ALGER
Alger Management, Ltd.

Market Update
Winter 2018

LA FRANÇAISE

RIGHT ISSUE TO WATCH BUT WRONG TIME TO WORRY

After hitting an all-time high on January 26, the S&P 500 Index declined into correction territory. As usual, the business media focused on the most recent data point—which in this case was wage inflation as depicted by the U.S. Bureau of Labor Statistics' February 2 report—and rushed to create a "story" from it. The story isn't really worth much comment, in our view, as there's no real correlation between a single wage data point, or for that matter, any single data point, and the ultimate direction of the stock market. The report depicted wages increasing 2.9% year-over-year in January versus 2.7% in December and the 2.5% average rate increase in 2017. The story was that investors suddenly became anxious about robust economic growth, higher inflation, and interest rates. Wasn't it roughly two years ago that the oft-repeated news story was that we were all supposed to be worried about economic stagnation, including wages that had failed to increase for years? And, further, that the equity rally from the lows of 2009 was a quantitative easing and central bank mirage that would end?

What in fact has happened in the last year and a half is we've had a much stronger than expected economy, continued low inflation and interest rates, and a strong continuation of the bull market. The most interesting aspect of this market is that up until late January, more than 18 months passed without a correction of more than 5%—the longest such stretch of low volatility in many years (See Figure 1).

Daniel Chung, CFA
CHIEF EXECUTIVE OFFICER
CHIEF INVESTMENT OFFICER

Brad Neuman, CFA
SENIOR VICE PRESIDENT
CLIENT INVESTMENT STRATEGIST

Figure 1
Frequency of Market Corrections

Source: FactSet.

ALGER
Alger Management, Ltd.

LA FRANÇAISE

Our view on the market is the long-term and patient one. First, of course, the record-setting run of low volatility had to end sometime. It just did. Second, the return of volatility in and of itself means very little: the market is normally volatile and has intra-year corrections, as we have commented on many times during the past several years. But that does not mean that the bull market is done. In our long and patient view, it is fundamentals first that determine the value of individual stocks, and therefore the overall market as a composite of companies across our diverse economy.

Current Interest Rates Are Not a Problem

High inflation and high interest rates are indeed negative for equity valuations and bull markets. But we note that when inflation and interest rates are low, as they currently are, modest increases in either should not derail bull markets. Indeed, it is the starting point, or fundamentals, that matter a lot here, especially with interest rates being low. Even though the 10-year Treasury yield closed at 2.85% on Friday, February 2, it was up only 44 basis points since the start of the year and a mere 22 basis points above its 2017 peak, which occurred in March. The real Federal Funds rate, furthermore, is approximately zero and has historically been 2% or higher prior to recessions.

When the U.S. economy is growing, it is normal to expect higher inflation and interest rates. There is a positive correlation for stocks in the early phase of such changes, i.e., higher price-to-earnings (P/E) ratios for the markets have been observed during such shifts. We think this shift started during the second half of 2017. The U.S. economy is, as the data shows, quite strong, and in particular nowhere near recessionary in our view.

We believe that 2018 will likely see 5% nominal U.S. GDP growth (including inflation) for the first time in over a decade (See Figure 2). We estimate that fourth quarter 2017 earnings will increase about 15% and we are optimistic regarding the future. The recent tax bill is very pro-growth for our economy. Additional economic stimulus could result from a potential infrastructure bill. The end result of those initiatives is likely to be an increase in corporate profits and capital spending.

In light of this strong economic backdrop, we do not think that a modest rise in interest rates will thwart GDP expansion and push the U.S. into a recession

Our belief is that interest rates and inflation need to be much higher on an absolute level before they substantially raise the prospects of an economic recession in the U.S.

When the U.S. economy is growing, it is normal to expect higher inflation and interest rates. There is a positive correlation for stocks in the early phase of such changes, i.e., higher price-to-earnings (P/E) ratios for the markets have been observed during such shifts.

and, therefore, a decline in corporate fundamentals that can spark a decline in equity valuations. That is the chain of cause and effect that we believe determines the ultimate direction of the market. And, in our opinion, we are not even close to being there yet.

Equities Are Attractively Valued

Theoretically, higher interest rates are problematic for equity valuations because the value of a company is the value of future cash flows discounted back to the present day at an estimated cost of capital. A higher interest rate used in that calculation would lower the price of that asset. However, we do not believe that higher interest rates are currently an issue for equity valuations.

Figure 2
2018 Nominal GDP Growth Expected to Climb

Note: These numbers have been rounded.
Source: U.S. Bureau of Economic Analysis and Alger estimates.

ALGER
Alger Management, Ltd.
LA FRANÇAISE

The earnings yield of equities is more than 300 basis points greater than the yield of the 10-year Treasury as compared to the 55 basis points median for the half-century prior to the Global Financial Crisis (See Figure 3). If stocks had been trading at very high P/Es or low yields, such as those of Treasury bonds, then a rise in bond yields would hurt stocks dramatically. To the contrary, however, stocks have remained cheap relative to bonds. Essentially, stocks never fully priced in low interest rates so it stands to reason that they shouldn't be hurt by higher rates.

The Great Rotation

Rising interest rates may support the equity bull market by prompting investors to sell bonds in favor of stocks. A steady decline of interest rates has resulted in $1.8 trillion in assets flowing into taxable U.S. bond funds, including ETFs, over the past decade, while only $0.2 trillion has gone into equity funds and ETFs, according to Morningstar. Rising interest rates that inflict capital losses on fixed-income assets may drive some of these bondholders to equities in what we at Alger suggest will be the next phase of capital markets (equities, bonds, real estate and other asset classes all considered). The phase will be the Great Rotation to equities and out of bonds by global investors. This would be aligned with our work indicating equities will outperform bonds over the coming years (See the Alger Winter 2018 Capital Markets: Observations and Insights presentation, Productivity Pick-Up on Alger.com).

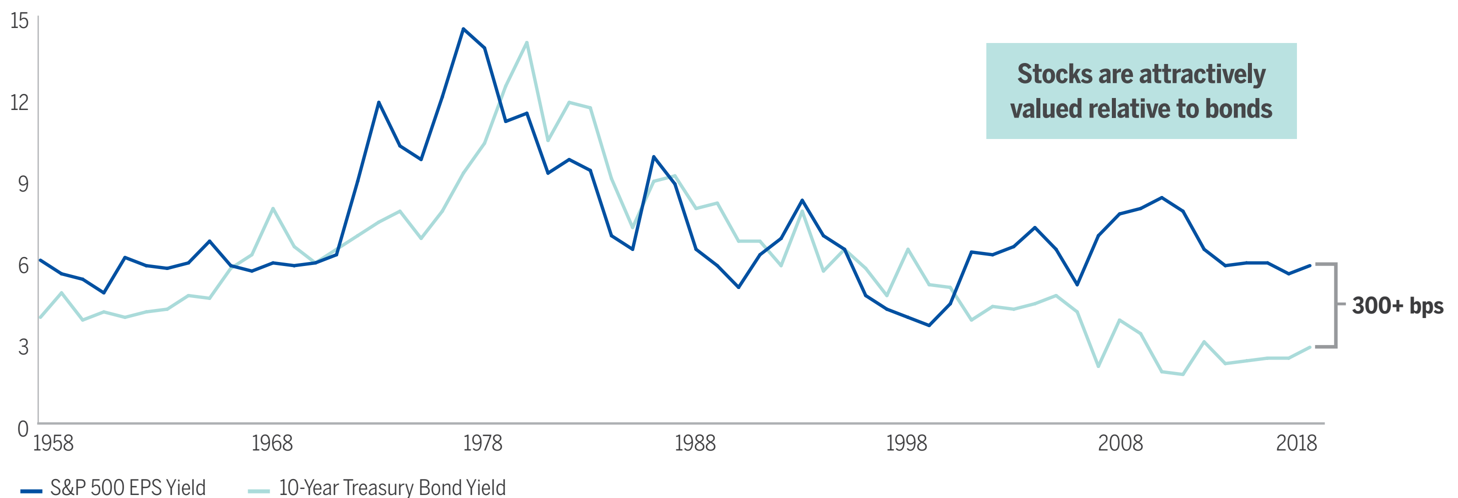
Rising interest rates may support the equity bull market by prompting investors to sell bonds in favor of stocks.

Finally, we think the renewed equity volatility will last for a few months before we resume a bull market with continued significant upside potential. During this period of volatility, we believe Alger's fundamental, research-based process and philosophy should help us find attractive opportunities to invest in, or more likely, compel us to increase our existing positions in high quality, innovative, growth companies at attractive valuations.

Daniel C. Chung, CFA
Chief Executive Officer, Chief Investment Officer

Brad Neuman, CFA
Senior Vice President, Client Investment Strategist

Figure 3
Stocks Versus Bond Yields



Source: FactSet, Federal Reserve, and S&P, as of 2/8/18.

ALGER
Alger Management, Ltd.

LA FRANÇAISE

Risk Disclosure: Investing in the stock market involves gains and losses and may not be suitable for all investors. Growth stocks tend to be more volatile than other stocks, as the prices of growth stocks tend to be higher in relation to their companies' earnings and may be more sensitive to market, political, and economic development. Past performance is no guarantee of future results. Certain Alger strategies may invest in stock issued by companies in foreign countries, including emerging markets. Special risks associated with investments in foreign country issuers, including issuers in emerging markets, include exposure to currency fluctuations, less liquidity, less developed or less efficient trading markets, lack of comprehensive company information, political instability and different auditing and legal standards. Foreign currencies are subject to risks caused by inflation, interest rates, budget deficits and low savings rates, political factors and government controls.

S&P 500®: An index of large company stocks considered to be representative of the U.S. stock market.

This commentary, its discussions of investment strategy (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics), and discussions of individual companies represent the views of Fred Alger Management, Inc. ("Alger") at the time of this commentary and are subject to change without notice and do not constitute recommendations by Alger. Alger Management, Ltd. is an affiliate of Alger.

Investing in the stock market involves gains and losses and may not be suitable for all investors. Growth stocks tend to be more volatile than other stocks, as the prices of growth stocks tend to be higher in relation to their companies' earnings and may be more sensitive to market, political, and economic development. Past performance is no guarantee of future results. Certain Alger strategies may invest in stock issued by companies in foreign countries, including emerging markets. Special risks associated with investments in foreign country issuers, including issuers in emerging markets, include exposure to currency fluctuations, less liquidity, less developed or less efficient trading markets, lack of comprehensive company information, political instability and different auditing and legal standards. Foreign currencies are subject to risks caused by inflation, interest rates, budget deficits and low savings rates, political factors and government controls.

Alger Management, Ltd. (company house number 8634056, domiciled at 78 Brook Street, London W1K 5EF, UK) is authorised and regulated by the Financial Conduct Authority, for the distribution of regulated financial products and services. La Française AM International has a signed agreement with Alger Management Ltd, whereby La Française AM International is authorised to distribute Alger products in Europe.

The information contained in this document should not be relied upon as a basis for investment decisions, nor does it constitute an offer or solicitation to buy or sell securities. The assessments contained herein reflect the opinions of their authors at the time of publication and are subject to change at a later date. Under no circumstances may Alger be held liable for any direct or indirect losses resulting from the use of this document or the information contained therein. This document may not be reproduced, transmitted or distributed to third parties, in whole or in part, without the prior written consent of Alger