ALPHA CUBED
INVESTMENTS

Investment Letter, Q4 2018

October 2, 2018

The Times, They Are A-Changin'

In our last letter, we noted the performance discrepancy between the broader market and technology stocks in general. The technology sector drove most of the returns through the first half of the year, but that all changed in the third quarter as the S&P 500 came back to life. The market has a way of normalizing over time, which is why we always advocate a diversified portfolio. Below are the metrics for the quarter and year-to-date:

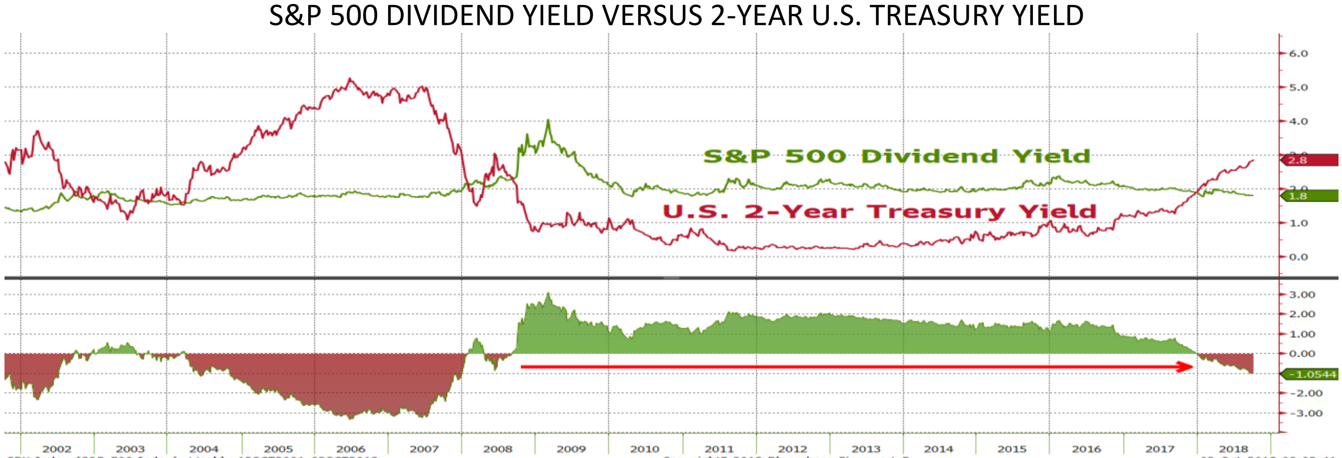
	2018 Q3	**2018 (through 9/30)**
S&P 500 Total Return	7.71%	10.56%
NYSE Composite Total Return	5.25%	4.09%
Barclays Aggregate Bond Index	0.02%	-1.60%

	9/30/2018
U.S. 2018 GDP (Consensus Est.)	2.90%
S&P 500 P/E (Current)	21.22
S&P 500 P/E (12mo. Forward)	16.99

The US markets have been generally healthy this year, and investments in domestically traded securities have been rewarded. It should be noted that the MSCI ACWI ex-USA Index (an index of global markets) was actually down -3.09% year-to-date at the end of the quarter. Allocations to international investments have severely negatively impacted returns in 2018, but we have been fortunate to avoid most of this area. Let's take a look at some of the bigger market drivers and what they may be telling us about the future.

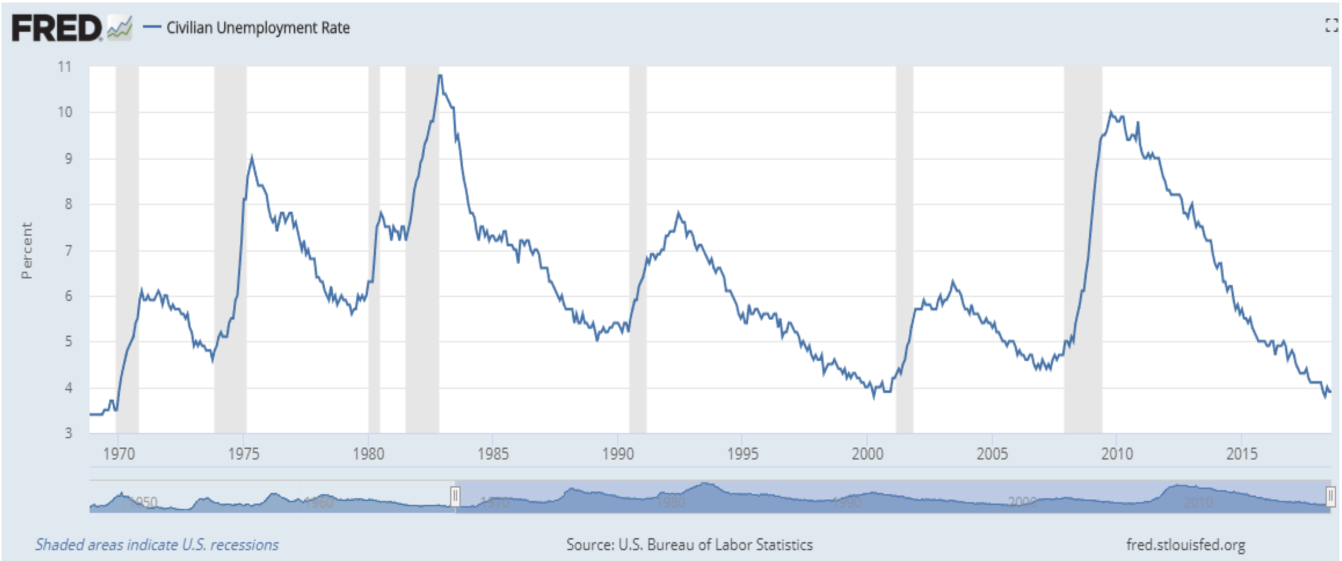
GDP continues to be revised upward with the Federal Reserve now looking for 3.1% real GDP growth for 2018, and consensus estimates for earnings-per-share for the S&P 500 show an increase of about 21% over 2017. A world with 3.1% GDP and strong corporate earnings suggests interest rates should continue to rise after many years of being at historic lows. That is exactly what is happening as the Federal Reserve continues to raise the Federal Funds rate and taper its balance sheet. In late September, the Fed raised the target range for the Fed Funds rate to 2-2.25%. Remember, we were under 0.5% on the Fed Funds rate just two short years ago. We have been talking about the growing competition for capital between relatively risk-free alternatives like money markets versus the stock market, and that is something we will have to carefully follow as the rate of the 10-year US Treasury moves up to levels not seen since 2013.

S&P 500 DIVIDEND YIELD VERSUS 2-YEAR U.S. TREASURY YIELD



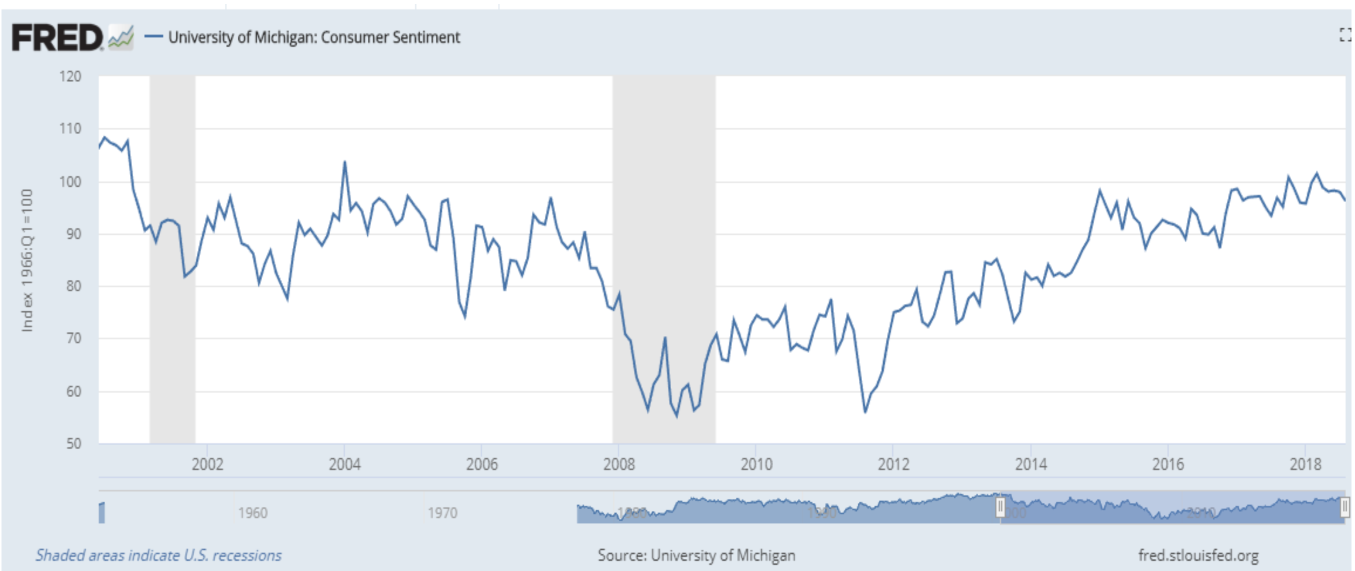
Employment numbers released in September continue to show that the economy is very robust. The chart of the civilian unemployment rate below illustrates that unemployment is at the lowest level since the late 1960s(!):

CIVILIAN UNEMPLOYMENT RATE



Along with this robust employment picture, we are also seeing consumer sentiment back to the very high levels that we haven't seen sustained since before the financial crisis in 2008 as shown in the following graph:

CONSUMER SENTIMENT



The trade wars that have been simmering this year continue to be an area of concern. Initially, each tariff announcement was met with fear and volatility in the markets. However, that cycle shortened with each new round, and the markets have generally ignored the potential ramifications of an escalation in this area. A full-blown trade war with China will definitely not be accretive to earnings in 2019, with some analysts estimating corporate earnings growth in 2019 could drop from the current consensus of a 10% increase down to as low as 5%. Hopefully, the rhetoric will decrease and some compromises can be reached as we saw in the U.S.-Mexico-Canada Agreement before there is a material impact to corporate earnings in 2019.

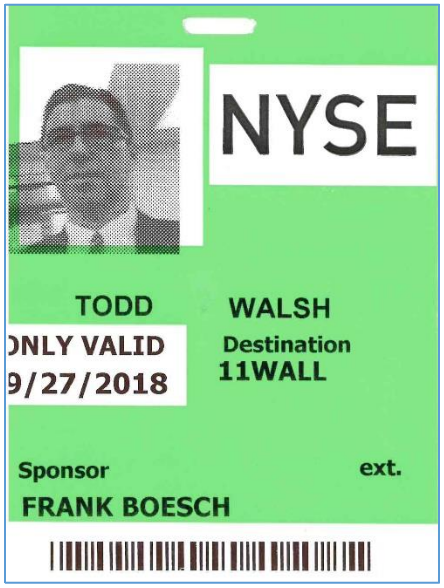
While the markets have been strong lately, it is our job to prepare for the future. As the title of this letter suggests, we think the nature of the markets may be in the process of changing. The explosion in corporate earnings, historically low unemployment, high level of consumer confidence, and historically low interest rates seem to all be generally priced into this market over the last couple years. We don't see a massive repricing of assets in the near future or a bear market like we saw in 2008, but it is likely that returns in the market may be more muted over the next few years, and it would be normal to expect an increase in volatility. If we assume the consensus estimate for 2019 S&P 500 earnings will hold at $178 and we assume a multiple of 17-18x for the markets, that gives us a target of ~$3,025 to ~$3,200, which would represent a return of about 3.5-9.5%, excluding dividends. Higher interest rates, trade wars, slower relative earnings growth, and the upcoming mid-term elections are all potential headwinds for stock prices, so we will have to wait and see how all these factors play out. These issues have been piling up for a while and may eventually affect market behavior and investor sentiment. For this reason, we have been building a margin of safety in most of the accounts this year with either cash or bonds available for the proverbial rainy day. Of course, every client has different goals and risk tolerance, so please make sure to confirm that your account is allocated the way that makes the most sense for your situation. When things are good, it makes sense to prepare for more difficult times. We call that being "on cycle." When everyone else is taking massive risks, we would prefer to be more conservative and then look to expand our growth investments when investors are fearful and prices are lower. The business cycle has not been retired, and we are confident we will see this cycle play out like most others throughout history.

On a separate note, I was lucky enough to be in New York City on business last week and was able to take a tour of the New York Stock Exchange. When I started at EF Hutton in 1986, part of our training was to go onto the floor of the NYSE and see how stocks were actually traded. Back then, each post handled a few different companies, and almost all trades in each stock would go through that post and be traded and recorded by hand, person-to-person. It was a fast-paced, incredible sight to see these traders move hundreds of thousands of shares back-and-forth with hand gestures, a bit of yelling, a quick nod, and a slip of paper exchanged to confirm the transaction. It was loud, physical, and intimidating! My guide was a true veteran named Frank Boesch, who had been on the floor since the late 1970s. He is still processing trades to this day on the NYSE floor, but as he showed me, things have changed a lot. The crush of humanity that was the old NYSE is now gone, and the open outcry system that characterized almost all of the trading in the 20th century has been replaced by the quiet hum of thousands of computers matching all of the trades. The posts where stocks are traded now are mostly empty except for one or two people who seem to be there just in case something goes wrong. Computers rule the day now, and the time of these talented men and women who carefully managed all of the trading in the last 100+ years is now a faded memory. It should be noted that the total dollar volume of shares traded on the NYSE floor in 1980 was $382 billion (all by hand), and in 2017, the number is a staggering $15.8 trillion in shares traded annually! The NYSE remains as a great symbol of American freedom and financial prominence, but I will never forget the contribution of all the great people who built it. Thanks to Frank and all the guys and gals at Prime Exchange for taking the time to walk me through this great American institution. The times, they are a-changin', but we continue as the greatest free market in the world.

Sincerely,

Todd R. Walsh
CEO
Portfolio Manager

Frank Boesch on the floor



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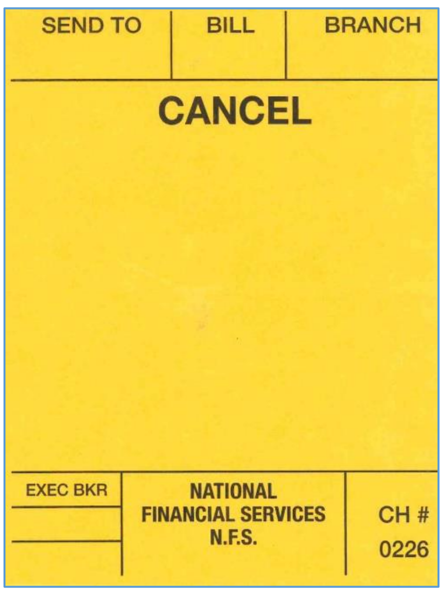
The Modern NYSE Floor



Original vintage NYSE Cancel Ticket

The Prime Exchange team in action

Yours truly with the opening gavel

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Data presented herein was sourced 10/2/2018 from Bloomberg.