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MARKET OUTLOOK LETTER

October 26, 2018

Our portfolios are now in the midst of another stunning earnings announcement season. Already, better than expected third-quarter earnings have been announced from Intuitive Surgical (ISRG), Netflix (NFLX), PayPal (PYPL), Progressive (PGR), and United Healthcare (UNH). Still, there is another major factor weighing on the overall stock market, namely the mid-term elections. On November 7th, in the wake of the mid-term elections, we expect that the stock market will stage a relief rally when the election is finally over. The stock market hates uncertainty and getting the mid-term election over will mean one less thing to worry about.

That said, there is no doubt that the best time to invest is the week before Thanksgiving. When we gather with friends and family for Thanksgiving, Americans tend to be in very good moods and those good feelings rub off on the stock market. Furthermore, there tends to be year-end pension funding and gifting during that last six weeks of the year that boosts inflows into the stock market. Overall, the stock market is expected to benefit from wave after wave of positive seasonal inflows.

There have been a lot of interest rate fears spooking the stock market, so we would like to discuss the present monetary policy environment. First, the Fed never fights market rates, so if Treasury yields rise, the Federal Open Market Committee (FOMC) will continue to raise key interest rates. Second, the latest FOMC minutes are signaling another key interest rate hike in December, but there is a vocal minority of outspoken doves from the Chicago, Minneapolis, and St. Louis Fed Presidents that does not want to raise key interest rates higher. Third, there are signals that economic growth may be stalling after (1) two lackluster months for retail sales, (2) existing home sales have slowed to the slowest pace in almost three years, and (3) both new home sales as well as building permits have declined in the past 12 months. Fourth, both consumer and wholesale inflation is now decelerating and running below economists' consensus expectations.

The bottom line is we can finally see the end of the Fed's key interest rate increases now that retail sales, housing sector, and construction activity appears to be slowing. When Wall Street realizes that the Fed's interest rate increases will finally be winding down, our Dividend Growth stocks are expected to rally impressively, as their interest-rate sensitivity becomes a positive factor.

Many stocks in our portfolios are also characterized by aggressive stock buy-back activity, so we expect that as the third-quarter earnings announcement season winds down there will be another wave of stock buy-backs, just like there was in previous quarters. Currently, corporate stock buy-backs are running 88% higher than last year and breaking all records, so we suspect that the S&P 500 will be characterized by between $800 billion to $1 trillion in stock buy-backs this year.

So in the end, our best defense from recent stock market volatility is a strong offense. Our average Conservative Growth stocks are characterized by at least 18% average annual sales growth and at least 32% annual earnings growth. Even more impressive, our average Conservative Growth stock has posted impressive earnings surprises. The analyst community has revised their consensus earnings estimates higher in the past few months for our Conservative Growth stocks, so further earnings surprises are highly likely.

In the New Year, it will become increasingly difficult for many companies to sustain strong earnings momentum due to more difficult year over year comparisons, so we expect that the breadth and power of the overall stock market may ebb a bit. Currently, the strongest sectors remain energy, healthcare, and specialty retail related companies. Our technology companies remain characterized by strong forecasted sales and earnings, so we would not be surprised if they reassert their leadership in the upcoming months.

In summary, we expect that the stock market will become increasingly narrow in the upcoming months, but we expect that our Dividend Growth and Conservative Growth stocks will increasingly break out as market leaders and benefit from persistent institutional buying pressure. We should add that 2018 has been a confusing year for most investors due to the failure of portfolio insurance that caused the February & March consolidation, a big short covering rally between April and July, then a mean reversion rally in many lagging stocks from index arbitrage. In other words, investors have been in a confusing "washing machine" this year where money is "sloshing around," but not leaving the stock market. As investors, we have to believe in the long-term fundamentals underneath our stocks and we are more confident than ever that our Dividend Growth and Conservative Growth stocks will benefit from (1) wave after wave of positive quarterly results, (2) more stock buy-backs, (3) dividend increases, and (4) positive seasonal buying pressure.

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