FOURTH QUARTER
WILL THE SANTA CLAUS RALLY COME?

Jay R. Penney *CFP ®, CFA ®, AIF ®*
Chief Investment Strategist for Ashton Thomas Private Wealth

As I type this on Christmas Eve day, a quarter of the U.S. Federal Government is shut down, technically unfunded through the balance of the fiscal year ending next September 30th. The Congress is hopelessly deadlocked over a $5 billion allocation that represents 0.114% of the Federal Government's $4.4 Trillion budget [(1)]. Politicians on both sides of the aisle would rather see the other side lose their arguments than see America win. The U.S. House of Representatives is changing hands in a week, and multiple investigations of the Trump Administration will likely commence shortly thereafter. The Secretary of Defense and the U.S. Envoy to Anti-ISIS Coalition have just resigned their posts in protest over the President's decision to withdraw U.S. troops from Syria, joining a long list of Cabinet Secretaries, Ambassadors, and Administration appointees who have already left the scene less than two years into Trump's presidency.

And the problems are not just on this side of the pond. The Yellow Vest protesters rioted in the streets of Paris for the sixth consecutive week-end. U.S. and Chinese trade negotiators are "on the clock" to avoid a trade war impacting $635 Trillion in trade [(2)] between the two nations before March's end. We have a migrant and humanitarian crisis on our southern border that (temporarily) required the assistance of the U.S. Military. People in Venezuela, Yemen, Syria, Guatemala, El Salvador and Ukraine are either starving, persecuted, under attack, or under the immediate threat of attack. From my office, I see a retail shopping mall teeming with very last-minute Christmas shoppers, but it doesn't "feel" like Christmas to me. And it all has to do with the capital markets.

Since October 1st, the stock market has been making it very clear it is not in the holiday spirit either. Through today's (12/24/2018) market close, the S&P 500 Index is down (-20.05%) from its all-time high reached on September 21st, the Dow Industrial Average has declined (-19.14%) since it's high on October 3rd. The Russell 200 Index and the Nasdaq Composite Index are in full-blown bear market territory, down (-26.88%), and (-23.86%), respectively, from their highs in late August [(3)].

ASHTON THOMAS
PRIVATE WEALTH

Domestic Stock Market Indices August 29th – December 24th

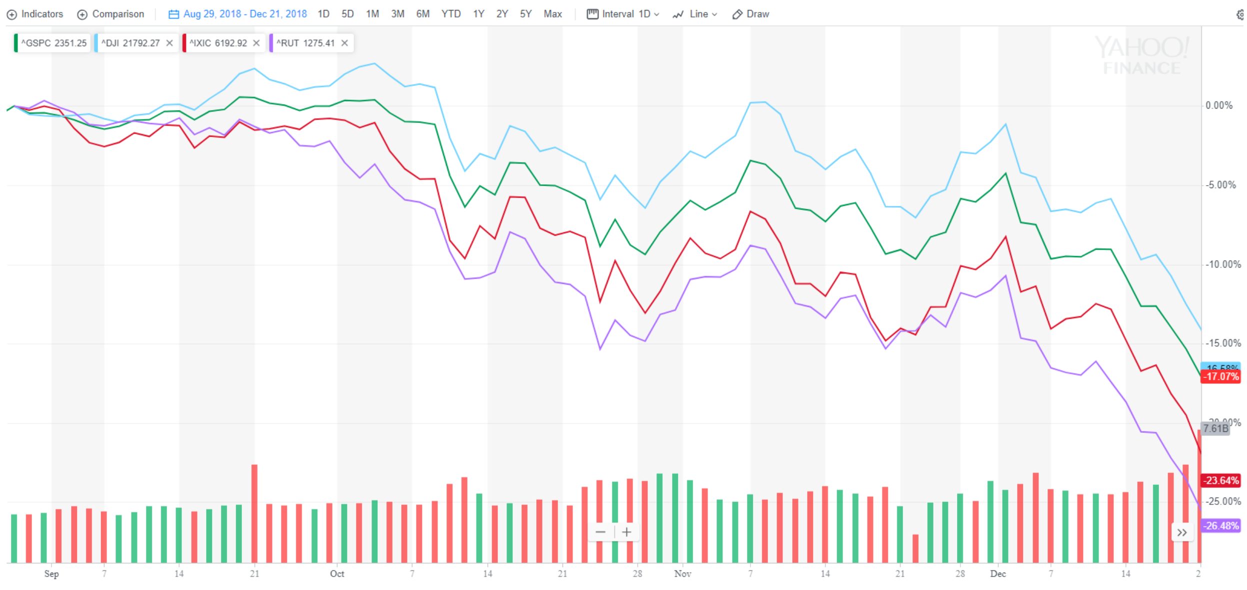

Chart Source: Yahoo Finance

It hasn't been an orderly decline either. In the 15 trading days we've had thus far in December, the market's volatility has been incredible, with daily swings in the Dow Industrials that have *averaged* 605 points. Three trading days (7th, 19th, and 21st) exhibited intraday swings in excess of 800 points [4]. It's been a complete washout.

A casual observer not familiar with the state of our economy might see these charts and think we were in a full-blown recession. While many prognosticators are openly concerned about the *possibility* of a recession, the economic data would suggest otherwise.

America's economic output (Gross Domestic Product) in the third calendar quarter of 2018 grew by +3.4%, and it followed the second quarter's 4.2% growth rate, the best two consecutive quarters of economic growth recorded this *decade* [5]. The Unemployment Rate in America stands at 3.7% today, the *lowest rate* of joblessness since December 1969 [6]. Wages are rising. Consumer Sentiment hit its *highest reading in 18 years* last month [7], and Holiday Retail Sales in the U.S. are expected to reach $719 Billion this season, a *record* [8]. The Business Confidence Index is at 100.64 today, down slightly from its cyclical high of 101.35 set in December 2017, which was its highest reading since May 2011[9]. The ISM Non-Manufacturing Index reading was 60.7 in November, its highest reading in over a decade, and its Manufacturing Index is at 59.3, down from its all-time high April reading of 61.3, but well above the readings seen in the middle of this decade, while capital markets were booming [10]. ***The U.S. economy is extremely healthy today in virtually every respect.***

Corporate earnings, fundamentally the most meaningful statistic as it comes to stock prices, are *dramatically higher this year*, largely due to the Tax Cuts and Job Act signed by the President on December 22nd, 2017. The S&P 500 Index, perhaps the most often used measure of stock market health, saw its Operating Earnings "per Index Share" rise from $124.51 in calendar year 2017, to an expected $157.17 when all is reported for 2018, a *+26.5% year-over-year increase* (11). **At today's close, the Index trades at a *trailing* Price/Earnings Ratio of 15.05x, its *lowest reading since 2012*.** Despite global recessionary concerns, consensus estimates for next year (2019) are that the S&P 500 Index' Operating Earnings per Index Share will rise to $172.76, a 12.46% increase over this year. If those earnings are realized, it would place the Index' *forward-looking* Operating Earnings P/E Ratio at 13.69x today, the *lowest reading seen since the end of 2011*, when the S&P 500 Index closed at 1257.60, or approximately half the current Index level (12). ***Corporate earnings are not the problem either*.**

I believe the reasons for this decline are not fundamental at all. I believe this recent decline is the result of *two* "non-fundamental" reasons. First, the daily drip, drip, drip, of political and geopolitical headlines, virtually none of which are positive is overwhelming the fundamental data. Secondly, there is widespread expectation that following the longest bull market in history, now 3,577 days old (13), and the second longest economic expansion observed in U.S. history, ***the end of both must be near***. (I do believe the advent of algorithmic trading strategies have added to the acceleration of the decline as well, just as they mindlessly added to the acceleration to the upside while corporate earnings were flat to declining from 2012 – 2016, inclusive, while GDP growth in those years averaged just 2.2% annually (14).)

Essentially, the capital markets have decided to have a nervous breakdown, and no amount of positive economic or earnings data are going to stop them, until and unless cooler heads prevail, and "value" investors like the legendary Warren Buffet, and his predecessors, Benjamin Graham, Irving Kahn, and Walter Schloss start buying stocks with both hands.

Most money managers we work with are sticking to their investment disciplines, which is exactly what we want them to do, since those disciplines have proven themselves time and time again to prevent the emotions of fear and greed distorting their decision making.

A week ago, we had one of our money managers in our offices to discuss what will certainly be their worst calendar year performance since they started managing money almost twenty years ago, in 1999. This is a manager who will remain unnamed in this essay, but one that has outperformed the S&P 500 Index over that period (15). For the record, let me remind the reader that their success and past performance are no guarantee they will continue to be successful going forward. This money manager *made money* in 2000 – 2002, when the S&P 500 index declined by (-49%), and they *made money* in calendar year 2008 as well, when that Index fell (-38.5%). They are a concentrated "value" manager, meaning they buy a relatively small number of stocks they have high conviction in, that they believe are inexpensive, yet profitable, and have the potential to grow their profitability. Their track record and their buy/sell disciplines are the reasons we've put them to work in some of our clients' portfolios.

Here is a list of the names they hold for clients today, their year-over-year change in earnings per share, their year-over-year change in share prices, and their current Price/Earnings Ratios [16]:

Company (Symbol)	Year-Over-Year % Change in Earnings [17]	Year-Over-Year % Change in Share Price [18]	Current P/E Ratio [18]
Beacon Roofing Supply (BECN)	+38.07%	(-52.68%)	28.73x
Crown Holdings, Inc. (CCK)	+118.49%	(-29.54%)	17.88x
Clean Harbors, Inc. (CLH)	(-33.52%)	(-13.60%)	19.89x
Dollar General Corp. (DG)	+6.75%	(-6.30%)	14.59x
Dycom Industries, Inc. (DY)	(-40.85%)	(-55.55%)	15.73x
First American Fin. Corp. (FAF)	+17.55%	(-24.07%)	7.98x
First Data Corporation (FDC)	(-10.26%)	(-6.58%)	8.31x
FedEx Corporation (FDX)	+50.95%	(-38.81%)	8.30x
Graphic Packaging Holding (GPK)	(-18.24%)	(-51.91%)	9.09x
International Paper Co. (IP)	+3.51%	(-35.17%)	4.94x
Knight-Swift Transport. (KNX)	(-45.62%)	(-45.04%)	6.01%
LKQ Corporation (LKQ)	+28.49%	(-41.23%)	13.18x
Marten Transport Ltd. (MRTN)	(-40.00%)	(-20.25%)	8.22x
Nuance Comm. Inc. (NUAN)	+321.54% [19]	(-21.22%)	N/A
The Progressive Corp. (PGR)	+76.83%	+1.33%	11.48x
Pinnacle Fin. Part., Inc. (PNFP)	+77.44%	(-33.59%)	11.75x
Werner Enterprises, Inc. (WERN)	(-16.79%)	(-24.68%)	8.26x

These numbers should be striking in that while most of these companies' earnings have improved, and in some case, by quite a bit, their share prices have almost universally declined. Price/Earnings Ratios have compressed dramatically, with eight of the seventeen now in single digits. Ten of the seventeen companies grew their earnings in 2018, but only one saw an increase in its share price this year. Except for Nuance, which had negative earnings in 2017, the companies this manager is holding for its clients now see their share prices trading at an average Price/Earnings Ratio of just 12.15x. Some of the most striking "mismatches" between the direction of earnings and share prices are Crown Holdings, which increased its earnings by +118%, but saw its price decline almost (-30%), Pinnacle Financial Partners, which increased its earnings by +77%, but saw its price decline by over (-33%), and FedEx Corp., which increased its earnings by +51%, and saw an almost (-39%) decline in its price. These numbers make no sense from a "fundamental" perspective, yet they are indicative of what is happening across the stock market. This is a seller's market, but the selling is indiscriminate, which tells me it can't last. "Value" investors are waiting for the "panic selling" to stop, and when it does, the value buyers will start bargain hunting, and they are going to find "value" they haven't seen in years, perhaps even a decade.

This is because value investors "buy low" and "sell high", which is the *opposite* of what the average retail investor does.

Fear and greed may motivate the average retail investor, but value investors are motivated by tangible evidence, things like revenues and earnings. They can remain calm even when the market discounts companies they own, often *buying more* when prices decline for non-fundamental reasons. This investment discipline, and the ability to remain relatively calm and dispassionate as others are losing their minds in panic and fear, is what we expect of our money managers, because that is how they've performed in the past.

Remember, Warren Buffett once famously said:

"*In the short-run, the markets are a* <u>*voting*</u> *machine. In the long run, they are a* <u>*weighing*</u> *machine.*"

Think about it.

As always, we welcome your comments and questions, and we wish you a happy, healthy, and more prosperous year in 2019!

Jay R. Penney *CFP*®, *CFA*®, *AIF*®
Chief Investment Strategist
Ashton Thomas Private Wealth, LLC

(1) https://www.thebalance.com/u-s-federal-budget-breakdown-3305789
(2) https://ustr.gov/countries-regions/china-mongolia-taiwan/peoples-republic-china
(3) https://finance.yahoo.com/
(4) https://finance.yahoo.com/quote/%5EDJI/history?p=%5EDJI
(5) https://www.bea.gov/data/gdp/gross-domestic-product
(6) https://www.npr.org/2018/10/05/654417887/u-s-unemployment-rate-drops-to-3-7-percent-lowest-in-nearly-50-years
(7) https://www.cnbc.com/2018/11/09/november-consumer-sentiment.html
(8) https://www.statista.com/statistics/243439/holiday-retail-sales-in-the-united-states/
(9) https://data.oecd.org/leadind/business-confidence-index-bci.htm
(10) https://www.instituteforsupplymanagement.org
(11) https://us.spindices.com/indices/equity/sp-500
(12) https://us.spindices.com/indices/equity/sp-500
(13) https://www.thestreet.com/investing/longest-bull-market-14804308
(14) https://www.statista.com/statistics/188165/annual-gdp-growth-of-the-united-states-since-1990/
(15) If you would like a copy of these statistics, please contact Jay Penney directly at (602) 732-4745
(16) Source for P/E Ratios on individual stocks listed: Yahoo Finance on 12/24/2018
(17) Based upon Consensus Estimates for 2018, and 2017 Annual Reports for each.
(18) As of the market's close on 12/24/2018
(19) NUAN's earnings in 2017 were (-$0.52) p/share. Consensus estimates are for 2018 earnings to be +1.15 p/share.