



DBR & CO Market Commentary

2Q 2019



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As we enter the final month of 2Q2019, I wanted to evaluate the broad themes that we introduced at the start of the quarter. This is a discipline we follow to bring accountability

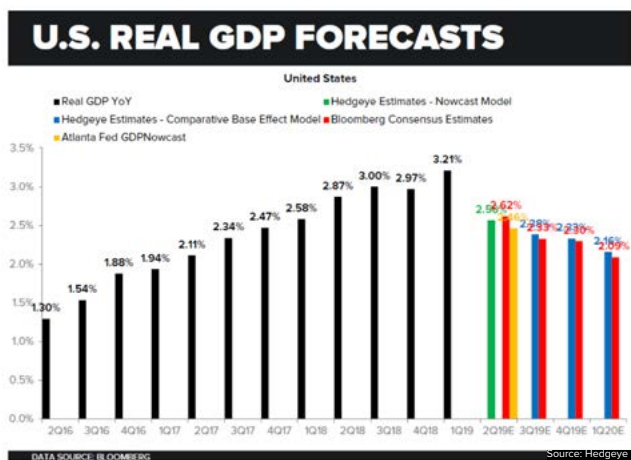
and transparency to our investment process and use to evolve and improve our delivery of advice to clients. To recap, here are the three themes we introduced in April:

1. Quad 3 - Domestic stagflation to deflation conditions
2. Profit recession for US Corporations
3. Opportunities – Emerging Markets and Energy

Quad 3 to Quad 4 – Stagflation to Deflation?

Stagflation is characterized by an environment where growth (GDP) is slowing at the same time inflation (CPI) is accelerating. To illustrate this at the personal level, imagine having your income/wages falling while the prices of things you buy regularly (gas, food, housing, etc.) are rising. Obviously painful, your discretionary income to buy the things you want, rather than what you need, begins to get constrained. Corporations feel the same pain as their input prices rise while their sales and profitability falls.

To review where we are on this theme, we should first look at where we were. Prior to the stock market correction in 4Q2018 (S&P 500 = -13.5%), the U.S. Economy enjoyed 9 consecutive quarters of YoY GDP growth. It was a tremendous run. The final quarter of 2018 marked the first quarter in which we expected GDP to roll over the other side of the historical economic expansion mountain. This has largely played out throughout the first and second quarter this year. Below is a graph provided by Hedgeye that shows the Real GDP data along with their estimates over the next few quarters.



Inflation (CPI), while very manageable from an absolute level has been creeping up with energy prices, housing, and wages. Interestingly, in May, some of the major components of CPI, such as Oil prices, have retreated. There is a potential that this could put us in Quad 4 (Growth and Inflation fall at the same time) in the 3rd Quarter. We will be monitoring the data closely and will update our thoughts accordingly.

Profit Recession for US Corporations

If you pay attention to any business-related TV show or publication, you have likely heard repeatedly, that 1Q2019 Earnings have been better than expected. Well, that might be, since investors had largely expected Earnings Per Share (EPS) Growth to be negative this period. In fact, with 463 companies (at the time of this writing) having reported, EPS Growth has been +1.4%. As you can see below, this is a very small victory for corporations:

S&P 500 EPS Growth (Source: Hedgeye Risk Management)

- 3Q2018 +24.2%
- 4Q2018 +12.6%
- 1Q2019 (through 5/23) +1.4%

Corporate earnings have dropped significantly since 2018, and we expect this trend to continue throughout the year.

Opportunities - Emerging Markets and Energy

This theme has not developed as we had called earlier this quarter. Historically, asset classes like Emerging Markets and Energy, have performed quite well in an environment where growth slows and inflation accelerates. The primary reason for this is a weakening US Dollar. With our expectation for Stagflation to persist domestically, we expected investors to seek inflation protection in these areas.

The breakdown of trade talks between the US and China have had a negative impact on both EM assets and the energy sector as investors fear the impact of a protracted trade war on these asset classes. We will continue to monitor these positions and manage risk accordingly.

Market conditions can often change. As a result, not all of our calls (or those of the industry) are right all of the time. But we can assure you we will continue to evolve and stay disciplined in our process, which we intend to be data-dependent, transparent and accountable.

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