Market Newsletter & Opinion

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John M. Zolidis, President

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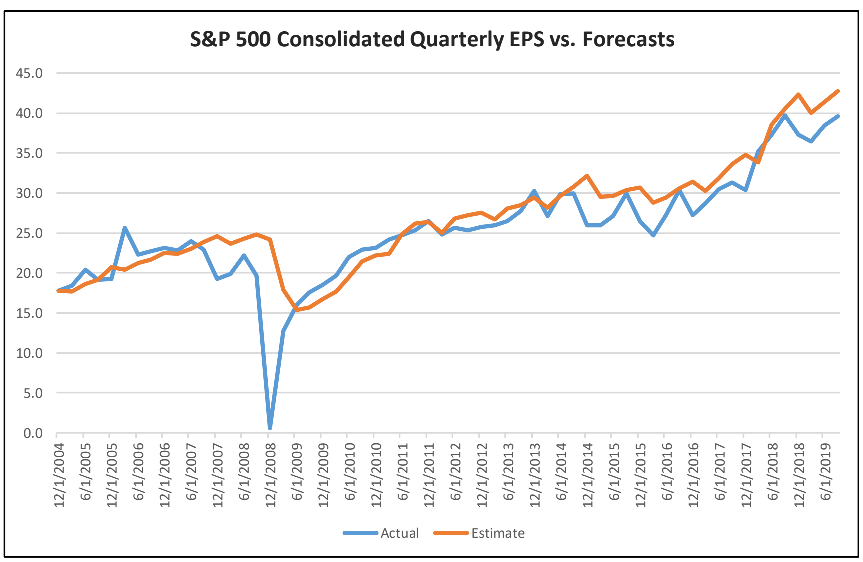
Bearish Positioning Sets Scene for Further Gains

Summary: Markets pushed to new highs on the combination of better-than-expected earnings and stimulus from rate cuts, offsetting and providing a counterpoint to the slowing global growth narrative. The debate in the market over the last 12-months has revolved around the length of the current expansion, valuations, and the likelihood of a downturn in the economic cycle. While there are certainly reasons to be concerned, we continue to focus on the strength of the U.S. consumer. (Consumer spending is more than 2/3 of economic activity in the largest economy in the world, after all.) The consumer remains in a very good state due to the best job market in decades and modest-to-non-existent inflation. We also remain bullish on the innovative qualities of U.S. companies and we believe that access to capital (both for companies and individuals) remains good.

Surprise! Corporate Earnings Accelerate vs. Expectations

Earnings recession not as bad as feared. We are still in the midst of the third quarter reporting period, but thus far, the data shows that companies are reporting upside to analyst estimates at a slightly-higher-rate than normal, indicating that forecasts either got too pessimistic *or the backdrop for growth improved*. Earnings are still expected to fall slightly year-over-year, a contraction that we discussed in our August newsletter. However, keep in mind what's important is where earnings are going, not where they've been. On this score,

Figure 1. 15-year chart of quarterly consolidated S&P500 EPS vs. consensus estimates. Companies have been beating estimates at a higher rate than usual and estimates imply that growth will resume next year. Actuals are GAAP figures.



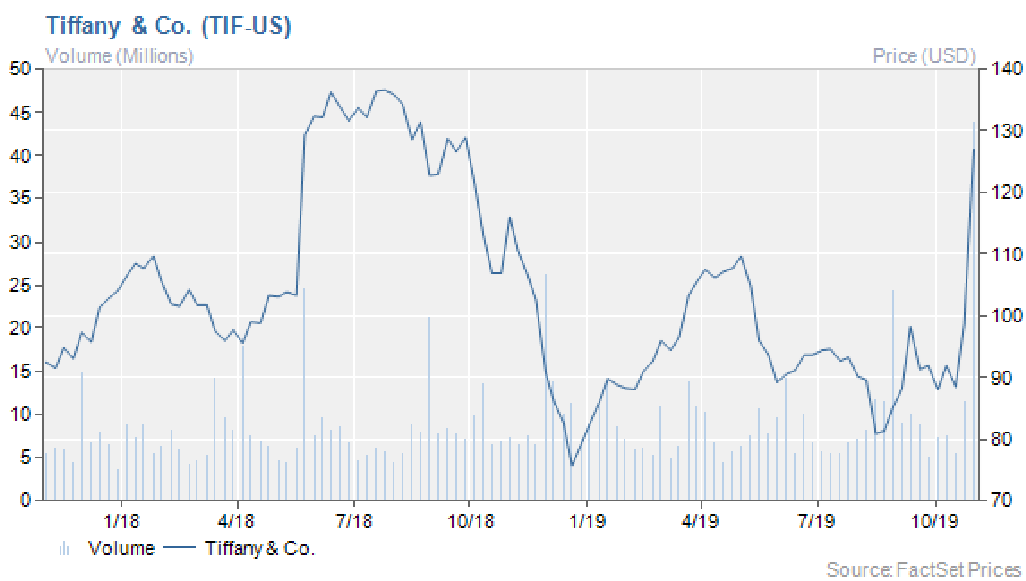
Source: FactSet, Quo Vadis Capital, Inc.

the earnings air pocket should close and growth will resume in 2020. How much risk is there to this forecast? We can't be sure but the experience in the current quarter (results *better* than forecasts) creates a foundation for optimism, in our opinion. Further, investor sentiment has dropped to levels not seen in two decades, according to the most recent Barron's survey of professional money managers. The fact that many investors are so pessimistic with the market at all-time highs (normally when everyone is about to get paid big) is by itself striking and something to think about. We suggest that the combination of companies beating forecasts and skeptical or downbeat investment managers (a contra-indicator) is ***a recipe for further stock gains***.

Selection from our Model Portfolio: A Mistake That Proves Our Earlier Point: Tiffany & Co. (TIF)

Tiffany & Co (TIF) was recently the recipient of an unsolicited takeover proposal from Louis Vuitton Moet Hennessey (LVMH). Our investment portfolio is mostly comprised of high-quality growth companies that are doing well with attractive long-term prospects and can be purchased at reasonable prices. We balance the portfolio by also including stakes in a few companies that we consider to be high-quality, but where current business is challenged for one reason or another. Frequently, companies with this latter profile can be bought at a meaningful discount. The offset is that the lack of a clear path to improved trends also means patience is required. An example of a name like this we owned is Tiffany & Co. (TIF). Tiffany has a fantastic brand name, its inventory has residual value (it's made out of gold and diamonds), margins are high (the EBITDA margin last year was 24%) and the company has historically generated a lot of cash flow. On the other hand, it also hasn't grown the top-line in years and margins have been sliding. A problem is TIF's exposure to the fickle spending patterns of the Chinese luxury shopper, which can shift based on, among other things, the Chinese government's capricious focus on corruption. We owned the stock with the hope that something would change in the future, leading to better sales growth and a higher valuation for the shares.

Figure 2. TIF shares jumped over 40% from October lows following a report that LVMH had proposed buying the company.



Despite all our talk in previous newsletters about not trying to predict macro, recent media stories and discussion regarding the potential for a recession appears to have rattled us on some level. Accordingly, one day when we should have been just going for a jog and kicking back, we instead reviewed our investments for cyclical risk and it was easy to identify TIF as the stock that was most exposed within our portfolio to a potential recession. The company is also struggling *right now*, as we discussed above, so to make ourselves feel better about our exposure, we exited the position.

Then, just two months later, here comes LVMH, the French luxury goods conglomerate, with an unsolicited offer to buy Tiffany's at $120 per share, sending the stock up more than 30% in a day to well above levels where we sold it. What gives? Has no one told Bernard Arnault (the long-time hard-charging $100- billionaire CEO of LVMH) about the big bad coming recession? Why buy TIF at this point in the cycle if discretionary spending is about to tank? Well, this illustrates perfectly several of the points we made in our September newsletter. If your time horizon is long enough, and you own high-quality companies, ***you don't need to worry about economic cycles*** and recessions. Yeah, that's what we said.

What's the takeaway? Stick with your discipline and the strategy that works with your investment approach. Sometimes easier said that done. Thanks for the reminder, Bernard.

This month I am traveling to England. In London and in the countryside, I will be participating in a "friendly" tournament of jeu de paume, which in English is called Real Tennis or sometimes, Court Tennis. Never heard of jeu de paume? Don't worry. I hadn't either. It's something I took up recently upon moving to Paris. There are questions about the game's origins, but it's generally agreed that jeu de paume is the ancestor to the better-known version called lawn tennis. Jeu de paume is currently played in about 50 locations worldwide, mostly by old white men. In the past it was a sport frequently played in aristocratic country houses. Think of this as a Renaissance-era equivalent to having your own basketball court or bowling lanes in your home today, which is the case for most of the readers of this newsletter. The Louvre (originally a royal palace) had a dedicated jeu de paume building in the Tuileries garden, which is now used as an exhibit hall. In any case, we'll be playing at two locations on this trip, one of which is one of these country homes, known as Hatfield House. Hatfield House was recently the setting for the film The Favorite with Emma Stone. You can see a photo of Hatfield House on the next page. It's not too shabby. If you'd like to get a taste of what jeu de paume is all about, here's a link to a brief (four minute) promotional video. Following my sporting tour, I will be sticking around in London for a few days to meet with clients and visit retail stores.

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Yours,

John Zolidis
President & Founder
Quo Vadis Capital, Inc.
John.zolidis@quovadiscapital.com
www.quovadiscapital.com

Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and Oxford University. He has followed U.S consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor and research boutique, in 2017 and works from New York and Paris, France.

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