KLCM Advisors, Inc.

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Return to Normal with a Twist

From the most recent bottom in February 2016 until this past February, the equity market rallied nearly 50% without a single meaningful pullback. This was accomplished despite having to deal with Brexit, a contentious US presidential election, geopolitical instability with North Korea, and at times uncertainty over interest rates, inflation, and global growth prospects. While enjoyable, the move felt unnatural as the market drifted higher as volatility ground lower. Throughout this move, we continued to upgrade our portfolios, buying stocks of large high quality businesses that had been abandoned by the market in favor of large growth companies. It was apparent that volatility was too low and a return to normal was in order. Like many others, we were unable to identify what the catalyst to bring volatility back into the markets would be.

The catalyst turned out to be the twist. While markets historically would cheer on strong employment numbers late in an economic cycle, January's numbers, released February 2nd became the catalyst for volatility's return. The twist in this cycle is the necessary unwinding of the extraordinary measures that the Fed has taken since 2008 to first stem the financial crisis and subsequently to continue supporting the tepid economic recovery. To many market participants, this employment report signaled that the mission had finally been accomplished and the unwind could begin. As a result, bond markets moved lower (pushing rates higher) causing volatility to increase sharply which resulted in a rapid repricing of equities as stocks fell nearly 10% over the course of several days.

While this move was painful for investors allocated to equities, this was a historically normal correction within a bull market. Traditionally, at this point in the economic cycle, corrections would be driven by questions around the sustainability of economic growth, geopolitical concerns, or simply overbought markets selling off. The twist is that this time good economic data is injecting volatility into the markets as monetary policy is being pulled back. As the Fed continues to normalize both interest rates and their balance sheet, we would expect volatility to continue. Unlike 2007, when major storm clouds were forming, **we do not see systemic issues in the financial system**. However, this bull market is aging, and while the economy appears to have positive momentum, the gains in the broader markets are likely to be muted relative to the past couple of years.

Returning to a normal late cycle environment, **asset allocation**, **security selection**, and **downside protection** will continue to become more important as we navigate the remainder of this economic and market cycle and prepare for the next cycle. In our view, IBM and PFE are examples of two large, quality companies with limited downside **and** the opportunity to still earn an attractive return from current levels.

IBM

IBM has spent the last seven years repositioning itself from a hardware centric company to a company whose growth will be driven by sales of software and services. To accelerate this transformation, the company has divested legacy businesses and spent more than $8 billion acquiring new, higher growth data and software companies. The company has also been taking advantage of its prodigious free cash flow to continuously invest in R&D, spending more than $1 billion annually for the past decade, to develop products such as Watson. This investment is beginning to pay off as the data and analytics business units of the company are growing quickly and currently make up more than 40% of revenue. In addition, the company is just beginning to benefit from a new mainframe ordering cycle. We believe the faster growing analytics businesses, combined with an uptick in mainframe sales, will result in companywide revenue growth for the first time in many years.

Our view is that as the market begins to see revenue growth return to IBM, investors will begin to recognize the transformation that has taken place. This recognition will result in earnings estimates that begin to move higher along with an increasing valuation the market is willing to pay for those earnings. Trading at 11 times earnings with a 4% and growing dividend yield, we believe the stock has minimal downside. Therefore, we believe we have identified a situation where the risk/reward is tilted heavily in our favor.

PFE

When we first purchased Pfizer we believed the company was well-positioned to handle the uncertainty of a rapidly changing drug landscape. The growth from the Innovative Products business would be complementary to the high cash flow, low revenue growth of the Established Products business. This thesis has come to fruition. Over the course of the past 18 months Pfizer has continued to work its way through negative political rhetoric and revenue headwinds resulting from branded to generic conversions. Despite the negative sentiment, the stock has slowly appreciated.

Currently, this globally diversified pharmaceutical company trades at only 12 times current earnings and pays a generous 3.8% and growing dividend. Relative to the market, we feel the valuation risk in Pfizer is minimal. However, Pfizer is more than a slow growth, high dividend paying drug company. Pfizer has one of the leading biosimilar pipelines in the industry. Biosimilars are generic versions of high cost biologic drugs and are a way to significantly lower drug costs over time. Additionally, Pfizer is looking to continue monetizing its non-drug portfolio via asset sales. Proceeds from these sales will likely be redeployed into accretive acquisitions that will contribute to company growth. While we wait for these revenue generating changes to take shape, we feel comfortable holding this stock given its low valuation and substantial dividend yield.

Volatility has returned to the market. We are prepared to act, trimming positions and selling stocks as they near our objectives as well as adding to stocks when opportunities present themselves. The continued evolution of both our equity and fixed portfolios towards lower risk positions is our primary objective late in this market and economic cycle. We expect this viewpoint will continue to shape our investment actions until a major correction or recession takes place.