Equity Market Update: 11/15/2018

- **SP500 in correction phase, trying to bottom**
- **Culprits for decline in stocks include Apple, tariffs, China trade, and strong US Dollar**
- **Put/Call ratio suggests a sell off in stocks may be near**
- **Reminder, stocks are for the long term, often defined as five years or longer**

November 15, 2018

What's happened….
Stocks have continued to have a rough 4th quarter with the SP500 down about 8% from its recent highs in early October, although up about 3% from the recent lows. At present, stocks are attempting to stabilize. The overall economic and corporate earnings remain positive, but there are emerging cracks in the financial market outlook. The sell-off in stocks began with rising interest rates associated with a Treasury bond auction. Due to the growing Federal Deficit, the supply of bonds issued is growing rapidly, thus pushing up interest rates to entice investors to buy. Corporate earnings for the third quarter were generally good with the average SP500 company growing sales by 8% and profits by 27%. But comments about the future is a source of problems. To illustrate, the impact of tariffs is beginning to impact the outlook for 2019. Caterpillar reported potential tariff costs of $200 million and, as a result, its stock has lost 28% in the past month. Within core holdings, SolarEdge, Deere, and Hexcel have the most exposure to tariff-related expenses.

Bearish factors…
White House trade policy continues to follow a protectionist trend employing tariffs as the tool. Trade with remains the primary concern with the potential for a January 1st jump from 10% to 25% tariff on an expanding list of Chinese products. Rumors of discussions with China is a positive and trade deal with China could be a catalyst for stock market rally. If China was not enough, the Trump

Administration recently decided not to proceed with 25% tariffs on all imported autos but has indicated that they may be next on the list. In summary, political concerns are growing and pose growing risks to the economy and the stock market. If the trade policies continue, it could lead the SP500 to fall to 2400, our bearish case.

Interest rates and Federal Reserve policy have been a contributing factor to the decline. Theoretically, as interest rates rise, the value of financial assets declines. Inflation, rising deficit, and economic growth have been pushing long-term rates higher. In addition, the Federal Reserve has been raising short-term interest rates as their process to "normalize" monetary policy. In a recent presentation, Fed Chair Jerome Powell acknowledged that the global economy was slowing. Domestically, the real estate sector is feeling the pressure of higher mortgage rates and expenses (not a surprise, given a 45% decline in Lennar's stock (Lennar is a leader in residential construction). Hopefully, the Federal Reserve will consider asset prices in addition to traditional economic indicators.

To round out the current stock market concerns, Apple is at the center of investor nerves. During Apple's September earnings conference call, guidance for the December quarter was light due to slowing sales in emerging markets. Collaborating Apple's comments, several Apple suppliers have announced declining orders speculated related to Apple causing many semiconductor companies to trade lower. Skyworks Solutions was one of the semiconductor companies that fell in this category, although its soft 1st quarter was relatively minor. Apple products continue to drive massive spending in the technology sector, so if there is a slowdown in iPhone sales, the impact will be bad for many supporting companies.

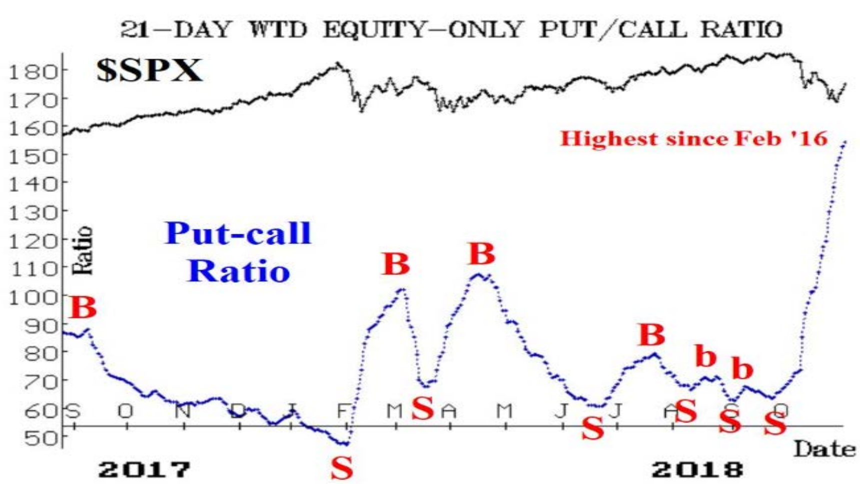
Bullish factors…

With investors focusing on any possible negative issue, and immensely punishing stocks for the slightest misstep, there is a strong case that the correction is close to having run its course. First, the data on mutual fund and ETF sales suggest that massive selling has already take place. Emotional or momentum-motivated selling is largely indiscriminate. Second, the economy is still growing with earnings of the SP500 expected still growing 11% next year and selling at less at reasonable price to earnings ratio of less than 15. In other words, stocks are now cheap.

Next, the charts are looking like a bottom is possible, but not guaranteed. As the chart below shows, stocks have had several sharp sell-offs recently but have recently held the lows of about 2600. The bearish case could bring the SP500 down to about 2400, while the bullish case could bring the SP500 up to 3200. Keep in mind, we are in a seasonally strong period.

Possible bottom in the SP500? For technical analysts,
an inverted "Head & Shoulder" pattern is emerging, (and no, we aren't talking about dandruff).

Is a bottom in the works? To gain a better insight with this question, the Put/Call ratio often provides a clue. This indicator measures the number of put option buys (betting on a stock decline) compared to call option buyers (betting on a stock appreciation).   Recently, the Put/Call ratio has risen to extremely high levels not seen in years suggesting fear is high.



Source: OPTION STRATEGIST McMillan Analysis Corp

On a fundamental basis, stocks should continue to benefit from the economy, which is still growing and creating higher corporate earnings. Using recent analysis from Bloomberg Intelligence, the new "fair value" for the SP500 is 2975, down about 4% from the prior calculation based on a lower price to earnings ratio but suggesting 10% appreciation and with a 2% dividend yield, a 12% total return which appears reasonable. See the table below for the numbers.

Macro Model for S&P 500 P/E, EPS

Macro Model	PE	EPS	
2Y Yield	3.26	155.44	LTM EPS
2s10s	0.15	3.00	New Orders % Chg
BAA Spread	2.25	0.35	Bps Chg in 2Y
NTM EPS Growth*	7.0	0.00	Bps Chg in UR
		3.00	CRB Commodity % Chg
Estimated EP	2.470	9.76	NTM % Growth
Estimated PE	17.5x	$170.61	NTM EPS
Fair Value Estimate	2,977.27		

* Estimated 12M growth 12M forward.

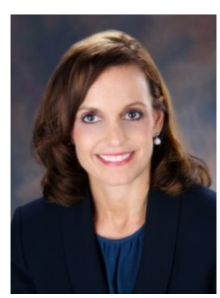
Source: Gina Martin Adams, Bloomberg Intelligence 11/8/2018

Our equity strategy remains focused on selecting companies with growth in their sales and earnings, low debt, sustainable competitive advantages and numerous other factors. In a recent analysis of our top 10 holdings, the level of debt as a percentage of total capital structure was very low, at 13.8%. Further, several companies have no debt, including Garmin and Intuitive Surgical.

With cash levels higher than normal, we can add to equities or fixed income once we get a better feel for the trends in the financial markets.

Our next update will focus on the fixed income markets and some of the opportunities we see.

Andrew D.W. Hill, CFA
President and Co-Founder



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