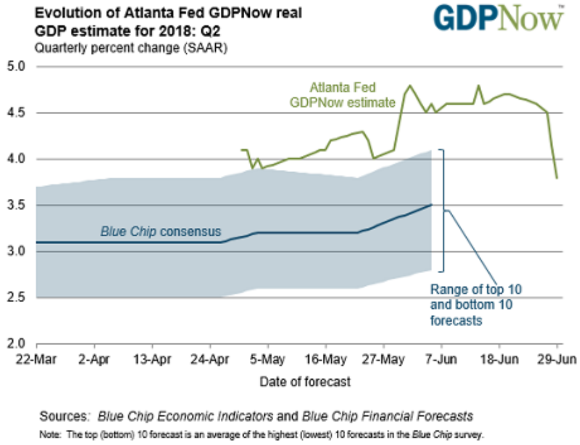
"Whoever controls the media, controls the mind." -- Jim Morrison of the Doors

<u>A Recession in 2020: Really?</u>



The current economic expansion is now the second longest on record and much of the data related to the economy and the market continues to be pretty darn good, but you would not know that from the headlines. "The press is sometimes called the fourth branch of government, but in the U.S., it's also very much a business – one whose ability to serve the public is dependent on its ability to attract eyeballs and dollars," according to The Pew Research annual report on the U.S. news media industry. According to *Psychology Today*, "…news programming has two aims. The first is to grab the viewer's attention. In the news media, this is called the teaser. The second aim is to persuade the viewer that the solution for reducing the identified fear will be in the news story." Case in point: the beefy July 2, 2018 cover story in *Barron's* magazine, as shown to the right, *Why the Bull Market Could End in 2020.*

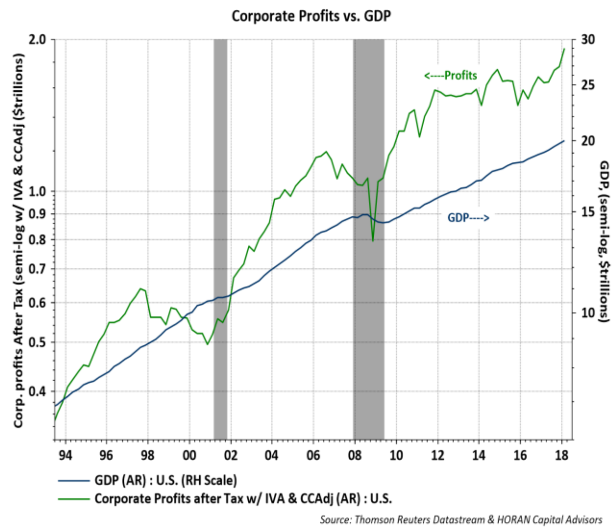
Predicting the end of the equity bull market two years into the future is something of a stretch when economists and strategists are unable to accurately predict economic growth (GDP) for the next one or two quarters. A good example is the GDPNow forecast provided by the Atlanta Federal Reserve Bank. On the last business day of June, the GDPNow forecast for economic growth in the second quarter was reduced from a 4.5% to 3.8% annual rate. The green line on the chart shows the GDPNow forecast trend since near the beginning of the second quarter. The GDP forecast is an ever-fluctuating value and predicting a recession in 2020 seems more a fools game than not.



<u>The Hard Economic Data</u>

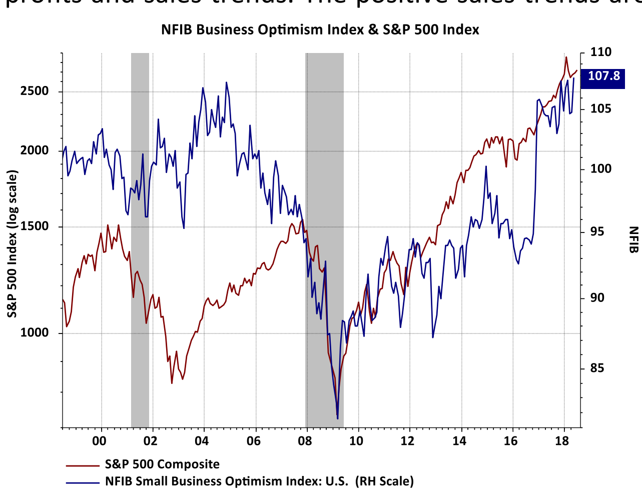
The economy is not the stock market and vice versa, but positive economic data tends to be supportive of a positive equity market environment. With the recent release of the final reading on first quarter GDP, the Bureau of Economic Analysis updated figures in the National Income & Product Accounts, the data behind the GDP calculation. One updated item is after-tax corporate profits. This particular corporate profit number is not based on GAAP (generally accepted accounting principles) but on true economic profits using IRS data filings.

In a recent analysis by Scott Grannis, former Chief Economist at Western Asset Management, he notes, "[corporate profits] reached a record $1.92 trillion (annualized), up almost 17% from a year ago. That's equal to 9.6% of GDP, a level that has been exceeded in only 4 quarters in our nation's recorded history. After-tax profits are likely to move higher still, once the full impact of lower corporate income tax rates filters through the data as the year advances. Corporate profits paint an attractive picture for today's investors, since equity valuations seem only moderately higher than their long-term averages, even as profits reach very high levels relative to GDP."



The surge in corporate profits is due in part to tax cuts, but business activity is strong. S&P 500 profits advanced 26.6% in Q1 on an 8.4% revenue gain and are forecast to advance 20.7% in Q2 on an 8.1% increase in revenues. Current estimates call for a 22.5% rate of profit growth for 2018 followed by 9.7% in 2019. Economic strength is translating into an increase in demand for employees. In June, for the second consecutive month, job openings exceeded the number of unemployed workers. Labor Secretary Alexander Acosta noted we have never had an economy where job openings exceeded job seekers.

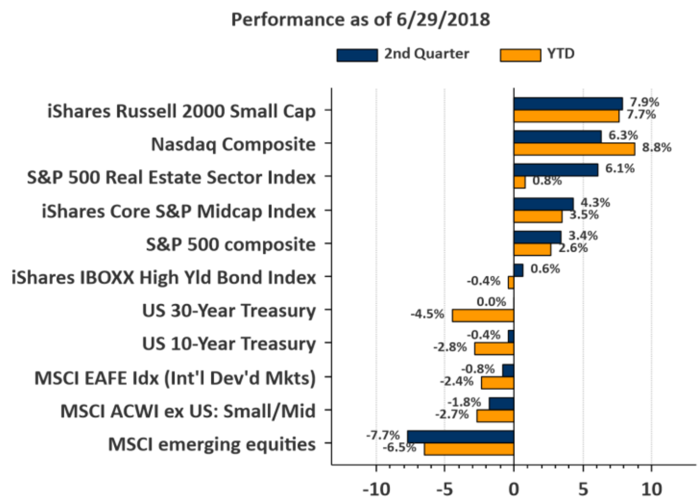
Despite the issues involving tariffs and the potential for a full-blown trade war, both individuals and businesses remain highly optimistic. The most recent NFIB Small Business Optimism Index reading of 107.8 is the second highest index reading in the survey's 45-year history. The report noted small businesses reported high readings in key categories: compensation, profits and sales trends. The positive sales trends are at their highest level since 1995. Importantly, the surge in NIPA corporate profits is on the back of strong top line sales growth as above noted.



A Look at the Markets

International markets, both developed and emerging, outperformed the U.S. market during the first quarter following a very strong performance in 2017. This reversed in the second quarter as International returns were significantly weaker and thus placed their year-to-date returns in the red. The U.S. Dollar found support during the quarter and strengthened as exhibited by the U.S. Dollar Index rising from 90.15 to 94.64. A stronger Dollar serves as a headwind for foreign markets, especially the emerging markets, in the short-term. The prospects of rising interest rates and tariff/trade tension rhetoric certainly contributed to increased stock market volatility around the world.

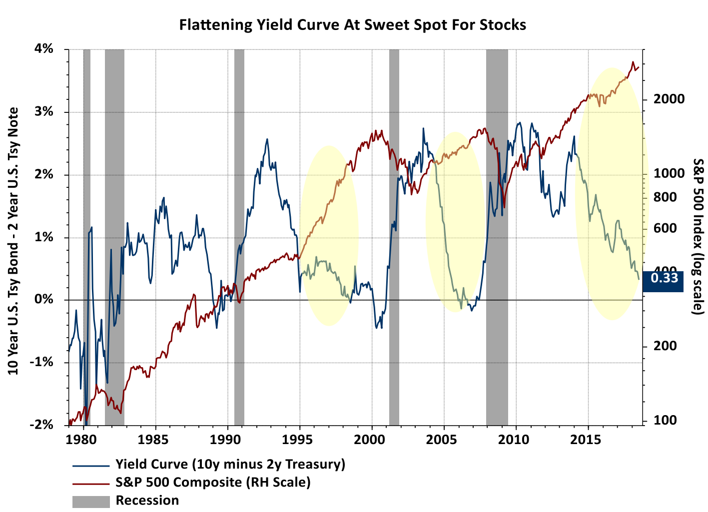
The returns in the U.S. stock market this year have been driven in large part by momentum stocks, those stocks that have been moving up at an increasing pace. Momentum investing relies more on capturing the continued short-term movement of a stock than its fundamental long-term value. This approach has contributed to the significant performance disparity between the growth and value styles of investing over the past year with the growth index registering a 20.82% return vs 7.76% for the value index. S&P Dow Jones notes, in an analysis of factor performance, that "Since the start of 2017, the S&P 500 Momentum Index has outperformed the benchmark S&P 500 by 15% in total return, a figure that has rarely been exceeded historically and, when it has been exceeded, has tended to predict a subsequent period of weakness for the strategy."



Source: Thomson Reuters Datastream & HORAN Capital Advisors

The Federal Reserve Bank increased the Fed Funds rate in June for a second time this year by 0.25% to a target range of 1.75% - 2.00%. Notable in the Fed's statement was the announcement of a potential fourth rate hike this year. Consequently, as short-term rates have risen, we are finding far more attractive options in short-term fixed income, including money market funds yielding more than 1.5%. A far cry from the 0.10% of a couple of years back.

As the table shows, it has been a tough year for long-term bond investors. The total return for the 10-year and 30-year Treasuries is -2.8% and -4.5%. High-yield bonds, with shorter durations, were up 0.6% for the quarter but are slightly negative for the year. High-yield bonds have a positive correlation with the equity market and therefore have displayed more volatility this year much like the U.S. stock market.



Source: Thomson Reuters Datastream & HORAN Capital Advisors

We do believe the Fed will continue to move interest rates higher throughout the year assuming the present economic conditions exist. During this increased rate cycle, the yield curve, the line that plots the amount of interest paid at specific maturity dates, has been flattening. A yield curve inversion occurs when the 2-year Treasury yield is higher than the 10-year Treasury yield. If an inversion occurs, this can be a leading indicator for recession beginning in the subsequent 12-18 months. The Fed's interest rate actions tend to influence the short-end of the Treasury curve. Longer term rates, the 10-

year Treasury for example, are more often influenced by long-term inflation expectations.

The Fed's favored inflation indicator is the Personal Consumption Expenditures Price Index (PCE). At the end of June, core PCE moved to the Fed's target of 2.0%. According to Econoday, the PCE report "marks a pivot for the Fed which now, as it has been signaling, will begin focusing on the upside of its 'symmetric' inflation goal that is protecting against an unwanted acceleration in prices. And that means, soft consumer spending or not, rate hikes to come." As the chart on the prior page shows, although the yield curve is flattening (yellow shading), equity markets perform well during this flattening period. Generally, there is a correlation between the increase of short-term interest rates and a strong economy. This tends to benefit stock prices.

<u>Old Age</u>

The Barron's article, referenced at the beginning of the Investor Letter, suggests a recession in 2020. It is noted that the length of this bull market, the second longest on record, is the demarcation line. This bull market has run 3,400 calendar days and second only to the 1987-2000 bull market that ran 4,494 days. However, we believe bull markets do not necessarily die of old age but of excesses that build up in the market and the economy. We are not seeing these excesses now. For example, capacity utilization stands at only 77.9%. The peak in this figure before the onset of the financial crisis was 81.5% and it reached 84.7% prior to the technology bubble peak. We do believe the economy is likely in the last third of this business cycle and therefore may require some different thinking in regard to where returns are appropriate for a commensurate level of risk.

<u>Sell the Media</u>

Jim Morrison of the Doors was astute in his opening quote "Whoever controls the media, controls the mind." Little did he know the extent to which the media would help to drive the polarization of our political landscape. Little did he know about the megaphone of social media and the increased relaxation of professional fact-checking standards. Doomsday scenarios sell ad time and pull emotional investors to the sidelines. A part of our role as investment advisors is to assist clients in sorting through the sound bite of the day, steady the emotion, and reflect on the hard data that will ultimately drive markets. A disciplined focus on solid values and fundamentals will prove to be a winning strategy and stand the test of time. We may recall the Royal Bank of Scotland economist who called for a stock market collapse in January 2016. Since that time, the S&P 500 Total Return Index is up more than 48%.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us for company news, reports and our blog at www.horancapitaladvisors.com.

Warm regards,

HORAN Capital Advisors

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CORPORATE HEADQUARTERS
4990 East Galbraith Road
Cincinnati, Ohio 45236
513.745.0707
800.544.8306

DAYTON
2480 Kettering Tower
40 North Main Street
Dayton, Ohio 45423
937.610.3700

COLUMBUS
6750 Avery-Muirfield Drive
Suite A2
Dublin, Ohio 43017
614.734.8406

KENTUCKY
Columbia Executive Center
207 Grandview Drive, Suite 100
Fort Mitchell, Kentucky 41017
859.572.4500

www.horancapitaladvisors.com