J.W. Burns & Company

Investment Counsel

Quarterly Update - October 2019

Roosters Make All the Noise But Hens Do All the Work

"Although it's easy to forget sometimes, a share is not a lottery ticket...its part-ownership of a business..." - Peter Lynch

Dear Clients and Friends,

Stocks finished the September quarter with positive though relatively modest gains, with the S&P 500 Index up 1.70%, the Dow Jones Industrial Average gaining 1.83%, and international stocks, as measured by the MSCI all world ex-USA Index, continuing to lag, down 1.70%. Bonds outperformed the stock market in the third quarter, with the

Barclay's Aggregate Bond Index returning 2.38%. Overall, however, stocks are having a superb year, with the S&P 500 up 20.55% through the end of the third quarter, the best start of a year since 1997. As I stated in our last client letter, we remain constructive on the outlook for stocks as we head into the end of the year, but believe returns will be more muted with greater volatility likely.

Our portfolio structuring has remained mostly unchanged. We believe our clients are well-positioned in world class businesses with consistently rising earnings and dividend streams and wide economic moats. As we continue to monitor market performance and leadership groups closely, we are prepared to make adjustments if needed. In recent weeks, we have added some more conservative investments, like high-yield corporate bond funds and preferred stocks to our buy list, which we are prepared to initiate or increase client positions if needed. On the whole, we believe your portfolio remains well-positioned for the current environment and that stocks will continue to be the best home for investors over the next 12-18 months.

"Given the political environment and 24/7 news cycle, boiling things down to what impacts a client's financial well-being - and what doesn't - is paramount."

As you know, there is much in the news lately, and we believe it is our job as your investment advisor to focus on what is important to your portfolio (economic fundamentals and earnings) versus what is not (just about everything else right now). In other words, given the current political environment and 24/7 news cycle, boiling things down to what impacts a client's financial well-being – and what doesn't – is paramount.

So here we go.

From an economic standpoint, there is no question that certain recent data has shown some growing weakness. ISM Manufacturing, which measures the general direction of the manufacturing industry, reported its worst reading since June 2009, dropping to 47.8, representing contraction territory.

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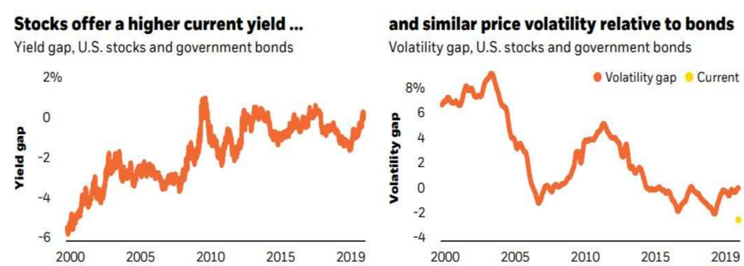
ISM Non-manufacturing slipped to its lowest reading in over three years, dropping from 56.4 to 52.6, (however any reading above 50 is considered expansion). Business confidence has also dropped, as corporate executives delay investment while awaiting the ebbs and flows of the U.S.-China trade war, which can make long-term planning difficult. Finally, the real GDP estimate for Q3 of 2019 came in at 2% which is well below 2017's Q4 peak reading of 3.5%.

It should be noted that although the ISM Manufacturing number was below expectations, the manufacturing industry comprises just 12% of the U.S. economy. Consumer spending, on the other hand, makes up nearly 70% of the U.S. economy and is, in fact, quite strong.[1] The recent September jobs report saw unemployment fall to a 50-year low of 3.5% and showed that there are currently more positions available than workers to fill them. American consumers are seeing their paychecks rise, with average wage growth clipping along at a healthy 3.5% pace. In fact, the National Retail Federation expects another strong holiday season, with sales rising 4.2% year-over-year to $725 billion. So, overall, we believe the U.S. consumer remains strong, which should offset the current weakness we see in the manufacturing and industrial sectors.

"As I write this in early October, Chairman Powell has reiterated his stance that the Fed will remain accommodative...and that the jobs and employment data for the U.S. economy remain healthy."

In addition to the strong consumer, another supportive pillar for the bull market in 2019 has been the accommodative Federal Reserve. In fact, the Fed has cut interest rates twice so far this year, and we expect two more cuts: one in October and in December. As I write this in early October, Chairman Powell has reiterated his stance that the Fed will remain accommodative and data dependent and that the jobs and employment data for the U.S. economy remain healthy.

The inverted yield curve remains a concern. In our last client letter I explained that the inverted yield curve is simply when short-term interest rates are higher than long-term interest rates and that it is viewed as a classic recession indicator. However, we believe the primary reason for the inverted yield curve is due to a technical factor rather than a fundamental one. Currently, over 25%, or $17 trillion, of international sovereign debt is yielding negative interest rates.[2] This has led many investors to pour money into U.S. treasury bonds, which still generate a positive yield. This increased demand for U.S. bonds drives down their interest rates, contributing to the inverted yield curve. It should also be noted the dividend yields on most of your portfolio holdings, as well as on the S&P 500 Index overall, has a higher yield than 10-year U.S. treasury bonds! Furthermore, the dividends on your stocks will almost certainly rise nicely over the next ten years, whereas the interest payments on treasuries are fixed. ***This reinforces our view that equities, on a risk adjusted and comparative yield basis, are the best home for our clients' hard earned money.***

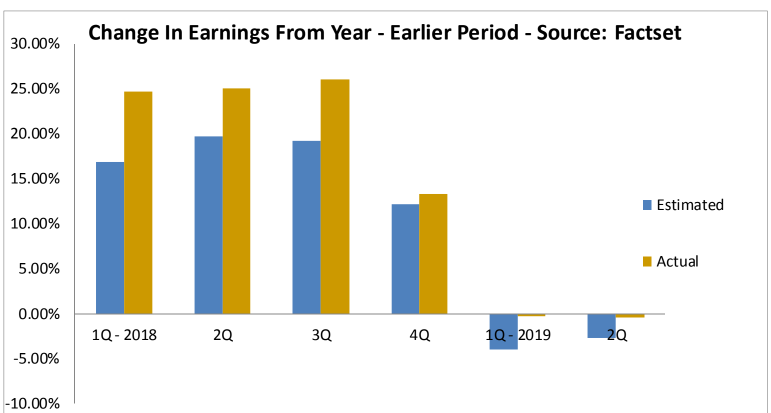


Source: BlackRock, with data from Bloomberg, September 2019. Left chart: The Bloomberg-Barclays U.S. Generic Government 10-

The topic of trade continues to pose real headaches for markets. China's unwillingness to budge on key issues, along with rising pressure by the U.S. over the Hong Kong Protests and China's treatment of ethnic Muslims, makes a major all-in-one blockbuster deal unlikely. Going forward, we believe incremental progress can be made, which could be a solid boost for markets and business confidence. Keep in mind, changing day-to-day headlines and unexpected tweets will continue to inject volatility into the market on the trade front. As I write this, senior level officials from the U.S. and China delegations have met to resume trade talks, and stocks are up sharply on reports that China and the U.S. have reached a "substantial phase 1 deal."

Lastly, earnings growth over the first half of the year was projected to be lower by 3-4% but actually ended up essentially flat as companies stuck to their "under promise, over deliver" strategy. As we move into 3rd quarter earnings season, analysts are predicting a 4-5% drop in results. Overall, earnings over the past five years have exceeded estimates by an average of 4.9% per year.[3] Additionally, last quarter, 75% of companies in the S&P 500 beat their earnings estimates.[4] The chart below reinforces this, showing that actual results have handily beaten estimates the last six quarters.

Therefore, our view is that 3rd quarter earnings will likely again come in better than expectations; probably flat to slightly positive, which would give stocks an added lift as we head into the end of the year and set the stage for an earnings rebound in 2020.



As I have stated frequently in our previous client communiques – a slow but growing economy, with low inflation and low interest rates, has historically been a great environment for stocks. So, while there are various challenges to the market as outlined above, on the whole, we don't believe that this bull market is close to done.

Now let's get to some of your questions.

Q: European Central Banks have recently announced stimulus. What is your position on international stocks, and is it time we increased our exposure?

A: International stocks have, for the last 10 years, significantly underperformed U.S. equities. Time and time again throughout this bull market, analysts and Wall Street "experts" have proclaimed that international stocks have cheaper valuations, greater growth prospects, and recommended investors increase their international exposure. The chart below shows just how wrong they have been.

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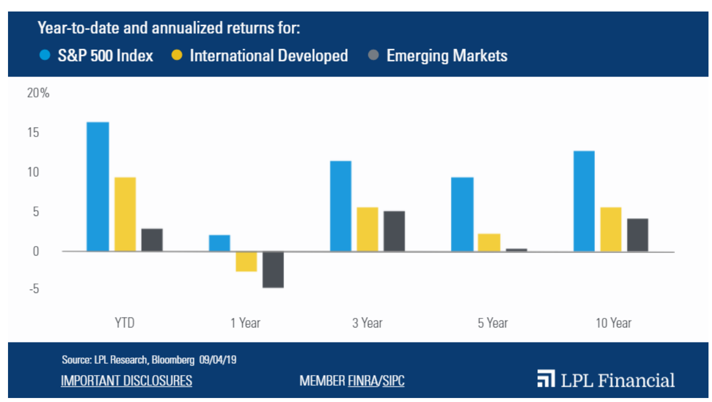
At J.W. Burns & Company, we have kept our international exposure modest (around 4-8%), which is well below the majority of investment firms. In fact, we have had several clients come to us from local competitors where they were positioned in international equities at 15%, 20%, and even more!



Not investing aggressively in international stocks when most investors have been overweight here is an example of how our active management adds unique value to our clients. We have remained true to our disciplined, time-tested philosophy of buying and holding high-quality U.S. equities for the long term. We always strive to give our clients our very best wisdom, judgment, and experience, and this has allowed us to filter out the noise, keeping our clients invested and on track to achieve their long-term financial goals.

There will no doubt be a time when international stocks outperform U.S. markets and we can increase exposure if needed for clients where it is appropriate. For international stocks, we primarily use top-performing, low-cost, exchange-traded funds (ETF's) as well as individual international equity holdings that we research in house. However, we remain confident in our current positioning at this time. Keep in mind, since our international exposure for most clients is already somewhere between 4-8%, clients will still have some benefit if international stocks begin to outperform.

Q: How do you see the upcoming 2020 election impacting markets as we go forward?

A: It is too early to really predict results in the upcoming 2020 election. However, there is no doubt that political tensions in Washington have risen since I last wrote to you. Namely, President Trump is facing an impeachment inquiry in the House of Representatives over his dealings with Ukraine. Meanwhile, left-of-center candidate, Elizabeth Warren, continues to rise in the Democratic primary polls, and her relatively anti-business platform could unsettle some investors. Furthermore, 2020 will likely be one of the most partisan and contentious elections in history with Americans digging further into their respective political views.

However, please remember, whoever is elected president and whatever party controls Congress, probably 85% of what is proposed by candidates never gets signed into law. Furthermore, the long-term positioning of your portfolio in outstanding businesses with rising earnings and dividend streams will be the real driver of your wealth. This is an old saying that is apropos here – ***"Roosters make all the noise, but hens do all the work."*** The hens in this case are your portfolio companies who make products and services that add value to people's lives. The roosters "making the noise" are, of course, the politicians along with the media talking heads. At J.W. Burns & Company, rest assured we will remain focused on your hens and their business performance! And that is good news for serious long-term investors seeking financial security for themselves and their families – such as you.

In our January client letter, I stated one of the reasons for my bullish thesis for 2019 was that it was the third year of the presidential election cycle – historically the best year for markets, returning an average of 16.07%. The fourth year is also quite strong, averaging around 7%, but it is usually back-end loaded after the November elections.[5] So timing wise, these are historically good months to be invested.

However, while we remain bullish, corrections and bear markets are simply part of the investment process and, quite frankly, should be expected. When market declines eventually happen, do not expect major market timing moves, or massive defensive changes to your carefully constructed portfolio. Numerous studies show that these types of moves can have a detrimental effect on your long-term returns. Instead, remember what Warren Buffett said earlier this year. When asked if he would prefer bonds or stocks over the next 10 years, he answered stocks "in a second."

Touché, Warren.

Thank you for your continued confidence, and have a wonderful fall and holiday season!

Best Wishes,

Jim

James C. Burns, CFA
President & Chief Investment Officer

P.S. I wanted to share another brief highlight of an employee here at J.W. Burns & Company: Ed

Grassi, Vice President and Senior Portfolio Manager. I hired Ed back in 1998 after a recruiter introduced me to him. He was, in fact, our first employee to take our unique personality profile before being hired, the same profile I use 20 years later for all potential new employees. As many of you assuredly know, the profile indicated that Ed is of the highest integrity, hard-working, and detail oriented. Now with us for over 20 years, Ed sports unrivaled investment experience and expertise. Many clients of J.W. Burns & Company work directly with Ed, and his hard work and dedication have helped our firm grow exponentially over the years. I am incredibly grateful for Ed's loyalty and commitment to our firm and to our clients.

Below are pictures of Ed with his lovely wife, Lisa, and their "kids": Olivia, Rocco and Joey.

P.S.S. I also wanted to quickly share that over the summer, one of our Portfolio Managers, Drew Derrenbacker, passed Level II of the Chartered Financial Analyst (CFA) exam. For those of you who don't know, the CFA is widely regarded as the most prestigious and rigorous financial designation in the industry. I received the CFA 27 years ago in 1992. This June, he will take (and hopefully pass) Level III, the final exam before he is eligible to earn the distinguished charter.

1 John Lynch, LPL Financial

2 Roger Altman, Evercore ISI

3 Factset Research

4 Akane Otani, Wall Street Journal

5 Rocky White, Schaeffer Financial