HALLMARK CAPITAL MANAGEMENT, INC.

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INVASION FROM BIZARRO WORLD?

Those of you who whiled away the idle hours of childhood by reading DC comics may be familiar with Bizarro World. This was a featured storyline in the *Superman* comics about a fictional, cube-shaped planet Htrae (Earth spelled backwards). On this planet, everything we know was reversed, e.g. identical twins looked nothing alike, bad things were considered good and vice versa. In the past six months, we have had a sneaking suspicion that stock traders from Bizarro World must have invaded the U.S. markets, since many long-established investment relationships have suddenly inverted.

For example, volatility has increased, but investors have been adding riskier stocks to their portfolios, not safer ones. Also, in this past earnings season, too many companies posting strong quarterly results saw their stock prices drop, while others showing poor results were rewarded with higher share prices. Just like Bizarro World, in those cases, good earnings were interpreted as bad and bad earnings as good. On down days, stocks in defensive sectors tended to drop more than the overall market, while aggressive growth companies outperformed … aggressive has been defensive. During the months when stock prices were generally higher, there was a net outflow of assets from equity mutual funds, so higher stock prices seem to have been interpreted as bearish. Many raw material prices are higher, along with interest rates, yet overall profit margins are near all-time highs. We are almost at the point of peering into the night sky to look for flying saucers.

Alien traders must have been altering some of the traditional relationships in other financial markets as well. Shorter-term bonds lost more in value than longer-term issues during a period of rising interest rates. When longer-term bonds fail to react to tighter Fed policies, it normally indicates that fixed income investors expect lower inflation; but prices in the U.S. inflation-adjusted TIPS markets show that investors were anticipating higher inflation rates, not a decline. Recently, despite rising rates, debt issuance from lower-quality companies has increased, not decreased. When was it more attractive to issue bonds when interest rates were up? Also, the unemployment rate is near generational lows, but somehow wage growth has barely budged.

EXPENSIVE HAS BEEN CHEAP

One of the most unusual "Bizarro World" influences on the stock market has been the outperformance of stocks with the highest Price/Earnings ratios. Historically, there has been a strong correlation between the valuation of a stock in relation to the underlying earnings, and the share's subsequent returns. Look at the total return of each of the stocks in the S&P 500 Index through June 30 grouped by their forward P/E ratios. The results are stunning:

Year-to-date Avg. Total Return	
Lowest P/E ratios:	*-0.6%*
Next Lowest P/E's:	*-0.4%*
Middle P/E's:	*-0.8%*
Second Highest P/E's:	*1.4%*
Highest P/E ratios:	*9.9%*

Investors found the "cheapest" group (with the lowest P/E ratios) to be too expensive, since those stocks were down an average 0.6% in the first five months. The "expensive" group (with the highest valuations by P/E) must have been bargains because they were up 9.9%. In fact, the two most expensive groups were the only quintiles that were up during the period. This has been challenging for investors like us, who care deeply about valuation. Assuming alien traders haven't actually landed, what is going on?

INVESTORS SEARCHING FOR SUSTAINABLE GROWTH

It is no secret that this recovery has been the slowest in the post-war era. Despite the sluggish economy, corporations have been able to increase their profits at favorable rates, by saving on wages, interest expenses and taxes. Ultimately, however, there is a limit to how long these factors can continue to enhance corporate profits. After all, these expenses can't go to zero. When these costs do stop declining, only those companies with the ability to truly increase revenues will be able to show meaningful profit growth. In this cycle, the most successful revenue growers have been firms using innovative technologies to disrupt the established order. Investors have increasingly come to believe that these firms will be able to flourish almost regardless of the underlying economic conditions. Unfortunately, many of these stock prices have reached nosebleed levels that impute very high future growth rates that will be awfully difficult to achieve.

Most investors understand that a company's stock price is driven more by its longer-term prospects than its current financial condition. Relatively unprofitable companies may be extremely valuable now, if they have outstanding opportunities to make money in the future. Other businesses may generate high returns today, but if the profits come from a depleting asset base, then the earnings will shrink in upcoming years. To account for such differences, each stock price carries within it an inherent rate of future earnings growth. If the collective forecast of a company's future rate of growth increases, the stock price tends to rise, even if current earnings are not expected to change very much. Conversely, the more investors bid up a stock price, the higher their implied estimate for future growth must be.

In the current market, the inferred growth rate of some of the favored high-tech stocks is astonishingly high. For example, some of the glamour growth-companies are selling at P/E ratios above 125, or an earnings yield of only 0.8%. This is at a time when many slower-growing companies have stocks selling at only 12.5 times earnings. In the first year, then, an owner of the high P/E stock would receive only a dime's worth of earnings for every dollar of profit produced by the low multiple stock. Given the head start of the low P/E company, over a ten-year period, how fast do the earnings from the high P/E stock need to grow to justify the lofty valuation? Investment analysts can answer this question mathematically through a Present Value calculation. In this case, the high P/E company needs to increase its profits for the next decade at an annual compound rate of over 40%. Not impossible, but clearly, this is a tall order for any business. The larger the company, the more challenging this type of compounding becomes. How difficult will growth be in the future? Will only a relative handful of companies realize all the economy's growth potential?

A NEW "NEW NORMAL"?

Much of the investment community has become convinced that the low rate of U.S. productivity has doomed us to a "New Normal" of subpar growth for years to come. While the stubbornly low rate of improvement in efficiency has been a concern, this may be a bit of the classic "chicken and the egg problem." Economists cannot state with certainty if better productivity is the cause of stronger economic growth or its result. Our sense is that the two share a symbiotic relationship and that each helps reinforce the other. Faster growth should lead to improved productivity which should then reinforce better economic growth. Perhaps we are too influenced by the economic environment of our youth, but if the U.S. can finally shake off the effects of the Financial Crisis, we believe there remain powerful forces within the economy waiting to be unleashed. The risks to this rosy outlook are if the Federal Reserve overtightens, or if a full-blown trade war breaks out.

WILL THE FED KILL THE BULL MARKET?

In the past nine years, investors have witnessed the second-longest post-war bull stock market. Given its longevity, many investors seem to believe this market advance must be in its late stages. Pessimists point to the lackluster economy, the increasing levels of public and private debt and the impact of tighter monetary policy as reasons why stock prices will not continue to climb.

The Federal Reserve is raising short-term interest rates, but we do not find monetary conditions to be especially tight. Inflation-adjusted interest rates remain near zero and global liquidity continues to expand. Neither the European Central Bank nor the Bank of Japan are expected to raise interest rates this year. Although the Fed Governors plan to raise short-term rates several more times, inflation remains very near the Fed's 2% target and wages gains have been moderate. We seem to be a long way from the infamous "wage-price spiral" that haunted Central Bankers in the inflationary '70s and '80s. If inflation stays reasonably well behaved, we see few reasons for the Fed to aggressively tighten. There could be many reasons for them to move slowly, however.

In years past, Federal Reserve members showed great self-assurance in their ability to steer the economy out of a tailspin. Recent events have demonstrated how difficult it is to reverse the momentum in an economy as large and diversified as ours. If a recession were to suddenly hit, the monetary and fiscal toolbox is running short. Yields are already so low, that the Fed has little room to reduce them without resorting to massive quantitative easing again. Amid the Financial Crisis, quantitative easing helped, but each subsequent round was marginally less effective. Fed officials may not have a high degree of confidence that quantitative easing would be able pull the U.S. out of a downturn. Theoretically, they could use negative interest rates, but the results of that strategy were poor when it was tried in Europe. There is also less room to move on fiscal policy, since running additional budget deficits may prove to be politically unpalatable. The annual U.S. budget deficit is already at least three-quarters of a trillion dollars and it would be expected to grow well beyond that in a recession. In such an environment, Congress might find it hard to pass additional spending bills or to cut taxes. Given the harrowing conditions of the last downturn, our sense is that policy makers will try to keep the expansion going for as long as humanly possible.

THE TARIFF ISSUE

The press has been filled with almost endless stories about the heated rhetoric and new tariffs affecting international trade. Given all the barrels of ink used on the topic, we doubt we could add much more to the discussion. As investors struggle with the risks of the President's negotiating strategy, there has been increasing skittishness in the markets. So far, there has been far more bark than bite, but there is a risk that the relative strength of the U.S. economy compared to most of our trading partners will lead the Administration to conclude their trade policies are working. The problem arises if they begin to believe that if a little is good, then a lot must be better. The result of an overall trade war would definitely not be good for the markets or the economy.

While there has been much handwringing over the risks of an escalating trade conflict, we've seen little written about what would happen if tensions eased. Only a few months ago, many of the TV pundits were terrified that the U.S. was on the brink of outright hostilities with North Korea. Somehow the two parties could eventually sit across the table, even though North Korea still retains its nuclear weapons. Ultimately, could a similar pattern repeat on trade? It is hard to know. We have often found that the stock market reacts most strongly to the events that were least expected.

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