Investment Outlook
Q1 2019

Mood Swings, Some Caution Flags, and Cleaning Up

What accounts for the mood swing of U.S. stock investors over the past six months? After the market declined 14% in the last quarter of 2018, it reversed course and gained 14% in the first quarter of this year. What's going on? The most plausible explanation goes along the following lines:

- In the fourth quarter, investors were spooked by mounting evidence of a global economic slowdown. Investors were anxious about the outlook for 2019.
- In the first quarter, the U.S. Federal Reserve acknowledged the slowdown and said they would stop raising interest rates. Investors breathed a sigh of relief and bought stocks.

	CLOSE 3/29/19	TOTAL RETURN First Quarter 2019
Standard & Poor's 500 Index	2,834	+13.65%
Dow Jones Industrial Average	25,929	+11.81%
NASDAQ Composite Index	7,729	+16.81%
Dow Jones Global (ex U.S.)	244	+9.56%
Barclays Aggregate Bond Index	2,107	+2.94%

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Some market participants see a flaw in the optimistic view that low interest rates offset the risks of slowing growth. According to the more skeptical view, corporate earnings are going to be under pressure if the global economy is slowing and those earnings disappointments will prove to be negative for stock prices.

The skeptics point to a developing "situation" in the bond market that historically has been an indicator of upcoming troubles for economic growth and the stock market. This "situation," which sounds like a yoga position, is called an inverted yield curve and it occurs when short term interest rates are higher than longer rates. (Readers: We have included a more complete explanation of the inverted yield curve—one of the more arcane financial situations at the end of this *Outlook*). An inverted yield curve does not happen very often, but it is taken seriously by investors as one of the best indicators of a looming economic recession and a bear stock market. In other words, it is a reliable caution flag that is not to be ignored.

If the yield curve is such a reliable predictor of upcoming weakness, why has the stock market boomed with its arrival?

Are these skeptics simply worrywarts—"permabears" in the vernacular of Wall Street? Investors are not putting much weight on this indicator; probably for the following reasons:

- The Federal Reserve raised short term rates from zero to over 2% to return from abnormally low levels to more normal levels. They did not raise rates to induce an economic slowdown.
- Longer term yields are incredibly low worldwide reflecting that weak economic growth will prevail going forward but not a recession.

Investors, to be sure, will remain very focused on upcoming economic data to divine whether the probability of a greater economic slowdown is on tap for the foreseeable future. We are on board with the slowdown scenario, but not the case for an imminent recession and accompanying bear market. With interest rates at current levels and apparently not going higher anytime soon, the attractiveness of stock dividends increases. In fact, an inverted yield curve suggests that the Federal Reserve is likely to cut short term rates, which is normally good for stock prices.

Another "situation," or caution flag, is occurring in the stock market that can be a sign of a market top or something worse like a significant downturn. This stock market "situation" is the flood of unprofitable technology companies going public. The upcoming barrage of new offerings brings back bad memories of the late 1999-2001 period, when one third of the new publicly traded companies—many unprofitable technology companies—lost over 90% of their market value over five years.

The first of these high growth technology/consumer companies, a ride hailing company called Lyft Inc., went public on the last day of the March quarter. Supposedly, the offering had huge demand as many public investors, particularly Lyft users, love the service. It is now trading below the price that it was initially offered at. Its larger competitor, Uber Technologies, will go public this spring, and it is sure to attract more investors. The two ride hailing companies lost over $4 billion last year on revenues in excess of $13 billion. More companies will follow assuming the appetite for emerging growth companies remains healthy. The upcoming list is likely to include Slack Technologies, Palantir Technologies, Peloton, and Pinterest Inc. We agree that a full slate of new, public offerings, particularly of unprofitable companies, is an important caution flag to pay attention to. We think it is important, however, to evaluate these fast growing companies. We might find another Facebook, Google or Amazon in the haystack.

Beyond Yield Curves and New Issues

In the last quarterly Outlook, we decided that we would occasionally include a write-up of one of our portfolio holdings—especially of a less well-known company—as a balance to the normal, hard-to-avoid stuff of interest rates, earnings, and valuations. Once again, these write-ups do not include our financial analysis, but are intended to show how companies navigate through recessions, industry headwinds, and strategic mistakes only to emerge more profitable. One commonality we see when we do our research is that so many companies go through periods of acquiring smaller companies, shedding businesses, and continually refocusing their strategy and plans. At the current time, some of the more obvious large companies going through transformations would be General Electric, Apple, Amazon, Disney, and Bristol-Myers. After reviewing Tetra Tech in the last quarter, we picked another—Ecolab, Inc.—to review in this *Outlook*.

Company Highlight: Ecolab

Merritt J. Osborn, a high school dropout, founded the company in 1923 in St. Paul, Minnesota when he developed a product that instantly cleaned carpets. This reduced the need for hotels to shut down rooms, hallways, and lobbies to clean. The company name comes from the idea of developing "economic" solutions through "laboratory" research. In 1924, Osborn acquired a better cleansing compound for mechanical dishwashers from a University of Minnesota graduate chemistry student named Leonard Englund. Ten years later, still in the Depression era, the company's sales people started working as consultants to repair and service industrial dishwashers. By the late 1950's the company's revenues were about $30 million with operations in Canada, Europe, and Mexico. They decided to go public in 1957 (funny how companies pick a good time to go public—the best three consecutive years of market returns were 1954, 1955, and 1956). The Osborn family went on to manage the company for some 60 years.

Ecolab is a story of a company that grew through acquisitions and internal product development. Through an acquisition in the dairy industry, Ecolab developed a cleaning solution that allows dairy plant operators to clean pipes with the push of a button instead of breaking down and hand washing pipes and valves. New products and technologies continued to be introduced in the institutional dishwashing area. In 1984, the company entered the pest control business through a series of acquisitions. By the end of 1986, the company had shortened its name from Economics Laboratory to Ecolab and listed its stock on the New York Stock Exchange.

In 1987 the company went through one of its first major restructurings. It sold its consumer dishwashing products (Electrosol and Finish), and more importantly, subsequently acquired a lawn care company. By 1992, they admitted the acquisition was a mistake and the company folded the lawn business and wrote off $260 million. The next strategic decision was better when it formed an alliance with Henkel KGaA, a German-based chemical company, in order to market more effectively in a united European market. Several years later Ecolab purchased the full ownership of Henkel-Ecolab. As further proof of the company's strategy to enter new businesses through acquisitions, Ecolab acquired Kay Chemical Company, which focused on the cleaning and sanitizing of kitchens and bathrooms in quick service restaurants.

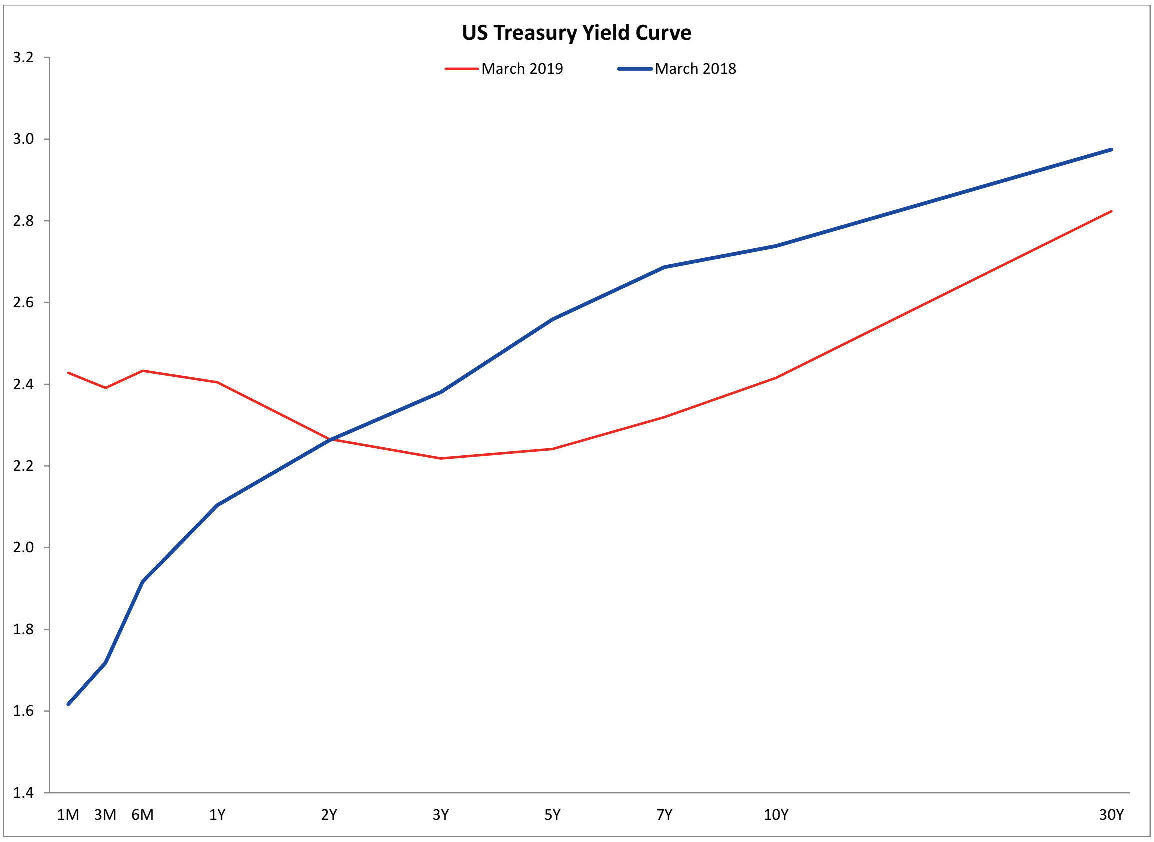
Acquisitions continued into the early 2000s with Microtek Medical Holdings, a manufacturer of infection prevention products for acute care facilities. These products included fluid control products and operating room cleanup systems. Finally, the company went big on the acquisition hunt by merging with Nalco in 2011 to make Ecolab the global leader in water, hygiene, and energy technologies and services. And, in 2013 it acquired Champion Technologies which focuses on the energy services market. The company's revenues topped $10 billion at this time.

Once again Ecolab is reshuffling its businesses lines by deciding to spin off a segment of Nalco and all of Champion. As investors, these strategic reversals can be viewed two ways: one, why did they acquire the business in the first place, or two, more positively, at least they are proactive to change course. Changes in the executive suite are occurring simultaneously. Shareholders will receive the spin off by the summer of 2020.

One final note on Ecolab. Although we promised not to refer to financial metrics, some of our clients so liked the write up on Tetra Tech that they wanted us to buy more. We did because we thought the stock was still reasonably valued. That is not the case with Ecolab, which has been a hugely profitable investment for clients, but not an attractive investment at this valuation. Ecolab now sells for 27 times next year's earnings.

More on Inverted Yield Curves

As we mentioned above, inverted yield curves reflect the bond market's consensus outlook that economic growth is going to slow significantly causing the Federal Reserve to cut short term rates to cushion the slowdown. Yield curves are the shape of yields from short term maturities (e.g. 30 day maturities) to the longer maturities (e.g. 10 year maturities or longer) normally looking like an upwardly sloping curve (see the graph below). The dark blue line is a normal yield curve.



Source: FactSet. Data as of 3/29/2019.

An inverted yield curve is one when short term rates are actually higher than yields on longer maturity bonds (the red line on the graph). Normally, if you were to lend money (e.g. buy a bond) you would expect a higher interest rate the longer you loan the money to reflect the uncertainty of the borrower and the risk of inflation (normal yield curve).

Some economists do not believe that inverted yield curves predict a recession but are the cause of a recession. We think this view makes some sense. When the Federal Reserve raises short term rates and bond investors force down intermediate rates below short term rates, bank lending tends to shrink since banks are forced to borrow at higher short term rates and lend at lower longer term rates.

According to this logic, as bank lending becomes tighter it reduces economic growth as well. At current interest rates in the 2 percent range as opposed to many prior periods of an inverted yield curve when rates were in excess of 5 percent, we do not think banks will become significantly tighter with their lending, but it is not a welcome development for banks. May the subject of inverted yield curves rest in peace in future *Outlooks*.

Bob Milnamow
President and Chief Investment Officer
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The Standard & Poor's 500 Index is an unmanaged broad-based index that is market weighted and used to represent the U.S. stock market. It includes 500 widely held stocks. Total return figures include the reinvestment of dividends. "S&P 500" is a trademark of Standard and Poor's Corporation.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Nasdaq Composite Index is the market capitalization-weighted index of approximately 4,000 common equities listed on the NASDAQ stock exchange. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.

The Dow Jones Global (ex U.S.) BMI (Broad Market Index) comprises the S&P Developed BMI and S&P Emerging BMI, and is a comprehensive, rules-based index measuring stock market performance globally, excluding the U.S.

The Barclays Aggregate Bond Index is a market capitalization-weighted index. Most U.S. traded investment grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.

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