Alley Company Quarterly Letter
"Mr. Market"

January 15, 2019

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be the most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow." – Warren Buffett

True to form, in 2018 Mr. Market had some mood swings. Early in the year he was ebullient as a new tax reform bill had just passed and the global economy was enjoying a period of synchronized growth. At the end of the year, however, his mood turned gloomy as he fixated on the uncertainty of a trade war, the appropriateness of Fed policy, and a polarizing political climate.

When Mr. Market gets particularly gloomy, he seems to lose sight of the long term, where returns for equity investors are favorable, especially relative to the deleterious effects of inflation over time.

Herein we discuss the macro-oriented clouds that overhang today's market and how some of these issues could improve in 2019 thereby uplifting the mood of Mr. Market.

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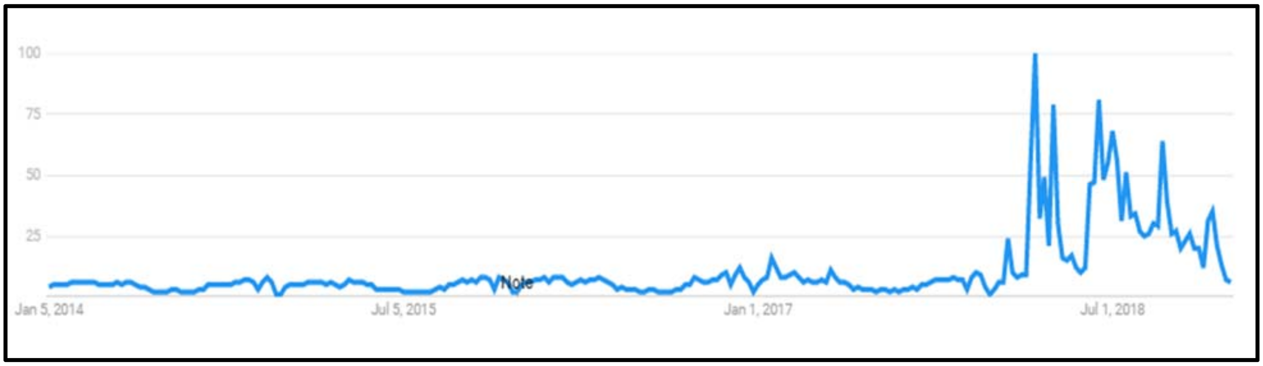
Tariffs

Tariffs have had little mindshare with the general public until recently. In fact, Google search trends from the past five years indicate that not until early 2018 did "tariffs" become a popular search term. [1]

Google Search Trends 2014-2019: "Tariffs"



Source: www.trends.google.com

The Trump administration has used tariffs with the threat of even larger tariffs as a negotiating tool with the goal of striking a new trade deal with China, our largest trading partner.

Given the size and importance of these two economies, free and fair trade is a worthwhile pursuit, but disruptive negotiations are harming business activity and confidence with ripple effects throughout the world.

Recent market volatility in the U.S. and China has signaled to the leadership of both countries that a prolonged skirmish is not in the best interest of anyone. Additionally, from a political standpoint, it would seem challenging to get re-elected in 2020 if this issue were still in the headlines or had caused a meaningful economic downturn. These forces should bring both countries to the bargaining table where a deal can be struck, reducing uncertainty for the global economy.

Fed Policy

The U.S. economy *incrementally strengthened* in 2018, allowing the Federal Reserve to continue on a path towards "normalizing" interest rates. The Fed hiked rates four times during 2018, taking the Fed Funds rate up to 2.50%, still a low rate by historical standards. Financial markets, however, raised concern when Chairman Jerome Powell signaled that the Fed would likely raise rates several more times in 2019 and continue to wind down its balance sheet.

Fed commentary has recently moved toward a more "flexible" and "patient" stance, indicating that economic data would be analyzed closely before increasing rates further. This change in communication was important in getting the Fed "out of the box," so to speak, and less committed to any pre-set path of monetary tightening in 2019. Additionally, the Fed may have "cover" to pause as the significant pullback in energy prices should mute near-term inflation readings and softer economic data outside of the U.S. may influence policymakers to take a more gradual approach.

Political Gridlock

The final issue, a polarizing political climate, has a lot of room for improvement to state the obvious. As we write, the U.S. government is partially shut down with both parties digging in their heels and refusing to compromise.

Increasingly, issues are seen in black or white terms with no shades of gray and reaching across the aisle is perceived as weakness. It is possible that the electorate will fatigue of tribal politics and force political leaders to seek more compromise on behalf of the country. While it is unlikely that we will see a substantial trend in this direction, re-opening the government would be a good first step!

Concluding Thoughts

Despite the macro clouds, the U.S. economy continues to show evidence of being on solid footing (robust employment market and well-anchored inflation) and corporate profits are currently expected to reach another record in 2019. After the recent pullback, the S&P 500 is trading at 15x forward earnings, or an earnings yield of 6.4%, while the 10-year U.S. Treasury bond yield is 2.70%, an attractive valuation relationship for stocks.

While heightened volatility in markets is likely to continue in 2019, Mr. Market's mood swings can create opportunities for investors. This is particularly the case when near-term volatility causes prices to detach from long-term fundamental value.

As Warren Buffett notes, *"Mr. Market is there to serve you, not to guide you…If he shows up some day in a particularly foolish mood, you are free to either ignore him or take advantage of him, but it will be disastrous if you fall under his influence."*

[1] Google Trends – "Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term."