Market Newsletter & Opinion **1/12/2019**

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Fed Takes Boot Off the Throat to Start 2019

Summary: The market continues to oscillate between concern of slowing global growth and optimism that U.S. economic expansion can be maintained. The two largest worries are the Fed's monetary policy, that is, concern that it would hike interest rates too much or too quickly, and that ongoing trade disputes could disrupt growth by creating uncertainty and incremental costs. Looking back, the disastrous December 19 2018 Fed meeting and mishandled messaging convinced investors that the Fed had failed to see the risks and was turning a blind eye to market worries. This in turn led equities to sell off and talk of recession to increase. Subsequent to that meeting, the Fed appears to have woken up. It is now going out of its way to repeatedly indicate a more accommodative and market-friendly stance which has been met with a rally in the markets to start 2019. For our part, we lean bullish as we believe the consumer remains strong, as discussed below, and our best guess is that the Federal Reserve will not tighten too quickly. We also think trade disputes, while unhelpful, will not derail the U.S. economy.

We Expect a Strong Start to Consumer Spending in 2019, Driven by Record Tax Refund Payments

Consumer spending is 2/3 of U.S. economic activity. Employment growth remains very strong. Wages are rising. It's probably never been easier to find a job or change jobs in the U.S. We believe that employment and wages are the number one determining factor for consumer confidence and spending. The story here continues to be good. That said, the consumer can be derailed and we have seen the consumer impacted in the past by factors such as political uncertainty around elections, changes in commodity prices (a spike in gasoline, for example), international events (such as military conflicts) or extreme volatility in financial markets. We also believe the current government shutdown and furlough could have an impact and we have discussed this with companies that service consumers who work for the government. (Retailers can see in their data that stores with a customer base composed of government employees perform differently than the balance of their chains.) However, taking all this into account, we believe the consumer remains in a good place and is likely to keep spending, providing support for the biggest element of U.S. economic growth.

MOST of last year's tax reform benefit for individuals is still in front of us. We're not sure how widespread this is known, but according to research done by a large retail company we trust, less than half of the benefit of individual tax reform for 2018 has been realized. The reason is that few companies and employees adjusted their withholding rates to reflect new credits etc. This same company estimates that 57% of the benefit of last year's tax reform will be reflected in 2018 tax refunds (paid out in the next few months). In other words, this will be the largest tax refund season in history. This will be positive surprise for most unless you're a high income $500k+ family living in a high state tax state like CA or NY, in which case you will probably owe more. Sorry. Don't shoot the messenger.

Tax refunds typically get spent, which will have the effect of boosting economic growth in 1H19. Our experience working with consumer companies over the past 20 years has shown us that tax refund season can have a material impact on the timing of consumer spending and the performance of specific product categories. For example, among the product categories that see a direct, measurable impact from tax refunds are consumer electronics (TVs), mattresses, and high-end athletic sneakers (Jordans). Yes, especially Jordans. Home improvement products are also often funded by tax returns, which brings us to our investment discussion below. Wrapping up, the consumer is already in a good place due to strong employment and wage growth. Tax reform has boosted spending in 2018. These factors will persist for at least the foreseeable future, in our opinion, which suggests to us that the economy will be fine for at least the near term.

An Investment Idea from the Consumer Electronics Show (CES)

Product upgrade cycles often form the basis of successful investment theses: We just returned from the CES show in Las Vegas and it was our first year attending the event. If you don't know about CES, it is an industry convention where major electronics and technology companies showcase existing and new product to the trade and to other techies. It's probably the largest conference in the world and is attended by over 180,000 people. Our purpose in attending the show, besides having an excuse to go to Vegas, was just to learn as much as possible and make sure we understand the potential for new products and technologies to change both consumer spending patterns but also how companies operate.

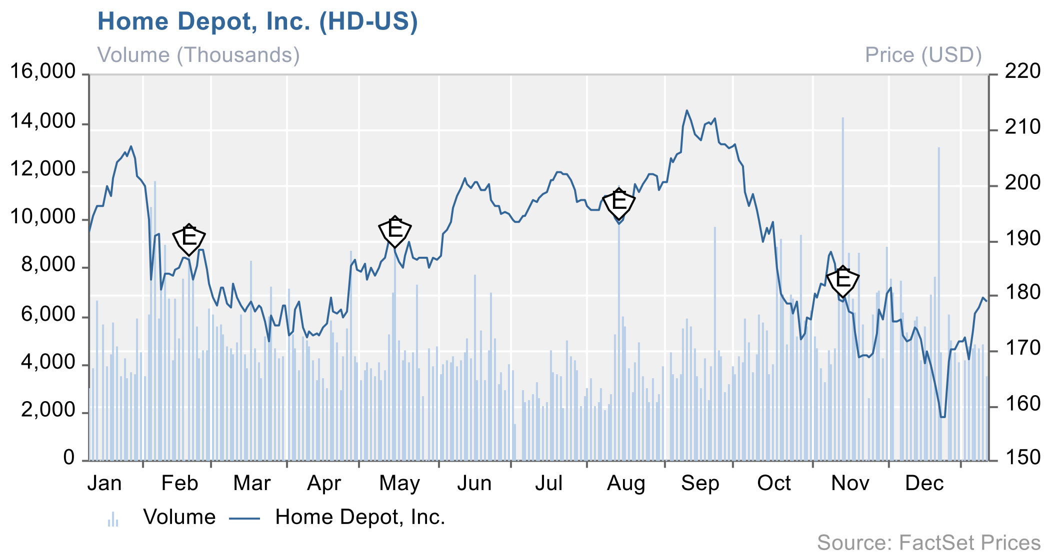
Connected home and smart home is one of the themes we explored: CES can be overwhelming and we saw plenty of cool gadgets, drones, toys, tech-enabled games (including virtual-reality and augmented reality) as well as updates on TVs, phones, and audio devices. Of particular interest to us were updates to traditional devices in the home which are enabling appliances (fridges, ovens, toasters, blenders) as well as utilities (hot water heaters, furnaces) and less-obvious places (doorbells, closets, toilettes) as well traditional electronics (TVs, speakers, and security cameras) to talk to each other and deliver control and analytics to home owners via applications. In turn, there is a competition to stich control of these connected appliances via voice-enabled e-commerce-ready hubs. Amazon's (AMZN) Alexa and Google's (GOOGL) Echo are the two leaders here but we expect Apple (AAPL) and other electronics companies to create and introduce solutions. The bottom-line is that the product offering and technology is still fragmented and a fully integrated connected and smart home is still a few years off. It is, however, close enough, in our opinion, to envision and invest in the coming upgrade cycle as consumers replace existing conventional home appliances to take advantage of new products and features.

How We are Managing Our and Client Money:

Our assumption is that our ability to forecast the overall market and macroeconomic conditions is highly limited. Accordingly, while we try to understand current conditions and trends, we try to make investment selections based on a long-term view and look for companies we can own throughout the economic cycle.

Selection from our model portfolio: Our approach is to own high-quality companies, bought opportunistically, and own them long-term with the intention to minimize trading costs and taxes. Our portfolio is concentrated (~20 positions) and generally we are favorably inclined towards companies we *know* or at least find easy to understand.

The Home Depot (HD): HD is one of the highest quality companies in the retail space. The company had the advantage of being the first mover in the big-box home improvement category and as it grew it squeezed out locals and grabbed the best real estate in most markets. Lowe's (LOW), which is also a good company, has always been plagued in comparison with its not-quite-as-good locations. HD shares are down about 9% over the past 12 months even as earnings expected over the next year are about 23% higher than a year ago (part of this is due to lower tax rates from corporate tax reform). In any case, the combination of a lower stock price and much higher earnings means that the stock's valuation has come in to about 12x on EV to EBITDA (EV to EBITDA is a short hand way to look at the company's total value compared to its expected cash flows) which is attractive, in my opinion. Investors have sold the shares despite good performance as there is concern about the health and outlook for the housing market. Generally, housing turnover is correlated with HD's business. Our view is that HD can continue to do well even if housing slows as it benefits from the need to spend on aging homes in the U.S. (since the financial crisis, new home construction has remained depressed leading to an increase in the average age of existing homes). We also see HD as a play on connected home and smart home upgrades. HD sells many of the products that do-it-yourselfers (DIYers) will buy to upgrade home appliances. However, it also acts as a supplier to pro contractors. We believe this group will also benefit from connected home as, in fact, many of these products are difficult to install, and we expect them to frequent HD for the goods they need to complete these upgrades and installations. Net, we view HD as among the highest quality retailers, currently trading at attractive valuations, and well positioned to benefit from both an aging U.S. housing stock as well as a multi-year product upgrade cycle for connected and smart home. Please see a one-year chart below.



This month I am attending the annual Consumer Electronics Conference (CES) in Las Vegas, an investment conference (ICR) held in Orlando, Florida and I am presenting at the ValueX Value Investors' Conference in Klosters, Switzerland. The purpose of attending these events is to stay current with developments in technology, meet with company management teams and understand trends, and discuss the market and investment ideas with other professional investors. On another level the travel is intended to challenge our thinking about the consumer and business and help us reframe how we approach understanding companies and investing.

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.

Yours,

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The analyst who is the author of this report has a long position in The Home Depot, Inc. (HD). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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