December 2019/ January 2020

It's Not Like Dominoes

Summary: The strongest consumer environment in our lifetimes, low interest rates, and ample access to capital underly the market's favorable momentum heading into 2020, in our view. Few would have predicted that the S&P500 would gain more than 26% in 2019. A year ago last December, stocks were selling off on worries about the Fed's intention to raise interest rates in a decelerating economy as well as the impact of trade disputes. (Here's the link to what we wrote about it.) Both worries were resolved as the Fed reversed course and cut rates (providing stimulus to the economy) and the consumer remained strong along with wage and job growth. These factors more than offset any impact from tariffs (the risk of which had been exaggerated, in our opinion) threats of increased regulation and political acrimony. Looking forward, 2020 is an election year, which is typically disruptive to the consumer. Certain left-leaning policies would be very negative for economic growth, if they were to be enacted. Our advice is focus on 1) the strength of the consumer (whose spending represents 2/3 of U.S. economic activity), 2) the stability of the financial system, and 3) the innovative nature of U.S. companies and industries.

According to the Financial Media, Every Negative Event Could be the Pinprick that Lets the Air out of the Bubble

A recession could start if a series of factors conspire to cause retrenchment in investment and job growth but a larger risk is a systemic issue, in our opinion. The financial media, like all media, is addicted to clicks and measuring engagement. Consequently, over the past five to ten years, headlines that play on emotions have multiplied. How does a journalist get readers to delve into obscure company results or trifling economic data? Each wiggle in the chart is a precursor to economic calamity and financial ruin. How about legislative disputes in far-off countries with tiny economies? Make each seem like the first domino tipping over in the collapse of an already-fragile and flawed global financial system. We don't blame the media for this kind of sensationalism. Readers are clicking.

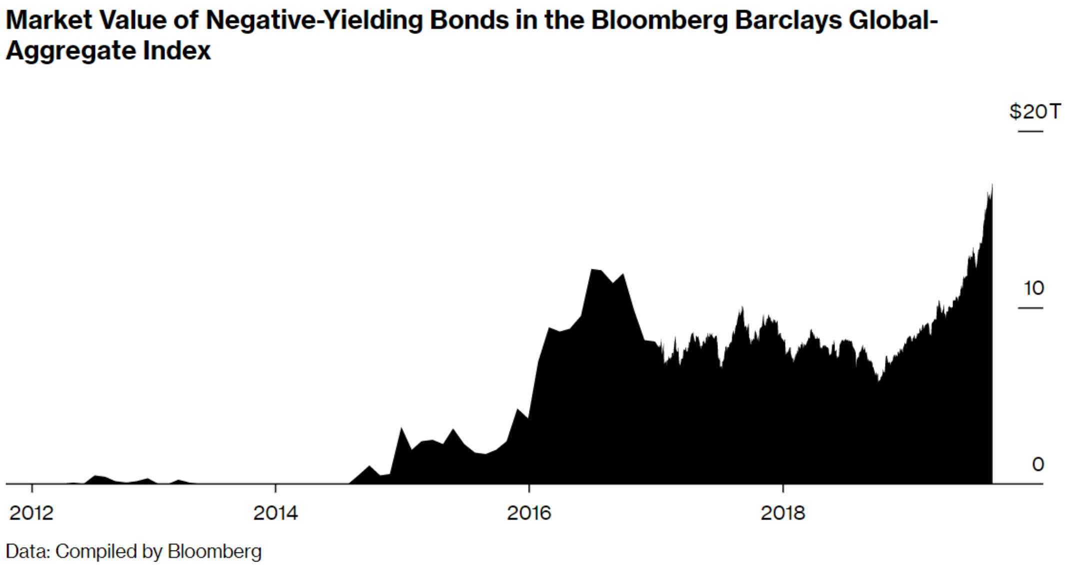
We spend our days working in financial markets. Accordingly, we are constantly consuming economic, political and corporate news from multiple sources. We are also talking to the management teams of companies and forecasting results. Accordingly, we are always on the lookout for patterns of information that might suggest the overall economy is slowing or some other problem is developing. That said, we think macro-economics are very difficult to predict. It's not impossible, but there is a very good chance of getting it wrong. Witness the market's fear and sell-off last December. A much better approach, in our opinion, is to focus on owning the best companies with solid balance sheets and cash flows and sustainable competitive advantages. This is also hard, but combined with a very long-term view, we think it can yield a favorable outcome.

What does worry us? Things we don't understand, especially if they represent distortions relative to the past. The previous two recessions we've experienced, the dot-com bust and the housing crisis, were both preceded by extreme pricing of assets. At the time, both seemed crazy to us. However, in neither case did we understand or foresee the mechanism by which unwinding the extreme asset prices eventually lead to a recession or financial crisis. Today, the biggest dislocation relative to history that we can see is in the bond market. More than $17 trillion of debt generating negative yields.* This is mostly debt backed by nations, like Germany but it includes

* *A negative yield occurs when a bond is priced so that the owner expects a loss. For example, a bond sells for $102.50 and in 10 years you'll get repaid $100 without any interest payments. Any takers?*

over $1 trillion of corporate bonds as well. To put this in context, the total value of all U.S. stocks is approximately $33 trillion (representing nearly half of the world's equity market value). Therefore $17 trillion dollars of financial assets generating negative returns is an amount we could describe as *very large*. Further, this situation has *never existed before*. Prior to 2014, the value of negative yielding debt was basically zero. The combination of something in the financial markets occurring for *the first time ever* on a *very large scale* that we have troubling understanding concerns us. See figure 1 for a chart of the aggregate value of negative-yielding bonds.

Figure 1.

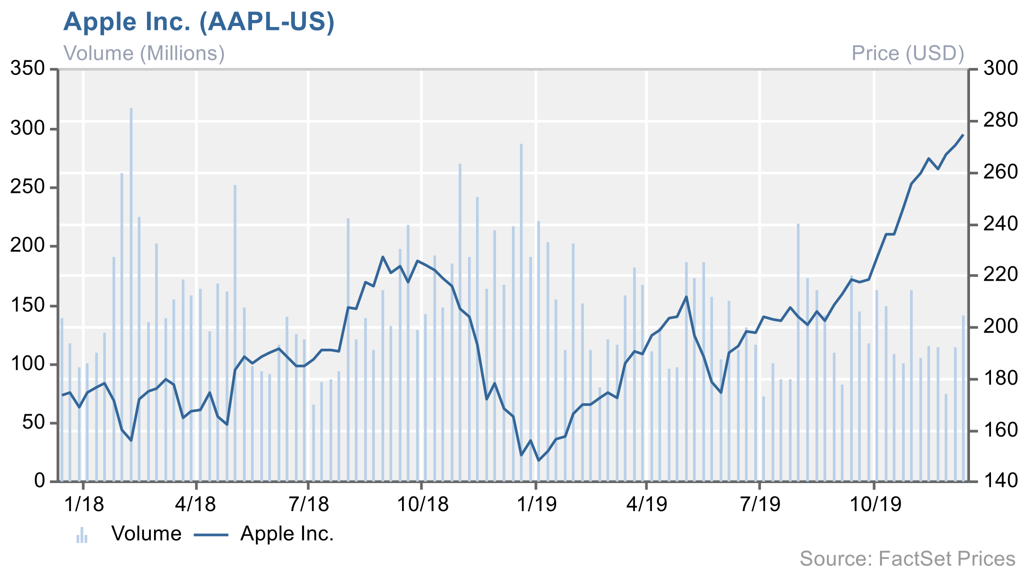


Could this represent a systemic risk or be the sign of some other systemic risk to the world financial system? Is it crazy for "investors" to park $17 trillion into assets that will definitely lose money? (We put "investors" in quotes here because losing money on purpose seems to us like the opposite of investing.) Is this a domino? Is it something more sinister? We'll keep thinking about it.

Selection from our Model Portfolio: Can Apple Inc. (AAPL) be worth $2 Trillion?

Apple Inc. (AAPL) is currently valued at $1.22 trillion, making it the most valuable U.S. public company. We've owned APPL shares in our investment portfolio from the outset. Our view is that AAPL is among the world's most valuable brands and the most innovative consumer products companies. It is also is extremely profitable. AAPL's operating margin was 27% in its most recent year. It generates very large amounts of excess cash. Over the past five years AAPL has generated an average of $59 billion per year. The company had over $100 billion in cash on the balance sheet at the end of the most recent quarter. We're not telling you anything that you don't already know about Apple. Rather, the question from here, at a market capitalization of $1.22 trillion, is whether AAPL shares could be one day worth $2 trillion. Our view is that if the company continues to innovate and create fantastic products it will maintain its dominance or grow share in existing or adjacent global categories. It will continue to produce excess free cash flows and these will either be returned to shareholders or reinvested in technology or growth. If all these things can happen, then $2 trillion is possible. Some day. So far it has been a smart to bet on AAPL's continued success.

Figure 2. AAPL shares are up 74% YTD but only 19% from their previous October 2018 peak. Curiously, expected earnings per share over the next year are today about 2% below what analysts were forecasting last October.



I am spending the first half of January in Florida and New York and traveling at the end of next month to Switzerland. We are traveling to Naples, Florida to spend New Year's Eve with my parents, following their recent exodus from Wisconsin. Subsequently, I will be in New York City and Long Island for about a week. I'll return to Florida, this time to Orlando, for an investment conference in mid-January. The ICR Conference features a combination of public company and private company management teams making presentations to professional investors. This is a good chance to hear from top CEOs and CFOs in the consumer space. At the end of January, I am attending a different kind of investment conference, VALUEx Klosters, in Klosters, Switzerland (near Davos). This event brings together investors from many countries to share investment ideas and community. This type of conference, which features "user-generated content," is very different from the typical Wall Street-arranged confabs of management teams and fee-generating hedge fund clients. It's instead a chance to take a step back and reflect a bit more intellectually about investing and other topics with a group of interesting people, something clearly best pursued on the ski slopes. I will be presenting an investment idea at VALUEx.

Do you already have enough ETFs and mutual funds? If you are looking for a more concentrated, thoughtful portfolio constructed by a manager available to answer your questions, please get in touch. An archive of our past newsletters can be found on our website by clicking this link .

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 sellside, 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.

The annual carrying of the tree with daughters, Happy Holidays!

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The analyst who is the author of this report has a long position in shares of Apple, Inc. (AAPL). 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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