Inversion and Opportunity

Hotchkis & Wiley

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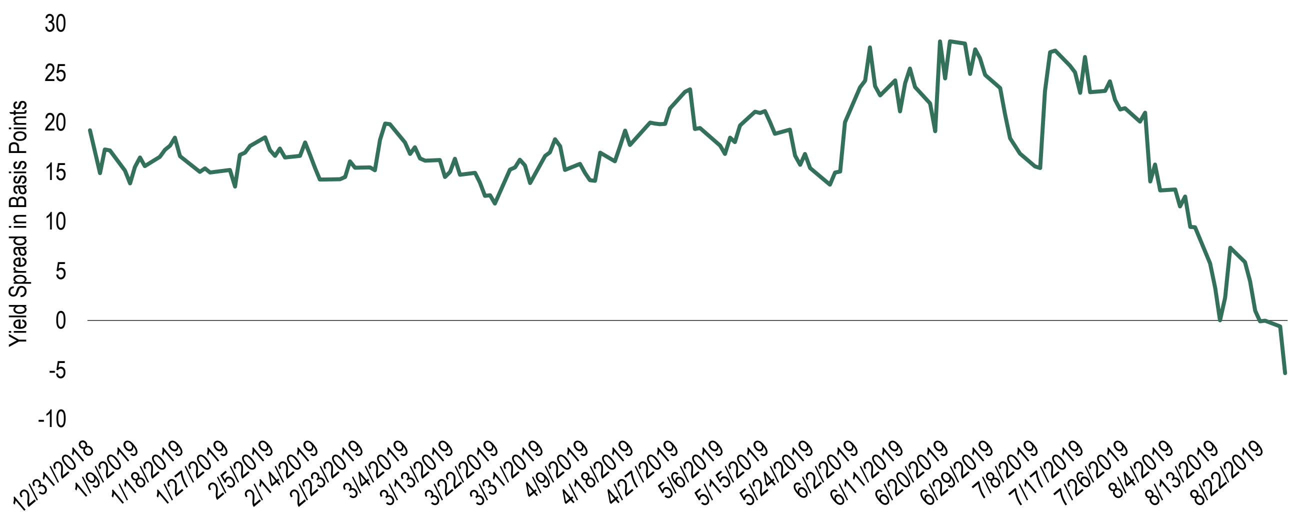
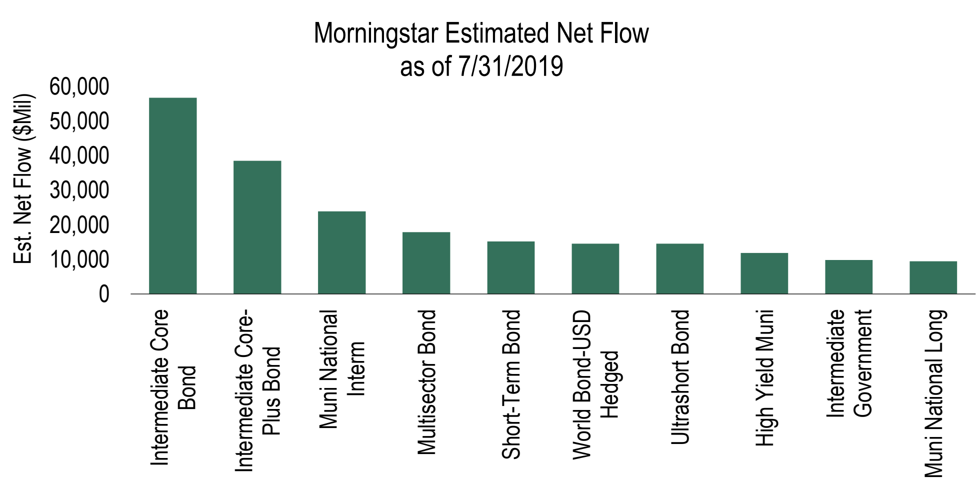
There has been a lot of digital and print ink devoted to the yield curve of late, particularly since August 14th when we got our first taste of yield curve inversion since 2007. Fears of recession have been stoked to varying degrees at a time when economic growth in the U.S. continues to plod along reasonably well, consumer sentiment is strong, unemployment is low, and inflation is basically trending around Federal Reserve's 2% target. While the brief inversion on the 14th was rather shallow it has now been followed up with an even steeper inversion – 5 basis points at the time of this writing.

Chart 1: Year-to-Date U.S. Government 2-Year/10-Year Spread



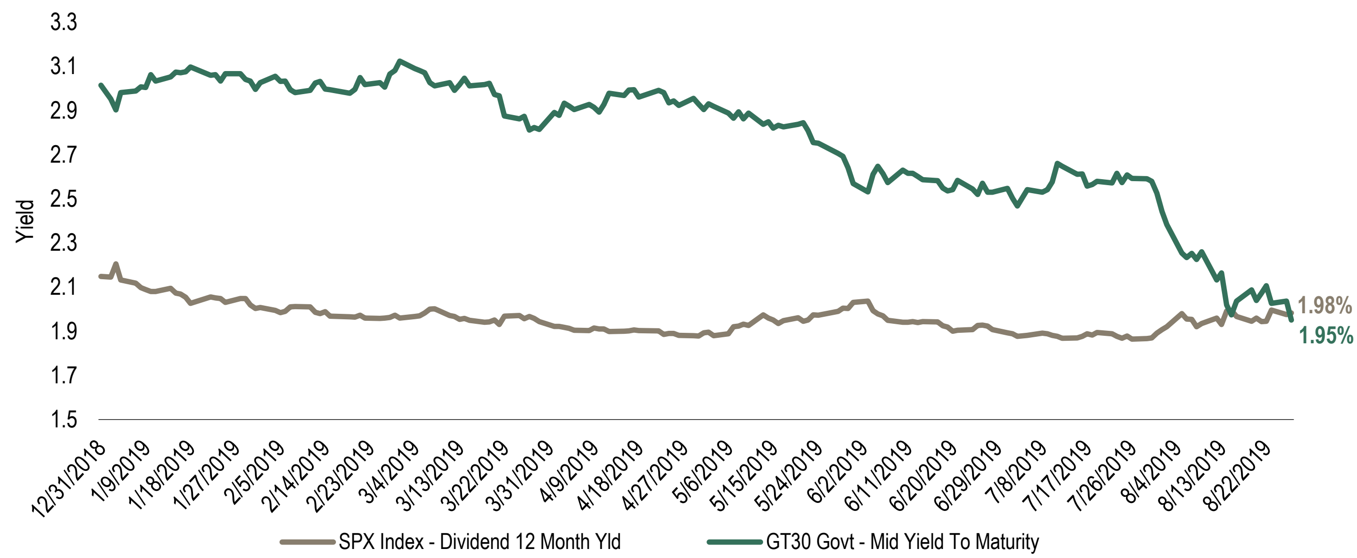
Of course all of the talk this year of impending recession have had investors on edge despite the 16% climb by the S&P 500 Index year-to-date. In fact, investors have been feasting on bonds in 2019 like they stepped into a Vegas buffet line after a three-day liquid diet. According to Morningstar, the top 10 flow gathering categories year-to-date belong to fixed income offerings, as shown in Chart 2.

Chart 2: Top 10 Morningstar Categories Ranked by Year-to-Date Estimated Net Flow



In a world where **95% of positive yielding investment grade corporate debt lies in the U.S.**[1], it shouldn't be surprising that capital flow continues to be strong in U.S.-domiciled debt. And for investors looking for yield the "Rubicon may have been crossed" on August 27th when the **30-year U.S. Treasury bond yielded 1.95% vs a 12-Month Dividend Yield of 1.98% for the S&P 500 Index** as shown in Chart 3. With the exception of a brief period during the extreme environment of the financial crisis, this is the first time since 1958 that the S&P 500's dividend yield exceeded the 30-year Treasury yield.

Chart 3: Year-to-Date U.S. Government 30-Year Yield vs S&P 500 12-Month Dividend Yield



What does this mean for investors looking to generate an attractive level of current income? This is the question that is likely to result in a few more sleepless nights for those tasked with making asset allocation decisions in the months and years ahead. Despite a remarkable 38-year bull run in bonds where yields are now well below their long-term average, the prevailing view by market pundits is central banks around the world are likely to continue pushing yields lower as global growth is showing some signs of slowing and inflation continues to be relatively muted.

Despite the recent yield curve inversion, history suggests that it could take 12 – 24 months for a recession to strike[2]. We aren't sure growth completely stalls to the point where we enter a recession but do believe a new paradigm may be forming where asset allocation programs designed to provide a high level of current income may be forced to include an additional dose of stocks with attractive dividend yields. Investors must tread carefully, however, as some of the higher yielding areas of the market have been bid up significantly in 2019 as investors have gravitated towards areas such as REITs and Utilities.

As long-term investors, we continually seek opportunities in good businesses where the market is significantly discounting the present value of future cash flows. One of the most attractive areas of the market to us is financials. Even with a more challenging operating environment due to interest rates plumbing new lows, fundamentals in the financials sector, and large banks in particular look very attractive, especially compared to areas of the market that have been bid up in recent years. Chart 4 shows an example of financials relative to Utilities which have seen significant multiple expansion of late.

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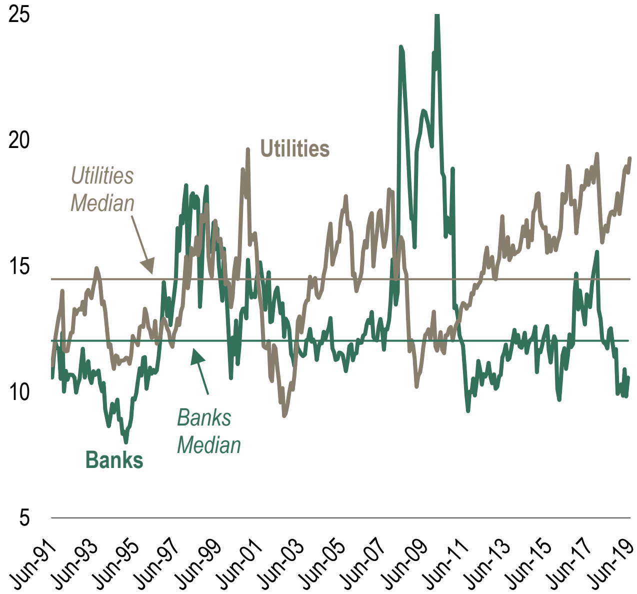
[1] https://www.bloomberg.com/opinion/articles/2019-08-20/all-signs-point-to-an-inflection-point-for-markets
[2] https://www.reuters.com/article/us-usa-economy-yieldcurve-explainer/explainer-what-is-an-inverted-yield-curve-idUSKCN1R32N0

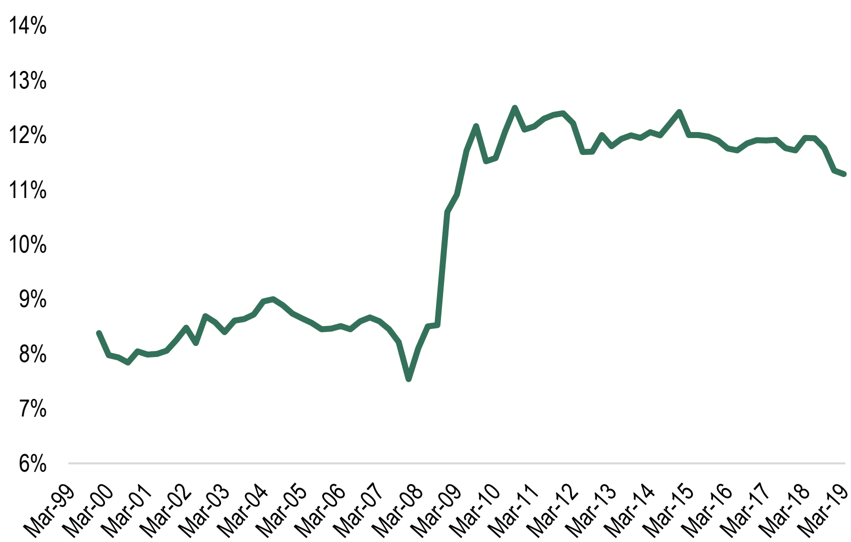
Chart 4: Forward P/E Ratio of Banks vs Utilities



	Banks	Utilities	*Notes*
PE	10.6x	19.3x	*FY1 estimates*
Earnings Yield	9.5%	5.2%	*1/PE*
Dividend Yield	3.0%	3.3%	*FY1 estimates*
Payout Ratio	31.9%	63.6%	*DY/EY*
Incremental ROE	11.7%	10.9%	*FY1 estimates*
Implied Earnings Growth	8.0%	4.0%	*(1-payout ratio) * ROE*
Implied Total Return	**11.0%**	**7.3%**	***DY + Earnings Growth***
Implied Total Return if P/Es revert to median (over 5 years)	**13.6%**	**1.7%**	

Even if rates don't rise, there are many bank stocks that offer attractive dividend yields, have strong brands and competitive positioning, attractive balance sheets, and in many cases trade at single-digit earnings multiples. In addition, capital ratios are stronger than they have been in many decades.

Chart 5: 20 Largest US Banks Tier 1 Capital Ratio



It is important to note valuation dispersions are not restricted to just financials, there are many pockets of opportunity within industrials, energy and technology. It is within these sectors that we are finding industry leaders offering attractive dividends and strong balance sheets, while trading at steep discounts relative to their historical long-term averages, growth counterparts, and the "low volatility" regime that has traded to new highs this year.

We are not market prognosticators, so we don't know if the recent yield inversion is a clear indication that a recession is around the corner. Economic cycles come and go with varying speeds. Market cycles are a bit more nuanced and somewhat less clear (e.g. cyclical bull vs secular bear). Regardless of where we are in a cycle, our combined experience and unwavering commitment to the principals of value investing at Hotchkis & Wiley informs our belief that increased market uncertainty and geopolitical turbulence often result in opportunities that are overlooked due to the market's infatuation with short-term sentiment. It is this same experience that also gives us confidence that these overlooked opportunities often result in portfolios that exhibit considerable upside potential relative to downside risk over the long-term.

All investments contain risk and may lose value. Equity securities may have greater risks and price volatility than U.S. Treasuries and bonds, where the price of these securities may decline due to various company, industry and market factors. Investing in value stocks presents the risk that value stocks may fall out of favor with investors and underperform growth stocks during given periods. Investing in smaller, medium-sized and/or newer companies involves greater risks not associated with investing in large company stocks, such as business risk, significant stock price fluctuations and illiquidity.

Data source: Charts 1,3 & 4: Bloomberg; Chart 2: Morningstar Direct; Chart 5: Bloomberg, H&W

Past performance is not a guarantee or a reliable indicator of future results.