Market Commentary Monday, October 7, 2019

October 7, 2019

EXECUTIVE SUMMARY

Newsletter Portfolio Purchases – 4 Stocks Bought for 3 Accounts this Past Friday
Buckingham in San Diego – AAII *Value of Dividends* Presentation Saturday, October 12
Week in Review – Roller Coaster Ride
ISM Numbers – PMI & NMI Disappoint
Recession Projections – GDP Growth Still the Likely Near-Term Forecast
Value Buy Signal – ISM Manufacturing & Equity Returns
Employment Report – Solid Stats and 50-Year Low Jobless Rate
Sentiment – Big Drop in Bullishness
Reason for Optimism – Extraordinarily Low Interest Rates
Stock Updates – AAPL, DAL, JNJ & GM

Market Review

A little housekeeping…As discussed in the October edition of *The Prudent Speculator*, on Friday, October 4, we bought 27 shares of **ManpowerGroup** (MAN – $83.24) at $82.4275 in Buckingham Portfolio, while in our hypothetical accounts, we added 149 shares of **Albemarle** (ALB – $66.32) at $67.05 to Millennium Portfolio and 131 **Exxon Mobil** (XOM – $68.97) at $68.11 and 884 **Allianz SE** (AZSEY – $22.72) at $22.61 to PruFolio.

This coming Saturday (October 12), your Editor will be speaking at the San Diego Chapter of the American Association of Individual Investors with the presentation of *The Value of Dividends* beginning at 9:00 AM in Solana Beach. Check out the following link for information…

https://aaiisandiego.com/events/upcoming-chapter-meetings/

…and note that the AAII folks will provide a special $5 admission rate for any *Prudent Speculator* readers.

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It was an awful middle of the trading week with the Dow Jones Industrial Average off more than 1100 points over three days at one point on Thursday morning before a massive turnaround took place that pared the five-day losses to less than 250 points, with the roller-coaster providing another vivid illustration of why we like the Warren Buffett quotation, “The fact that people will be full of greed, fear or folly is predictable. The sequence is not predictable.”

THE PRUDENT SPECULATOR
Pity the Poor CNBC Headline Writers

Illustrating why we always say that the only problem with market timing is getting the timing right, the Dow plunged more than 200 points on the morning of 10.3.19 due to a "disappointing services economy reading," but ended the day up 100 points because "rate cut expectations increased!"

No doubt, it was a big week for economic news, but even if folks had advance notice of the statistics, predicting the equity market response would have proved very difficult. For example, the big plunge on Tuesday and Wednesday, over which the Dow skidded 342 and 494 respective points, was caused by a sizable drop in the Institute of Supply Management's Manufacturing Index. The PMI, as the measure is known, came in 47.8, well below expectations of 50.0, with the survey indicating contraction in the factory sector, which, not surprisingly we suppose, led to heightened talk of recession.

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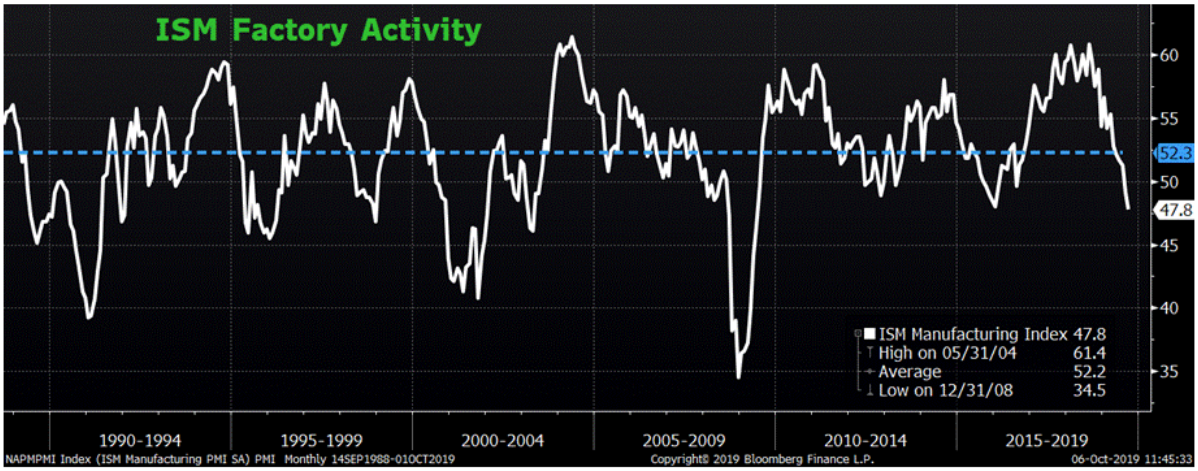
THE PRUDENT SPECULATOR
ISM Manufacturing = 1.5% GDP Growth

The latest read on the health of the manufacturing sector dipped to 47.8 in September. While the measure indicated contraction in the factory sector, manufacturing accounts for around 11% of the U.S. economy, and the Institute for Supply Management stated, "The past relationship between the PMI and the overall economy…corresponds to a 1.5% increase in real gross domestic product (GDP) on an annualized basis."



Of course, 1.5% GDP growth does not a recession make, while ISM stated, "A PMI above 42.9, over a period of time, generally indicates an expansion of the overall economy. Therefore, the September PMI indicates growth for the 125th consecutive month in the overall economy." Indeed, though the important ISM Non-Manufacturing Index (NMI) also trailed estimates and added to investor consternation,…

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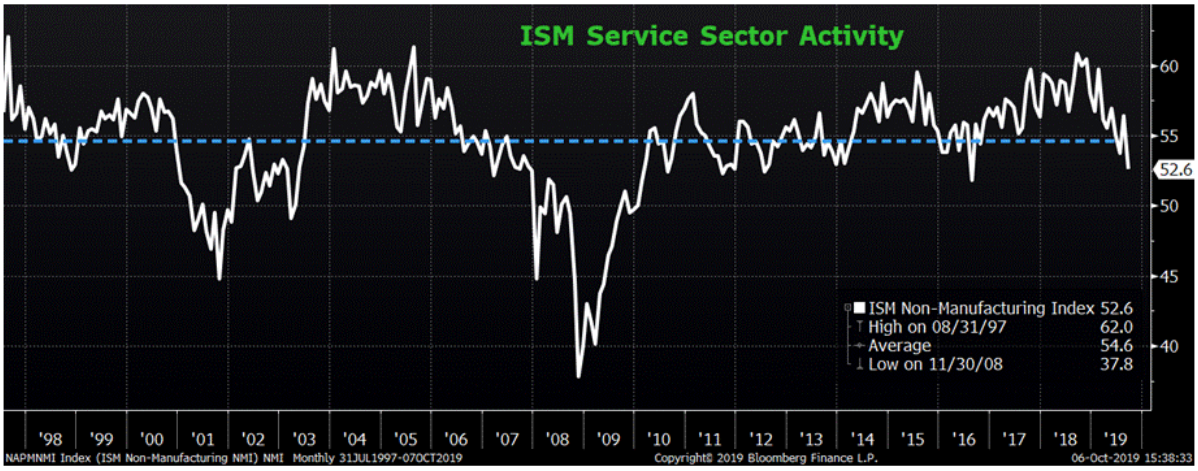
THE PRUDENT SPECULATOR
ISM Non-Manufacturing Falls

The September reading on the health of the service sector (NMI) came in weaker-than-expected at 52.6, below the historical norm, but still a signal of growth in the non-manufacturing economy, with the Institute for Supply Management stating, "The past relationship between the NMI and the overall economy…corresponds to a 1.4% increase in real gross domestic product (GDP) on an annualized basis."



…the odds of recession, at least according to Bloomberg, have remained unchanged,…

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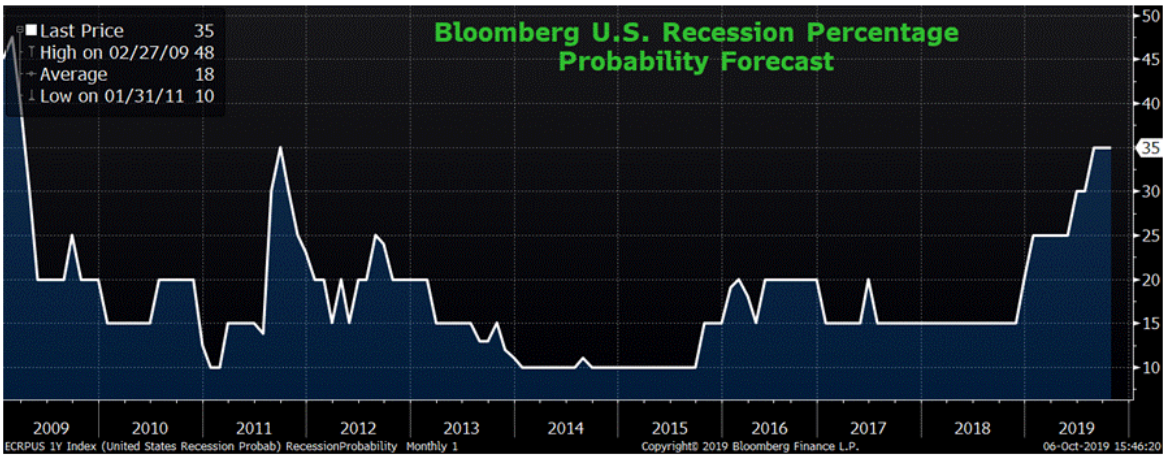
THE PRUDENT SPECULATOR
Recession Probability: Still at 35%

While it is clear that domestic and global economic growth is not as robust as most would like, and recent data points targeting how folks feel have come in surprisingly below expectations, the probability of recession remains at 35%. To be sure, this is the highest level since the fall of 2011…which proved to be a fantastic time to buy equities, as the S&P 500 returned 30.2% over the ensuing 12 months.



…while the latest GDP growth projection from the Atlanta Fed still is a long way from negative,…

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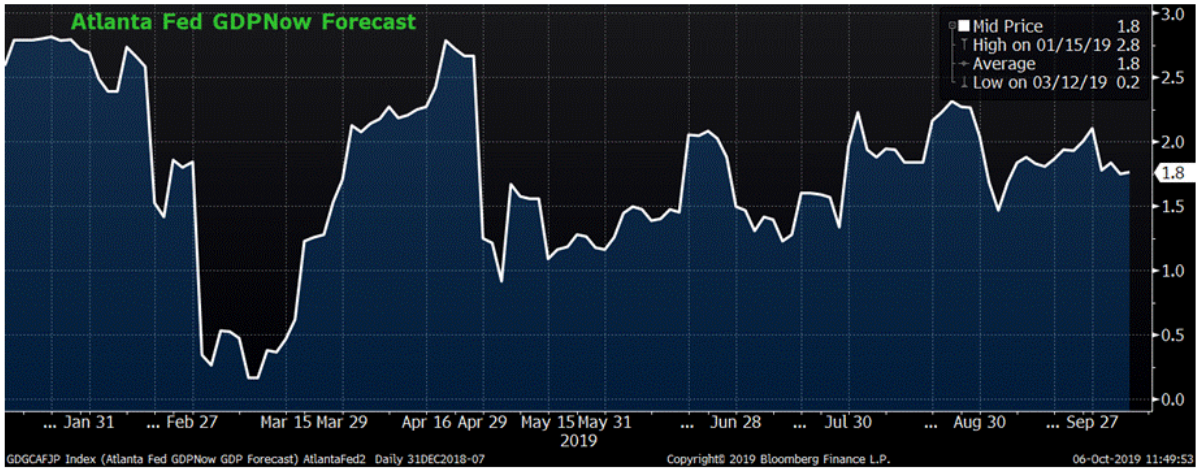
THE PRUDENT SPECULATOR
Recession Not Presently the Prediction

As the old saw goes, economists have predicted nine of the last five recessions, and the soothsaying so far in 2019 vividly illustrates why we like the Niels Bohr quotation, "Prediction is very difficult, especially if it is about the future." Indeed, seven months ago, forecasts for U.S. GDP growth were near zero, only to quickly rebound to a 2.8% annualized growth estimate, but then sink anew to a 1.8% guess today.



…and the big jobs report out on Friday suggested that a contraction does not appear to be in the near-term cards,…

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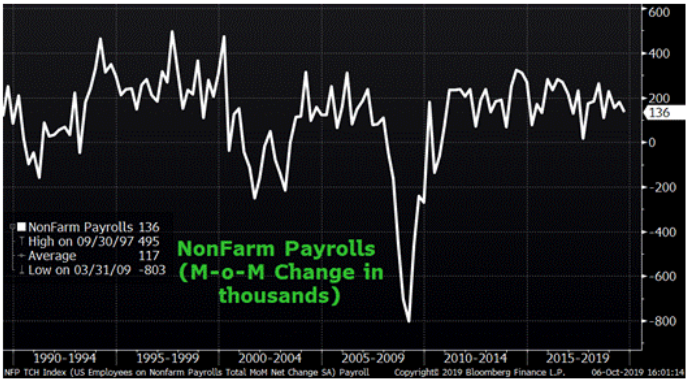
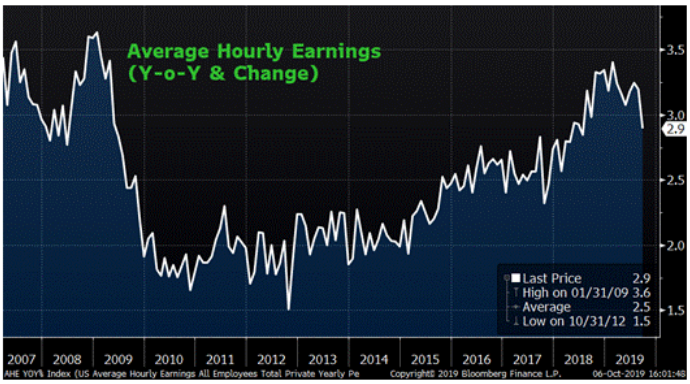
Decent Employment Report





Uncle Sam said that the number of new jobs created during September came in at 136,000, modestly below the consensus forecast of 145,000 and the revised-sharply-higher 168,000 tally for August. Also, the gain in average hourly earnings was lower than projected at 2.9% on a year-over-year basis, versus 3.2% in August, continuing to suggest that inflation in the labor market remains contained.

…especially with a half-century low in the unemployment rate.

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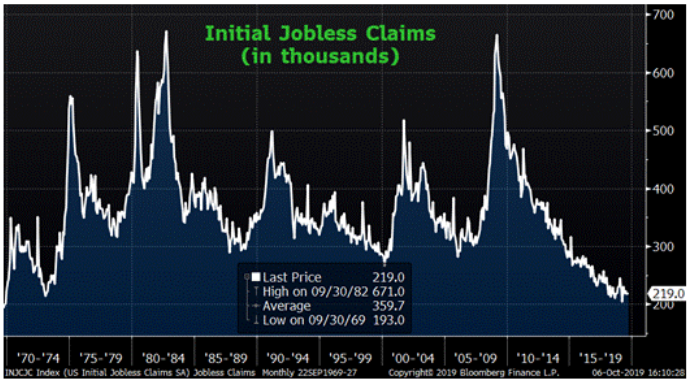
THE PRUDENT SPECULATOR
Historic Lows in Jobless Numbers



The jobs number in September came in below forecasts, but the unemployment rate dropped to 3.5%, a 50-year low, with a 63.2% labor participation rate. And, the latest figures on initial claims for unemployment benefits saw 219,000 new filings, still near lows last seen back in December 1969, when the workforce was significantly smaller than it is today.

No doubt, anything can happen and there will be another recession at some point, but the historical evidence suggests that, on average, Value would still be the place to be before and after such an event,…

As the saying goes, economists (and the stock market) have predicted nine of the last five recessions, meaning that no one has a crystal ball to know in advance when two or more quarters of negative economic growth (i.e. a recession) might occur. Of course, the historical evidence pre- and post-recession shows that long-term-oriented investors should (on average) stay invested (in Value, quite clearly) no matter what.

U.S. Recession Commencement (per NBER) and Equity Returns
Fama French Value, S&P 500 & Fama French Growth

Year Prior FF Value TR	Year Prior S&P 500 TR	Year Prior FF Growth TR	Recession Start Date	1 Year FF Value TR	1 Year S&P 500 TR	1 Year FF Growth TR	3 Year FF Value TR	3 Year S&P 500 TR	3 Year FF Growth TR	5 Year FF Value TR	5 Year S&P 500 TR	5 Year FF Growth TR	10 Year FF Value TR	10 Year S&P 500 TR	10 Year FF Growth TR
30.8%	51.9%	28.8%	August 1929	-32.0%	-32.6%	-40.1%	-64.9%	-73.5%	-71.7%	-61.4%	-71.1%	-42.1%	-47.7%	-58.0%	-25.3%
42.6%	18.2%	19.9%	May 1937	-55.8%	-39.3%	-45.3%	-55.1%	-33.2%	-26.4%	-44.3%	-32.5%	-29.8%	142.7%	53.7%	71.9%
54.4%	26.3%	34.6%	February 1945	42.2%	26.0%	37.1%	28.5%	12.0%	8.0%	75.7%	64.3%	50.9%	468.6%	379.2%	265.3%
4.6%	4.0%	-4.5%	November 1948	12.4%	19.2%	20.9%	108.9%	101.8%	89.0%	130.7%	145.2%	116.6%	584.7%	542.0%	438.4%
4.7%	3.1%	4.1%	July 1953	25.6%	31.9%	28.1%	118.0%	128.9%	98.0%	138.2%	136.5%	114.4%	381.9%	308.5%	252.6%
-0.4%	-1.2%	0.0%	August 1957	16.4%	10.0%	13.7%	55.0%	40.2%	58.3%	77.9%	55.1%	62.2%	418.4%	188.9%	238.1%
-6.4%	-2.4%	-1.5%	April 1960	29.0%	24.2%	25.0%	51.5%	41.7%	23.4%	131.0%	92.4%	60.0%	268.9%	107.7%	107.6%
-20.9%	-8.4%	-11.8%	December 1969	8.7%	3.9%	-13.7%	40.3%	41.4%	20.1%	-7.3%	-11.3%	-45.3%	267.9%	77.0%	59.6%
-19.4%	-15.2%	-32.5%	November 1973	-14.8%	-23.8%	-28.2%	77.1%	20.8%	19.5%	142.4%	23.7%	46.1%	719.9%	182.3%	275.6%
31.3%	20.6%	32.6%	January 1980	12.3%	19.5%	29.1%	80.4%	49.5%	58.0%	183.5%	102.4%	81.7%	480.7%	342.4%	194.7%
22.9%	13.0%	22.8%	July 1981	-0.8%	-13.3%	-21.7%	78.6%	34.0%	11.4%	217.1%	127.9%	75.1%	408.6%	343.4%	180.9%
-6.9%	6.5%	4.8%	July 1990	9.9%	12.7%	14.5%	76.0%	38.2%	34.1%	129.3%	83.2%	78.0%	424.9%	407.2%	320.9%
17.0%	-21.7%	-34.0%	March 2001	14.6%	0.2%	3.9%	33.8%	1.9%	11.7%	83.4%	21.4%	33.8%	96.0%	38.3%	64.8%
-5.7%	9.0%	9.1%	December 2007	-36.2%	-40.4%	-37.0%	-6.6%	-13.0%	3.9%	5.7%	5.3%	18.5%	119.5%	117.4%	154.6%
10.6%	**7.4%**	**5.2%**	**Averages**	**2.3%**	**-0.1%**	**-1.0%**	**44.4%**	**27.9%**	**24.1%**	**85.8%**	**53.0%**	**44.3%**	**338.2%**	**216.4%**	**185.7%**

As of 8.30.19. Source: Kovitz Investment Group using data from Bloomberg, Professors Eugene F. Fama & Kenneth R. French and the National Bureau of Economic Research

…while, perhaps more importantly, the supposedly scary ISM PMI figure that sent equities into a tailspin last week actually represents a major buy signal for stocks in general and Value in particular.

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THE PRUDENT SPECULATOR
Major Value Buy Signal: ISM PMI

Returns Following ISM PMI Readings of <= 47.8

Statistic	Fama French Value	Fama French Growth	S&P 500
One-Year			
Average	26.6%	22.7%	19.9%
Median	26.8%	23.6%	21.1%
Max	84.6%	83.8%	61.0%
Min	-24.5%	-28.0%	-23.6%
# Positive	151	153	153
# Negative	26	24	24
Three-Year Annualized			
Average	20.5%	14.0%	15.4%
Median	22.1%	15.4%	15.4%
Max	38.9%	28.4%	32.7%
Min	-6.6%	-7.2%	-4.6%
# Positive	176	166	166
# Negative	1	11	11
Five-Year Annualized			
Average	18.7%	13.1%	14.6%
Median	18.8%	13.3%	15.1%
Max	32.5%	25.7%	29.7%
Min	3.2%	-6.3%	-0.6%
# Positive	177	172	176
# Negative	0	5	1

From March 1948 - July 2019. Source: Kovitz Investment Group using data from Bloomberg, Professors Eugene F. Fama & Kenneth R. French and the Institute for Supply Management.

There was plenty of hand-wringing as October 2019 began when a sizable equity market selloff (so far short-lived) occurred following a sub-par Manufacturing Index (aka PMI) tally from the Institute for Supply Management. With a reading of 47.8, the PMI signified contraction in the factory sector, which would seemingly be a negative for the U.S. economy and, in turn, stocks…yet the historical evidence convincingly argues otherwise. In fact, looking at what actually has occurred with equities following the 177 times that the PMI has tallied 47.8 or lower shows that, on average, one-, three- and five-year returns have been more than fantastic, with Value leading the way by a wide margin.

And, echoing the contrarian nature of many data points, we might thank the aforementioned American Association of Individual Investors for helping turn the market around on Thursday, given that the latest AAII Sentiment Survey out before the open of trading that day saw the number of Bulls plunge by 8.0 percentage points to 21.4% and the number of Bears jump 6.2 points to 39.4%, the former number well below the historical optimistic norm of 38.0% and the latter solidly above the historical pessimistic norm of 30.5%.

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THE PRUDENT SPECULATOR
Big Spike in Pessimism

The AAII 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.

October 3, 2019 - Optimism among individual investors about the short-term direction of the stock market is at a 10-month low. The latest AAII Sentiment Survey also shows higher levels of neutral and bearish sentiment. Bullish sentiment, expectations that stock prices will rise over the next six months, plunged 8.0 percentage points to 21.4%. Optimism was last lower on December 12, 2018 (20.9%). Bearish sentiment, expectations that stock prices will fall over the next six months, jumped by 6.2 percentage points to 39.4%. Pessimism remains above its historical average of 30.5% for the ninth time in 11 weeks. Bullish sentiment is back at an unusually low level for the first time in five weeks. Historically, such readings have been followed by higher-than-average and higher-than-median six- and 12-month S&P 500 index returns

The latest AAII Sentiment Survey showed a plunge in optimism and the most recent ICI calculation of exchange traded and mutual fund flows showed a renewed exodus out of U.S. stocks, with both numbers coming out on Wednesday evening, AFTER stocks had tumbled and before a big two-day rebound.

Combined Estimated Long-Term Fund Flows and ETF Net Issuance
Millions of dollars

Week Ended	9/25/2019	9/18/2019	9/11/2019	9/4/2019	8/28/2019
Total Equity	-15,779	10,036	7,551	-4,106	-9,506
Domestic	-13,957	11,807	8,598	-4,389	-5,324
World	-1,822	-1,771	-1,047	283	-4,182
Hybrid	-1,918	-843	-687	-1,132	-1,404
Total Bond	6,913	9,293	13,021	6,924	7,954
Taxable	4,587	8,906	11,734	5,708	5,994
Municipal	2,327	387	1,287	1,217	1,961
Commodity	2,356	260	-396	914	1,745
Total	-8,428	18,747	19,489	2,599	-1,211

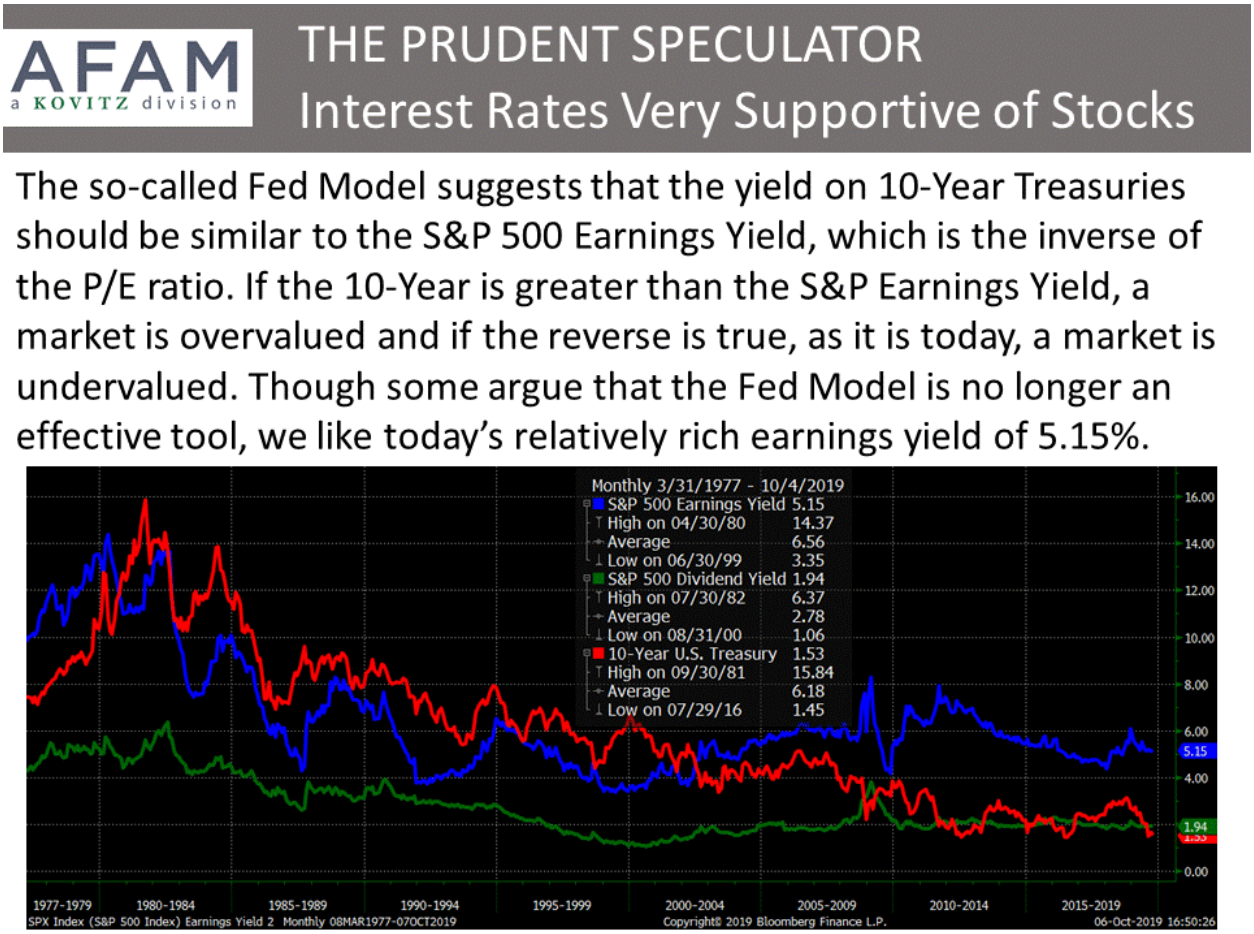
Source: Investment Company Institute

AAII itself concedes that its Sentiment Survey is often a contrarian indicator, "Bullish sentiment is back at an unusually low level for the first time in five weeks. Historically, such readings have been followed by higher-than-average and higher-than-median six- and 12-month S&P 500 index returns." Of course, there is no foolproof gauge that will predict which way the market is headed in the short run, but history shows that it is much better to be greedy when others are fearful and fearful when others are greedy, so we prefer to see pessimism amongst the masses, which also seems to be the current case with exchange traded and mutual fund investors, at least according to the latest data from the Investment Company Institute.

Certainly, the recent downturn can continue (equity futures are pointing to a soft opening to trading in the new week), especially given drama on the Impeachment and trade front. U.S.-China talks resume later this week, while the E.U. is weighing retaliation after Washington said it plans to order punitive tariffs on billions of dollars' worth of EU goods after winning a long legal fight at the World Trade Organization last week. Further, we have to expect Corporate America to be cautious in comments regarding the outlook for sales and earnings as Q3 reporting season kicks off in a week or so.

However, we continue to see no reason to alter our enthusiasm for the long-term prospects of our broadly diversified portfolios of what we believe to be undervalued stocks. This is especially true, given the extraordinarily low interest rate environment, whereby even if the S&P 500

doubled in price (which would cut the current earnings yield in half), stocks would still not be expensive on that metric relative to the yield on the 10-year U.S. Treasury.



Stock Updates

Chris Quigley and Jason Clark offer updates on a few of our companies that had news last week that was of sufficient importance to trigger a review of their Target Price. 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/.

We have been reporting over the last few years, including last month, that the replacement cycle for **Apple's** (AAPL – $227.01) iPhone smartphones continues to lengthen, as mobile phone carriers have been pushing the full cost of the devices onto customers and customers are no longer excited to upgrade every two years for more than $1,000 in many cases. Yet, Nikkei Asian Review reported late last week that Apple sent notices to suppliers that it wanted to increase production of its newest batch of iPhones by about 10% (~8 million units), as a result of unexpectedly strong demand.

Apple reports its next quarterly earnings update on October 30, which we would expect to include solid iPhone unit sales. Apple shares are just a few bucks below the all-time high set in October of last year, and we wouldn't be surprised to see an earnings-related jump above that record, should the company be able to turn in a quarter better than the analyst estimates. Despite the huge market capitalization, we think that the valuation remains reasonable, with metrics like a forward price to earnings ratio of 18.3, a free cash flow yield of 5.4% and a dividend yield of 1.4%. We have ratcheted our Target Price for AAPL up to $241.

Delta Air Lines (DAL – $53.81) reported strong operating performance for September last week. The company saw year-over-year increases across the board in Revenue Passenger Miles (miles traveled by paying passengers) and Available Seat Miles (a measure of capacity), while the load factor improved for all markets except for International-Pacific. The company also narrowed its Q3 EPS guidance to a range of $2.20 to $2.30, tightened from a prior $2.10 to $2.40 outlook, but investors took exception to news that Delta expects its cost per available seat mile to have risen about 2.5%, up from its previous guidance issued in June for a 1% to 2% advance.

Adding to the negative tone, which sent shares of the airline down more than 7% last week, was a WTO (World Trade Organization) ruling in favor of the U.S. on a decade-plus-old dispute with the E.U. over Airbus subsidies.The ruling was followed by a Trump Administration announcement that it will levy a 10% import duty on Airbus planes, which is expected to hurt Delta since it has more than 250 planes on order from the Toulouse, France-based company.

The duty is painful for Delta, though its order book is a long-term project and there is plenty of opportunity to work with the accounting department on mitigating the tax. Plus, things in Washington D.C. can change relatively quickly, so we believe that Delta may not bear the full financial brunt.

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 7.4 times NTM earnings and yields 3.0%. Our DAL Target Price is presently $78, and we note that full Q3 results will be out later this week.

Shares of **Johnson & Johnson** (JNJ – $133.66) rose approximately 4% last week after the company announced it had reached a settlement in an opioid-related case with two Ohio Counties. JNJ will contribute $10 million to the settlement, with an additional $5 million paid for the counties' legal fees and $5.4 million for "charitable contributions to non-profit organizations in connection with opioid-related programs in these two counties."

J&J said via press release, "The company is open to identifying an appropriate, comprehensive resolution of the overall opioid litigation. At the same time, the company remains prepared to defend its actions. The company responsibly marketed DURAGESIC®, NUCYNTA® and NUCYNTA® ER, which, since launch, have accounted for less than one percent of total opioid prescriptions in the United States. The company sold the U.S. marketing rights for NUCYNTA® in 2015 and has not marketed DURAGESIC® in the U.S. since 2008."

The light settlement seemed to point to a much smaller liability for JNJ than some had thought. If the population is an indication of the scale of the opioid settlement costs down the road, Cuyahoga County has 1.25 million people, while Summit County has just over 540,000. Using 330 million as the U.S. population size and extrapolating using the $20.4 million figure, JNJ would be on the hook for approximately $3.7 billion. We think that's much less than $10 billion or $20 billion we might have expected, although there are no guarantees that other plaintiffs will be as willing to accept a relatively modest settlement. Our Target Price for JNJ is $145 and we continue to monitor the legal battles.

Shares of auto and truck maker **General Motors** (GM – $34.93) skidded nearly 6% last week as the UAW strike heads into its fourth week. Meanwhile, the company's U.S. auto sales were 6.3% higher in the third quarter on strength within the pickup-truck and sport-utility categories. By comparison, both Ford Motor and Fiat Chrysler faced sales declines in the period.

While the strike will impact near-term profits, GM is benefiting from newly redesigned pick-ups that hit dealerships in good supply. Sales of SUV models Traverse and Acadia were up 25% and 50%, respectively, year over year. Also of note, dealership inventory remains relatively healthy at 760,000 vehicles, enough stock to last approximately 80 days. Absent the strike news, we think the latest sales numbers would have boosted the stock price.

Some estimates put the UAW strike cost around $1 billion for GM in the quarter, while the United Auto Workers (UAW) union has been paying its 48,000 striking members $250 per week out of its "Strike and Defense Fund," totaling nearly $800 million before the strike. This compares to typical hourly wages of between $16 and $30 for the workers. The UAW's negotiations with GM are expected to set the tone for its other ongoing talks with Ford and Fiat Chrysler, so we are not looking for a quick resolution.

As readers are likely aware, we strive to stay neutral during these situations, focusing our attention on how actions and reactions impact our investment thesis. With that said, we remain constructive on GM's efforts to lower labor costs per worker to those more in line with its foreign and domestic competitors and preserve its flexibility in the utilization of temporary workers.

All things considered, we continue to believe that GM is executing on its core business well. The company has initiatives in place to control costs and generate favorable free cash flow, which allows a generous capital return program. The company also is making progress on its electric and autonomous vehicle programs and has done a terrific job of monetizing these assets via sales to outside investors. The stock trades for an attractive 5.1 times expected earnings and yields 4.4%, with a much better balance sheet and cost structure than in prior years. We also think that an economic downturn actually may be the catalyst to boost the stock when investors realize that earnings are not as cyclical as in the past. Our current Target Price for GM is $53.