Notes from the Trading Desk

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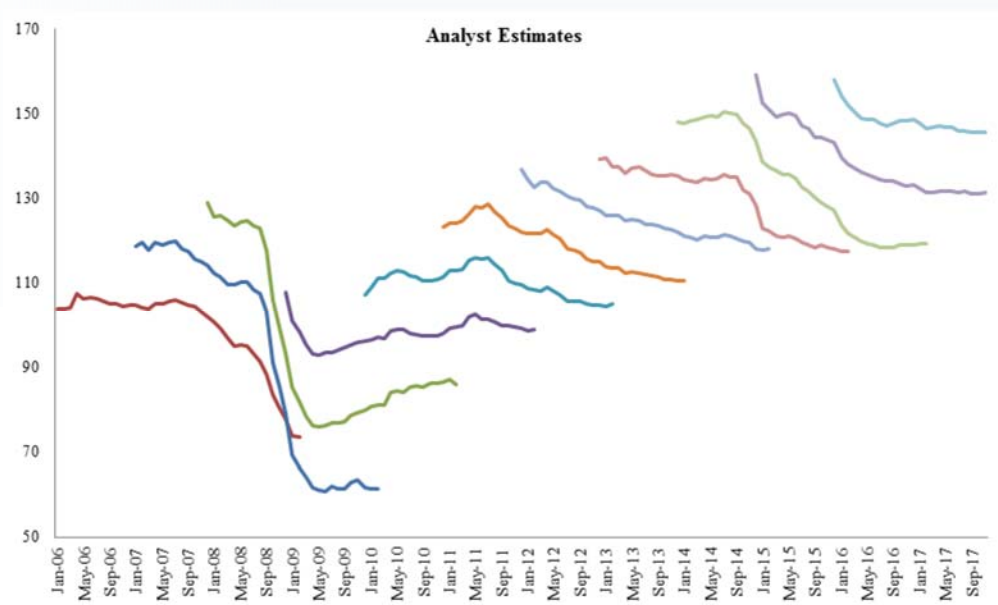
December 1, 2017

Market Movers & Shakers

Stocks continued their upward ascent this past week — though it was not without a little drama. The Dow closed higher 2.9%, good for its best weekly performance in 2017, as it crossed 24k for the first time. The S&P closed up 1.5%, with strong positive moves on both Tuesday and Thursday seemingly on the backs of good news surrounding the Senate tax bill. The Nasdaq actually gave back a little of its impressive YTD gains, it moved lower 0.6% this week. The week, by and large, was positive till 11am Friday when two headlines hit seemingly simultaneously. First, it became unclear whether or not the Senate Republicans would have enough votes to pass their tax bill. Shortly thereafter, news broke that General Flynn was pleading guilty to lying to the FBI about his communications with Russia *and* that he was directed to do so by senior officials on the Trump Transition Team. These headlines were enough to spark a 350 point slide in the Dow and a rush into safe havens. Treasuries, the Dollar, and Gold were all bid higher on this news as stocks slid. The VIX also jumped 29% intraday — marking the fear that quickly gripped the market. However, the markets gained their footing as confidence in the passing of the tax bill increased throughout Friday afternoon. Indices ultimately rallied and the S&P, which was down more than a percent intraday, eventually clawed back and closed down only 21 bps.

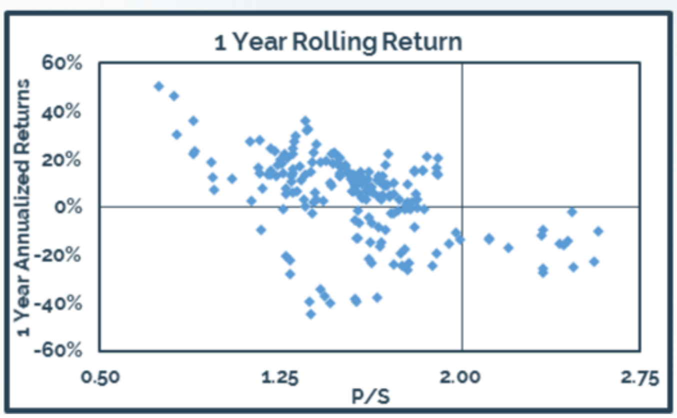
Since we are bottom up, we do not have an opinion on where the market as a whole stands. However, we can and do take a look at the numbers behind the market to more or less gauge the health of the system. A lot of the recent move in the S&P has been earnings driven. This has in turn caused analyst earnings forecasts to rise nicely. According to FactSet, the current CY18 earnings estimate is roughly $145. The S&P is currently trading at 22.3x trailing earnings. If we use this multiple on the CY18 price target, then you get an S&P 500 price target of 3,234 — an astounding 22% price gain from current levels. Now this could certainly happen — I am not attempting to suggest that it could not. However, analyst estimates have a history of starting out way higher than where they eventually end up. Take a look at the chart below. It charts over 10 years of data, and each year estimates ultimately come down. The CY18 estimate that FactSet is producing has already come down to $145 from $158 – a drop of 8%. CY17 had analyst estimates starting at $159, they have now come all the way down to $131 – a drop of 18%.

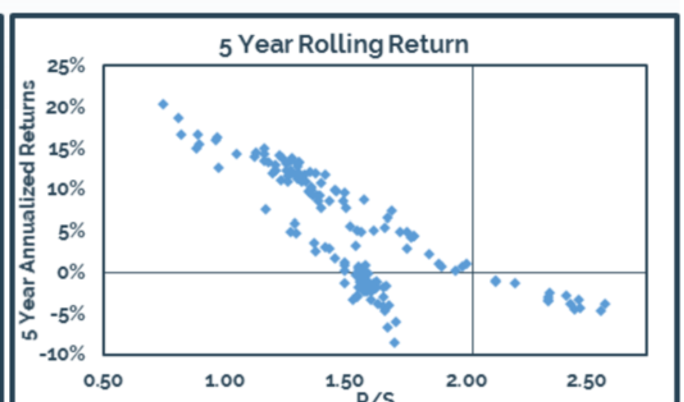


Let's discuss earnings. Earnings experienced nice growth from 2009 to 2014 — which ultimately stalled out as we entered an earnings recession. However, they have since grown again. According to Standard and Poor's, trailing Non-GAAP earnings peaked in Q3 of 2014 at $114.51. They finally passed that on a Non-GAAP basis back in June. This quarter, with only 3% of the S&P left unreported, we have earnings sitting nicely at $118.75. Earnings have grown 3.70% in the last 3 years. Meanwhile, the S&P has gained more than 34%. The S&P was trading at 17.2x earnings on 9/30/2014, now it is trading at 22.3x. Multiples have expanded 29.7%.

As far as valuations are concerned, using data going back to 1999, we are currently in the 86th percentile of Forward P/E Rankings. Using LTM instead of forward numbers, we are again in the 86th percentile. Finally, using P/S rather than P/E – a number that is arguably purer than earnings which are more easily manipulated – and we find ourselves in the 94th percentile. What's more, our current P/S ratio is 2.15. The S&P has never had a positive annualized 1 year, 3 year, or 5 year period when P/S gets above 2.0 (see the charts below). Returns in the broad index (and we are not the broad index) are severely limited when starting at elevated valuations.

None of this means that the S&P has to go lower – it doesn't. We are awash in liquidity across the world because of Central Banks. There is no reason the party has to stop now. Speculating when the party might stop is simply that, speculation. However, we are in an extended bull market with valuations notably high — which in the past has suggested limited returns going forward. Caution, as always, is certainly necessary.





Upgrades & Downgrades

HRL — reinstated overweight at Barclays with a price target of $40 (12/1).

NKE — downgraded to hold from buy at HSBC. Their price target was cut to $62, down from $64 (11/28).

Portfolio News

Once again, it was a positive week here at Tandem for our core names. The average Tandem stock moved 2.6% higher over the past week compared to the S&P's 1.5% gain. The mix was a nice composition of both recent leaders and laggards. Costco, Expeditors International, and Intercontinental Exchange — all recent leaders — continued their upward ascents as they all closed higher than 6% this week. Recent laggards like CVS, ORLY, TJX, and Tractor Supply all made 6% moves as well. Our laggards for the week included PayPal, eBay, and Cognizant Tech — all were impacted by the Nasdaq's move lower for the week. PayPal, down 4.2% for the week gave back some of its massive YTD move (it's still up 90.8% for the year).

On the news-side of things, *The Wall Street Journal* reported that CVS is nearing a deal to purchase Aetna between $200-205 per share. They are reportedly trying to finalize a deal in the next few weeks. Also in the healthcare spectrum, MEDNAX is reportedly working with Bank of America to field interest from private equity firms. Finally, Costco reported November comps of 10.8%, handily beating analyst estimates of 7.9%. This solid beat helped Costco's weekly gain of 7.9% as it climbed to all-time highs.

	WTD	MTD	QTD	YTD
Dow Jones	2.9%	-0.2%	8.2%	22.6%
S&P 500	1.5%	-0.2%	4.9%	18.0%
Nasdaq	-0.6%	-0.4%	5.4%	27.2%
Russell 2000	1.2%	-0.5%	3.1%	13.3%
C.D.	2.1%	0.0%	7.0%	18.5%
C.S.	2.4%	0.2%	4.0%	8.6%
Energy	2.7%	0.8%	1.3%	-7.4%
Fins	5.2%	0.2%	6.4%	18.1%
H.C.	1.8%	-0.2%	1.6%	20.7%
Ind.	2.9%	-1.2%	2.5%	15.1%
I.T.	-2.0%	-0.6%	8.1%	36.2%
Mats	0.4%	-0.9%	3.7%	18.3%
Utes	0.9%	-0.4%	5.8%	15.3%
REITs	-0.5%	0.2%	3.4%	8.0%

Earnings Calendar

Date	Time	Ticker
12/6	Pre-Market	BF.B
12/7	Pre-Market	DG