Marble Harbor Investment Counsel, LLC
Excerpt from
Second Quarter, 2018 Letter

We are pleased to send an excerpt from our second quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

For the past decade or so, we've regularly attended an annual conference that focuses exclusively on Industrial companies. Over the course of several days, we immerse ourselves in the issues facing this sector and hear how the CEOs are thinking about current conditions and the year ahead. This year their near uniform refrain was, "I've been doing this for 20 years, and I've never seen every business and every region doing well at the same time." Indeed, we've never seen this group of companies as consistently optimistic. Their forecast horizon is limited to about 12 to 18 months, but for that period, they see nothing but smooth sailing. This buoyancy differs significantly from the mood we've encountered in previous years when somber discussions focused on a litany of woes where oil prices, the dollar, debt levels and inflation were either too high or too low. It appears that for the moment, these stars have finally aligned.

Corporate earnings are indeed encouraging. The profits for companies in the S&P 500 are expected to grow about 20% this year. This is the strongest earnings growth on record that wasn't preceded by a recession. It's a big increase, so let's dig into it a little more. The largest source of growth comes courtesy of the Tax Cuts and Jobs Act of 2017. With the stroke of a pen, on December 31, 2017, corporate tax rates dropped from 35% to 21%. This reduction will provide about half of earnings growth. That leaves about 10% growth in earnings that come from traditional business operations. The growth in Energy stocks alone accounts for about 3 to 4% of the remaining 10%, powered by resurgent oil prices. This leaves us with about 6 to 7% core earnings growth from the rest of the market. 7% is certainly a healthy clip, but it's not 20% percent, so don't get too excited about the headline number.

With a backdrop of robust profits and a rosy outlook from industrial CEOs, what could go wrong with the economy? We've seen a lot of articles in the financial press about the over-indebtedness of U.S. corporations. It's true that they have higher debt levels than in the past, and this is something we keep an eye on when evaluating our companies. Even at a global level, the majority of this debt is fixed at low rates and doesn't mature for many years. Most corporations are well-situated to pay interest on their debt even in a rising rate or recessionary environment. Your companies are especially so. While Emerging Market and private-equity-funded organizations could encounter more substantial problems with their debt loads, overall, we are not especially concerned about corporate debt levels today.

What about valuations? Aren't they stretched? Well, not really. Again, looking more closely at the numbers, we find that through solid earnings growth, valuations are reasonable at about 16 times this year's profits. This is neither cheap nor expensive. Strong growth and lower taxes have boosted the value of companies.

Financial pundits also voice the concern that margins have peaked and will revert to the long-term averages, taking profits and stock prices down. We've been hearing this chorus for the past 10 years, and as we have been arguing that entire time, the margin structure of U.S. corporations has changed substantially from 25 years ago. The topic warrants a more extensive discussion, but the basic issue is one of comparing Apples and Turkeys: The companies that comprise the S&P 500 today are significantly different than they were back then. To say that Apple's, Google's, Microsoft's or Facebooks's profit structure is going to bear any sort of resemblance to Union Carbide's, GM's or U.S. Steel's in the near future is simply poor analysis. Profit margins will of course rise and fall over the years, but we don't expect today's average profit margins to approach those of yesteryear any time soon.

What does give us pause is the possibility of tariffs on global trade. U.S. companies' margins and sales have benefited greatly from globalization, low-cost labor, open supply chains and low global tax rates. U.S. consumers have benefited from globalization's lower inflation, in the form of lower priced consumer goods. It would be a shame to no longer avail ourselves of these steady tail winds.

While it's pleasing to hear CEOs so uniformly sanguine, our contrarian streak gives us pause and has us vigilant to the external threats that could bring some storm clouds into the forecast. We are hopeful that the lessons of the past three decades of open markets and global growth will continue to fill the mainsail.

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