Investing INSIGHTS
from Evanston Advisors

January 2019

Happy New Year! And… thank goodness 2018 is over! As someone whose life revolves around the financial markets, 2018 is one year I'm happy to have in the rearview mirror. I'm not just talking about the final few months of the year either. For me, 2018 was one of the most frustrating years in a very long time.

With the benefit of 20/20 hindsight, I can see the genesis of the frustration was in the latter part of 2017. As the market began to digest the implications of the Trump tax cuts, a wave of economic growth was unleashed. This is a good thing but can (and did) lead to some market anomalies. When the prospect of widespread economic growth is on the table, investors often become short-sighted – they assume that "you can't go wrong" investing in the hot stock of the moment, and they stop doing their homework. They stop paying attention to the fundamentals of the companies in which they are investing, and to the price they are paying to purchase the stock. In the short run they are often rewarded, which has a bit of a snowball effect. The mindset becomes "XYZ Co. has been on a tear, so I better get in before it's too late". The problem with that is that it exacerbates an already risky proposition – one that is based on speculation about continued growth of future earnings, not on the company's fundamentals.

Worry and Excitement

That's when I start getting worried… and excited. Yeah, I know, worry and excitement usually don't live together in anything like perfect harmony. The worry stems from the knowledge that a market lacking breadth is not likely to remain healthy in the short run. The excitement stems from knowing a market lacking breadth creates all sorts of opportunity if you're willing to be patient.

When I talk about "breadth", I'm referring to how broad the advances are in the market. Are they focused on a handful of stocks? Or is the market recognizing that the strong economy is leading to earnings growth broadly? One measure of this is known as the "Advance/Decline Ratio", or ADR. In its simplest form, it is a very easy concept: The number of stocks that increased in price (advanced) divided by the number that decreased (declined). If 100 stocks advanced and 100 declined, the ratio is 1.0. If more advanced than declined, the ratio will be greater than 1.0, and vice versa. In a market with good

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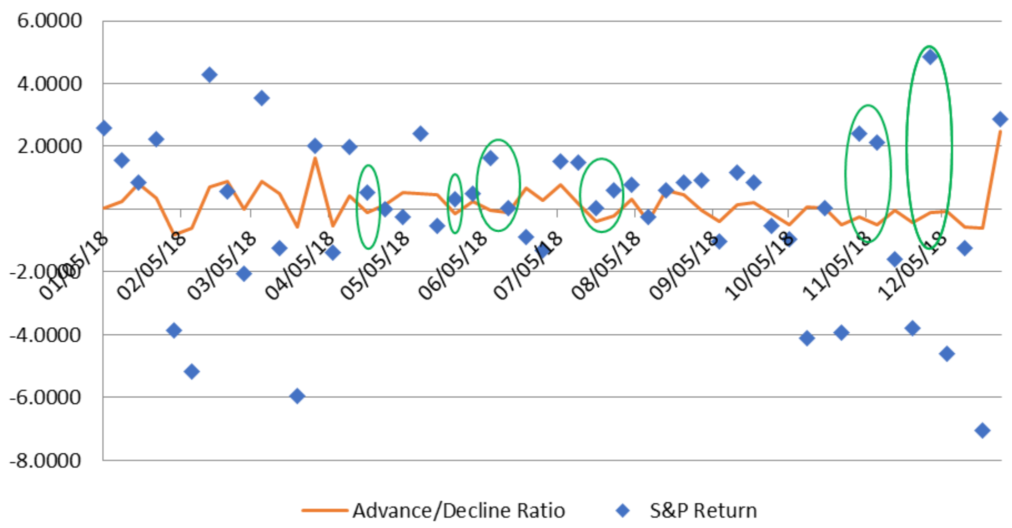
S&P 500 Returns vs. Advance/Decline Ratio



breadth, the ratio is much higher than 1.0. For example, three stocks advancing for each one stock declining gives you an ADR of 3.0. This would be a healthy, broad-based market advance. However, three declining for every one advancing would be a ratio of 0.33. If the market is going up but the ratio is below one, it means that the market's strength is not as great as it appears on the surface.

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The Advance/Decline Ratio (ADR)

On the chart above, I've displayed the weekly returns of the S&P 500 vs the weekly ADR of the New York Stock Exchange (NYSE). While this may appear to be an apple to oranges comparison, it's not. It's more like a navel orange to oranges comparison. There are just over 500 companies in the S&P 500, and roughly 2,800 on the NYSE. Many, if not most, of the S&P 500 companies trade on the NYSE, so using the ADR of the NYSE is an apt comparison. Moreover, it accentuates the point I'm trying to make.

I've shifted the axis of the ADR line from 1.0 to 0.0 simply for clarity in this chart, but what it displays remains the same.

Note where I've circled data in green – those are weeks where there are gains in the market, but on little breadth, i.e., more stocks went down than went up, but the market still went up.

The above doesn't tell the whole story either. If we look at daily advancers vs decliners, we see that in 2018 55% of the trading days saw more decliners than advancers. On the days where decliners outnumbered advancers, there were roughly three stocks declining for each two that advanced.

Underappreciated Values

As I said earlier, while lack of breadth conveys the presence of some level of risk, it is also an indicator that there is likely a fair amount of opportunity available. Because all of the attention is concentrated on a small number of stocks, opportunities begin to present themselves in the ignored stocks. These are the ones that, because of inattention from market participants, underappreciated value can be found.

It can be difficult to invest in these underappreciated companies. In periods like we've been experiencing, the stock prices of these companies can languish. They are strong companies, with strong earnings, good management – in short, those with strong fundamentals. But they aren't the current darlings of the market, so their stock prices will fail to reflect their true value, sometimes for quite a while. This can (and does) get frustrating, especially when we hear about the market reaching all-time highs. Unfortunately, the pundits usually fail to mention that the all-time highs are on very narrow breadth.

Aspects of a Slowing Economy

In time, it all comes back around to fundamentals and valuation. In the fourth quarter, we began to see a bit of that, and it appears to be gaining steam these first few weeks of 2019. When the economy slows, companies whose share price hinged on continued rapid growth tend to get hit hard. Witness the declines in Facebook (down 20.3%), Apple (down 30.1%), Amazon (down 25%), and Netflix (down 28.5%) in the fourth quarter. Each of these far exceeded the declines in the broader market.

The reason behind the declines is the very real fear that growth may be slowing. Tariffs will have a negative effect on growth. Compounding the issue is that the Fed has stated that it intends to continue raising interest rates. Higher interest rates are intended to slow an overheating economy. The increases promulgated by the Fed to date appear to have been done in an effort to keep the economy from getting overheated in the first place. That said, there is an almost tangible fear that the Fed will go too far, too fast, and kick the economy into a recession. When fear becomes tangible, the market tends to get messy.

Time to Refocus

When the market can no longer count on "easy money" investing (i.e., follow the crowd and just buy what everyone else is), a focus on the fundamentals becomes much more important. This is precisely the manner in which we invest – a focus on the fundamentals drives the decisions. We believe that in the coming months, this is going to prove much more important than it has been in recent periods. And thus (hopefully) my frustration will be coming to an end.

The economy remains strong, for now at least. We are a consumer driven economy, and Consumer Confidence remains at levels not seen since the dot-com era. GDP growth is at the highest level since before the Great Recession. Unemployment is the lowest since 2000. Profit margins remain near all-time highs, and inflation remains in check. All told, the economy looks great.

So, What Might Go Wrong?

Debt levels are a serious concern. Consumer Installment Debt as a percentage of Disposable Personal Income is at all-time highs. Total Household Debt stands at 75% of GDP. To put that in perspective, it's the equivalent of about $59,000 worth of debt for every man, woman, and child in the United States. And that's just personal debt, not to mention corporate debt and the ever-increasing debt levels of municipalities, states, and the Federal government. Increasing interest rates make it more expensive to meet the obligations of that debt, which could lead to another financial crisis.

Trade issues are likely to have an effect on the economy if not resolved soon and favorably. One merely must watch the market on days that Trump tweets about how wonderful his discussions with

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Chinese counterparts are going to see how serious this is.

We have a divided (and highly antagonistic) Federal government. Both sides seem to be steadfastly refusing to compromise in any way on any topic at any time. This has resulted in the current government shutdown.

Piggybacking on the above, as the government shutdown wanes on, government employees are without pay, government services cease, and navigating regulatory regimes becomes impossible. In some cases, businesses cannot remain operating, as government approval is required to deliver goods/services to market, but those departments of government are not in operation.

Geopolitical issues abound, from unstable regimes to trade and tariffs, to migrant questions.

Where are the Opportunities?

In closing, I believe that there is a fair amount of opportunity in the equity markets right now as many equities are inefficiently priced. I'm actually more excited about prospects than I have been in a while, as the market appears to be pricing things more appropriately. That said, the assumed valuations depend on economic stability, and that is going to be highly dependent on trade and on the Fed.

If you have any questions, please feel free to contact us.

Very truly yours,

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