Alley Company Quarterly Letter
FactCheck

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While the United States economy still has room for improvement in the aftermath of the Great Recession, our country is by far the best performing economy in the world today, having achieved sustained economic growth and significant unemployment reduction. Given the early 2016 stock market decline, caused in large part by the ongoing energy sector decline and the concerns about China, a fresh inventory of the investment landscape is warranted.

First, let's do a FactCheck on some key economic metrics:

- Since the economic bottom was made in 2009, real GDP has grown at a rate of 2.3% per year, achieving 25 straight quarters of steady growth that appears to have sustainability.
- The unemployment rate has declined to 5.0% from 10.5% since 2009. The 292,000 jobs just added in December certainly supports this trend.
- The U.S. banking system is in a historically strong position as Tier One capital ratios at the four largest banks are over 12% today vs. 7.5% in 2008. The banking system is estimated to have over $2.5 trillion in excess reserves, underscoring strong liquidity.
- The Household debt service ratio (debt payments as a percentage of disposable income) has declined to historic lows of approximately 10%.
- U.S. corporations have record amounts of cash on their books.
- The Leading Economic Index (LEI) rose 1.5% during the six months ending in November, signaling continued economic growth.

While the economy is always subject to a slowdown, or even recession (e.g., that could be induced by what is presently occurring in the energy economy), we believe these metrics are a good indication of a strong underlying foundation.

Continuing our FactCheck at the individual company level, American businesses are on the cutting edge in innovation which is powering broad-based growth in the economy. In prior quarters, we have written about major economic developments, inventions, and megatrends – cloud computing; tablets and hand-held mobile devices; evolving energy independence through hydraulic fracking; the housing market recovery; pent-up auto demand; new cancer drugs and other biotech breakthroughs, etc. – that are adding wealth, creating jobs, and boosting profits.

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The exhibit below provides a sampling of the many American blue chip corporations that are leading the charge in innovation.

Company	Innovation
amazon.com	Global leader in e-commerce with an unprecedented supply chain capability that can bring products to your door in two days or less. Amazon Web Services is emerging as the leading cloud computing platform for businesses.
LOCKHEED MARTIN	F-35 program for the U.S. and its allies is the most advanced aircraft in military history.
Google	Wide ranging innovations, including search, Android operating system, YouTube! and more. Information is now at our fingertips practically anywhere in the world.
ExxonMobil	Fracking technology has unlocked vast reserves of fossil fuels for current and future consumption driving the U.S. towards energy independence.
Bristol-Myers Squibb	The global leader in Immun-Oncology drugs that is altering the course of cancer for many patients and honing in on developing cures for many cancers.

This snapshot of innovation at the company level highlights our philosophy of "understanding what you own" and fosters more staying power and engagement in the investment process for our clients.

Energy and China

Over the past year we identified the energy economy and the Chinese industrial sector as areas that will face headwinds in the coming years, and thus reduced what was already a small exposure to companies that do business in those arenas.

The energy sector has become a major focal point as the decline of 70% in the price of oil to $30 from $110 per barrel in the past year and a half has been a true shock, causing a major ripple effect that has slowed the commodity-industrial base of the economy. Demand for energy has remained stable, but oversupply due to the success of hydraulic fracking has weighed heavily on the price of oil as well as natural gas. The initial shock of the decline in energy may be masking the significant ongoing benefit to the rest of the economy which is estimated to be more than 90% of U.S. GDP. Gasoline prices, home heating bills, and business input costs have declined in some cases by 50% or more and represent a huge boon to the non-energy economy for both consumers and businesses alike. How long energy prices will stay low is anybody's guess, but the longer they stay low the better it is for the majority of the worldwide economy.

China is in the news again as we begin 2016, as their shift from an industrial to a more consumer based economy is experiencing transition pains. Stock market manipulation by traders coupled with currency manipulation by the government has unnerved investors. The jury is still out as to what effect, if any, China will have on the U.S. economy. A point of reference is that U.S. exports to China are estimated to be only 0.7% of U.S. GDP, which implies a fairly muted direct effect. It is also interesting to note that Starbucks just announced their plan to open 500 stores in each of the next five years in China, a strong vote of confidence.

Our final FactCheck is on valuation, where the S&P 500 currently has a dividend yield of 2.30% which is above the ten-year U.S. Treasury yield of 2.03%, an occurrence that in the past has signaled opportunity for stocks. Further, the earnings yield (earnings divided by price) of the S&P 500 is 6.5% on 2016 estimated earnings, also a very attractive metric for stocks relative to fixed income yields. More importantly, we see solid fundamentals in individual companies in the non-energy sectors of the economy, and are believers that individual company analysis will be the arbiter of disputes!

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