QUO VADIS
CAPITAL
Private Wealth Management

Market Newsletter & Opinion 10/12/2018

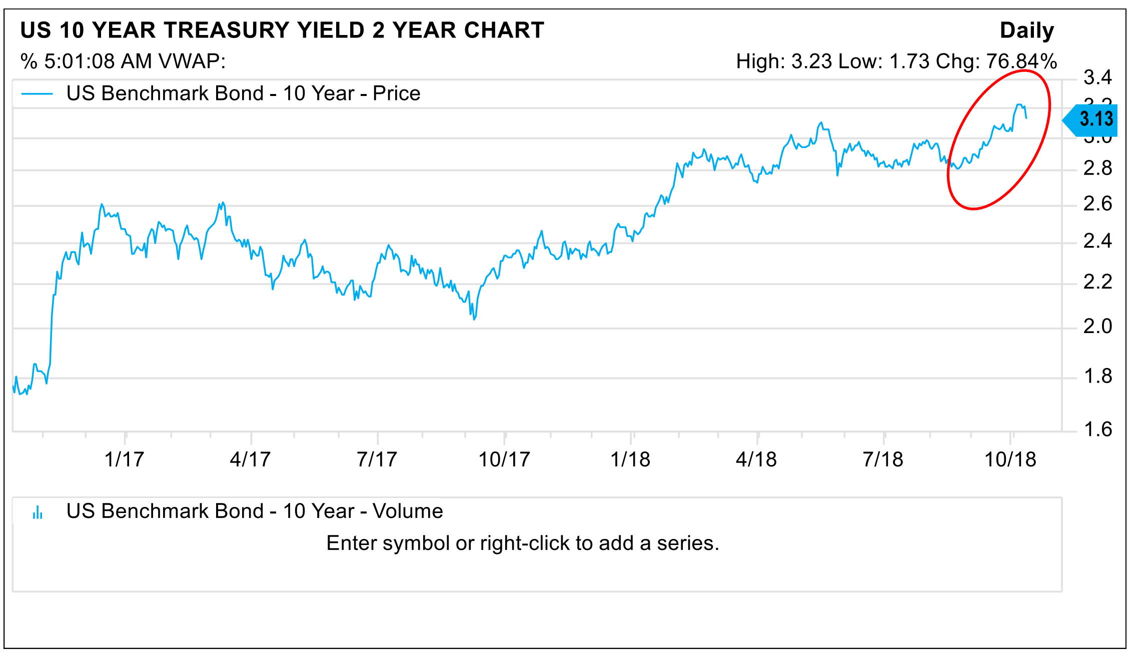
October 2018 Market Outlook & Opinion

Valuation Contraction Starting

Summary: The market's recent action represents the tension between very strong economic and corporate earnings growth & positive price momentum with reasons to expect slower growth next year including (most significantly, in our opinion) lapping tax reform, rising interest rates, and (modest) inflation in labor rates. We see tariffs and political acrimony more as a distraction than a giant concern. Longer-term deficit spending is a worry. Our advice: lower your expectations for near-term market returns but stay involved.

Want to See Something Really Frightening?*

Interest rates went up! The sell-off in the market MTD has mostly been attributed to a spike in interest rates. I've included a chart of the 10-year treasury yield below which represents this move. Why does this matter? When interest rates rise, it costs more for companies to borrow (which reduces their profits) and it costs more for consumers to borrow on credit cards or from the bank for mortgages, for example (which reduces consumer spending and depresses demand for housing). By itself, the change in interest rates is not that meaningful, in my opinion. Rather, I believe this week's sell-off reflects investors starting to face reality *that next year's corporate earnings growth cannot be anywhere as good as 2018*. The rise in interest rates was simply the news item that made investors start paying attention.



Highly unlikely that 2019 will be better than 2018. If we look back a year ago to October 2017, tax reform was just about to be passed. Simplistically, this legislation boosted corporate profits and lowered personal tax rates. However, from a market perspective, it created a significant *upward revision to expectations* for both absolute earnings and earnings *growth*. This was incredibly bullish for equity prices as stock values typically are pegged to near-term earnings expectations and investors tend to pay higher multiples (the ratio of

*Irony intended

SEE DISCLOSURES ON PAGE 4

price to earnings or cash flow) for faster growth. In fact, 2018 earnings growth has been very strong, partially due to economic momentum heading into this year but also surely due to the benefits from tax reform.

Lower corporate taxes will continue to lead to stronger economic growth going forward. However, as it is lapped, earnings *growth rates* will slow. Further, 2019 is likely to experience other negative offsets including rising labor rates which are a function of the late stage in the economic cycle. Add in slightly higher borrowing costs (from this week's increase in interest rates) and now investors may be *lowering forecasts* for next year. This is exactly the opposite of the situation a year ago with accelerating growth and rising earnings expectations and it justifies lower valuation multiples. This is what the sell-off is about, in my opinion.

Not a reason to abandon stocks: Things can always change, which is the main reason few people (if anyone) can call the market. I don't pretend to have this ability. What does make sense, in my opinion, is to invest in great companies that are innovative, are taking market share, can grow, and (if possible) are attractively valued. Also interesting are high-quality companies with strong brands that have some temporary problem, leading the share prices to be depressed, and a path to fix the problem. It is possible, potentially, to identify these companies, understand the investment case, and have conviction to own them long-term without massive anxiety about short-term market volatility or valuations.

We've launched our model portfolio. Consistent with the above, the portfolio is a (mostly) equal weighted selection of high quality, growing consumer and technology names. Our objective is to buy companies we believe in for the long-term (five+ years) and, when possible, to buy them at a temporary discount. It is intended to be run for tax efficiency and is not a trading book. Below I will discuss an investment in the portfolio. If you'd like to discuss the full group of stocks or invest with us, please get in touch. I am investing my own money in the strategy.

Limited Brands (LB): LB is the owner of Bath & Body Works and Victoria's Secret and a few other smaller brands. Victoria's Secret is the largest piece. VS has been suffering for some time as girls and women have shifted their lingerie purchasing to unconstructed and comfortable looks and away from the aspirational, highly constructed undergarments (one could say male-oriented) for which VS is known. Recent product has moved in the right direction, in my opinion, but there is still a lot of work to be done on updating the marketing, in-store merchandising and branding. My optimism increased recently that things can improve after learning that the company promoted Amy Hauk to CEO of Pink, which is a sub-brand. I worked with Amy in the past and believe she's a fantastic merchant and leader. I know she "gets it" and feel that this is a reason to believe VS can accelerate a change away from the supermodels-with-wings-on-catwalks-amid-fireworks-and-glitter to an image that is more accessible and inclusive. Ultimately, my hypothesis is that this will help turn around sales and margins at Victoria's Secret. In the meantime, Bath & Body Works is doing great and LB recently announced the shut down or intended divestiture of two smaller properties that were losing money, Henry Bendel and La Senza. Finally, from a stock perspective, LB has fallen to $30 from as high as $100 (in 2015) and currently sports an 8% dividend yield and sub-10 P/E. The 8% yield reflects Wall Street's view that he dividend is unsustainable, which may be accurate. Nevertheless, the company remains very profitable and while cutting the dividend will be a negative, LB remains very profitable and generates strong free cash flows, providing downside production while we wait for signs of improvement. See chart below.

Next week I am traveling to Arkansas to attend Wal-Mart's (WMT) analyst day meetings. Wal-Mart remains the largest retailer in the world (1/2 trillion in annual sales) and is a leader in investing in technology to merge its terrestrial store assets with e-commerce, in my view. I expect to learn a lot about the future of retail and also to hear about expectations for Holiday 2018 as well as much conversation about the potential impact of tariffs.

If you or someone you know is looking for help investing in the markets, please get in touch to discuss whether our equity portfolio is appropriate.

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