Alley Company Quarterly Letter
<u>Glass Half Full</u>

April 12, 2017

In the wake of the Great Recession, pessimism was pervasive and investor sentiment was severely damaged. It was a difficult time to be optimistic about the future. We felt alone at times striking an optimistic tone in our quarterly letters, including those titled: Nattering Nabobs and the Wall of Worry; A Great Time to be an Investor; What Can Go Right in America?; and Plenty of Room for Improvement (www.alleycompanyllc.com).

Fast forward to today and it's clear that our optimistic take was well placed as the economic recovery has endured. In fact, the current economic expansion cycle in the United States has now entered its 93^{rd} month, which ranks it the *third longest* in U.S. history (expansion cycles in the 1960s and 1990s were 106 months and 120 months, respectively).

While the *pace* of the economic recovery since 2009 has been subpar by historical standards (and, of course, criticized ad nauseam by the naysayers), the *duration* of the cycle has proven to be stellar and, quite possibly, could become the longest on record.

Corporate America, meanwhile, has operated well with this backdrop of steady, albeit slow, economic growth and earnings on a per-share basis will most likely make another *all-time high* in 2017. In turn, the stock market has appreciated meaningfully over the past eight years and shareholder-friendly companies have rewarded investors with *trillions* of dollars in cash dividend payments.

We have spent our entire careers in the investment management industry and have frequently witnessed market participants that choose to look at the glass as half empty. Unfortunately, the ongoing proliferation of the media in financial markets feeds this mentality. But for individual investors, acting on this mindset or "betting against America" for any extended period of time has proven to be the wrong approach. Warren Buffett made the same point in his most recent letter to shareholders:

> "American business – and consequently a basket of stocks – is virtually certain to be worth far more in the years ahead. Innovation, productivity gains, entrepreneurial spirit, and an abundance of capital will see to that. Ever-present naysayers may prosper by marketing their gloomy forecasts. But heaven help them if they act on the nonsense they peddle."

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Today, like any period in history, there is plenty to worry about – and market corrections can be right around any corner – but "missing the forest for the trees" has been costly for market timers and permabears. Without being Pollyannaish, we contemplate the following glass as half full scenarios that could play out over the remainder of 2017 and into 2018:

- Although the Fed may raise short-term interest rates a few more times, the general yield curve could stay "lower for longer," which would be supportive of equity valuations. Additionally, when the 10-year Treasury yield is below 5%, stocks tend to have a *positive* correlation with interest rates (i.e., rising rates and rising stocks). Currently, stocks are attractively valued relative to bonds with the earnings yield (earnings/price) on the stock market at approximately 5.6% compared to the yield on the 10-year Treasury bond of 2.4%.
- Not only has the global economic recovery been subpar, but it has also lacked meaningful periods of *synchronized* growth. There is a growing view among economists that the global economy could produce its most synchronized growth since the immediate aftermath of the Great Recession.
- The policy agenda in the U.S., including tax reform, loosened regulations, and infrastructure spending is aimed at increasing nominal economic growth. While the implementation of any changes will almost certainly be messy and uneven in terms of timing, there could be "icing on the cake" for a U.S. economy that is already on solid footing.
- After two years of flattish corporate earnings, due largely to a recession in the energy sector, 2017 could show a growth spurt. And if the economy were to accelerate and pro-business reforms take hold, then earnings could begin to outperform Wall Street expectations.

A healthy dose of skepticism is important for investors, but to remain engaged in one's investment management program, a glass half full mindset is equally important. Risk should be managed through the all-important strategic asset allocation decisions that investors make and the quality of the individual holdings in one's portfolio.