MARKET COMMENTARY MONDAY, JANUARY 7, 2019

January 7, 2019

EXECUTIVE SUMMARY

Friday Rally – Better-than-Expected Payrolls
ISM Manufacturing Index – Actual Number vs. Headlines
Powell Speaks – Fed Chair Says He Will Be Patient and There is No Pre-Set Course for Rate Hikes
Flip-Flop – Futures Now Suggest No Fed Rate Hikes in 2019
Week in Review – The Only Problem with Market Timing…
Growth vs. Value – Russell 3000 Index Weightings
Stock Updates – AAPL, DAL & ALK

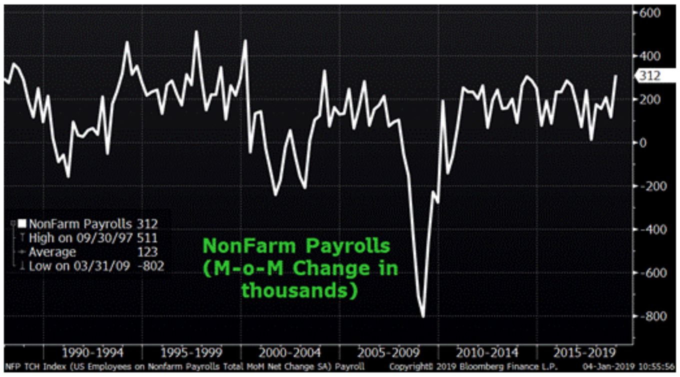
Market Review

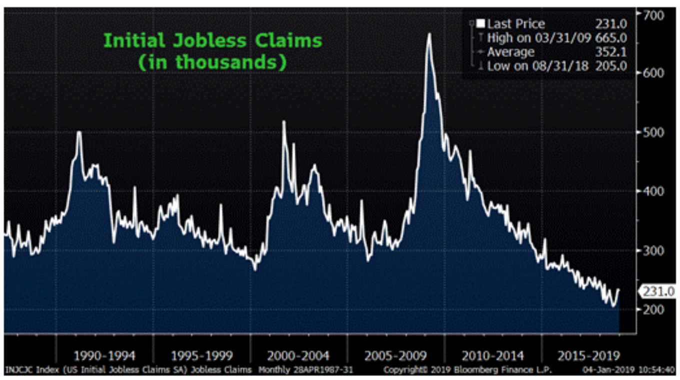
With the January edition of *The Prudent Speculator* just hitting email boxes on Friday morning, it was nice to see market action that day support the assertions put forth in this month's *Editor's Note*: "To be sure, prognosticators are often overly optimistic, but we believe that the massive pullbacks in the prices of the majority of stocks have discounted a modest to moderate economic AND profit recession, neither of which presently appear to be on the horizon…We think that long-term-oriented investors should take comfort in the fact that arguments against equities (e.g. not having a Bear Market in ages, the Fed is tightening, interest rates are rising and valuations are too rich) have lost more of their validity."

Obviously, one huge rebound does not a long-term, or even short-term, trend make, but the much-stronger-than-expected December Employment Situation report from the Labor Department alleviated, for the moment anyway, fears that the U.S. economy was on a fast track toward recession,…

AFAM CAPITAL

THE PRUDENT SPECULATOR
Solid Employment Situation





While the Labor Department said that the unemployment rate ticked up to 3.9% in December from November's near-50-year-low of 3.7%, as more folks entered the workforce, a much-better-than-expected 312,000 new jobs were added. Wages last month grew at 3.2%, the highest increase since 2009, while first-time filings for jobless benefits rose to 231,000 in the latest week, with the figure still very low by historical standards.

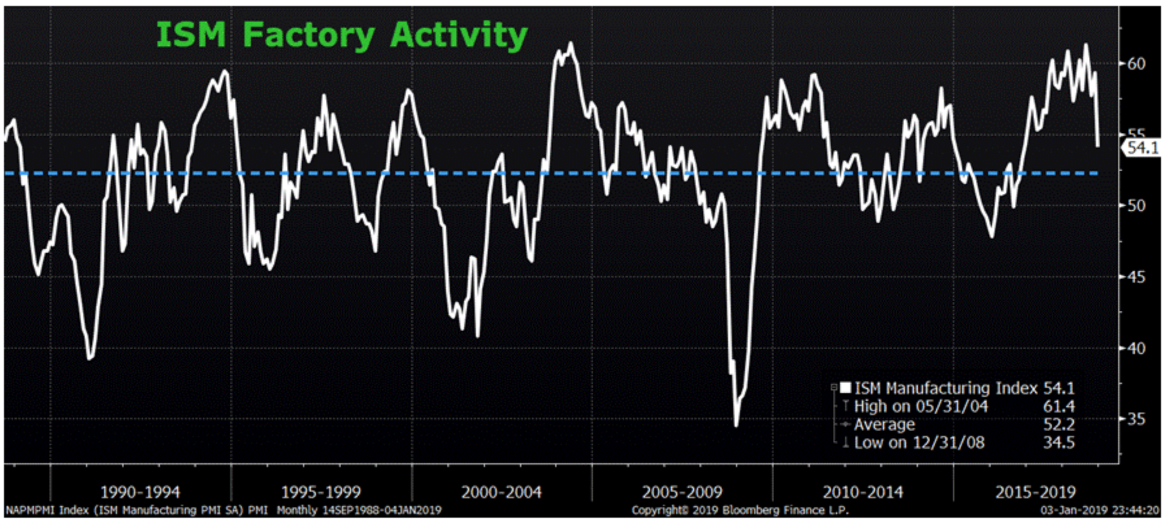
…after short-sighted folks freaked out the day prior when the latest widely watched read on the health of the factory sector saw a big pullback to a much weaker-than-expected tally. Of course, anyone who bothered to read beyond the scary headlines ("Largest One-Month Drop in a Key Manufacturing Survey Since the End of 2008") would quickly understand that the December PMI measure of 54.1 actually was terrific by historical standards.

AFAM CAPITAL

THE PRUDENT SPECULATOR

Perplexed: 3.4% GDP Growth is Bad?

The latest read on the health of the factory sector tumbled to 54.1 in December, a reading that is still nicely above average, with the Institute for Supply Management stating, “The past relationship between the PMI® and the overall economy…corresponds to a 3.4% increase in real gross domestic product (GDP) on an annualized basis.”



To be sure, we respect that many traders care only about the change or the rate of the change, but we point out that the near-record PMI for August 2018 of 61.3 corresponded to a 5.6% rate of growth in GDP, a figure that was well off the charts (and due for a sizable pullback in the months ahead) for even the most optimistic of economic forecasters. This is especially true when one considers that the September 2018 U.S. GDP projection from the Federal Reserve for 2019 called only for 2.5% growth.

THE PRUDENT SPECULATOR
No Recession in the Fed Forecast

The Fed raised its longer-run projection for GDP growth to 1.9%, though its outlook for 2019 growth (yes, growth!) decreased to 2.3%, down from 2.5%. The long-run forecast for the Federal Funds rate fell to 2.8%.

Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy, December 2018

Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2018	2019	2020	2021	Longer run	2018	2019	2020	2021	Longer run	2018	2019	2020	2021	Longer run
Change in real GDP	3.0	2.3	2.0	1.8	1.9	3.0–3.1	2.3–2.5	1.8–2.0	1.5–2.0	1.8–2.0	3.0–3.1	2.0–2.7	1.5–2.2	1.4–2.1	1.7–2.2
September projection	3.1	2.5	2.0	1.8	1.8	3.0–3.2	2.4–2.7	1.8–2.1	1.6–2.0	1.8–2.0	2.9–3.2	2.1–2.8	1.7–2.4	1.5–2.1	1.7–2.1
Unemployment rate	3.7	3.5	3.6	3.8	4.4	3.7	3.5–3.7	3.5–3.8	3.6–3.9	4.2–4.5	3.7	3.4–4.0	3.4–4.3	3.4–4.2	4.0–4.6
September projection	3.7	3.5	3.5	3.7	4.5	3.7	3.4–3.6	3.4–3.8	3.5–4.0	4.3–4.6	3.7–3.8	3.4–3.8	3.3–4.0	3.4–4.2	4.0–4.6
PCE inflation	1.9	1.9	2.1	2.1	2.0	1.8–1.9	1.8–2.1	2.0–2.1	2.0–2.1	2.0	1.8–1.9	1.8–2.2	2.0–2.2	2.0–2.3	2.0
September projection	2.1	2.0	2.1	2.1	2.0	2.0–2.1	2.0–2.1	2.1–2.2	2.0–2.2	2.0	1.9–2.2	2.0–2.3	2.0–2.2	2.0–2.3	2.0
Core PCE inflation[4]	1.9	2.0	2.0	2.0		1.8–1.9	2.0–2.1	2.0–2.1	2.0–2.1		1.8–1.9	1.9–2.2	2.0–2.2	2.0–2.3	
September projection	2.0	2.1	2.1	2.1		1.9–2.0	2.0–2.1	2.1–2.2	2.0–2.2		1.9–2.0	2.0–2.3	2.0–2.2	2.0–2.3	
Memo: Projected appropriate policy path															
Federal funds rate	2.4	2.9	3.1	3.1	2.8	2.4	2.6–3.1	2.9–3.4	2.6–3.1	2.5–3.0	2.1–2.4	2.4–3.1	2.4–3.6	2.4–3.6	2.5–3.5
September projection	2.4	3.1	3.4	3.4	3.0	2.1–2.4	2.9–3.4	3.1–3.6	2.9–3.6	2.8–3.0	2.1–2.4	2.1–3.6	2.1–3.9	2.1–4.1	2.5–3.5

Source: Federal Reserve, December 19, 2018

True, the Fed's current forecast is for GDP growth this year of 2.3%, and we note that Friday's big gains were partially attributed to Jerome Powell stating, "With the muted inflation readings that we've seen coming in, we will be patient as we watch to see how the economy evolves," with the Fed Chair's suggestion that interest rates are not on a pre-set course to increase in 2019 reducing fears of additional rate hikes.

THE PRUDENT SPECULATOR

Dovish or Hawkish: Fed is Still Friendly

99) Export — World Interest Rate Probability

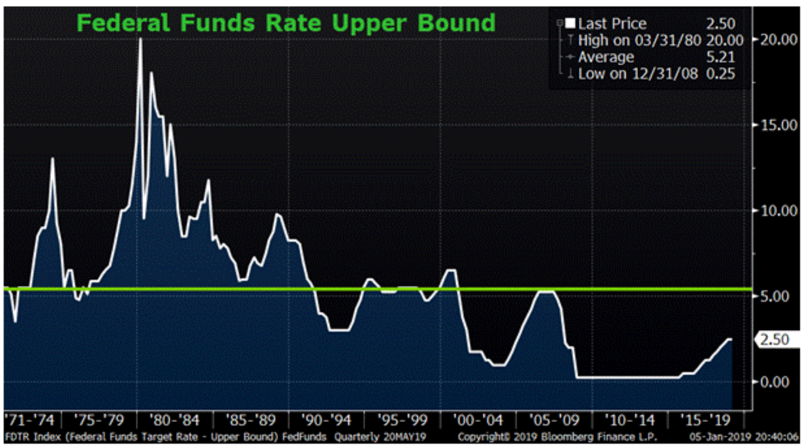
United States | Instrument: Futures: Fed Funds - Effective | Fed Effective Rate 2.40

1) Overview | 2) Future Implied Probability

Current Implied Probabilities | 3) Add/Remove Rates

Dates: Meeting / Calculation | Calculated 01/04/2019 | Based on rate 2.25-2.50

Meeting	Hike Prob	Cut Prob	1.25-1.5	1.5-1.75	1.75-2	2-2.25	2.25-2.5	2.5-2.75	2.75-3	Fwd Rate
01/30/2019	0.0%	0.5%	0.0%	0.0%	0.0%	0.5%	99.5%	0.0%	0.0%	2.40
03/20/2019	0.0%	2.9%	0.0%	0.0%	0.0%	2.9%	97.1%	0.0%	0.0%	2.39
05/01/2019	2.0%	2.9%	0.0%	0.0%	0.0%	2.8%	95.1%	2.0%	0.0%	2.40
06/19/2019	6.9%	2.7%	0.0%	0.0%	0.0%	2.7%	90.4%	6.8%	0.1%	2.41
07/31/2019	6.5%	7.4%	0.0%	0.0%	0.2%	7.2%	86.1%	6.4%	0.1%	2.40
09/18/2019	6.3%	10.5%	0.0%	0.0%	0.4%	10.1%	83.2%	6.2%	0.1%	2.39
10/30/2019	5.8%	16.6%	0.0%	0.0%	1.1%	15.5%	77.5%	5.7%	0.1%	2.37
12/11/2019	5.0%	27.9%	0.0%	0.2%	3.2%	24.5%	67.2%	4.9%	0.1%	2.33
01/29/2020	4.2%	39.0%	0.0%	0.7%	6.7%	31.5%	56.9%	4.1%	0.1%	2.29



It is incredible that investors, at least as evidenced by the Fed Funds Futures market, now believe that the Federal Reserve has a better chance of lowering interest rates over the next year after just a few weeks ago fretting that Jerome Powell & Co. were not "dovish" enough in their December 2018 FOMC Statement.

When all was said and done, the wild gyrations in equities prices last week ended with stocks well into the green,...

AFAM CAPITAL

THE PRUDENT SPECULATOR
Investing is an Emotional Roller-Coaster

For the second straight week, the equity markets illustrated why the only problem with market timing is getting the timing right. A massive 660-point plunge in the Dow Jones Industrial Average on Jan. 3 was followed by an even more massive 747-point rally on Jan. 4 that sent New Year's Week 2019 to a solid gain for the four days of trading.

… with the S&P 500 and Russell 3000 indexes advancing 1.90% and 2.03%, respectively. Happily, Value outperformed Growth, as the Russell 3000 Value index rallied 2.23%, compared to a 1.82% increase for the Russell 3000 Growth index. No doubt, the plunge in the now-second largest holding in the latter index accounted for most of its underperformance last week,…

THE PRUDENT SPECULATOR
Value Rules, but We Don't Discriminate

Russell 3000 Growth/Value Index Membership

Name	% Wgt	Bloomberg Ticker	Name	% Wgt	Bloomberg Ticker
RUSSELL 3000 GROWTH IDX (RAG)			**RUSSELL 3000 VALUE IDX (RAV)**		
MICROSOFT CORP	5.82	MSFT US	JPMORGAN CHASE & CO	2.60	JPM US
APPLE INC	5.60	AAPL US	BERKSHIRE HATHAWAY INC-CL B	2.57	BRK/B US
AMAZON.COM INC	5.09	AMZN US	EXXON MOBIL CORP	2.35	XOM US
FACEBOOK INC-A	2.61	FB US	JOHNSON & JOHNSON	2.19	JNJ US
ALPHABET INC-CL C	2.59	GOOG US	PFIZER INC	1.94	PFE US
ALPHABET INC-CL A	2.56	GOOGL US	BANK OF AMERICA CORP	1.82	BAC US
VISA INC-CLASS A SHARES	1.87	V US	VERIZON COMMUNICATIONS INC	1.82	VZ US
UNITEDHEALTH GROUP INC	1.82	UNH US	PROCTER & GAMBLE CO/THE	1.79	PG US
HOME DEPOT INC	1.59	HD US	AT&T INC	1.72	T US
BOEING CO/THE	1.39	BA US	INTEL CORP	1.68	INTC US
MASTERCARD INC - A	1.39	MA US	CHEVRON CORP	1.64	CVX US
COCA-COLA CO/THE	1.12	KO US	WELLS FARGO & CO	1.58	WFC US
PEPSICO INC	1.10	PEP US	CISCO SYSTEMS INC	1.52	CSCO US
ABBVIE INC	1.07	ABBV US	MERCK & CO. INC.	1.44	MRK US
NETFLIX INC	0.99	NFLX US	COMCAST CORP-CLASS A	1.27	CMCSA US
AMGEN INC	0.93	AMGN US	CITIGROUP INC	1.05	C US
WALT DISNEY CO/THE	0.93	DIS US	WALMART INC	1.04	WMT US
ADOBE SYSTEMS INC	0.88	ADBE US	DOWDUPONT INC	0.98	DWDP US
PAYPAL HOLDINGS INC	0.82	PYPL US	MEDTRONIC PLC	0.93	MDT US
SALESFORCE.COM INC	0.79	CRM US	ABBOTT LABORATORIES	0.91	ABT US
ALTRIA GROUP INC	0.76	MO US	MCDONALD'S CORP	0.87	MCD US
UNION PACIFIC CORP	0.74	UNP US	PHILIP MORRIS INTERNATIONAL	0.84	PM US
NIKE INC -CL B	0.74	NKE US	ORACLE CORP	0.84	ORCL US
3M CO	0.72	MMM US	UNITED TECHNOLOGIES CORP	0.68	UTX US
ACCENTURE PLC-CL A	0.72	ACN US	THERMO FISHER SCIENTIFIC INC	0.65	TMO US
Top-25 Weighting	**44.67**		**Top-25 Weighting**	**36.72**	

As of 1.4.19. Source: Bloomberg Finance L.P.

Though we decidedly favor companies that fall into the Value category, as evidenced by far more *TPS* names (those in green) on the right than the left, we do not exclude stocks that others, including the purveyors of the Russell indexes, would call Growth.

...even as we would argue that consumer electronics giant **Apple** (AAPL – $148.26) actually is a Value stock.

Stock Updates

Keeping in mind that all stocks are rated as "Buy" until such time as they are a "Sell," while a listing of all current recommendations is available for download via the following link: https://theprudentspeculator.com/dashboard/, Chris Quigley offer updates on three of our companies that had news last week that was of sufficient importance to trigger a review of their respective Target Prices...

Alas, Apple CEO Tim Cook's fiscal Q1 revenue guidance cut sent ripples through the market on Thursday and pulled Apple shares down by more than 10% (though some losses were recovered in Friday's trading session). The guidance cut resulted in a broader market downturn due in part to Apple's large weighting within indexes and index-benchmarked ETFs like SPY (tracks the S&P 500, AAPL is a 3.1% position), IWV (tracks the Russell 1000, AAPL is a 3.0% position) and DIA (tracks the Dow Jones Industrial Average, AAPL is a 4.2% position).

Via a letter posted on Apple's website, Mr. Cook said, "Today we are revising our guidance for Apple's fiscal 2019 first quarter, which ended on December 29. We now expect the following: Revenue of approximately $84 billion; Gross margin of approximately 38 percent; Operating expenses of approximately $8.7 billion; Other income/(expense) of approximately $550 million; Tax rate of approximately 16.5 percent before discrete items. We expect the number of shares used in computing diluted EPS to be approximately 4.77 billion. Based on these estimates, our revenue will be lower than our original guidance for the quarter, with other items remaining broadly in line with our guidance."

Mr. Cook explained, "When we discussed our Q1 guidance with you about 60 days ago, we knew the first quarter would be impacted by both macroeconomic and Apple-specific factors. Based on our best estimates of how these would play out, we predicted that we would report slight revenue growth year-over-year for the quarter. As you may recall, we discussed four factors:

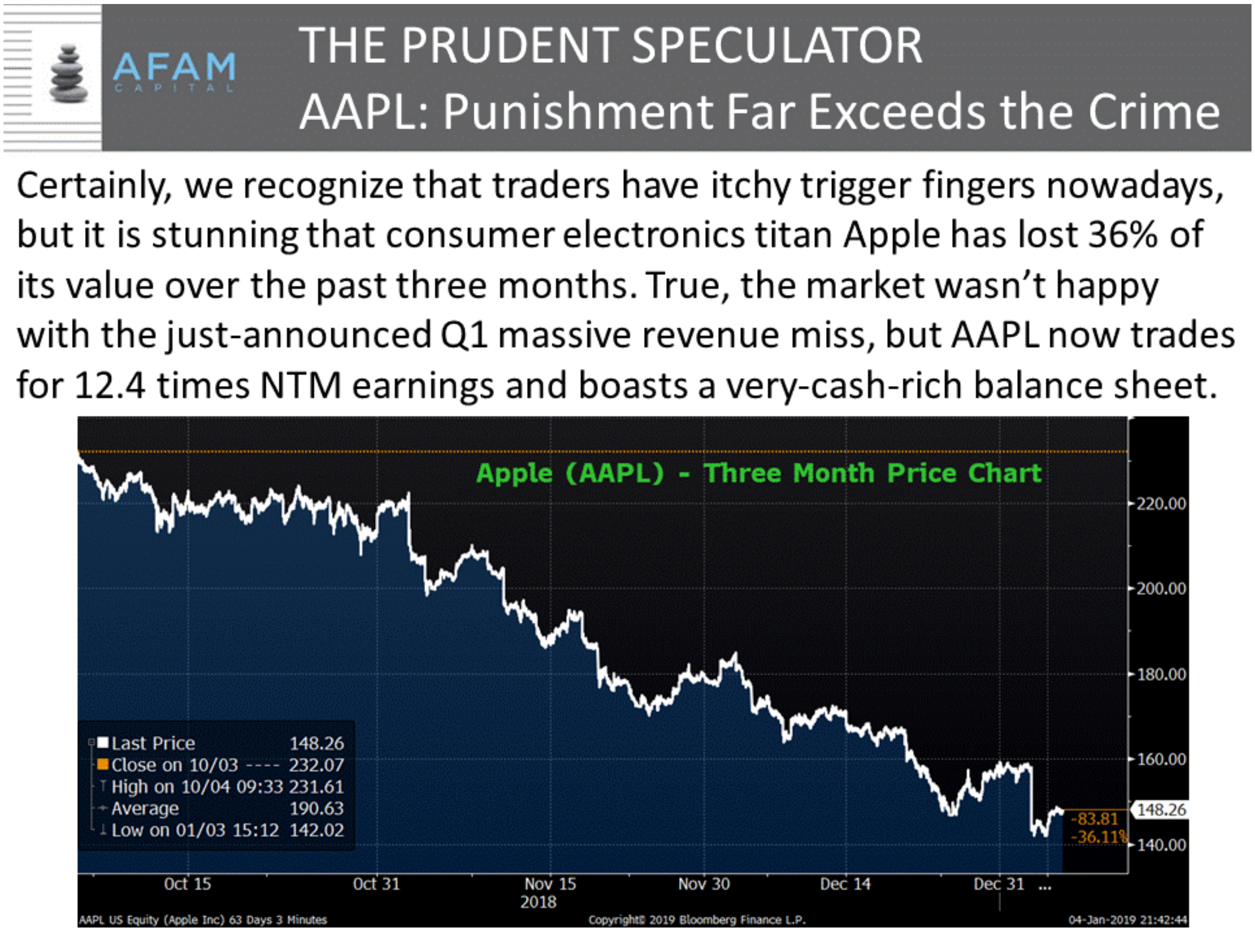
"First, we knew the different timing of our iPhone launches would affect our year-over-year compares. Our top models, iPhone XS and iPhone XS Max, shipped in Q4'18—placing the channel fill and early sales in that quarter, whereas last year iPhone X shipped in Q1'18, placing the channel fill and early sales in the December quarter. We knew this would create a difficult compare for Q1'19, and this played out broadly in line with our expectations.

"Second, we knew the strong US dollar would create foreign exchange headwinds and forecasted this would reduce our revenue growth by about 200 basis points as compared to the previous year. This also played out broadly in line with our expectations.

"Third, we knew we had an unprecedented number of new products to ramp during the quarter and predicted that supply constraints would gate our sales of certain products during Q1. Again, this also played out broadly in line with our expectations. Sales of Apple Watch Series 4 and iPad Pro were constrained much or all of the quarter. AirPods and MacBook Air were also constrained.

"Fourth, we expected economic weakness in some emerging markets. This turned out to have a significantly greater impact than we had projected."

Mr. Cook added, "While we anticipated some challenges in key emerging markets, we did not foresee the magnitude of the economic deceleration, particularly in Greater China. In fact, most of our revenue shortfall to our guidance, and over 100 percent of our year-over-year worldwide revenue decline, occurred in Greater China across iPhone, Mac and iPad. China's economy began to slow in the second half of 2018. The government-reported GDP growth during the September quarter was the second lowest in the last 25 years. We believe the economic environment in China has been further impacted by rising trade tensions with the United States. As the climate of mounting uncertainty weighed on financial markets, the effects appeared to reach consumers as well, with traffic to our retail stores and our channel partners in China declining as the quarter progressed. And market data has shown that the contraction in Greater China's smartphone market has been particularly sharp."



Recently it has seemed like the slightest blemish will result in a large share price whack, and Apple proved no exception. For the guidance hit and concerns about China, Apple's market capitalization dropped from $749 billion on Wednesday to $674 billion on Thursday afternoon. While Apple's shortfall for Q1 definitely is large ($84 billion vs. the prior estimated range of $89 billion to $93 billion), the stock had already fallen precipitously over the last three months, so plenty of bad news "should" have been in the price. Further, Apple's balance sheet still sports its mountain of cash and the demand for its products we believe is robust over the long term. Apple's App Store also has a substantial amount of recurring and ancillary revenue, which we would argue is hugely valuable even if Apple never sold another iPhone. We believe the valuation after the drop makes Apple one of the most attractive tech names in our universe, with metrics like a forward price to earnings ratio of 12.4, a free cash flow yield of 8.7% and a dividend yield of 2.0%. That said, we have trimmed our Target Price for AAPL to $205.

Also difficult to understand was the devastation of the airline sector on Thursday after **Delta Air Lines** (DAL – $47.79) modestly lowered its guidance, a move that resulted in a share price drop of more than 10% for the Atlanta-based airline, and pulled peers like **Alaska Air Group** (ALK – $60.00) down with it. Delta now expects total revenue growth to be up 7% year-over-year, 4% from capacity growth and 3% from total unit revenue growth. While Delta said it sees a strong overall demand environment, close-in yield improvement was "more modest than expected" in December. For Q4, DAL expects $1.25 to $1.30 in EPS, compared with the estimated range of $1.10 to $1.30 offered at the beginning of December.

Not surprisingly, given that the bad news was hardly awful, we continue to be fans of Delta, especially given the big drop in fuel costs over the past few months. We still believe the airline has a terrific management team headed by an industry veteran (Ed Bastian). We also like that the company has lowered its debt load and rewards employees for solid performance (which we believe aligns employee and shareholder interests), while the extended low-interest-rate environment allowed Delta to pick up less expensive new (A350, A321, 737NG, A330neo) and used (717, 757) planes. Delta continues to strive to woo business travelers by renovating lounges around the world, offering gate transfers via Porsche and serving top-notch food, in an effort to ensure that the highest-margin travelers return. In addition, DAL trades for just 7.4 times NTM earnings and yields 2.9%. Our Target Price now stands at $71. Our Target Price for ALK, which trades for 10.1 times estimated earnings and yields 2.1%, is now $94.