Intrinsic Investors

Investors Quarterly

Timely Insights into Markets and the Economy

Christopher P. Shea, CFP®

Third Quarter, 2018

Equities

- I've heard it said that at the end of the day, stock prices all come down to earnings. They're either there (or not). In the third quarter, investors chose to ignore saber-rattling on the trade front in favor of actual financial results. In 3Q2018, the Dow saw an increase in trailing earnings of almost 6%. The broad market responded with a gain of over 10%.

- That's how things are supposed to work. True, tax cuts played an important roll in the earnings improvement and they are largely already baked into the cake; and so the market has it's work cut out for itself going into the final quarter of the year. And the economy remains strong, even in the face of whatever headline you care to look at on a daily basis.

- We are well into the "silly season," also known as election time, just over a month away. October has a history of unpleasant surprises, especially when there's an election around the corner. And so, in addition to some real challenges to equities in short run, we have to contend with political shenanigans as well. So long as the economy is still firing on all (or most) burners, I view any sell-off as a buying opportunity.

- Here's something else to think about regarding tariffs. Since WWII, the U.S. has essentially subsidized much of the global growth by paying more in foreign tariffs and effectively assisting our trading partners through higher corporate rates and regulations. What if we just all agreed to trade freely with each other?

- Back on the "headwinds" front, I detect a growing number of nay-sayers convinced the end is nigh, due to the length of the current bull-market. I think they are missing the earnings recession from 2015-16 and the rough going many sectors experienced during that period. But that's often what a soft-landing looks like. We may have more room to run.

Fixed Income

- In the August Month-in-Review, I referenced some analysis I came across regarding the shape of the yield curve and what might be affecting it. It relates to buying activity in 10 year Treasuries for tax purposes in funding pension benefits.

- Without climbing back into the weeds, the upshot of the piece was that the yield curve might have been getting distorted due to this activity and that after September 15th, the yield on the 10 yr. T-Note might begin to rise again. That appears to be happening. While this is a potential negative to equity investors over time, it is also starting to widen the spread on the yield curve, relieving growing pressure on the recession-watch front.

- The obvious reason that rising rates concern equity investors is that they create a competing asset class for investment dollars. While still historically low, the continued increase in rates bears careful monitoring. The Fed should raise rates again in December and there is talk on the street of possibly three more hikes in 2019. Talk is cheap, but we have to understand the Fed's policy of return to normal. They need some room to maneuver if a recession hits.

- The Fed has two main missions - maintain high employment (that part is working) and control inflation. While the Fed has been successful on this front so far, as discussed in the last installment of this letter, sometimes the moves to control inflation have the unintended consequences of driving it higher as consumers accelerate spending driving prices (and interest rates) higher.

Conclusions

- Continued fundamental strength continues to benefit equity investors. Although the challenge from fixed income investing is rising, rates are still not a compelling enough reason to justify a shift out of equities. While not the immediate threat, they are making headlines and this has the potential to "spook" the markets.

- Internally, our proprietary investment model (iCore) has extended it's outperformance over "Style Neutral" investing, as has been its history. It doesn't always out-perform in the short run, but over time, it has supported our belief that the smart money follows the earnings.

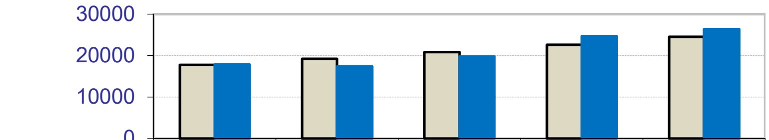
- We continue to view the market favorably. Progress is being made locally on trade. Earnings continue to support stock prices, although we will keep a close eye on third quarter earnings as they roll out to determine if the "tax-bump" stocks received this year is already baked into the cake. Finally, we continue to watch developments on the geopolitical and international economic fronts. For the number crunchers out there, some of our internal analysis follows.

Market Monitor

Relative Value

Compares the DJIA (blue) to a hypothetical price (Beige) based on he long term cumulative average growth rate of the Dow. Data for the past 5 years is presented here.

Nominal Price	$26,447
Model Price	$24,554
Difference ($)	$1,893
Average % (since 1988)	8.38%
Implication	Watch

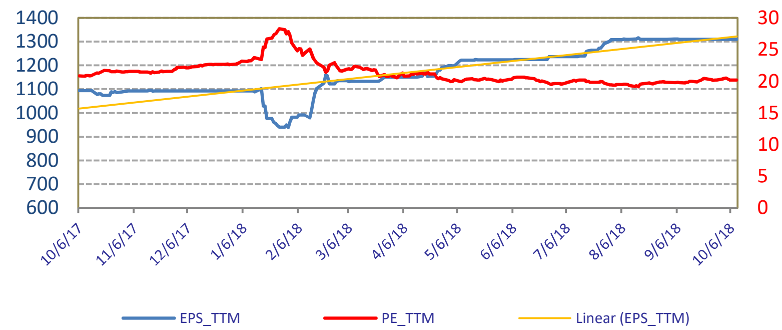


	2014	2015	2016	2017	2018
Model Price	17766	19262	20885	22645	24552
Actual Price	17823	17425	19763	24743	26431

Earnings Growth

Presents the rate-of-change in the DJIA trailing earnings (blue) and also the relevant PE ratio (red) based on those earnings. Growing earnings support current prices.

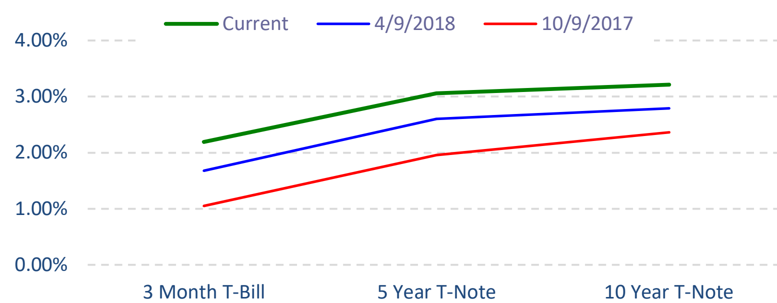
Time Period	*% Change*
1 Month	-0.09%
3 Month	5.91%
6 Month	13.92%
Y-O-Y	19.84%
Trailing PE Ratio	20.18
Implication	Positive



Yield Curve

The prospects for continued economic growth are improved when the yield curve slopes up. This graphic presents the yield curve over the past year.

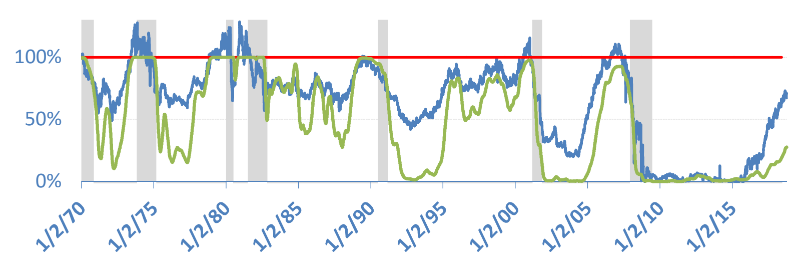
Maturities	*% Yield*
3 Month T-Bill	2.17%
5 Year T-Note	3.07%
10 Year T-Note	3.23%
Long-Short Spread	1.06%
Risk Implication	Rising



Recession Predictor

The Yield Score (blue) and Probability Odds (Green) both must approach/exceed 100% prior to a new recession (gray).

Yield Curve Score	67.18%
Recession Probability	27.62%
Risk Implication	Rising



Disclosures:

Opinions expressed are as of the current date and subject to change without notice. Intrinsic Investors, LLC shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses or opinions contained herein or their use, which do not constitute investment advice, are provided as of the date written, are provided solely for informational purposes and therefore are not an offer to buy or sell a security.

This commentary is for informational purposes only and has not been tailored to suit any individual. References to specific securities or investment options should not be considered an offer to purchase or sell that specific investment.