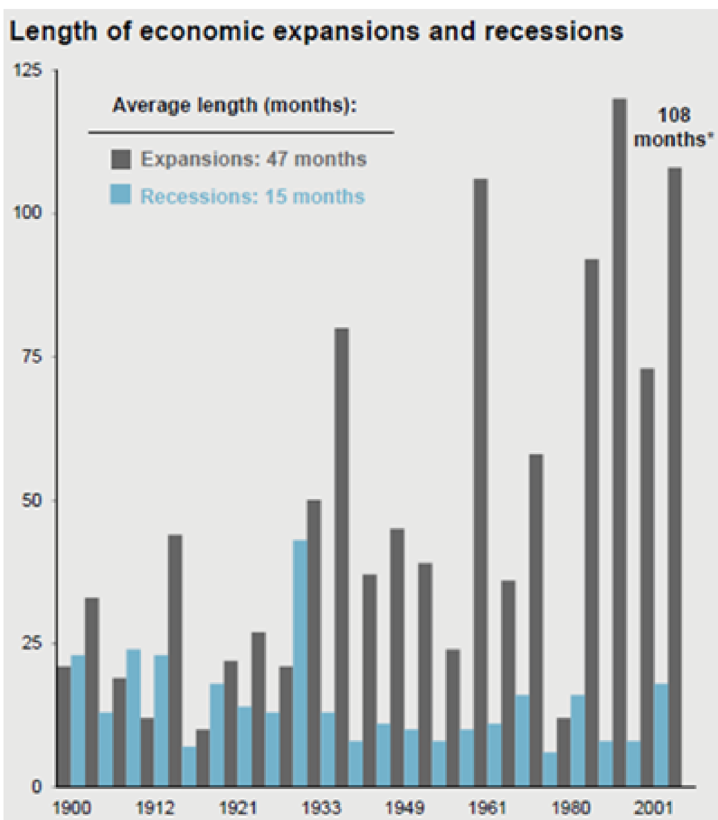
Alley Company Quarterly Letter
Take Me Out to the Ballgame

July 13, 2018

"It's a beautiful day for a ballgame… Let's play two!" ~ Ernie Banks

The current economic expansion cycle in the U.S. – with a duration of 108 months, or 9 years – now ranks as the second longest since 1900 (see exhibit below). This phenomenon seems to be causing economists and pundits to use the analogy of a baseball game to suggest that the cycle must be near its end. Back in December, for example, a prominent Wall Street strategist claimed that the business cycle was **"somewhere between the 7th inning stretch and the bottom of the 9th inning."**



Source: National Bureau of Economic Research, JPM Guide to Markets.
*Through June 2018.

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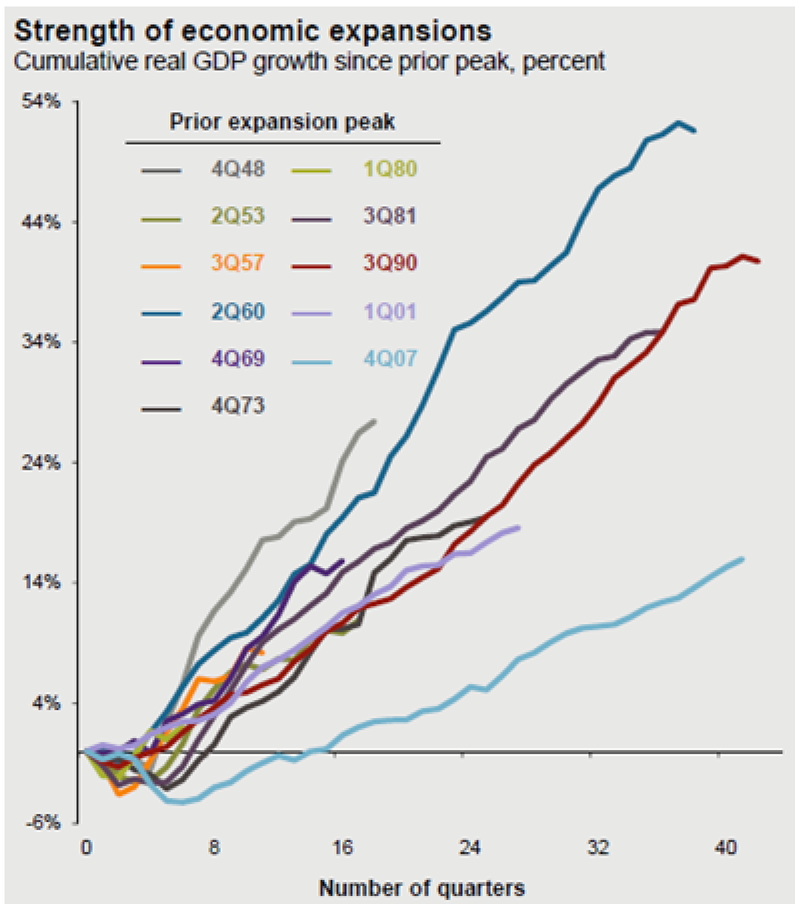
Despite the aforementioned prediction, the economy has not waned, and to the contrary has now increased its rate of growth. (The Atlanta Federal Reserve Bank model estimates that 2Q gross domestic product grew at an annual rate of 3.8 percent, above the average growth of 2.2 percent in this expansion.) Also, while this economic expansion has been lengthy in duration, it has been less than robust from a *cumulative* perspective. The exhibit below depicts the cumulative economic growth of the past eleven expansions. This cycle (bottom light blue line) has been subpar relative to past cycles, including several that were significantly shorter in length. This analysis is what Jamie Dimon, CEO of JPMorgan Chase, had in mind when he recently stated that **"we are only in the 6th inning of the ballgame."**



Source: National Bureau of Economic Research, JPM Guide to Markets.

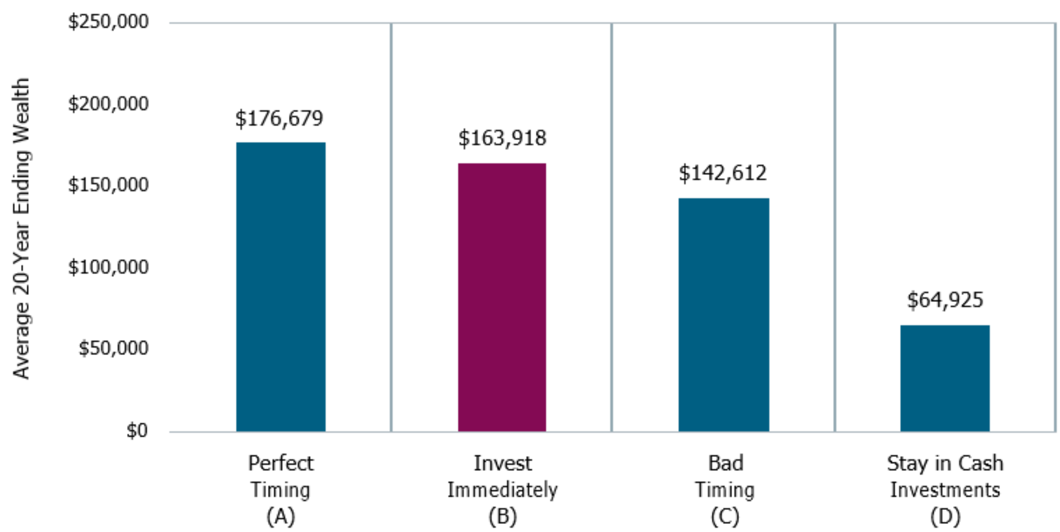
The use of analogies and metaphors can be witty and effective in communicating and learning. But in this case, predicting the precise position of the economic expansion is challenging at best and can be counterproductive for an investor if this activity is allowed to drive the investment process. **For successful long-term investors that have a sound investment philosophy and**

an appropriate asset allocation structure, the “ballgame” doesn’t end, but rather it is continually managed according to goals and objectives.

The study below illustrates that staying in the ballgame, even with bad timing, is better than “sitting on the bench” over the long pull.

The costs of waiting to invest

Ending wealth for four types of investors over all 20-year periods (1926 - 2017)



Source: Schwab Center for Financial Research. This chart shows the outcomes for four hypothetical investors who invested $2,000 a year for 20 years. Investor A invested each year at the market trough. Investor B invested immediately on the first day of each year (highlighted by the purple bar). Investor C invested each year at the market peak. Investor D never implemented the plan and stayed in T-bills. Investors A & C invested their yearly $2,000 investments in T-bills while waiting to invest in stocks. Stocks are represented by the S&P 500® Index with all dividends invested. Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Average results remained relatively unchanged when the study is extended to 12-month periods that begin with a month other than January. In the case of the 12-month period that goes from February to January, Investor B invested immediately on the first day of February each 12-month period for 20 years. **Past performance is no indication of future results.**

Economies and markets always ebb and flow – and no doubt recessions and market corrections will occur in the future – but investors that spend inordinate time trying to pinpoint these movements are more likely to strikeout than to hit a home run.

Today, the topic du jour is the ongoing global trade negotiations, which in many cases are being played out in the public eye. Rhetoric and tariff implementations could affect the economy in the near term by (1) impacting confidence and causing delays in investment and spending, and (2) pushing up costs via raw materials price inflation. Ultimately, deep and prolonged trade disputes would put sand in the gears of a world economy that has become more globalized, so even after political posturing, it is in the best interest of all parties to work toward agreements and solutions.

Meanwhile, with an assist from recently enacted corporate tax reform, earnings for corporate America are booming. For example, 1Q18 earnings per share (EPS) grew at a clip of 24 percent and current expectations are for 2Q-4Q growth of 20 percent, 22 percent, and 18 percent, respectively. Historically, long-term earnings growth has run closer to 6-7 percent, so naturally the recent pace of growth will slow at some point.

As “Mr. Cub,” Ernie Banks, said: “Let’s play two!” For investors, this mindset is more productive than trying to predict the bottom of the 9th. Since 1928, the stock market has risen on 54 percent of trading days, 58 percent of months, and 73 percent of years. Put simply, participating in the markets is mostly a winner’s game. Put me in coach!