Market Newsletter & Opinion 1/19/2020

John M. Zolidis, President

January 2020

Everyone Leaning on the Same Side of the Canoe

Summary: The two biggest worries of 2019 have now unwound, unleashing a breakout to higher levels for equity prices. The debate over the past year has considered on one hand consistently strong employment growth and consumer spending (2/3 of U.S. economic activity), and on the other slowing corporate earnings growth and risks including the impact of trade disputes, potential increased regulation for big tech (Facebook, Google, etc.), and actions of the Federal Reserve. The threat from the Fed was reversed early in 2019 when it pivoted to cutting rates (and thus providing stimulus) from raising rates. However, it wasn't until last week with the signing of both the USMCA (United States Mexico Canada Agreement) and Phase 1 of a deal with China that 2019's most powerful fear-based narrative on trade disputes lost its force.

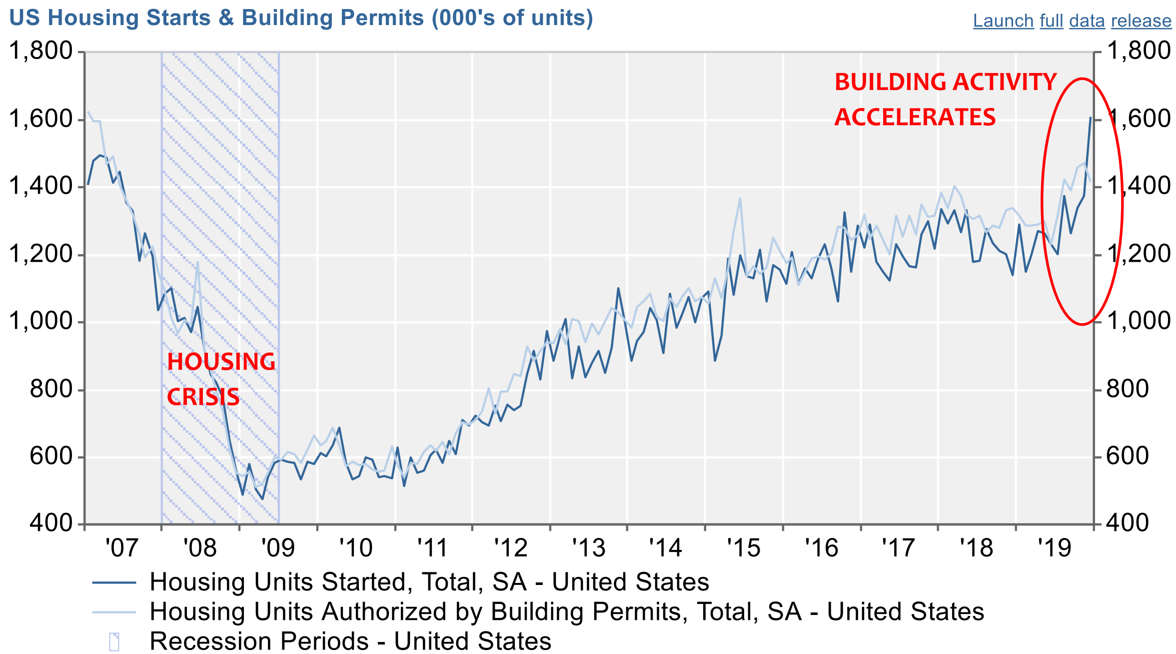
Resolution of Uncertainty

Normally you want to buy uncertainty and sell when the uncertainty is removed. Generally, prices for assets are discounted when there are worries about the future and discount goes away when the reason for concern is eliminated. With the benefit of hindsight, the worries of a year ago definitely provided a buying opportunity, and the recent resolution of concern regarding the Fed, trade wars, and economic growth, appears to provide a much better opportunity to sell at higher prices. Our approach is not to trade the market in this way. Rather, we look to own high quality companies with sustainable competitive advantages and the ability to grow. We want to own these names for the long term, provided their positioning remains attractive, and thereby minimize any trading costs and tax implications. On the other hand, we do look for moments of either company-specific or macro-driven anxiety to start or add to positions. We got a very brief window recently following the U.S.'s action to take out an Iranian General. The market worried about this for about a day and a half. We have also been watching the impeachment debate. So far, the market has been concerned about impeachment for exactly, well, not even a second. We can't identify the next big worry. Nevertheless, as when everyone leans on the same side of the canoe, natural forces in the market eventually generate a snap back in the other direction.

Even Housing Appears to be Participating

A (perhaps) unintended consequence of tax reform was weakness in certain housing markets. This soft spot in housing over the past two years was related to the changes in deductions for state and local income taxes, including real estate taxes, that were included in the December 2017 tax overhaul. Simplistically, the reform made it more difficult to deduct real estate taxes from federal income tax, which essentially made buying a home more expensive, especially in certain markets. This, unsurprisingly, had a negative impact on transactions and prices for homes, thereby hurting other housing-related activities as well. This impact may have run its course. Data released last week on permits for new home construction jumped to levels not seen in more than 10 years. (See figure 1 below.) This is important to recognize, in our opinion, as the housing industry has economic implications that go well beyond construction, as was on display during the housing and financial crisis over 2008-2009. Of course, the December data for housing could be somewhat suspect, but even if it's not quite as good as it looks, we think the figures are telling us something that makes sense. The impact of lowering interest rates, together with higher equity prices and employment, are spurring more housing-related activity. This is a positive.

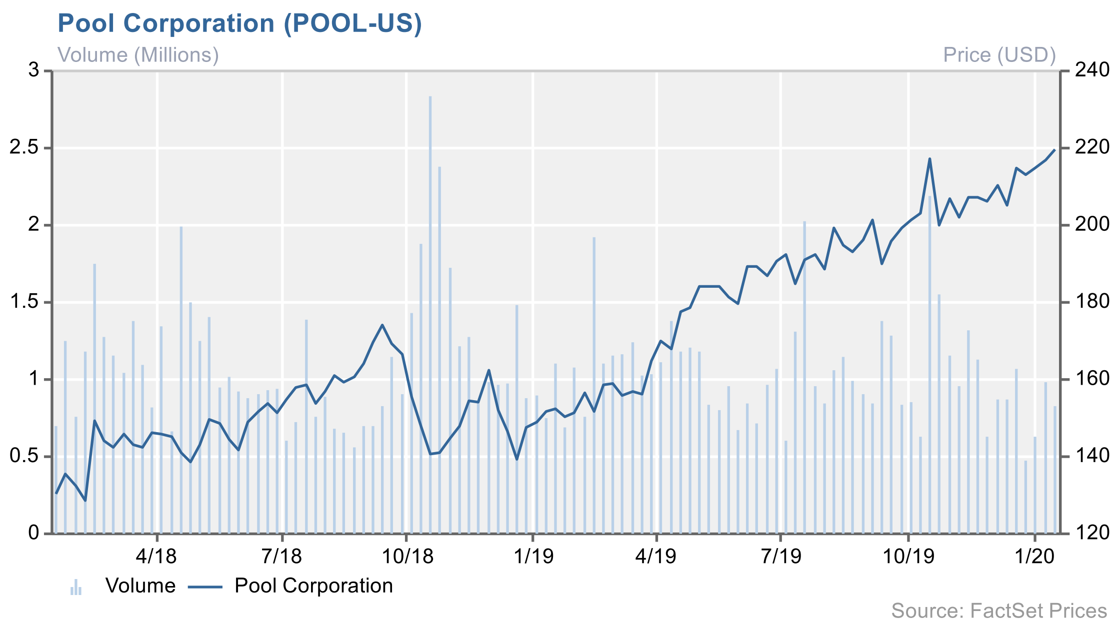
Figure 1. Single family housing permits for new construction jumped to levels not seen in over 10 years to end 2019



Selection from our Model Portfolio: Pool Corp. (POOL)

POOL is a $9B distributor of pool and outdoor home related products followed by a meager 9 Wall Street Analysts, only two of whom like the stock. Would you believe you could get a 26% combined average annual return in a swimming pool supply distributor over 20+ years? Unfortunately, I was not smart enough to see this coming when I first encountered Pool Corp. as a young analyst in 1999. (I missed plenty of other great investments. I continue to regret each of those whenever I happen upon them today. I am sure I also avoided plenty of names that went to zero, but I have long since forgotten them.) Back then, Manuel Perez de la Mesa had just joined as COO before eventually running the company as its CEO for 20 years. He retired in early 2019 but continues on as Chairman of the Board. During this tenure, he oversaw Pool Corp.'s expansion from a regional player into the dominant U.S. company in its space via acquisitions and market share gains as well as expansion into many international markets. While we didn't foresee this success back in 1999, we *have* enjoyed owning POOL shares over the past year during which time the company built on the legacy created by Perez de la Mesa. POOL is among three housing-related investments in our book, together with Home Depot (HD) which we wrote about in our January 2019 Newsletter. We chose POOL for the strength of its operating history, together with its business model, which benefits from modest industry growth and from the recurring revenue stream generated by the installed base of swimming pools. (Once you stick one of those in your backyard, you are essentially signing up to a lifetime of equipment and chemical purchases.) We also note that POOL participates in remodel-related spending, which increases as home prices rise. Further, 95% of installed in-ground pools in the U.S. are over 10 years old. This bodes well for POOL given the strong economy and as we lap the shock to certain housing markets created by tax reform discussed above. See figure 2 below for a chart of the two-year performance of Pool Corp. shares.

Figure 2. No drain here: POOL shares have returned 44% over the past 12 months.



I am back from three weeks in the U.S. with a late January trip to Switzerland next on the schedule. The end of my U.S. trip included a three-day investment conference in Orlando, Florida. At this conference I listened to presentations and met with the management teams of consumer companies. Coming up later this month I am will attend VALUEx Klosters, in Klosters, Switzerland (near Davos). This event brings together investors from many countries to share investment ideas and community. 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 the University of Oxford. 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 (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

The walk from my hotel in Orlando to the neighboring location for last week's conference. The signs advertised alligators and snakes, which removed the feeling of tranquility a bit, but I was disappointed not to see any.

General Disclosures:

Quo Vadis Capital, Inc. ("Quo Vadis") is an independent research provider offering research and consulting services. The research products are for institutional investors only.

The price target, if any, contained in this report represents the analyst's application of a formula to certain metrics derived from actual and estimated future performance of the company. Analysts may use various formulas tailored to the facts and circumstances surrounding a specific company to arrive at the price target. Various risk factors may impede the company's securities from achieving the analyst's price target, such as an unfavorable macroeconomic environment, a failure of the company to perform as expected, the departure of key personnel or other events or circumstances that cannot be reasonably anticipated at the time the price target is calculated. Quo Vadis may change the price target on this company without notice. Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources Quo Vadis believes to be reliable; however, Quo Vadis does not guarantee its accuracy and does not purport to be complete. Opinion is as of the date of the report unless labeled otherwise and is subject to change without notice. Updates may be provided based on developments and events and as otherwise appropriate. Updates may be restricted based on regulatory requirements or other considerations. Consequently, there should be no assumption that updates will be made. Quo Vadis disclaims any warranty of any kind, whether express or implied, as to any matter whatsoever relating to this research report and any analysis, discussion or trade ideas contained herein. This research report is provided on an "as is" basis for use at your own risk, and neither Quo Vadis nor its affiliates are liable for any damages or injury resulting from use of this information. This report should not be construed as advice designed to meet the particular investment needs of any investor or as an offer or solicitation to buy or sell the securities or financial instruments mentioned herein. This report is provided for information purposes only and does not represent an offer or solicitation in any jurisdiction where such offer would be prohibited. Commentary regarding the future direction of financial markets is illustrative and is not intended to predict actual results, which may differ substantially from the opinions expressed herein. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur.

The analyst who is the author of this report has a long position in shares of Pool Corp. (POOL) and Home Depot (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].

SEC Reg AC Certification:

All of the views expressed in this research report accurately reflect the research analyst's personal views about any and all of the subject securities or issuers. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst in the subject company of this research report.