

Market Commentary Monday, July 15, 2019

July 15, 2019

EXECUTIVE SUMMARY

Dow 27,000 & S&P 3000 – Emotional Roller-Coaster Generally Moves Higher Over Time

Sentiment – Still Not Much Enthusiasm for Equities

Bonds – Still Attracting Plenty of Love Even as Risks are not Insignificant

Powell on Capitol Hill – Looking Like the Fed Will Be Cutting Interest Rates Soon

Income Investments – Stocks Remain Very Competitive

Rising Tide – 20 Undervalued Dividend-Paying Boats Yet to Be Lifted

Stock Updates – BASFY, COHU, MDC, DAL, Pharma/Biotech & JNJ

Market Review

While it was hardly a great week for the majority of stocks, as the average constituent in the Russell 3000 index dropped 0.25%, it was a momentous occasion for the most widely followed of the equity market benchmarks. Indeed, the S&P 500 crossed over the 3000 mark and the Dow Jones Industrial Average pushed through the 27,000 level, with both indexes hitting all-time highs. The gains added to their terrific rebound since the big selloff in last year's fourth quarter that saw the S&P skid 20.2% on an intra-day basis from its October 3, 2018 high to its Boxing Day low, and plummet 19.8% on a closing basis from the September 20, 2018 high to its Christmas Eve low.

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2018 Bear Market: 10.3.18 – 12.26.18

While some correctly called it a Bear Market, given the 20.2% decline on an intraday basis from the high on 10.3.18 to the low on 12.26.18, the loss from 9.20.18 to 12.24.18 on a closing basis was “only” 19.8%



No doubt, it has not been easy for many folks to stay invested through thick and thin,...

THE PRUDENT SPECULATOR Managing Emotions a Challenge



While we have come to believe that there isn't a camera for which he won't pose, there may be no better visual aid to remind folks that investing is an emotional roller coaster than Wall Street's most photographed trader (per *Marketwatch*) Peter Tuchman. Incredibly, it was just six weeks ago that Mr. Tuchman was looking very concerned about the equity markets, following an awful month of May, yet his latest snapshot, complete with Dow 27,000 cap, shows a little enthusiasm.

...even as significant ups and downs are always part of the investment process.



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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%	108.4%	927	26	3.5	3/9/2009	7/12/2019
17.5%	66.6%	575	38	2.4	12/24/2018	7/12/2019
15.0%	66.3%	559	44	2.1	12/24/2018	7/12/2019
12.5%	43.9%	333	71	1.3	12/24/2018	7/12/2019
10.0%	34.5%	242	97	0.9	12/24/2018	7/12/2019
7.5%	23.4%	147	154	0.6	12/24/2018	7/12/2019
5.0%	14.7%	72	299	0.3	6/3/2019	7/12/2019

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%	-19.5%	103	96	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	298	0.4	4/30/2019	6/3/2019

From 02.20.28 through 7.12.19. 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 an 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	13.1%	25.9%
Growth Stocks	9.4%	21.4%
Dividend Paying Stocks	10.4%	18.0%
Non-Dividend Paying Stocks	8.8%	29.5%
Long-Term Corporate Bonds	6.0%	7.5%
Long-Term Gov't Bonds	5.5%	8.5%
Intermediate Gov't Bonds	5.1%	4.4%
Treasury Bills	3.3%	0.9%
Inflation	3.0%	1.8%

From 06.30.27 through 05.31.19. 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

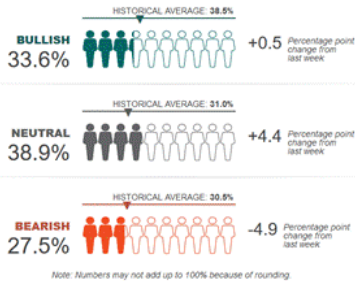
And, despite the near- and long-term gains enjoyed by U.S equities, it remains puzzling why so many are disinterested in domestic stocks,...

AAll Investor Sentiment Survey

Since 1987, AAll members have been answering the same simple question each week. The results are compiled into the AAll Investor Sentiment Survey, which offers insight into the mood of individual investors.

Survey Results for Week Ending 7/10/2019

Data represents what direction members feel the stock market will be in next 6 months.



The AAll Investor Sentiment Survey has become a widely followed measure of the mood of individual investors. The weekly survey results are published in financial publications including Barron's and Bloomberg and are widely followed by market strategists, investment newsletter writers and other financial professionals.

July 11, 2019 - Pessimism among individual investors about the short-term direction of the stock market is at its lowest level since early May.

Bullish sentiment, expectations that stock prices will rise over the next six months, edged up 0.5 percentage points to 33.6%. Though a small increase, it puts optimism at a nine-week high. Nonetheless, bullish sentiment is below its historical average of 38.5% for the 21st time this year.

Bearish sentiment, expectations that stock prices will fall over the next six months, fell 4.9 percentage points to 27.5%. Pessimism was last lower on May 8, 2019 (23.2%). This week's decline puts bearish sentiment below its historical average of 30.5% for the first time in nine weeks.

With stock indexes at record highs, it is fascinating that optimism remains well below normal in the latest AAll Sentiment Survey, while flows into domestic stocks in the most recent week were extraordinarily negative via data compiled on mutual and exchange traded funds by ICI.

Combined Estimated Long-Term Fund Flows and ETF Net Issuance					
Millions of dollars					
Week Ended	7/2/2019	6/26/2019	6/19/2019	6/12/2019	6/5/2019
Total Equity	-28,759	-8,830	10,121	5,039	-9,636
Domestic	-25,153	-5,417	11,676	6,195	-8,210
World	-3,606	-3,413	-1,555	-1,156	-1,427
Hybrid	-560	-1,947	-156	-1,282	-1,017
Total Bond	10,440	10,528	7,932	11,934	4,614
Taxable	8,814	8,011	6,342	10,653	3,154
Municipal	1,626	2,517	1,590	1,281	1,460
Commodity	143	1,703	389	317	681
Total	-18,735	1,454	18,285	16,008	-5,359

Source: Investment Company Institute

...and why so much money continues to pour into bonds,...



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Bonds Remain Stunningly Popular

With the S&P 500 at an all-time high, many think folks are infatuated with U.S. equities, but data from the ICI show that a massive net sum of money has flowed out of domestic stock mutual funds/ETFs over the last 4-plus years. Bonds have been the major beneficiary of the exodus.

Investment Company Institute											
Long-Term Mutual Fund and Exchange-Traded Fund (ETF) Flows											
Millions, U.S. dollars											
Month	Stocks Domestic	Bonds Total	Month	Stocks Domestic	Bonds Total	Month	Stocks Domestic	Bonds Total	Month	Stocks Domestic	Bonds Total
Jan-15	-14,465	17,535	Mar-16	7,711	29,296	May-17	-10,816	33,128	Jul-18	984	25,956
Feb-15	5,547	30,321	Apr-16	-12,610	22,114	Jun-17	-8,022	29,420	Aug-18	-6,658	19,585
Mar-15	-1,494	4,905	May-16	-14,252	16,925	Jul-17	-12,386	29,164	Sep-18	880	18,102
Apr-15	-34,681	11,027	Jun-16	-15,530	16,623	Aug-17	-18,937	26,418	Oct-18	-12,009	-32,405
May-15	-17,287	5,010	Jul-16	292	33,575	Sep-17	-9,636	36,476	Nov-18	2,780	-11,250
Jun-15	-7,023	6,324	Aug-16	-9,956	30,859	Oct-17	3,211	38,818	Dec-18	-28,957	-49,413
Jul-15	-14,864	-1,255	Sep-16	-5,713	24,669	Nov-17	-4,429	21,628	Jan-19	-21,191	29,298
Aug-15	-18,569	-18,122	Oct-16	-23,109	13,855	Dec-17	-9,066	19,158	Feb-19	3,604	45,094
Sep-15	-4,725	-10,849	Nov-16	22,993	-13,289	Jan-18	10,777	56,779	Mar-19	-3,658	38,363
Oct-15	-807	15,397	Dec-16	18,859	-4,142	Feb-18	-41,447	1,772	Apr-19	-5,326	40,472
Nov-15	654	-5,573	Jan-17	4,966	31,061	Mar-18	-22,173	15,920	May-19	-24,375	21,018
Dec-15	476	-25,043	Feb-17	17,530	34,026	Apr-18	-7,422	22,435	Jun-19	4,636	35,019
Jan-16	-27,222	7,686	Mar-17	8,906	36,632	May-18	9,970	13,108	Totals:	-374,640	882,131
Feb-16	-9,108	11,915	Apr-17	-8,370	22,116	Jun-18	-13,123	14,470			

...especially when interest rates are extraordinarily low (or even negative) around the world,...

It must be new math European fixed income investors used last week when they rationalized buying the new issue of zero coupon Bunds at prices near €103. After all, in just three days, the price of the German government bond (which if held to maturity provided a loss of 0.31% per year), declined by 0.86%. Of course, as the two negatives cancel, they more than doubled their expected full-year return in just three



...which, in our view, amplifies the risk of potential losses associated with fixed income investments.

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Stocks Not the Only Volatile Asset Class

Though we respect that U.S. Treasuries are far less volatile than equities, action in the government bond market last week illustrated that supposedly safe fixed income investments can suffer sizable short-term setbacks. Indeed, the yield on the benchmark 10-Year Treasury jumped from 2.03% to 2.12%, with the resulting price drop equaling 0.77%.

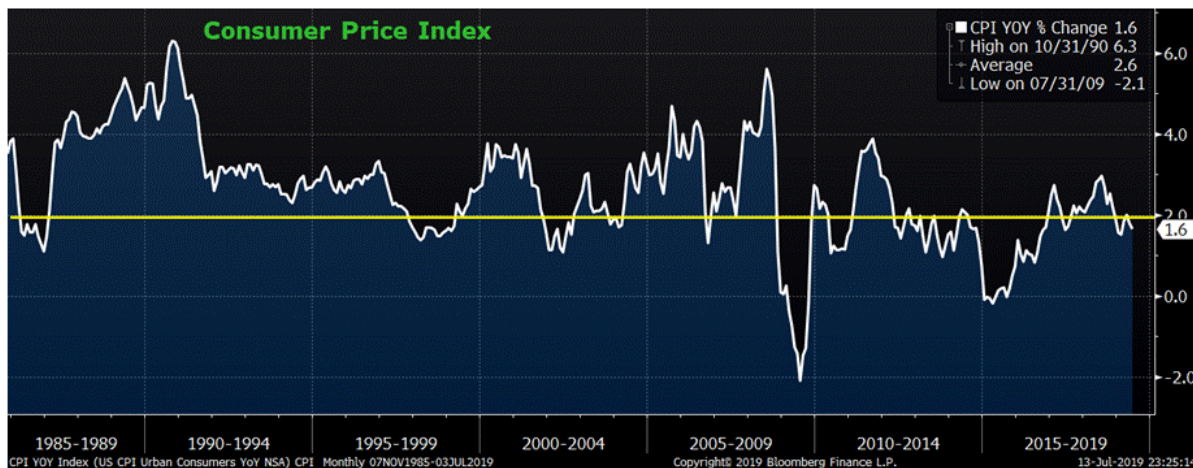


And, it was somewhat surprising to see Treasuries drop in price last week, given that Federal Reserve Chair Jerome Powell was on Capitol Hill where his prepared remarks included, “The economy performed reasonably well over the first half of 2019, and the current expansion is now in its 11th year. However, inflation has been running below the Federal Open Market Committee’s (FOMC) symmetric 2 percent objective,...

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Inflation Continues to Run Unusually Low

The Consumer Price Index for June came in at a very tame 1.6% year-over-year gain, matching the latest (for the month of May) reading on the “core” Personal Consumption Expenditure (PCE), the latter the Federal Reserve’s preferred measure of inflation, with both gauges remaining below the desired 2.0% level, meaning that there is plenty of cover for Jerome Powell & Co. to reduce the Federal Funds rate target.

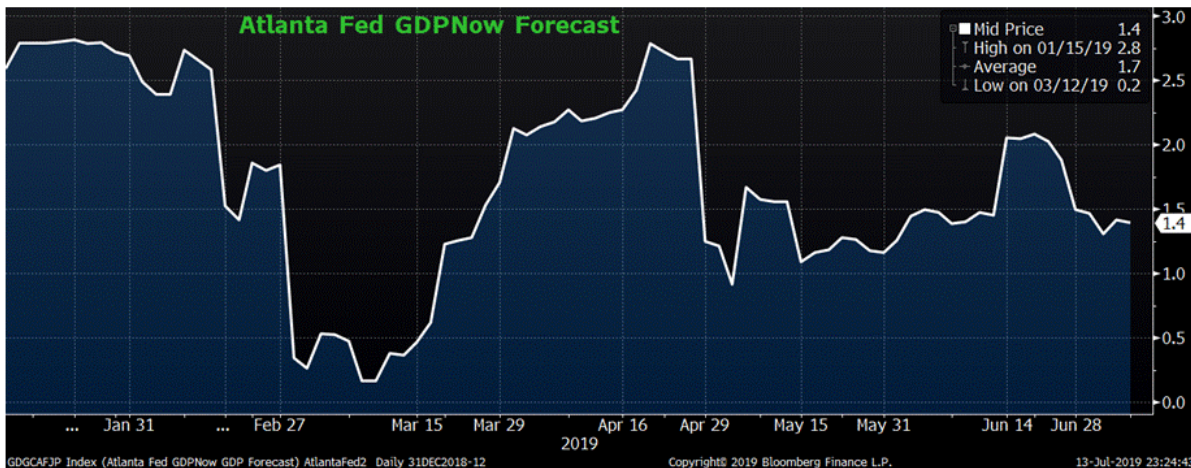


...and crosscurrents, such as trade tensions and concerns about global growth, have been weighing on economic activity and the outlook.”

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Slowing Growth Argues for Fed Rate Cuts

The John Kenneth Galbraith quotation, “The only function of economic forecasting is to make astrology look respectable,” appears quite apt this year, as four months ago, projections for U.S. GDP growth were near zero, only to rebound one month later to a 2.8% annualized growth estimate, and then sink anew to a 1.4% guess today. Still, expectations for sub-par growth suggest the Fed has reason to lower interest rates.



Following Mr. Powell’s testimony, the likelihood of a 50-basis-point rate reduction at the upcoming July 31 FOMC Meeting jumped to 19.5% from 1.5% the week prior.

Over the past week, futures players increased their bets on rate cuts, with the odds of a 75 basis-point or greater paring by year-end climbing to 56.9% from 47.6%. Of course, such a reduction to a range of 1.5% to 1.75% or lower is below any of the latest FOMC multi-year projections.

FOMC Participants' Fed Funds Rate Target Level				
Number with each projection				
Midpoint of Target Range	2019	2020	2021	Longer Run
3.375				
3.250				2
3.125		1	1	
3.000				2
2.875			1	
2.750				3
2.625	1	2	3	
2.500				8
2.375	8	5	5	1
2.250				
2.125	1	2	2	
2.000				
1.875	7	7	5	
1.750				

Source: Federal Reserve, June 19, 2019

Export		Instrument		Futures: Fed Funds - Effective		World Interest Rate Probability		Fed Effective Rate		2.40	
United States											
Overview											
Future Implied Probability											
Current Implied Probabilities											
Add/Remove Rates											
Calculated 07/12/2019											
Based on rate 2.25-2.50											
Dates	Meeting	Hike Prob	Cut Prob	1-1.25	1.25-1.5	1.5-1.75	1.75-2	2-2.25	Fwd Rate		
07/31/2019		0.0%	100.0%	0.0%	0.0%	0.0%	19.5%	80.5%	2.09		
09/18/2019		0.0%	100.0%	0.0%	0.0%	13.0%	60.3%	26.7%	1.93		
10/30/2019		0.0%	100.0%	0.0%	5.6%	33.4%	45.8%	15.2%	1.82		
12/11/2019		0.0%	100.0%	2.2%	16.5%	38.2%	33.8%	9.2%	1.72		
01/29/2020		0.0%	100.0%	5.9%	22.1%	37.1%	27.4%	6.8%	1.66		
03/18/2020		0.0%	100.0%	9.2%	25.2%	35.1%	23.3%	5.5%	1.60		
04/29/2020		0.0%	100.0%	11.1%	26.3%	33.8%	21.2%	4.8%	1.57		
06/10/2020		0.0%	100.0%	14.0%	27.8%	31.3%	18.0%	3.9%	1.53		
07/29/2020		0.0%	100.0%	15.5%	28.2%	29.9%	16.5%	3.5%	1.50		

Export		Instrument		Futures: Fed Funds - Effective		World Interest Rate Probability		Fed Effective Rate		2.41	
United States											
Overview											
Future Implied Probability											
Current Implied Probabilities											
Add/Remove Rates											
Calculated 07/05/2019											
Based on rate 2.25-2.50											
Dates	Meeting	Hike Prob	Cut Prob	1-1.25	1.25-1.5	1.5-1.75	1.75-2	2-2.25	Fwd Rate		
07/31/2019		0.0%	100.0%	0.0%	0.0%	0.0%	1.5%	98.5%	2.13		
09/18/2019		0.0%	100.0%	0.0%	0.0%	1.1%	74.3%	24.6%	1.94		
10/30/2019		0.0%	100.0%	0.0%	0.3%	22.3%	59.9%	17.5%	1.87		
12/11/2019		0.0%	100.0%	0.1%	9.5%	38.0%	42.1%	10.2%	1.77		
01/29/2020		0.0%	100.0%	2.6%	17.0%	39.1%	33.8%	7.5%	1.70		
03/18/2020		0.0%	100.0%	5.5%	21.5%	38.0%	28.4%	6.0%	1.65		
04/29/2020		0.0%	100.0%	7.7%	23.7%	36.7%	25.4%	5.2%	1.62		
06/10/2020		0.0%	100.0%	10.9%	26.3%	34.5%	21.3%	4.1%	1.57		
07/29/2020		0.0%	100.0%	12.6%	27.2%	33.0%	19.4%	3.7%	1.54		

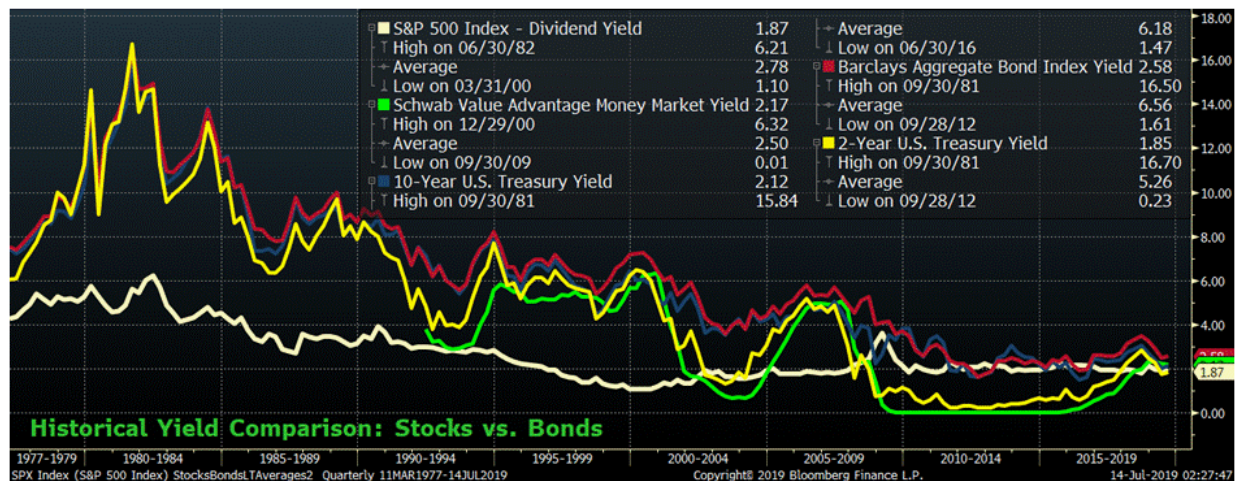
Source: Bloomberg

While we do not know the exact path of interest rates over the balance of 2019 and into 2020, the prospect of a non-friendly Fed for the foreseeable future remain remote, unless the economy gathers plenty of steam. Either way, we would argue the backdrop is favorable for equity prices going forward, as the chance of an economic recession would seem to be diminished with potential reductions in the Fed Funds rate, while a stronger economy would be a major boost for corporate profits. And, no matter what happens, we think the overall very low interest rate climate will persist, which should continue to make the yields on stocks very competitive,...

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Equity vs. Fixed Income Yields

Though stocks are not necessarily a substitute for bonds, U.S. Treasuries and money market funds, the current payout on the S&P 500 (1.87%) is still very generous versus the income provided by fixed income. And, the comparison to the average yields for all of the securities below over the past four-plus decades very much favors equities.



...even as we recognize that geopolitical events remain a major potential headwind, while we suspect that Corporate America will be guarded in its outlooks as second quarter earnings reporting season gets underway in earnest this week.

Not surprisingly, then, our thinking remains unchanged. We are always braced for downside volatility, but we expect the U.S. economy to continue to muddle along, with corporate profits staying healthy and stocks remaining reasonably priced within the context of the likely lower-for-longer interest rate climate. We are optimistic about the long-term prospects of our broadly diversified portfolios of what we believe to be undervalued stocks, especially as the rising tide has not lifted all boats.

Even as last week the Dow eclipsed 27,000 for the first time and the S&P 500 topped 3000, not all stocks have had their day in the sun.

2019 Laggards - Dividend Payers Still in the Red														
Symbol	Common Stock	2019 TR	7.12.19 Price	Target Price	Sector	P/E	P/S	P/TBV	ROCE	EV/EBITDA	FCF Yld	Debt/TE (%)	Div Yld	Mkt Cap
ALB	Albemarle	-5%	\$72.63	\$127.21	Materials	13.4	2.3	4.4	18.6	8.3	-3.9	87%	2.0%	7,696
AMGN	Amgen	-9%	\$174.93	\$221.24	Pharma, Biotech	12.1	4.5	nmf	61.1	9.5	8.7	nmf	3.3%	106,696
BK	Bank of NY Mellon	-6%	\$43.56	\$60.81	Diversified Financials	10.8	nmf	2.4	10.1	nmf	nmf	nmf	2.6%	41,709
BMJ	Bristol-Myers Squibb	-13%	\$44.27	\$64.98	Pharma, Biotech	10.7	3.1	9.5	37.0	11.1	7.2	81%	3.7%	72,414
CCL	Carnival Corp	-4%	\$46.26	\$74.17	Consumer Services	11.0	1.6	1.6	12.4	7.8	3.3	45%	4.3%	31,598
COHU	Cohu	-9%	\$14.58	\$23.25	Semiconductors	12.7	1.2	nmf	-15.2	-45.4	9.5	nmf	1.6%	598
CVS	CVS Health	-11%	\$57.55	\$103.87	Health Care Equip/Srvcs	8.0	0.4	nmf	-0.3	15.9	9.8	nmf	3.5%	74,763
DBI	Designer Brands	-21%	\$19.00	\$32.03	Retailing	11.2	0.4	2.3	-1.6	7.2	4.8	184%	5.3%	1,429
FL	Foot Locker	-20%	\$41.87	\$78.84	Retailing	8.7	0.6	1.9	21.3	4.5	11.0	121%	3.6%	4,593
GT	Goodyear Tire	-25%	\$15.14	\$28.07	Autos & Components	7.6	0.2	0.9	11.7	5.0	4.3	151%	4.2%	3,516
HAL	Halliburton	-9%	\$23.75	\$53.80	Energy	13.8	0.9	3.1	19.6	6.8	2.8	163%	3.0%	20,757
HFC	HollyFrontier	-4%	\$48.54	\$72.12	Energy	7.8	0.5	2.9	18.5	5.1	13.4	96%	2.7%	8,289
KR	Kroger Co	-20%	\$21.89	\$33.72	Food & Staples Retailing	10.5	0.1	4.0	23.8	6.2	5.5	422%	2.9%	17,486
KSS	Kohl's Corp	-25%	\$48.71	\$85.26	Retailing	8.7	0.4	1.5	14.6	5.3	14.7	106%	5.5%	7,892
MOS	Mosaic Co	-21%	\$23.00	\$45.67	Materials	10.6	0.9	1.0	5.3	6.4	3.1	53%	0.9%	8,873
PFE	Pfizer	-1%	\$42.40	\$48.16	Pharma, Biotech	13.8	4.4	nmf	17.8	12.8	5.4	nmf	3.4%	235,741
SNY	Sanofi	-1%	\$41.28	\$57.79	Pharma, Biotech	13.1	5.1	nmf	7.4	15.2	3.9	nmf	3.4%	103,367
TPR	Tapestry	-8%	\$30.34	\$54.39	Consumer Dur/App	11.8	1.5	28.4	21.2	7.4	14.0	516%	4.4%	8,803
TRN	Trinity Industries	-1%	\$19.88	\$27.93	Capital Goods	14.4	0.8	1.3	4.4	8.3	-54.4	225%	3.4%	2,581
WBA	Walgreens Boots	-17%	\$55.74	\$100.29	Food & Staples Retailing	9.2	0.4	nmf	18.6	9.0	8.5	nmf	3.3%	50,341

As of 7.12.19. nmf=Not meaningful. ROCE = Return on Common Equity. TBV = Tangible book value. EV/EBITDA = Enterprise value to earnings before interest, taxes, depreciation and amortization. FCF Yield = Free Cash Flow Yield

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://theprudentpeculator.com/dashboard/>, Chris Quigley and Jason Clark offer updates on more than a few of our companies that had news last week that was of sufficient importance to trigger a review of its Target Price.

Shares of German chemical maker **BASF SE** (BASFY – \$17.00) tumbled after the company issued a profit warning on July 8, cautioning that, “Significantly weaker-than-expected industrial production negatively impacted volumes and margin development at BASF.”

The press release stated, “At around 1.5% according to current estimates, growth in industrial production in the first half of 2019 was much slower than expected. The downturn in growth in the global automotive industry was particularly strong: Globally, production declined by around 6% in the first half of 2019. In China, the world’s largest automotive market, the decrease was more than twice as high, at around 13%. The weak development of the agricultural sector in North America was an additional burden: Due to difficult weather conditions, the planting of key field crops in the region was down from the previous year and far below the historical average. The decrease in earnings prospects for farmers and the trade disputes led to lower demand for

crop protection products. To date, the conflicts between the United States and its trading partners, particularly China, have not eased – contrary to what was assumed in the BASF Report 2018. In fact, the G20 summit at the end of June has shown that a rapid détente is not to be expected in the second half of 2019. Overall, uncertainty remains high.”

It continued, “In this environment, the preliminary figures for the second quarter of 2019 are significantly below current analyst estimates and BASF’s expectations at the beginning of the year. Sales declined by 4% in the second quarter of 2019 to €15.2 billion (second quarter of 2018: €15.8 billion). EBIT before special items for the second quarter of 2019 is expected to be €1.0 billion, 47% below the figure for the same quarter of the previous year (second quarter of 2018: €2.0 billion). The decline in EBIT before special items was mainly the result of considerably lower earnings in the Materials, Chemicals and Agricultural Solutions segments compared with the prior-year quarter.”

BASF has been operating in a brutal environment, with many factors adversely impacting the company’s performance out of its control. We wrote in March that “near-term headwinds continue to mount” and those headwinds have been much stiffer than we—or BASF—anticipated. Stronger execution, cost controls and the company’s acquisitions can help weather the near-term challenges, but ultimately we think that BASF is heavily discounted and should trade much higher once the operating environment becomes more favorable. In addition, we like BASF’s strong free cash flow yield, favorable valuation in our proprietary scoring framework and net current yield of 3.8%. That said, our Target Price for BASFY has been shaved to \$27 though one might argue that, all things considered, the stock held up fairly well last week, losing *only* 2.7% over the five days.

Shares of **Cohu** (COHU – \$14.58) tumbled more than 10% on July 9, before clawing back more than half the loss by the end of the week, after the semiconductor equipment firm reported in an investor presentation that headwinds would adversely impact the company in the near term.

Update on Market Conditions

Delay in previously expected second half 2019 recovery

U.S./China trade tensions creating a drag on the global economy

Huawei export restrictions impacting our customers' business, in addition to announced decline in smartphone unit forecast

Auto sales have declined in first half 2019

May utilization fell 3 pts to 77% reflecting excess capacity

Recent order trends project further softening in Q3

Focused on design win opportunities for mid-term growth

The presentation certainly lacked the upbeat take that CEO Luis Mueller offered in May and the notes indicate that headwinds will likely put a damper on the Q2 report (due 8/5). But we think the challenges are broadly transitory in nature. A prolonged U.S./China trade spat would likely damage both economies over a long period of time, while companies picking up COHU's testing equipment can only defer or delay for a limited time. Thus, we remain undeterred and continue to hold COHU in our broadly diversified portfolios. Shares trade for 34 times 2019 earnings, but once the pending Xcerra integration is complete, the P/E improves to the 7 to 9 range for 2020+. COHU yields 1.7%. Our Target Price is presently \$23.

Shares of homebuilder **MDC Holdings** (MDC – \$37.24) rose more than 12% last week after the company reported preliminary results for Q2 2019. MDC's official release will be July 31, but the preliminary figures include a 32% increase in new home orders (to 2,273 from 1,721), a slight tick up in new home deliveries (1,514 vs 1,512 in Q2 last year) and a 7% increase in backlog (to 4,293 from 3,998). MDC also expects a gross margin around 19%.

Larry A. Mizel, MDC's Chairman and Chief Executive Officer, stated, "We are encouraged by the positive momentum generated by the year-over-year improvement in both our community count and our absorption rate. These improvements resulted in a 32% year-over-year increase in our 2019 second quarter net new home orders, which was our largest quarterly percentage increase since 2012. Importantly, the growth in our new home orders has been complemented by

strong gross margins, which are expected to exceed 19% in the second quarter. Given the success of our spring selling season, we believe that we are well positioned for the remainder of 2019.”

MDC has had a terrific 2019, returning more than 45% including dividends. We think that the shares remain undervalued, though, despite the big run. The stock trades for just 11.1 times forward earnings estimates and offers investors a just-increased 3.2% dividend yield, while management also paid an 8% stock dividend in February. We think that the recent drop in interest rates in anticipation of cuts in the Fed Funds level certainly helps MDC as the cost of borrowing will get less expensive again. MDC sports a broad geographic footprint, boasts successful cost control initiatives and maintains a solid balance sheet, with ample liquidity that the company can use to smartly acquire land in attractive markets. Additionally, we like MDC’s focus on first time buyers (many Millennials) with its Season collection of homes. Our Target Price for MDC has been boosted to \$45.

Delta Air Lines (DAL – \$61.65) turned in an even better than what was pre-announced Q2, pushing the YTD gain for the air carrier north of 25% including dividends. Delta earned \$2.35 per share in the quarter, versus the analyst consensus estimate of \$2.28, while revenue rose to \$12.54 billion, compared with the estimate of \$12.50 billion and the \$11.78 billion top-line for the quarter a year ago. Delta boosted its profit forecast for the full year to \$6.75 to \$7.25 a share, compared with its earlier estimate of \$6.00 to \$7.00 per share. Delta, with no 737 MAX aircraft in its fleet, was unaffected by the grounding.

CEO Ed Bastian said, “We continue to run the best operation in the global industry by far. To date, we’ve achieved 82 days without a single cancellation across the Data system, a 26% improvement over last year’s record performance. And for our mainline product, we’ve already reached 153 days without a cancellation. This reliability, combined with a great service our people provide, is translating to more consumers than ever choosing Delta. As a result, we ran the highest load factors in our industry and flew a record 53.9 million passengers in the June quarter. And even with these record volumes, this was the first time in our history that Delta had 0 involuntary denied boardings for an entire quarter. This strong demand drove an 8.7% improvement in our top line, and total revenue of \$12.5 billion, which marked the highest quarterly result in our history, and our momentum continues to build. We’ve experienced 5 of the top 10 revenue days in our history just over the last 30 days. With our people consistently delivering best-in-class travel experiences for our customers, we are seeing our Net Promoter Scores reach new heights and our brand affinity grow. We have the world’s most valuable airline brand, one that’s mentioned not just among the best global airlines, but also alongside top consumer brands.”

Mr. Bastian continued, “We also announced the Board’s decision to raise our quarterly dividend by 15% to \$0.4025 per share. This is the sixth year in a row that we have increased the dividend, and this increase represents a 2.7% yield at yesterday’s price. Importantly, it demonstrates the sustainability of the Delta business model and our shareholder-friendly capital allocation strategy. We’ve also raised our total shareholder return expectations for 2019 to \$3 billion on the strength of our free cash flow results and our expectations for the rest of this year. The business has positive momentum with significant opportunity ahead. We have a durable foundation of strategic advantages. Our culture, leading operational reliability and unrivaled network, our

loyalty program and relationship with American Express and an investment grade balance sheet. These advantages, combined with a great brand powered by very best people in the business, provide the engine to drive meaningful long-term value for our customers, our employees and our owners.”

Premium cabin capacity was up around 7% (we continue to view too much capacity growth as a negative), while DAL’s growth expectation for system capacity is 4% for the September quarter. Delta continues to strive to woo business travelers by renovating lounges around the world, offering gate transfers via Porsche and serving top-notch food, to ensure that the highest-margin travelers return. This strategy is paying off, we think. In addition, DAL trades for just 8.5 times NTM earnings and yields 2.6%. Our Target Price has been lifted to \$79.

Drug distributors, including **McKesson** (MCK – \$144.60), **Cardinal Health** (CAH – \$47.59) and **CVS Health** (CVS – \$57.55), as well as drug makers **Amgen** (AMGN – \$174.93), **Biogen** (BIIB – \$231.42), **Bristol-Myers Squibb** (BMY – \$44.27), **Gilead Sciences** (GILD – \$66.26), **Merck** (MRK – \$79.73), **Pfizer** (PFE – \$42.40) and **Sanofi** (SNY – \$41.28) rode the emotional roller coaster late last week, after news came out that President Trump killed a proposal that potentially would have reduced out of pocket costs for people on Medicare and a federal judge threw out a requirement that drug companies disclose drug prices on television advertisements. The White House continues to negotiate limits to drug prices and limits to out-of-pocket Medicare spending, measures that have earned some strong support from voters and plenty of heavy opposition from drug companies and insurers.

The debate over health care costs is expected to resonate strongly with voters as the presidential election in 2020 nears, and the news has served to charge both sides. Measures to limit pricing have earned broad popular support, but the White House has had a difficult time deciding on the implementation of price caps, whether they be applied to the pharmaceutical companies (like Merck and Pfizer), middlemen (like CVS Caremark or Express Scripts) or at the end consumer via rebates.

Looking at the news out on Thursday, the Trump Administration made a surprising withdrawal of a rule that would have let people on Medicare receive rebates directly that drugmakers presently pay to insurers and middlemen. The non-partisan Congressional Budget Office estimated that the cost of the bill would have been \$177 billion over 10 years, due to higher Medicare premiums that would be subsidized by taxpayers, with little effect on manufacturer prices. Not surprisingly, given that investors tend to shoot first and ask questions later, the big pharma and biotech stocks took it on the chin as worries increased that more draconian price control moves out of Washington might be coming. Incredibly, “blue-chip” drug stocks like MRK, PFE and AMGN shed \$13 billion, \$9 billion and \$4.5 billion in respective market capitalization last week.

Certainly, we respect that drug pricing is and will continue to be a hot-button issue, even as we can’t forget that Washington has targeted the matter on and off since the Clinton Administration. We also remember that separating investing decisions from political views is important, as 80 years of market history demonstrate that investors can make money regardless of which party is in control of the White House, House of Representatives, Senate or Congress. This in mind, we

think the drubbing inflicted on the pharma and biotech sector has been overdone, as we hardly think the news out this past week was damning enough to warrant the hefty setbacks suffered by the already reasonably priced shares. We have edged our Target Prices lower, but we note that Amgen, Bristol-Myers Squibb, Pfizer and Sanofi would seem to have discounted a tremendous amount of bad news, given that they are all down in price since the start of 2019.

Following a dip on the news out of Washington, **Johnson & Johnson** (JNJ – \$134.30) shares fell another 4%+ on Friday after *Bloomberg* reported that the U.S. Justice Department is investigating whether or not JNJ management lied to the public about the possible cancer risks of widely used talcum powder. According to *CNBC*, JNJ categorically denied that there “has been a new development” in the litigation.

“We have been fully cooperating with the previously disclosed DOJ investigation and will continue to do so,” said J&J spokeswoman Kim Montagnino. “Johnson’s Baby Powder does not contain asbestos or cause cancer, as supported by decades of independent clinical evidence.”

In February, JNJ reported via an SEC filing, “Johnson & Johnson and certain of its subsidiaries are involved in numerous product liability claims and lawsuits involving multiple products. Claimants in these cases seek substantial compensatory and, where available, punitive damages. While the Company believes it has substantial defenses, it is not feasible to predict the ultimate outcome of litigation. The Company has established accruals for product liability claims and lawsuits in compliance with ASC 450-20 based on currently available information, which in some cases may be limited. The Company accrues an estimate of the legal defense costs needed to defend each matter when those costs are probable and can be reasonably estimated. For certain of these matters, the Company has accrued additional amounts such as estimated costs associated with settlements, damages and other losses. To the extent adverse verdicts have been rendered against the Company, the Company does not record an accrual until a loss is determined to be probable and can be reasonably estimated. Product liability accruals can represent projected product liability for thousands of claims around the world, each in different litigation environments and with different fact patterns. Changes to the accruals may be required in the future as additional information becomes available. The most significant of these cases include: the DePuy ASR™ XL Acetabular System and DePuy ASR™ Hip Resurfacing System; the PINNACLE® Acetabular Cup System; pelvic meshes; RISPERDAL®; XARELTO®; body powders containing talc, primarily JOHNSONS® Baby Powder; INVOKANA®; and ETHICON PHYSIOMESH® Flexible Composite Mesh. As of December 30, 2018, in the United States there were approximately 1,800 plaintiffs with direct claims in pending lawsuits regarding injuries allegedly due to the DePuy ASR™ XL Acetabular System and DePuy ASR™ Hip Resurfacing System; 10,500 with respect to the PINNACLE® Acetabular Cup System; 34,800 with respect to pelvic meshes; 13,400 with respect to RISPERDAL®; 25,600 with respect to XARELTO®; 13,000 with respect to body powders containing talc; 1,050 with respect to INVOKANA®; and 2,100 with respect to ETHICON PHYSIOMESH® Flexible Composite Mesh.”

We endeavor to avoid trading on speculation and think that the latest drop in JNJ’s price should be classified as such. Although lying to customers would presumably draw the ire of many parties and perhaps enlarge settlements, the talcum-related risks have been known for more than

a year now and it seems likely to us that the litigation will carry on for years. Meanwhile, we think JNJ's overall product mix and specialty drugs remain attractive, while the courtroom will seemingly always be part of the equation. We continue to view the company as uniquely situated with unmatched depth and breadth in growing global health care markets, and we think that there is solid potential for a number of its compounds in clinical trials. Shares trade for 15.3 times forward earnings estimates, with a yield of 2.8%. Our Target Price now stands at \$146.