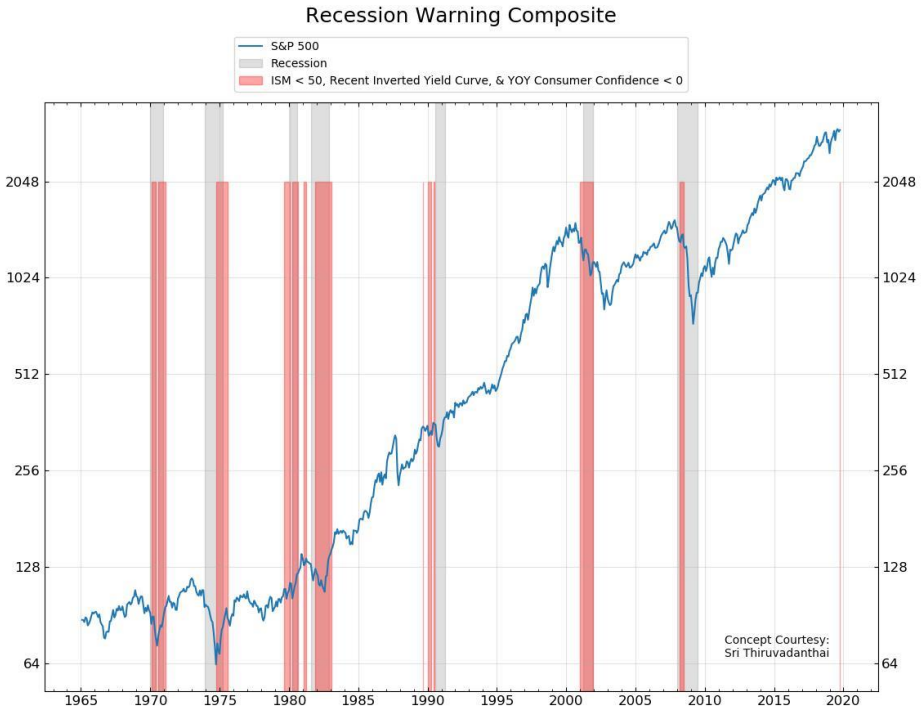
Wedgewood Partners Third Quarter 2019 Client Letter

Mr. Market Memo to Fed: We Expect A Soft Landing



Source: Bill Hester

Review and Outlook

Our Composite (net-of-fees)[i] was flat (+.39%) during the third quarter of 2019. The benchmark Russell 1000 Growth Index gained +1.49%. The S&P 500 Index gained +1.87% during the quarter.

Top performance detractors for the third quarter include Ulta Beauty, Tractor Supply Company, Facebook, PayPal, and Alcon.

Top third quarter performance contributors include Edwards Lifesciences, Apple, Alphabet, Ross Stores, and Bookings Holdings.

During the third quarter we sold Berkshire Hathaway. We trimmed Edwards Lifesciences, C.H. Robinson, and Ulta Beauty. We purchased Nvidia and CDW Corporation. We added to Alphabet and Alcon.

Ulta Beauty reported 12% growth in revenue on 6% growth in comparable sales (comp) and a 7% increase in operating income but guided to a low single-digit comp as management cited a slowdown in demand for cosmetics. It is unclear to us what is driving this sudden slowdown in their business, as the backdrop does not appear to have changed much over the past several quarters. Management did not have much visibility about a reacceleration, nor did they provide details about what their expense structure would look like if comps remain at a low, single-digit level. We reduced our weighting in Ulta as we think it will be increasingly difficult for Ulta to grow earnings in the near to mid-term.

Tractor Supply Company's net sales increased 6% with earnings per share up about 7% during the quarter. Tractor Supply Company lapped difficult comparisons both on a sales basis (2018 hurricane season) and profitability basis (2018 tax cut), so we would expect Tractor Supply Company to generate closer to double digit growth over a multi-year timeframe. Despite the relatively in-line quarter, the stock sold off based on what we believe are unfounded fears about the Company's exposure to employment in energy-levered regions. Unlike 2015, Tractor Supply Company has fewer customers levered to the fortunes of oil and gas. In addition, the slowdown in oil and gas activity over the past 12 months has been much shallower relative to 2014 – 2015.

Facebook reported 32% growth in constant currency ad revenue, along with expectations for 50-55% growth in expenses as the Company continued with their telegraphed plan to accelerate investments in privacy and security across their social platforms. The Federal Trade Commission (FTC) also approved a $5 billion fine for violating a 2012 FTC order by misrepresenting users' ability to control data privacy. While this removed an overhang dating back to early 2018, continued pressure from politicians and regulators kept Facebook's earnings multiple in check.

Edwards Lifesciences reported a strong acceleration in transcatheter aortic valve replacement (TAVR) sales, up 18% over last year, and helped drive the stock's performance during the quarter. As we mentioned last quarter, Edwards reported positive clinical results for the "low-risk" population of TAVR patients, which we expect to generate more awareness about minimally invasive procedures, now indicated for nearly all populations that suffer from severe aortic stenosis. We believe Edwards' addressable market has expanded significantly by about 50% due to this new data and augurs well for the next several quarters.

Apple grew revenues 4% constant currency, driven by 18% adjusted growth in its services business which has generated nearly $45 billion in revenues over the trailing four quarters, and 50% growth in wearables and accessories. We expect Apple's consolidated revenues will accelerate over the next 12 to 18 months as they complete the development of 5G-

capable mobile devices. Despite a quickly growing, high-margin software franchise, Apple continues to trade at undemanding earnings multiples.

Alphabet also saw revenues accelerate across their key advertising business (Google), in addition to rapid growth in their cloud services business that the Company sized at a $2 billion per quarter revenue run rate. Compute and data analytics drove Google's cloud acceleration, which we estimate is growing faster than Microsoft's Azure and Amazon's AWS offerings. As Google's advertising business stabilized, and with Google Cloud services now driving a more meaningful portion of revenues, combined with a massive cash balance and undemanding multiple, we added to our Alphabet position to take portfolios about 250 basis points overweight relative to the benchmark.

Q3 Top Contributors	Avg. Wgt.	Contribution to Return
Edwards Lifesciences Corporation	9.26	1.57
Apple Inc.	8.61	1.09
Alphabet Inc. Class A	6.15	0.43
Ross Stores, Inc.	3.65	0.37
Booking Holdings Inc.	5.81	0.25

Q3 Bottom Contributors		
Ulta Beauty Inc	4.33	-1.45
Tractor Supply Company	6.23	-1.06
Facebook, Inc. Class A	8.30	-0.63
PayPal Holdings Inc	4.98	-0.47
Alcon, Inc.	2.86	-0.19

[1]

[1] Portfolio contribution calculated gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended. Returns are presented net of fees and include the reinvestment of all income. "Net (actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred. Past performance does not guarantee future results. Additional calculation information is available upon request.

Company Commentaries

Berkshire Hathaway

We sold our multi decade-long position during the third quarter after first trimming the position during the second quarter this year. We went into some detail in our change of thesis on Berkshire in our last Client Letter. In short, Berkshire's industrially/economically sensitive businesses have slowed considerably over the course of 2019. Their utilities business (Berkshire Energy) needs continued acquisitions to restart utility growth. In addition, Warren Buffett's cash hoard of +$125 billion continues to be a considerable impediment of growth, rather than our previous hard expectation of a valuable call option on opportunity in the hands of one of the most elite capital allocators extant. Further, the efficacy of putting this cash pile to work (plus +$25 billion in annual operating cash flows in Omaha) will be paramount if Berkshire Hathaway is to once again regain their former status as a meaningful grower over just baseline U.S. GDP growth. Thumb-sucking has not cut the Heinz mustard during the Great Bull Market of 2009 – 2019. The Great Bull could have been one helluva of an astounding career *denouement* for Messrs. Buffett and Munger.

In terms of errors of omission by Buffett & Co. over the past ten years, a few stocks stand out to us as considerable head scratcher errors that should have been in Buffett's wheelhouse, and should have been huge winners for Berkshire shareholders. The first stocks are Mastercard and Visa. Buffett is incredibly well-versed in the payments processing industry given his half-century knowledge in longtime holding American Express. These two stocks should have been layups for Buffett. Mastercard and Visa have been massive wealth creators during the Great Bull Market.

Indeed, since the Great Bull started back on March 9, 2009, Berkshire Hathaway B stock is up a notable +269% through the recent ending 3rd quarter. Over the same time period, the S&P 500 Index is up +370%. Mastercard is up a stunning +1,521%. Visa is up a near-stunning +1,137%. Not all is lost, though. Buffett's two CIO lieutenants currently own both stocks at a combined weight of just a thumb-sucking *1.50%* of Berkshire's current equity portfolio. The current combined weighting should be *15.00%!.*

Two other layups are Costco and Microsoft. Buffett has had at his disposal unrivaled expert tutelage on each company in his hind pocket for years – but to no shareholder avail. Charlie Munger has been a director at Costco for 22 years. Costco's stock Great Bull gain is +522%. Once again, not all is lost. Buffett's lieutenants currently own a whooping *0.55%* position in Coscto.

More numbing still is Microsoft. Buffett first met Bill Gates nearly 30 years ago. They became fast best friends. In 2004, Gates joined Berkshire's board of directors. Buffett probably spends more time talking with Gates (Gates Foundation and bridge playing too) each day than he does with key Berkshire vice-chairman employees Ajit Jain and Greg Abel. Buffett has long (and proudly) proffered his opinion that "technology" companies are far outside his "circle of competence." His more recent multibillion foray into IBM and Apple belie his long-held assertion. In our view, if Buffett can endeavor to figure out the business models of both

Apple and IBM enough to pour multibillions in stock purchases, then figuring out Microsoft's business model under *sensai* Gates should have been Remedial Technology 101. Microsoft's stock Great Bull Market gain is +657%.

A final lament, if Berkshire's current *Breaking Bad*-style cash hoard represents stock market timing, then shareholder-partners deserve to be informed of as much.

On this capital allocation front we have growing concerns. Buffett & Co. have repeatedly stated their considerable disadvantage in competing against private equity (with levered billions in tow) for acquisitions, yet Buffett & Co. continue to play this game – very un-Buffett-like, in our opinion. Buffett has also repeatedly offered his opinion for a few years now that if interest rates would stay at their current low levels then stocks aren't (weren't) expensive, yet Berkshire's equity portfolio on a net basis to total corporate assets hasn't really grown that much. (Our portfolio does though share Buffett's success in his outsized Apple position.) Last, despite Buffett's share-buyback tutorials – and our perceived signaling – over the past few years that he is open to large, accretive share repurchases, little has been done on this front as well. (Buffett seems to abhor returning "capital paint" to shareholders while his Berkshire canvas is still "in paint.") Net-net, capital allocation needs to improve dramatically in order to reaccelerate the current stasis of middling, GDP-like growth. Recent billions in capital investments in notable mistakes such as IBM, Lubrizol, Precision Castparts and Kraft do not inspire confidence that Buffett & Co. are still at the top of their game. Any future conviction of ours in Berkshire Hathaway shares will closely mirror that of Buffett's own conviction in Berkshire share buybacks.

CDW Corporation

As our clients know, we try to find ways to invest in best-of-breed businesses at attractive valuations. Particularly in many areas of technology, we struggle with this. It is easy enough to find rapidly growing companies that are not viable, cash-flow-positive, self-funding businesses; alternatively, there are many legitimate businesses trading at valuations we find unreasonable and lacking any consideration of the risks involved.

In its most basic form, we would call our new holding, CDW, a participant in and enabler of many of the fastest-growing areas of technology, but with a uniquely profitable and sustainable business model at an attractive valuation. CDW was originally incorporated in 1984 as MPK Computing. The Company later became Computer Discount Warehouse and then simply CDW.

Notionally, clients may think of CDW as fulfilling a similar role in the portfolio that Cognizant Technology Solutions had fulfilled for many years, before they lost their way a bit in more recent times. Whereas Cognizant has struggled to redefine their business strategy as they moved from their rapid growth phase to a more mature phase, and while they have struggled to balance growth and profitability as the industry has shifted toward a more digital/virtual model, CDW has seamlessly adapted their model to drive both solid revenue growth and very high returns on capital.

CDW is officially called a "value-added reseller." Like Cognizant, they are in the supply chain between technology providers (hardware, software, cloud, etc.) and the businesses that are these providers' end customers. We generally like the idea of being in this tech supply chain for a variety of reasons: participating in attractive industry growth; the lack of reliance on a single technology or technology vendor, which lessens obsolescence or disruption risk; and the ability to invest in a viable, significant money-making business at a much more attractive valuation than we could find on many of the vendors (some of whom are unprofitable themselves) with whom these supply chain businesses work.

This supply chain ecosystem features companies from pure-play tech distributors, like TechData, at one end of the spectrum, to companies much closer to pure-play consulting/service providers such as Accenture or Cognizant. We do not believe that either end of the spectrum is inherently "better" than the other; the business models and value propositions are just much different – and we evaluate any of these companies on their abilities to grow their businesses at attractive returns.

The primary differences between CDW and Cognizant, for clients who were familiar with Cognizant, are as follows:

- CDW functions as a sales force, distributor, and solutions provider for technology, helping primarily small and medium-sized businesses design solutions for their technology needs and then fulfilling those solutions through a large stable of vendors.

- Their value to tech vendors: outsourced sales force, outsourced DC/warehouse/fulfillment, the ability to design individual vendors' products into solutions spread across multiple product categories and vendors
- Their value to tech customers: solution design across multiple product categories and vendors, product availability, installation and integration with existing technology
- The Company has outgrown many of their peers over the last several years by focusing on hiring engineers and specialists focused on creating solutions for its customers, rather than focusing on salespeople. This has allowed them to tap into booming areas of tech such as helping smaller organizations plan their cloud and digital workplace transitions.

- Cognizant participated in solution design, as well, and talked up their abilities in that area, but their primary value proposition in implementing these solutions was what we think of as "bodies on the ground," or outsourced labor for software design, implementation, and integration, and this labor often was provided from a lower-cost location (i.e. India).
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    - Cognizant's value proposition required a much heavier investment in office space (property, plant, and equipment, along with operating leases) than seen at peers, as they required space to recruit and train the massive influx of employees required to execute their business model; however, over time, they began to struggle to offset this heavier investment with higher growth and better margins, as they had in the past.
    - Cognizant's competitive advantage also became blunted over time as technology solutions moved off-premise, meaning that the ability to put bodies on the ground became less important.

CDW, as a hybrid between pure distribution and pure consulting/service/implementation providers, has aspects of both. As distribution is a significant component of its business, turns on their assets (both "building" assets in plant and leases, and net working capital assets) drive a significant component of their returns on investment. However, as they also have concentrated on building out their solution design and integration capabilities, they have been able to capture more growth (with smaller businesses in particular) and to improve their margins, as they have moved toward more value-added services. We note that the Company has been able to deliver a significant improvement in its returns since IPO six years ago through improving both the margin and asset turn sides of the equation.

We should note that we also have monitored Accenture, a more direct peer of Cognizant, for many years, and we find that business attractive, too. However, we struggle to fit Accenture into our criteria for growth, as they have not been a regular double-digit grower in revenues, earnings, or cash flows. In CDW, we get slightly better organic growth, firmly in the double-digit range we need for our growth criteria; returns are attractive if not quite as attractive as Accenture's returns, but unlike Accenture's stable returns, returns have been steadily improving at CDW. We also get CDW at a more attractive valuation, both on an absolute basis and in relation to their growth rates.

In summary, CDW gets us exposure to many attractive technology sectors, although we would not expect this company to grow anywhere near the pace of some of the fastest-growing technology vendors. Offsetting this, we have a much more reasonable valuation, a very steady and attractive business model delivering +20% ROIs (and significantly higher than that on an operating basis, excluding acquisitions), and no risk from any particular technology provider's possible obsolescence or share loss. This does not signal, of course, that we have no appetite for participating in individual tech providers' equities, as you can see from our exposure to such companies in our portfolio. This is just another way to gain attractive exposure to an attractive industry.

NVIDIA

NVIDIA is a pioneer in the development of the graphics processing unit (GPU) – a semiconductor traditionally utilized for rendering computer graphics – and has extended the GPU beyond the graphics domain into "general purpose computing." We attribute NVIDIA's success in general purpose computing to their proprietary computing platform and programming model, known as CUDA.

NVIDIA's compute acceleration platform forms the backbone of a unique value proposition for steadily emerging compute-intensive applications, such as image processing, natural language processing, assisted driving, and ray tracing (the latter relates to the video game domain). The central processing unit (CPU) has been the workhorse of general-purpose computing for decades, as reliable, almost annual efficiency gains helped drive the development of increasingly complex computing applications. As those CPU efficiency gains have slowed over the past several years, developers have begun utilizing GPUs to accelerate applications. While a CPU usually has between a couple and a few dozen cores that are very fast at computation, that contrasts with a CUDA-based NVIDIA GPU that breaks a computation down across hundreds or even thousands of cores and completes it in a fraction of the time. Yet similar to CPUs, and much like Intel's x86 standard, virtually any industry application can utilize NVIDIA's GPUs to accelerate performance, thanks to CUDA's programmability and rich library of software that has been developed for more than a decade.

We expect that the total addressable market served by NVIDIA's acceleration platform can double over the next five years as data science is increasingly applied in the enterprise, similar to how it has been applied at hyperscale (e.g., Facebook, Google) and scientific computing domains, where NVIDIA has over 90% market share, we estimate. NVIDIA maintains a very high market share in PC and cloud gaming, scientific computing, and hyperscale domains as there are no other GPU-based general compute platforms with software and standardized architectures to rival NVIDIA. Of course, there will be plenty of competitive attempts from alternative silicon providers to accelerate specific computing workloads, namely field-programmable gate arrays (FPGA) as well as other application specific integrated circuits (ASICs); however, we think these offerings lack the standardization and compatibility inherent to NVIDIA's platform.

The stock has pulled back nearly -40% from its 2018 highs, after growth decelerated from unsustainable levels – driven by a small number of hyperscale operators building inventory. Further, a not insignificant amount of NVIDIA's revenue over the past few years was generated by cryptocurrency mining applications. As capital fled from cryptocurrency applications, NVIDIA's revenue from crypto-mining has approached zero and should not be much of a risk going forward. Overall, we think NVDA's business has bottomed and should be able to sustain faster growth over the next few years. As such, NVIDIA's fiscal 2021 price-to-earnings multiple is 24X and trading well below its 5-year average of 29X.

Ulta Beauty

Ulta Beauty was our top detractor during the quarter, following bleak commentary during the Company's latest earnings call and management's subsequent reduced annual guidance for top and bottom-line performance, noting a slowing U.S. makeup category. Based on what management is seeing in their own stores as well as information from market research firms, growth in both mass cosmetics and the higher-priced prestige cosmetics has steadily declined over the last couple of years. The broad category, not specific to Ulta stores, put up strong growth figures in 2016 and into 2017. Those growth figures have hence slowed nearly continuously to the point where the Company is seeing figures (as of their earnings report in late August) indicating that the U.S. cosmetics category had turned negative, pointing to a volatile and sudden change. This seemed to take everyone by surprise, Wedgewood included, as no other peer had indicated a market slowdown to this extent in reports provided only a month prior.

Ulta has a diverse offering of non-makeup categories in skin care, hair care, fragrance, and bath, which are all producing strong, healthy gains. However, cosmetics accounts for approximately 50% of Ulta's business and is one of the highest-margin categories, especially the prestige category, which has experienced a stronger slow-down than mass over the past couple of years. Ulta has a slightly stronger weighting to prestige in their offering. For many years there was an influx of innovations around multiple makeup behaviors, application techniques, and formulas. More recently, these innovations have slowed, and while they are still very important to the overall category, they are no longer driving the incremental growth of which Ulta was once the beneficiary, and unfortunately, new entrants have not yet replicated that excitement and growth.

Despite the slowing category growth and recent volatility which saw a swing to negative, Ulta has continued to gain share in this very fragmented industry. At their Investor Day last year, management noted that Ulta holds an approximate 7% market share of the vast $87 billion U.S. beauty products market and specifically, an approximate 20% share in cosmetics. They attribute their ability to continue taking share not only to their diverse offerings across price points but also to their strong loyalty program, which is now 33 million members who represent a vast majority of annual revenue. However, we cannot ignore the slowing sales growth in both the industry and Ulta Beauty and the resulting near-term volatility in revenue. At the same time, we are cognizant the Company will continue with planned investment initiatives to position themselves for future growth, which will likely

weigh on operating earnings for a period of time. Therefore, we trimmed our holding to a minimum weighting during the quarter. Management – and Wedgewood – remain confident in the long-term outlook of the business. As we neared the end of the quarter and shortly after the close, we saw reports of substantial insider buying in Company stock, a typically strong positive indicator. While the years of mid-teens same store sales growth are likely behind them, Ulta continues to report industry-leading comp sales growth as well as growing their new store footprint at a mid-single-digit growth rate.

Mr. Market Memo to Fed: We Expect A Soft Landing

In our last Client Letter, we wrote the following:

Since 1950, the Fed has engineered just three soft landings. In our previous two Client Letters we outlined the accumulating evidence of the former robust U.S. economy beginning to stagnate and posing risk to domestic corporate profit growth. As we enter mid-summer, the news continues to be negative on balance. Most of the developed world's economies continue to worsen. The risk of recession in the U.S. refuses to abate. The U.S. yield curve as a predictor of recession is currently as ominous as it gets. The two-year Treasury has now dipped 75 basis points below the high target range of the Fed Funds rate, signaling that the Fed is at least 100 basis points too tight. Note too, with the exception of just 1966, 1984 and 1995, every episode of the Fed tightening monetary policy has been part and parcel of the Fed being too tight for too long has led to a recession.

CHART 6: THERE HAVE BEEN 13 HIKING CYCLES, 10 LANDED IN RECESSION!

United States

First Hike	Last Hike	Result
October 1950	May 1953	Recession
October 1955	August 1957	Recession
September 1958	September 1959	Recession
December 1965	September 1966	Soft Landing
November 1967	June 1969	Recession
April 1972	September 1973	Recession
May 1977	March 1980	Recession
August 1980	December 1980	Recession
March 1983	August 1984	Soft Landing
January 1987	May 1989	Recession
February 1994	February 1995	Soft Landing
June 1999	May 2000	Recession
June 2004	June 2006	Recession
December 2015	???	???

Source: Haver Analytics, Gluskin Sheff

It appears that the stock market has entered a period in which "bad news is good news" in as much as poorer economic news continues to hit the tape and the concomitant odds of the Fed cutting rates sooner and sharper buoys the stock market. Consider the following economic data along with the first graphic below: As of early October, the ISM Manufacturing index fell to a 10-year low – 47.8, a level associated with recessions 79% of the time at that reading. According to the ISM Services index, CEO and CFO confidence fell to 3-year lows, jobless claims have risen 3 straight weeks, and consumption has fallen to six-month lows. As we have written in past Client Letters, the lag effects of the Fed's monetary tightening in 2017 and 2018 continue to kick hard as 2019 unfolds.

Over the past few years now, the U.S. economy has been the world's beacon of strength and growth – arguably its best relative strength position in 60 years. The current economic

expansion – at least in terms of duration – is the best since at least back to the infamous Kansas-Nebraska Act of 1854. But that isn't saying much against the backdrop of considerable weakness in China (including a stalled economy in protest-torn Hong Kong, plus Germany and Japan in recession.) Australia's, Canada's and South Korea's economies continue to weaken. The limits of the supposed stimulative effect of negative interest rates are now manifested around the globe.

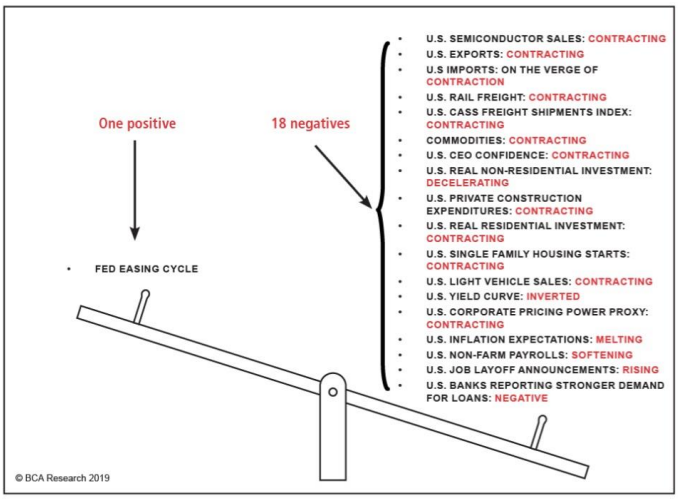
(For you history buffs, according to Wiki, *"The Kansas–Nebraska Act of 1854 was an organic act that created the territories of Kansas and Nebraska. It was drafted by Democratic Senator Stephan A. Douglas, passed by the 33rd United States Congress, and signed into law by President Franklin Pierce. Douglas introduced the bill with the goal of opening up new lands to development and facilitating construction of a transcontinental railroad, but the Kansas–Nebraska Act is most notable for effectively repealing the Missouri Compromise, stoking national tensions over slavery and contributing to a series of armed conflicts known as 'Bleeding Kansas.'"*)

Both consumer confidence (future expectations) and CEO confidence are at levels that have historically presaged recessions. Undoubtedly the weekly (daily) drama of U.S.-China trade/tariff negotiations have thrown a wet blanket on CEO confidence. The all-important Institute of Supply Management indices also tell a tale of historic woe. ISM indices are fancy "diffusion" indices. Readings over 50 portray manufacturing or services that are in expansion mode. Readings under 50 speak to contraction. The bond market feasts off ISM data – perhaps even more than the seemingly daily speeches by the seemingly countless Federal Reserve presidents. The latest ISM manufacturing and service readings continued recent poorer trends – and were both recessionary awful.

Both inverted yield curves (see our past two Client Letters) as well as sub-50 ISM manufacturing readings have signaled a number of false recession "calls" over the decades but take a close look at the chart on the first page. The trifecta combination of sub-50 ISM readings, *plus* inverted yield curves, *plus* a decline in Consumer Confidence has never generated a false recession signal in over 50 years. It recently generated a recession signal.

Expectations of further rate cuts by the Fed have increased sharply – much more sharply than the Fed's expectations. According to Charlie Bilello, 12 months ago the Federal Reserve was projecting a Fed Funds Rate of 3.375% by the end of 2020. Just last month on the heels of continued poor economic data, that projection has been significantly reduced for the fourth time to just 1.875%. However, the market sees a very different Fed Funds Rate path. The market is now expecting a year-end 2020 rate *below 1.00%!* – which would require 3-4 more rate cuts by year-end 2020 against the Fed's current projection of zero future rate cuts. The key to every "soft landing" over the past decades (1966, 1984, and 1995) was a Fed cutting rates ahead of market expectations, not *behind.*

Mr. Market (trading at forward P/E multiple of 17X) is clearly expecting Powell & Co. to engineer the rare "soft" economic landing – and reverse the current profits recession. On this score, one may be surprised by the fact (source: Leuthold) that more than *25%* of companies in the Leuthold 3000 Index have not generated profits over the past 12 months.



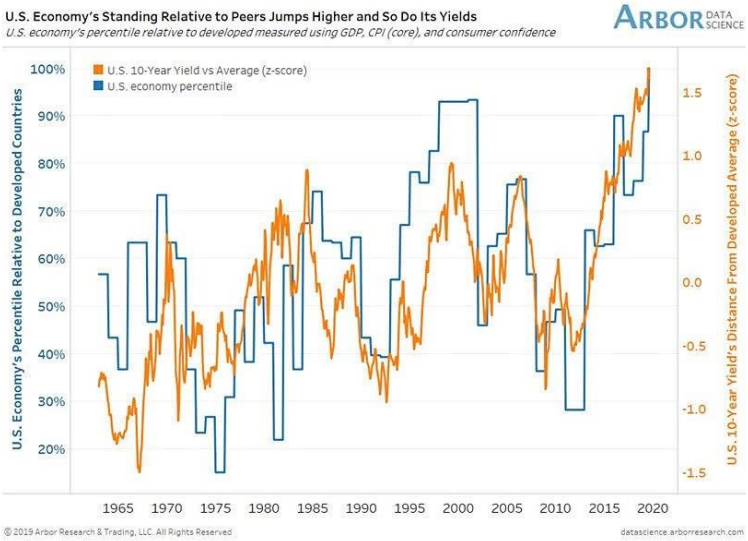
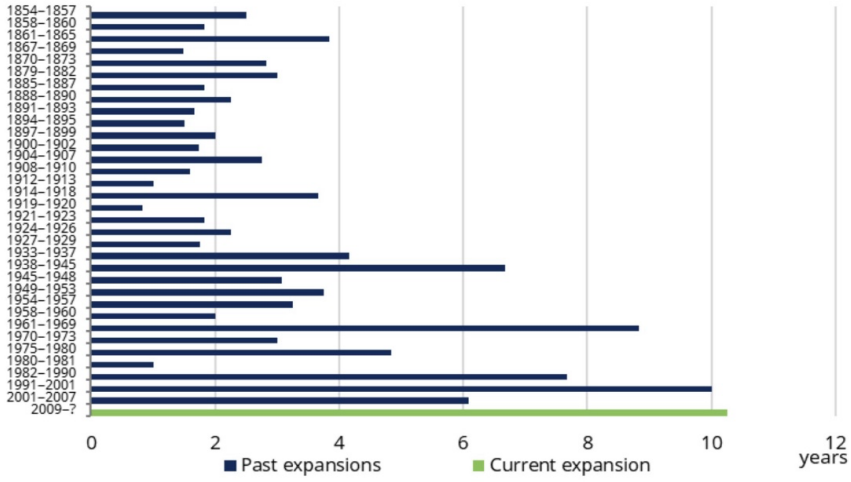
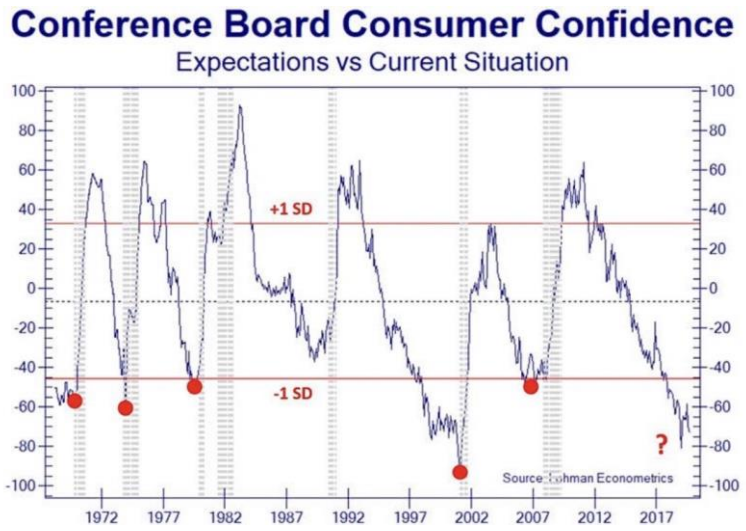
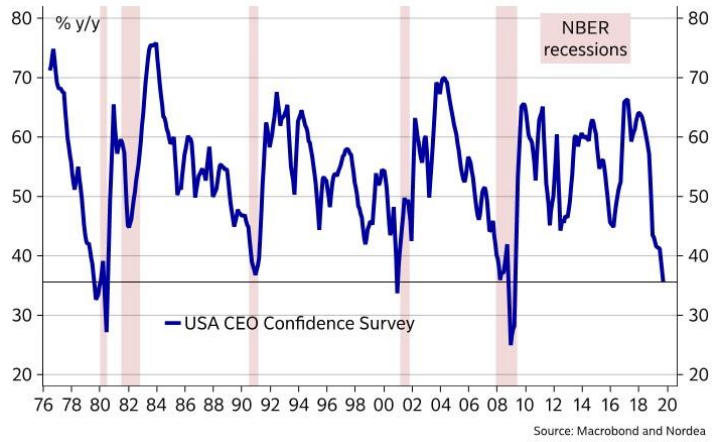


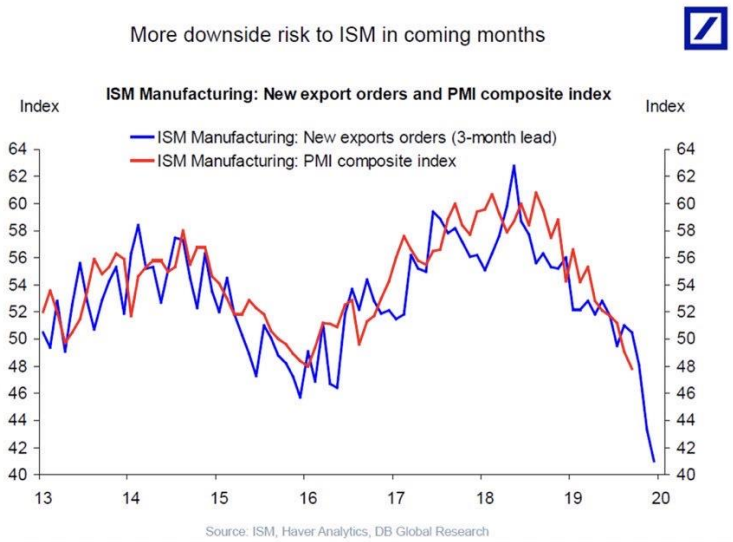
Chart 1: Longest on record: US expansions by length

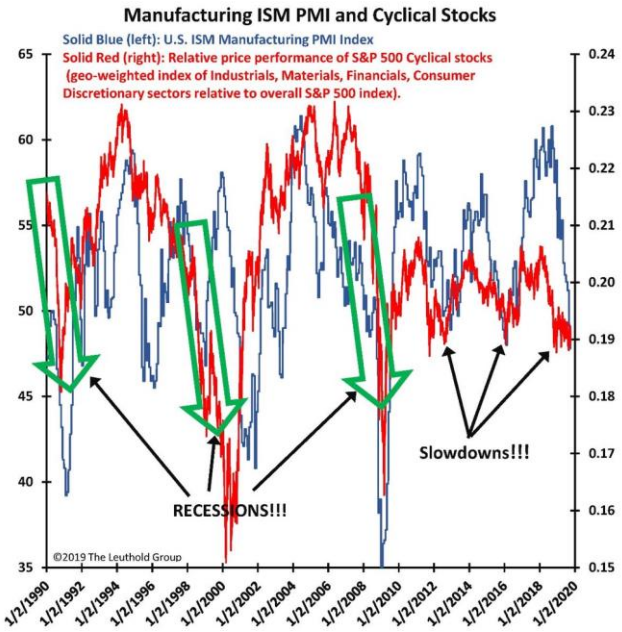


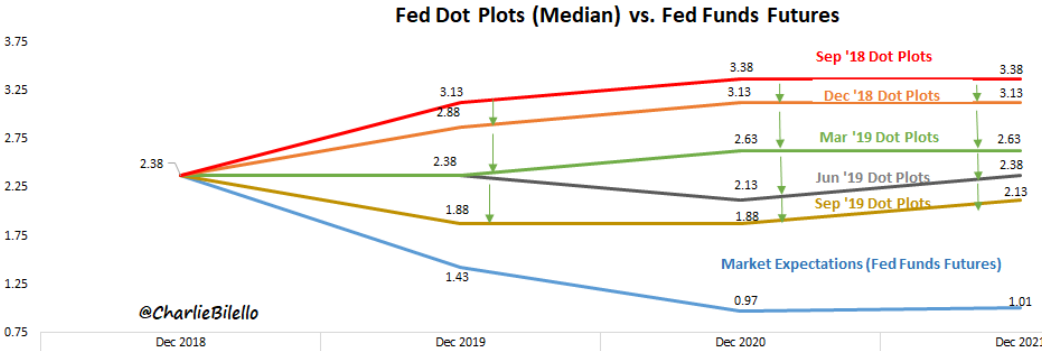
Source: Investech


Conference Board Consumer Confidence
Expectations vs Current Situation
+1 SD
-1 SD
?
Source: Lehman Econometrics


% y/y
NBER recessions
USA CEO Confidence Survey
Source: Macrobond and Nordea

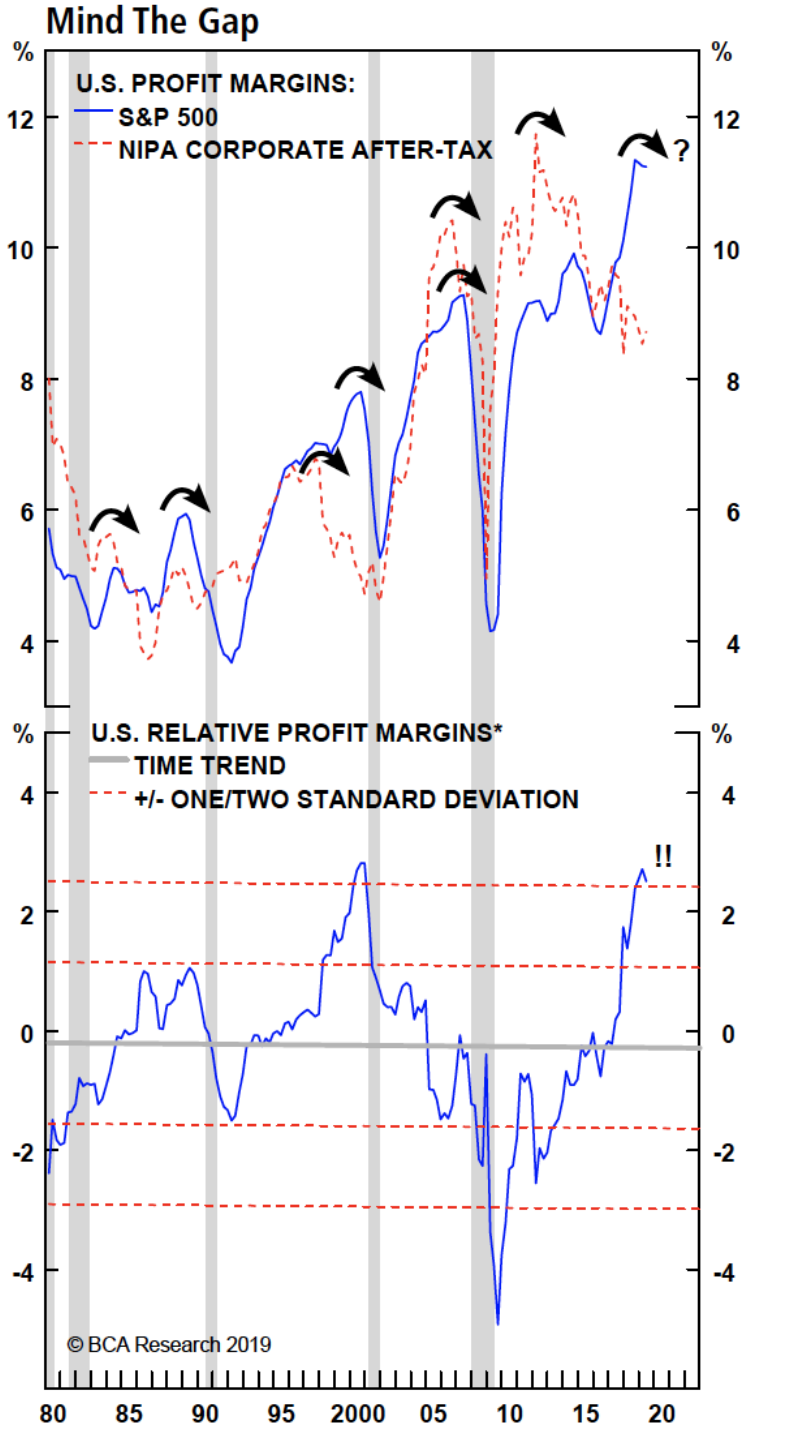

More downside risk to ISM in coming months
ISM Manufacturing: New export orders and PMI composite index
Index
Index
ISM Manufacturing: New exports orders (3-month lead)
ISM Manufacturing: PMI composite index
Source: ISM, Haver Analytics, DB Global Research





	Dec 2018	Dec 2019	Dec 2020	Dec 2021
Fed Funds Futures (Market)	2.38	1.43	0.97	1.01
Fed Dot Plots (Median - Sep 2019)	2.38	1.88	1.88	2.13
Fed Dot Plots (Median - Jun 2019)	2.38	2.38	2.13	2.38
Fed Dot Plots (Median - Mar 2019)	2.38	2.38	2.63	2.63
Fed Dot Plots (Median - Dec 2018)	2.38	2.88	3.13	3.13
Fed Dot Plots (Median - Sep 2018)	2.38	3.13	3.38	3.38

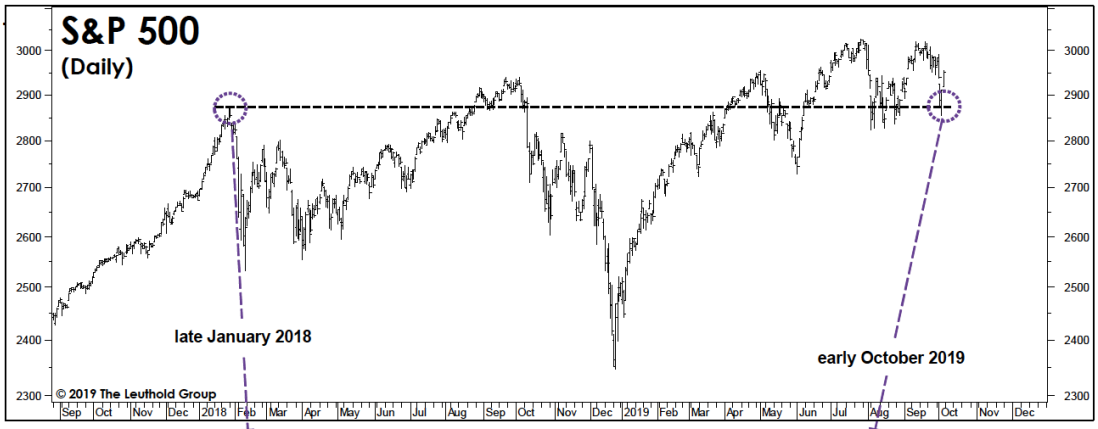
Source: Charlie Bilello



NOTE: SHADED FOR NBER DESIGNATED RECESSIONS
*S&P PROFIT MARGINS MINUS NIPA CORPORATE AFTER-TAX PROFIT MARGINS

Where Would You Rather Be?

On October 3rd, the S&P 500 briefly traded below the high it made in January 2018 before reversing to close the day higher. This event led to us to ask if one "had" to own the S&P 500 at around the 2,900 level, would you rather own it at that level in January 2018 or in October 2019? The boxes below summarize conditions existing at both junctures. To our eyes, the latest flirtation with 2,900 looks cyclically and technically more dangerous than the initial one, with only a mild improvement in valuations to compensate for the elevated risks.



- + **MOMENTUM** - The S&P 500 records highest 14-Wk. RSI in the history of the index. Since momentum usually precedes price, this is very bullish.
- + **INDEX BREADTH** - Almost every important index joins the S&P 500 at late-January highs, including the DJIA, NASDAQ, S&P MidCap 400, Russell 2000, Russell 1000 Growth, Russell 1000 Value, S&P 500 Low Volatility, S&P 500 High Beta, Dow Transports, NYSE Composite, and ACWI. Index participation looks far too broad for a major top to occur.
- + **NYSE BREADTH** - Almost 69% of NYSE stocks are above their 30-week moving averages. No major top has occurred with breadth that strong.
- - **MONEY GROWTH** - Annual growth in M2 is 5%, down almost 8% in late 2016. A caution sign.
- + **YIELD CURVE** - The 10-Yr. Treasuy yield stands 120bp above Fed Funds. Bullish.
- + **CREDIT** - Yields on Moody's BAA corporates are just 160bp above 10-Yr. Treasury yields, near the cycle "tights" of not only the current expansion but the tights of the previous two expansions as well.
- + **ECONOMIC MOMENTUM** - ISM Composite near 60 and rising, prompting Fed to hike rates and emboldening White House to start trade war.
- - **VALUATION** - Valuation measures for the "median stock" reach all-time peaks, while ratios for the cap-weighted S&P 500 and the S&P Industrials reach top-decile levels.

- - **MOMENTUM** - The RSI was significantly lower at the S&P's three "higher highs" of September 2018, April 2019, and July 2019, setting up a huge negative divergence. (Sometimes bearish.)
- - **INDEX BREADTH** - The S&P 500, DJIA, and NASDAQ enter October a few percent below all-time highs. But a surprising number of indexes have not made bull market highs in more than a year, including the S&P MidCap 400, Russell 2000, Russell 1000 Value, S&P 500 High Beta, Dow Transports, NYSE Composite, and ACWI. Some non-confirmations have lasted 20 months.
- - **NYSE BREADTH** - Only 47% of NYSE stocks are above their 30-week moving averages, similar to readings seen at past bull market peaks.
- + **MONEY GROWTH** - Growth in M2 is 5.5%, up from 3% in late 2018. A hopeful sign.
- - **YIELD CURVE** - The curve has been inverted for almost five months. Bearish (but with a variable lead time).
- - **CREDIT** - The BAA spread over the 10-Yr. yield is 229bp, a level that warned of impending recessions in both 2000 and 2007.
- - **ECONOMIC MOMENTUM** - ISM below 50 and falling, prompting rate cuts and emboldening White House to expand trade war to Eurozone.
- - **VALUATION** - Measures for cap-weighted indexes remain at top-decile readings; measures for the median S&P 500 stock drop to 7th and 8th deciles; median Small Cap valuations fall to 5th and 6th deciles.

In sum, as evidence mounts, we continue to refuse to believe that Quantitative Easing (QE) creates permanent economic prosperity. We do believe though, that much like Pavlov's dogs, QE has been psychologically ingrained in investors to such extents and extremes that far too many have abandoned any prudence of "risk-adjusted returns." We at Wedgewood refuse to believe that central bankers have permanently "nationalized" a new doctrine that more risk will always generate more returns.

As such, during the third quarter we continued to reduce or sell those holdings where economic/yield curve forces trump management's ability to outmanage such headwinds. Recent sales of Berkshire Hathaway and Charles Schwab fit this bill. We remain quite patient too, awaiting better entry points on new purchases on stocks that we have wanted to own for some time. Nvidia fits this bill.

We wish to once again thank those clients who have been steadfast in support of Wedgewood Partners.

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[i] Returns are presented net of fees and include the reinvestment of all income. "Net (Actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.