Alley Company Quarterly Letter
Flashing Green

January 12, 2018

At her final press conference last month, outgoing Fed Chairwoman Janet Yellen said: "We're enjoying solid economic growth with low inflation, and the risks in the global economy look more balanced than they have in many years. When we look at financial stability risks, there's nothing flashing red there or possibly even orange. We have a much more resilient, stronger banking system, and we're not seeing some worrisome build-up in leverage or credit growth at excessive levels."

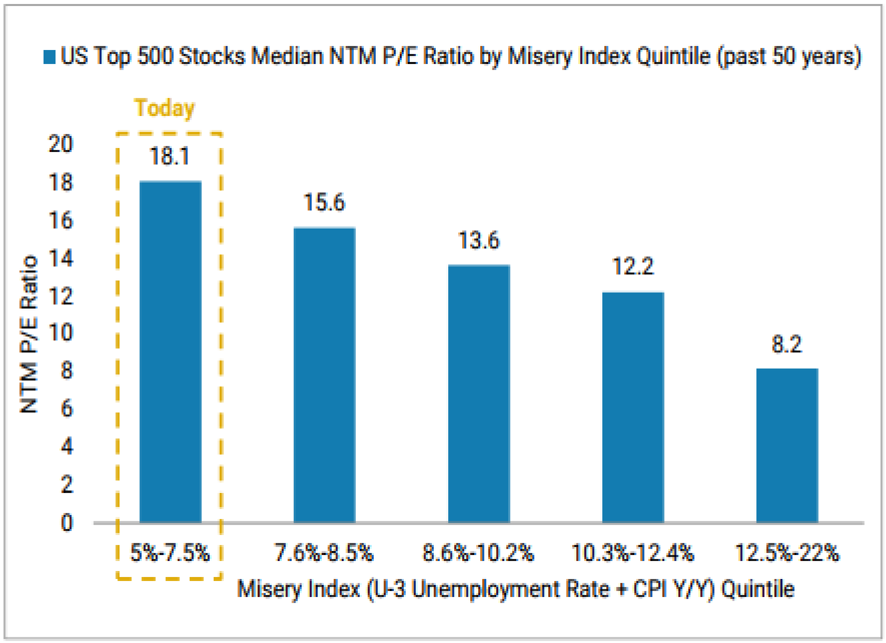
Despite the current economic expansion cycle in the United States having now reached its 102nd month (3rd longest since the early 1900s), it doesn't appear that excesses have built-up and the next recession is presently not in sight. In fact, the most recent quarterly growth actually *accelerated* to the 3 percent level and new tax policy starting in 2018 is expected to further support economic output. In short, the lights for the U.S. economy are flashing green.

Meanwhile, the Eurozone economy is showing improved growth and its unemployment rate is exhibiting sustained improvement. Japan has also shown improvement in growth and unemployment. Of the 45 countries tracked by the Organization for Economic Cooperation and Development (OECD), *all* are on pace to expand, an uncommon synchronicity.

This global economic backdrop is favorable for corporate fundamentals as strong growth in revenue, earnings, and cash flow is likely in the offing. With that said, investors should remain disciplined and vigilant. On one hand, the financial markets theoretically function as discounting mechanisms, but on the other hand, it is impossible to precisely gauge what is accurately priced in at one point in time or another. Our longstanding advice: remain *engaged* in your investment management program (including the all-important Asset Allocation decision) and don't let yourself think you can time the markets.

Stocks indeed enjoyed an above-average year in 2017, with the S&P 500 rising over 19 percent on a price-only basis. But prices shouldn't be viewed in a vacuum because, importantly, expectations for corporate earnings also increased steadily throughout the past year. Fundamental momentum coupled with tax reform, could drive earnings for the S&P 500 to $155 per share in 2018, placing the next-twelve-month (NTM) price-to-earnings (P/E) ratio at approximately 17.5x. This multiple is higher than the *average* multiple of 16.0x for the market, but that stands to reason because valuation levels are typically higher when unemployment and inflation are low (see Misery Index exhibit on top of next page).

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com



Source: Morgan Stanley Research and U.S. Bureau of Labor Statistics

The "Misery Index" is the sum of the unemployment rate and the inflation rate. When the Index has a high reading (e.g., the highest quintile in the chart above is the range of 12.5 to 22 percent), the market has a low median P/E ratio. Conversely, when the Index has a low reading (e.g., 5 to 7.5 percent), the market can support much higher valuation levels. Today, the unemployment rate is 4.1 percent and the inflation rate (core Consumer Price Index) is 1.7 percent for a Misery Index reading of 5.8 percent. Inflation, in particular, could rise moderately from here, but it still seems likely that we will stay in the lowest quintile range for the Misery Index for the foreseeable future. In this context, the current NTM P/E of 17.5x compares favorably to the 50-year median of 18.1x.

While the economic outlook is positive, the stock market valuation level is not stretched, and corporate fundamentals are strong and likely improving, we are nonetheless staying disciplined by "rebalancing" portfolios. This action includes rebalancing toward agreed-upon Asset Allocation targets as well as monitoring individual position sizes and sector weightings where appropriate. A sound investment management program should always have an eye toward risk control even when the lights are flashing green.