Market Commentary Monday, April 15, 2019

April 14, 2019

EXECUTIVE SUMMARY

Week in Review – Value Ends on a Nice Note
Bull Market – Nearly All of the U.S. Indexes Now Up 20%+ Since Christmas Eve Close
Econ Forecasting – IMF Trims Global Growth Outlook
U.S. Econ News – Numbers Remain Solid
Inflation – CPI Shows Little in the Way of Pricing Pressure
Myth Debunking – 1966-1981 Inflationary Period Very Good for Stocks in General and Value Stocks in Particular
Volatility – Markets Move Up and Down in the Short Run; Long-Term Trend is Up
Stock Updates – DIS, NOV, JPM & PNC

Market Review

Certainly, one day does not a trend make, but it was nice to see Value stocks have a little time in the sun on Friday, even as the modest outperformance (0.77% vs. 0.53%) of the Russell 3000 Value index over the Russell 3000 Growth index was driven almost entirely by bank stocks. Of course, given the massive advance for U.S. stocks in general since the Christmas Eve closing lows, and the pessimism then surrounding the trade skirmish with China, the tightening of monetary policy from the Federal Reserve and the slowing of the global economy, we suspect that most are pleasantly surprised by the magnitude of the gains, even if Value stocks have only recently joined the Bull Market party.

The Only Problem with Market Timing...

Bull Market 12.24.18 - 4.12.19	Bear Market 9.20.18 - 12.24.18	Bloomberg Symbol	Index
Stock Indexes			
21.99	-17.79	INDU Index	Dow Jones Industrial Average
29.36	-22.63	CCMP Index	NASDAQ Composite Index
24.96	-19.69	RIY Index	Russell 1000 Index
25.66	-26.08	RTY Index	Russell 2000 Index
25.01	-20.18	RAY Index	Russell 3000 Index
24.45	-19.37	SPX Index	S&P 500 Index
28.49	-21.44	RLG Index	Russell 1000 Growth Index
21.55	-17.94	RLV Index	Russell 1000 Value Index
28.95	-27.83	RUO Index	Russell 2000 Growth Index
22.30	-24.24	RUJ Index	Russell 2000 Value Index
28.53	-21.94	RAG Index	Russell 3000 Growth Index
21.60	-18.40	RAV Index	Russell 3000 Value Index
26.03	-20.15	SGX Index	S&P 500 Growth Index
22.70	-18.44	SVX Index	S&P 500 Value Index
27.92	-22.33	SPXPG Index	S&P 500 Pure Growth
23.21	-22.39	SPXPV Index	S&P 500 Pure Value
14.69	-14.02	MXWOU Index	MSCI World Ex. U.S.
	Source: Bloomberg		

We suspect that some will still argue that the big gains since Christmas Eve simply represent a Bear Market rally, but the move up over the first two weeks of Q2 has pushed the returns on even the Value indexes above 20% since the 12.24.18. True, foreign stocks, from which we also have found undervalued names, have rebounded only 14.7%, but they were not battered as badly in Q4.

This is especially true, given that last week, the International Monetary Fund (IMF) added its name to the ranks of economic forecasters downgrading their outlook for worldwide GDP growth.

IMF Lowers its Global Growth Forecast

WORLD ECONOMIC OUTLOOK: GROWTH SLOWDOWN, PRECARIOUS RECOVERY

Table 1.1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

		Projections		Difference from January 2019 *WEO Update*[1]		Difference from October 2018 WEO[1]	
	2018	2019	2020	2019	2020	2019	2020
World Output	**3.6**	**3.3**	**3.6**	**–0.2**	**0.0**	**–0.4**	**–0.1**
Advanced Economies	**2.2**	**1.8**	**1.7**	**–0.2**	**0.0**	**–0.3**	**0.0**
United States	2.9	2.3	1.9	–0.2	0.1	–0.2	0.1
Euro Area	1.8	1.3	1.5	–0.3	–0.2	–0.6	–0.2
Germany	1.5	0.8	1.4	–0.5	–0.2	–1.1	–0.2
France	1.5	1.3	1.4	–0.2	–0.2	–0.3	–0.2
Italy	0.9	0.1	0.9	–0.5	0.0	–0.9	0.0
Spain	2.5	2.1	1.9	–0.1	0.0	–0.1	0.0
Japan	0.8	1.0	0.5	–0.1	0.0	0.1	0.2
United Kingdom	1.4	1.2	1.4	–0.3	–0.2	–0.3	–0.1
Canada	1.8	1.5	1.9	–0.4	0.0	–0.5	0.1
Other Advanced Economies[2]	2.6	2.2	2.5	–0.3	0.0	–0.3	0.0
Emerging Market and Developing Economies	**4.5**	**4.4**	**4.8**	**–0.1**	**–0.1**	**–0.3**	**–0.1**
Commonwealth of Independent States	2.8	2.2	2.3	0.0	0.0	–0.2	–0.1
Russia	2.3	1.6	1.7	0.0	0.0	–0.2	–0.1
Excluding Russia	3.9	3.5	3.7	–0.2	0.0	–0.1	0.0
Emerging and Developing Asia	6.4	6.3	6.3	0.0	–0.1	0.0	–0.1
China	6.6	6.3	6.1	0.1	–0.1	0.1	–0.1
India[3]	7.1	7.3	7.5	–0.2	–0.2	–0.1	–0.2
ASEAN-5[4]	5.2	5.1	5.2	0.0	0.0	–0.1	0.0
Emerging and Developing Europe	3.6	0.8	2.8	0.1	0.4	–1.2	0.0
Latin America and the Caribbean	1.0	1.4	2.4	–0.6	–0.1	–0.8	–0.3
Brazil	1.1	2.1	2.5	–0.4	0.3	–0.3	0.2
Mexico	2.0	1.6	1.9	–0.5	–0.3	–0.9	–0.8
Middle East, North Africa, Afghanistan, and Pakistan	1.8	1.5	3.2	–0.9	0.2	–1.2	0.2
Saudi Arabia	2.2	1.8	2.1	0.0	0.0	–0.6	0.2
Sub-Saharan Africa	3.0	3.5	3.7	0.0	0.1	–0.3	–0.2
Nigeria	1.9	2.1	2.5	0.1	0.3	–0.2	0.0
South Africa	0.8	1.2	1.5	–0.2	–0.2	–0.2	–0.2
Memorandum							
European Union	2.1	1.6	1.7	–0.3	–0.1	–0.4	–0.1
Low-Income Developing Countries	4.6	5.0	5.1	–0.1	0.0	–0.2	–0.2
Middle East and North Africa	1.4	1.3	3.2	–0.9	0.3	–1.2	0.3
World Growth Based on Market Exchange Rates	3.1	2.7	2.9	–0.3	0.0	–0.4	0.0

Stocks had another temporary tumble on 4.9.19, supposedly on renewed concerns for global economic growth, after the International Monetary Fund lowered its 2019 projection by 0.2%. Of course, the IMF still expects worldwide GDP growth of 3.3% in 2019 and 3.6% in 2020, and the markets rebounded by week's end.

The IMF explained, "After strong growth in 2017 and early 2018, global economic activity slowed notably in the second half of last year, reflecting a confluence of factors affecting major economies. China's growth declined following a combination of needed regulatory tightening to rein in shadow banking and an increase in trade tensions with the United States. The euro area economy lost more momentum than expected as consumer and business confidence weakened and car production in Germany was disrupted by the introduction of new emission standards; investment dropped in Italy as sovereign spreads widened; and external demand, especially from emerging Asia, softened. Elsewhere, natural disasters hurt activity in Japan. Trade tensions increasingly took a toll on business confidence and, so, financial market sentiment worsened, with financial conditions tightening for vulnerable emerging markets in the spring of 2018 and then in advanced economies later in the year, weighing on global demand. Conditions have eased in 2019 as the US Federal Reserve signaled a more accommodative monetary policy stance and markets became more optimistic about a U.S.–China trade deal, but they remain slightly more restrictive than in the fall."

The IMF's outlook for the all-important rate of growth for the U.S. economy now stands at 2.3% this year and 1.9% next year, which is actually a smidge better than the current Federal Reserve projections. And, despite a relatively pessimistic projection of 2.1% for 2019 domestic GDP growth, Jerome Powell & Co. seem comfortable with where things stand interest-rate wise. The minutes of the March Fed meeting were released last week, with the Fed Chair and his

colleagues then stating, "A majority of participants expected that the evolution of the economic outlook and risks to the outlook would likely warrant leaving the target range unchanged for the remainder of the year."

While the Fed reserves the right to change its mind as Mr. Powell and his predecessors have oft-said that the FOMC will remain "data-dependent," last week's batch of statistics suggested that the economy was not-too-hot to argue for additional rate hikes and not-too-cold to suggest a return to cuts in the Fed Funds rate, whether in actual numbers calculated by Uncle Sam,…

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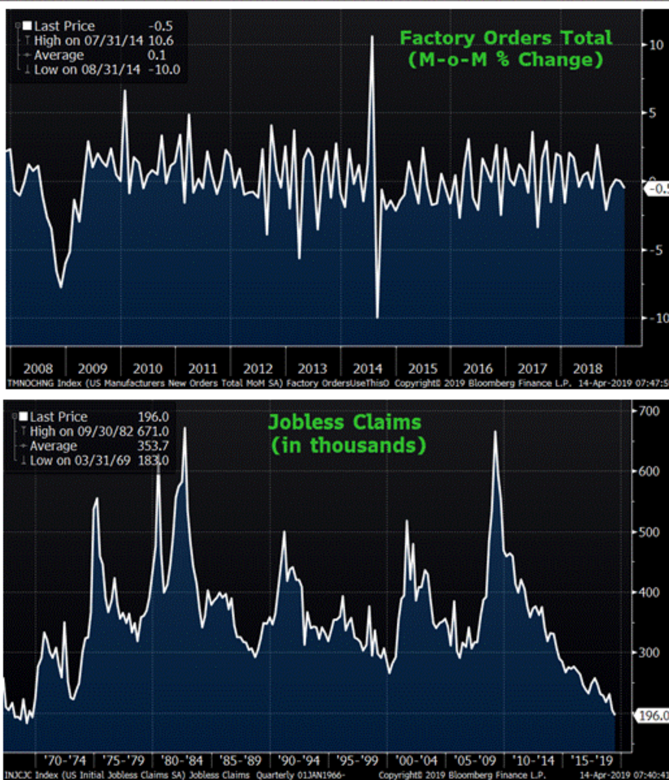
THE PRUDENT SPECULATOR
Latest Econ Numbers were Mixed



While the 0.5% drop in factory orders for February was actually a tiny bit better than expected, the durable goods component skidded 1.6%, with the manufacturing industry extending its disappointing run in 2019. On the other hand, the latest number of first-time claims for unemployment benefits fell in the latest week to below 200,000 for the first time in 50 years, an impressive feat given how much the labor force has expanded since then.

…or in surveys of confidence at the consumer and small-business levels.

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THE PRUDENT SPECULATOR
Solid Consumer and Small Biz Sentiment

The first read on consumer sentiment for April from the University of Michigan trailed expectations, coming in at 96.9, versus 98.4 in March, though the figure was well above the historical average. Meanwhile, the NFIB Small Business Optimism Index edged up to 101.8 in March, with NFIB stating, "Overall, the Index anticipated solid growth, keeping the economy at 'full employment' with no signs of a recession in the near term."

Equally important, given the Fed's dual mandate of fostering economic conditions that achieve both maximum sustainable employment and stable prices, the latest read on inflation at the consumer level was tame. Indeed, the Consumer Price Index for March came in at a 1.9% increase, with the CPI less Food and Energy rising 2.0%.

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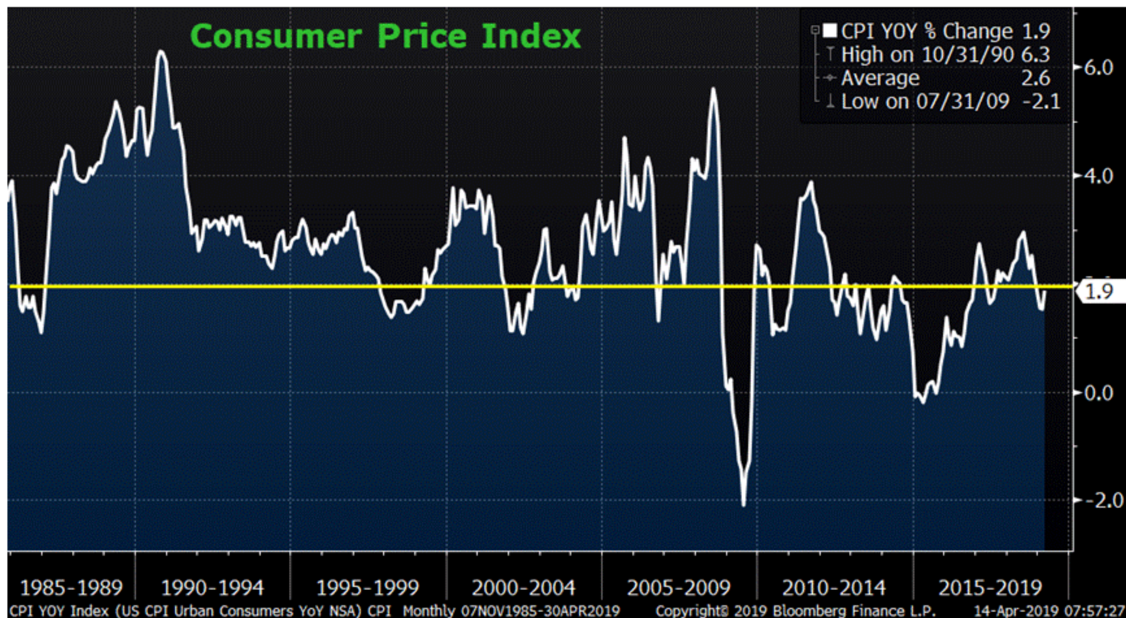
THE PRUDENT SPECULATOR
Inflation Remains Relatively Low

The latest read on prices at the consumer level shows that this measure of inflation continues to be subdued, supporting the Federal Reserve's statement of a 2% objective over the medium term.



While neither CPI number is presently worrisome, we know that monetary policy works with a lag and inflation can quickly accelerate, as was the case back in 1966. We certainly are not suggesting that we will see a repeat of 1966-1981, and that period's 7.0% annualized inflation rate, on the horizon, but it is fascinating to see what happened to equities during that supposedly dire period.

THE PRUDENT SPECULATOR
Fear Over Facts - Inflation

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Why an Unpleasant Inflation Surprise Could Be Coming

If inflation turns up, economists have long assumed it would do so slowly, giving the Fed plenty of time to respond. But Michael Feroli of J.P. Morgan notes this assumption is built on models in which the world behaves in a predictable, linear way. In fact, he says, the world isn't linear and inflation can change suddenly for unexpected reasons: it "is sluggish and slow-moving, until it isn't."

A case in point: in 1966, inflation, which had run below 2% for nearly a decade, suddenly accelerated to over 3%. Some of the circumstances echo the present: unemployment had slid to 4%, taxes had been cut and federal spending for the Vietnam War and Lyndon Johnson's "Great Society" programs was surging. Deutsche Bank economists note the budget deficit jumped by more than 2% of gross domestic product between 1965 and 1968, similar to what they project between 2016 and 2019. Except in recessions, stimulus of this size "is unprecedented outside of these two episodes," they said.

The effect of an overheating economy was then compounded by policy errors. Fed chairmen William McChesney Martin Jr. and Arthur Burns were too optimistic about how low unemployment could go without pushing prices higher, and succumbed to pressure from Johnson and then Richard Nixon to keep interest rates low. ***From 1966 to 1981, inflation and interest rates climbed to double digits, decimating stock and bond values.***

Wall Street Journal, February 28, 2018

In yet another example of fear over facts, *The Wall Street Journal* warned of dire consequences should we have another inflation and interest rate scare like 1965-1981. If past is prologue, as Value investors, we hope they are right.

Annualized Returns December 1965 - December 1981	
Inflation	7.0%
IA SBBI US 1 Yr Treasury TR	7.1%
IA SBBI US 30 Day TBill TR	6.8%
IA SBBI US LT Govt Bonds TR	2.5%
IA SBBI US IT Govt Bonds TR	5.8%
IA SBBI US LT Corp Bonds TR	2.9%
FF Growth Stocks TR	7.4%
S&P 500 TR	6.0%
Dow Jones Industrials TR	3.9%
FF Value Stocks TR	13.4%
Source: Morningstar	

No doubt, folks have seen the above slide before, but we always seek to debunk market myths with actual return figures as we know how difficult it can be to stay on track with a long-term investment plan, given the cacophony of negative market commentary screaming for reader attention.

That does not mean that all disconcerting data should be dismissed nor does it mean that the recent rally will continue, especially as the advent of Q1 earnings reporting season is likely to bring added volatility, but we remain optimistic about the long-term prospects of our broadly diversified portfolios of what we believe to be undervalued stocks, primarily of dividend paying companies. To be sure, we are always braced for pullbacks, which are very much normal, but history shows that those willing to ride through the inevitable ups and downs, will usually end up with very attractive long-term gains.

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THE PRUDENT SPECULATOR
Volatility is Normal: Value/Divs Win Race

Selloffs, downturns, pullbacks, corrections and even Bear Markets are events that equity investors always have had to endure on their way to the best long-term performance of any of the financial asset classes.

Advancing Markets

Minimum Rise %	Average Gain	Average # Days	Count	Frequency (in Years)	Last Start	Last End
20.0%	107.9%	916	26	3.5	3/9/2009	9/20/2018
17.5%	66.4%	572	38	2.4	12/24/2018	4/12/2019
15.0%	66.2%	557	44	2.1	12/24/2018	4/12/2019
12.5%	43.8%	331	71	1.3	12/24/2018	4/12/2019
10.0%	34.9%	247	105	0.9	12/24/2018	4/12/2019
7.5%	23.4%	147	154	0.6	12/24/2018	4/12/2019
5.0%	14.7%	73	298	0.3	12/24/2018	4/12/2019

Declining Markets

Minimum Decline %	Average Loss	Average # Days	Count	Frequency (in Years)	Last Start	Last End
-20.0%	-34.3%	371	25	3.6	1/6/2009	3/9/2009
-17.5%	-30.3%	222	37	2.4	9/20/2018	12/24/2018
-15.0%	-28.3%	192	43	2.1	9/20/2018	12/24/2018
-12.5%	-22.6%	140	70	1.3	9/20/2018	12/24/2018
-10.0%	-19.3%	102	104	0.9	9/20/2018	12/24/2018
-7.5%	-15.4%	65	153	0.6	9/20/2018	12/24/2018
-5.0%	-10.9%	37	297	0.4	12/3/2018	12/24/2018

From 02.20.28 through 4.12.19. Price return series. We defined a Declining Market as an instance when stocks dropped the specified percentage or more without a recovery of equal magnitude, and an Advancing Market as in instance when stocks appreciated the specified percentage or more without a decline of equal magnitude. SOURCE: Kovitz Investment Group using data from Bloomberg, Morningstar and Ibbotson Associates

LONG-TERM RETURNS

	Annualized Return	Standard Deviation
Value Stocks	13.2%	25.9%
Growth Stocks	9.5%	21.4%
Dividend Paying Stocks	10.5%	18.0%
Non-Dividend Paying Stocks	8.8%	29.5%
Long-Term Corporate Bonds	5.9%	7.5%
Long-Term Gov't Bonds	5.4%	8.5%
Intermediate Gov't Bonds	5.1%	4.3%
Treasury Bills	3.3%	0.9%
Inflation	2.9%	1.8%

From 06.30.27 through 02.28.19. Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index. SOURCE: Kovitz Investment Group using data from Professors Eugene F. Fama and Kenneth R. French and Ibbotson Associates

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 offers updates on a couple of our companies that had news last week that was of sufficient importance to trigger a review of their respective Target Prices.

You can count our editor as one of the few ESPN+ subscribers, but we are thinking that the whole Investment Team will be subscribing to the new Disney+ when it launches on November 12. **Walt Disney** (DIS – $130.06) announced at its 2019 Investor Day that the company's hotly anticipated direct-to-consumer platform will cost $6.99 per month and include content from brands like *Disney*, *Pixar*, *Marvel*, *Star Wars* and *National Geographic*. The service will be available on a wide variety of mobile and connected devices, will support 4K HDR and will be available first in the U.S. (and rolled out globally over the next two years). DIS expects to release 25 original series and 10 original films in the first year.

CEO Bob Iger said, "Disney+ marks a bold step forward in an exciting new era for our company—one in which consumers will have a direct connection to the incredible array of creative content that is The Walt Disney Company's hallmark. We are confident that the

combination of our unrivaled storytelling, beloved brands, iconic franchises, and cutting-edge technology will make Disney+ a standout in the marketplace, and deliver significant value for consumers and shareholders alike."

Shares rose more than 11.5% to record-high levels in Friday's trading session, as investors signaled grand enthusiasm for the platform. The company expects Disney+ to have between 60 million and 90 million subscribers by 2024, with just one third of the subscriber base located in the U.S. DIS will invest about $1 billion of cash for content in fiscal 2020, ramping up to $2 billion per year by 2024.

While ESPN+ has been a little bit of a yawn, we are pleased –and not surprised– that the non-sporting content of Disney is likely to generate such strong worldwide demand. We continue to like the focus on DTC, as cutting out middlemen should yield stronger financial results and perhaps a more positive customer experience. In addition, the Disney film studios have been able to churn out plenty of winners that have dwarfed the inevitable losers, and we see no change in that success formula anytime soon. DIS shares yield 1.4%. Our Target Price, for the time being, has been bumped to at $159, though we note that if DIS garnered a P/E just half of Disney+ streaming-video rival Netflix's current 108 multiple, the shares would be trading for $380!

Shares of **National Oilwell Varco** (NOV – $26.87) dropped more than 8% on Friday after the oil services concern reported operational updates that left investors less than thrilled. NOV expects Q1 revenue of $1.94 billion, which is lower than the company's own estimate and analyst expectations of $2.1 billion.

CEO Clay Williams said, "The severity of the decline in demand for oilfield equipment resulting from the sharp fall in oil prices during late 2018, further compounded by capital austerity that has taken hold in upstream oil and gas markets, was greater than we expected. Market weakness was particularly acute among our oilfield service company customers resulting in a disproportionate impact to our Completion & Production Solutions segment; however, all three operating segments will report results below prior expectations. On a consolidated basis we expect to report a GAAP operating loss of approximately $48 million and Adjusted EBITDA of approximately $140 million."

Despite rising energy prices recently, the company has struggled in the international and offshore markets. The energy sector continues to be a turbulent place to invest, but we are optimistic about the right-sizing and optimization of its operations and costs, which should prove beneficial when the always-cyclical industry begins to swing back upward. We still believe in long-term energy demand growth with the global population expected to expand to 9 billion and economic output more than doubling by 2040. For NOV, this should create opportunities as energy companies move toward unconventional technologies, replace aging rig fleets, build out deepwater fleets and develop floating production systems. Still, the big step backward in the latest quarter in mind, our Target Price has been trimmed to $37.

Banking giant **JPMorgan Chase** (JPM – $111.21) posted earnings per share of $2.59, versus the $2.35 estimate, in fiscal Q1 2019. The bank had Sales & Trading revenue of $3.73 billion (vs. $3.67 billion est.), Investment Banking revenue of $1.75 billion (vs. $1.63 billion est.) and

overall revenue of $29.85 billion (vs. $28.36 billion est.). The company's Tier 1 ratio was 12.1%, while the return on equity was 16%. Shares gained more than 4% on the news and allayed some investor concerns about the possibility of a looming recession.

JPM CFO Marianne Lake said, "Highlights for Q1 include core loan growth ex CIB (Corporate & Investment Bank) of 5% with known trends continuing to progress as expected. Credit performance remains strong across businesses. We saw record client investment assets in Consumer of over $300 billion and record new money paid this quarter. And double-digit growth in both comp sales and merchant processing volumes up 10% and 13% respectively. That's number one in global IB fees and then meaningful share which are well about 9% this quarter. In the Commercial Bank, we had record gross Investment Banking revenue. In Asset & Wealth Management record, AUM and client assets and the firm delivered another quarter of strong positive operating leverage. Revenue of $29.9 billion was up $1.3 billion or 5% year-on-year driven by net interest income which was up $1.1 billion or 8% of higher rates as well as balance sheet price and mix."

Ms. Lake continued, "This quarter that really showcases the strength of the Fund's operating model, benefiting from diversification and scale and our consistent investment agenda. We delivered record revenue and net income in the clean first quarter performance despite some hangover from the fourth quarter. Underlying drivers across our businesses continue to propel us forward and in March and coming into April, the economic backdrop was increasingly constructive, client sentiment has recovered and recent global data shows encouraging momentum."

We think that JPM continues to execute well, while we remain quite fond of the fortress balance sheet. JPM shares are currently trading for just 11.1 times NTM projections, while carrying a dividend yield of 2.9%. With the continued progress and momentum, we believe that the financial titan is well-positioned for the next few years. Our Target Price for JPM has been raised to $139.

PNC Financial Services (PNC – $132.70) delivered a solid quarter that saw the big bank beat analyst bottom-line expectations. PNC reported adjusted EPS of $2.70, versus the $2.61 consensus estimate. Net interest margin increased to 2.98% in Q1, while the Tier 1 ratio was 9.8% and the return on equity was 11.1%. Loans grew to $232.3 billion from $226.3 billion quarter-over-quarter and revenue increased to $4.31 billion (vs. $4.26 billion est.). For 2019, PNC expects revenue to be on "the higher end of low-single digits," with average loans up 3% to 4%. For Q2, PNC expects net interest income "up low-single digits" and non-interest income between $275 million and $325 million.

CEO Bill Demchak said, "As we look forward from here, we still feel very good about the economy, notwithstanding some mixed signals from economic indicators, we have seen very little from our clients that would indicate that there is inherent weakness in the U.S. economy. Having said that, there is clear weakness in the global economy, pressure from trade and fears of a hard Brexit that will continue to weigh on the U.S. economy. Regardless of the path ahead, we believe having a strong balance sheet, a solid mix of fee-based businesses, significant focus on

expense management and differentiated strategies for organic expansion will provide the foundation for success."

CFO Rob Reilly added, "Our overall credit quality remained strong. However, at these historically low levels of provision, we will continue to see some volatility quarter-to-quarter, due to the pace and mix of loan growth and the timing of specific loan reserves and releases. We believe that we continue to be appropriately reserved for the current environment as reflected in our consistently strong credit quality metrics. And importantly, we're not seeing any signs of broad-based credit issues. In summary, PNC posted very good first quarter results. For the balance of this year, we expect continued steady growth in GDP, and we no longer expect an increase in short-term interest rates this year. Our full year guidance remains consistent with what we shared on our fourth quarter earnings call in January."

PNC repurchased 5.9 million shares for $725 million in Q1 and returned $438 million to shareholders via dividends. While competition for deposits continues to stiffen, we remain relatively pleased with PNC's ability to control overall costs and drive fee income. Additionally, we like that overall credit quality has remained strong. We support management's continued effort to evolve and expand into new markets, and we think the firm's asset management business will add to the bottom line. PNC continues to see declines in non-performing loans and total delinquencies, which we view as a positive for the company and a positive overall barometer for the business environment. PNC currently trades for 11.4 times NTM earnings projections, while the shares yield 2.9%. Our Target Price has been hiked to $168.