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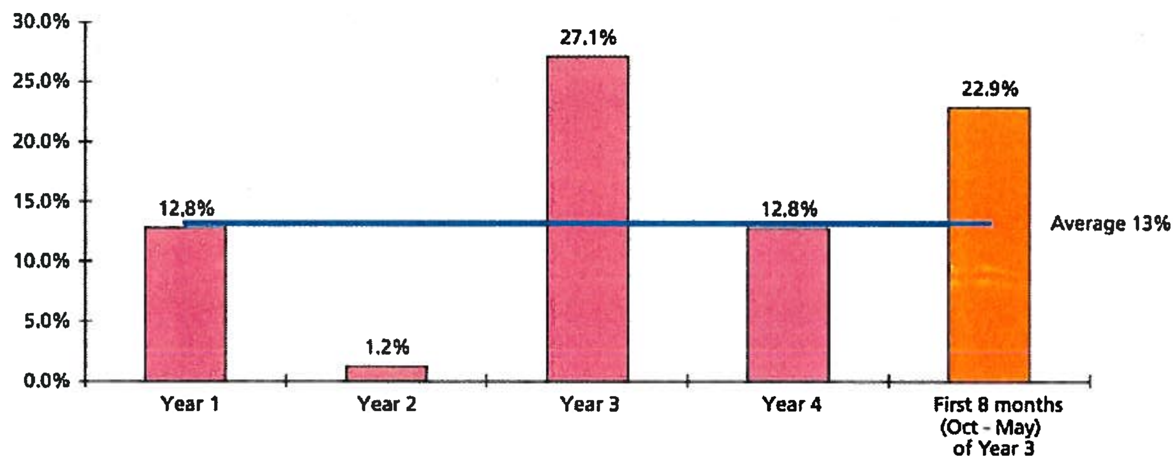
Letter

History was Against Investors in 2018
But History Favours 2019

Presidential Election Cycle Returns (1928 - 2012)



[1]

In our January 2018 conference call, I suggested investors lower their expectations for returns in 2018 because, although there would be no recession, the market faced three key obstacles.

The first was that when the year began, investor sentiment was extremely optimistic. A survey by the American Association of Individual Investors showed the highest bullishness (excessive optimism) since the peak of the 2000 tech bubble. High investor optimism is associated with high investor participation in the markets; consequently, when everyone is "all in," markets typically hit a short-term peak.

The second hurdle for 2018 was where the year fell in the US presidential election cycle. As the above chart shows, Year 2 of a presidency tends to result in lower US stock market returns than any other year of a presidential term. This is largely due to the fact that investors tend to embrace

[1] The Presidential Election Cycle and Stock Market Returns. "Perspectives" Volume 5. Issue 10.

new policies during the first "honeymoon" year of the new presidency. Case in point, stocks posted solid gains in 2017, the year Donald Trump took office. The second year of a presidential term tends to be the year the president does the "dirty work" – a trade war with China for example.

The third challenge of 2018 was rising U.S. interest rates, which have preceded every recession in U.S. history. The US Federal Reserve Board will have raised the federal funds rate four times in 2018 (assuming an expected raise in December), causing stock and bond markets to get a little anxious!

Reasons for Optimism in 2019

1. Stock market sentiment has swung from optimism to pessimism. Just as high sentiment often signals a market peak, the current readings suggest low bullish and high bearish (pessimistic) readings, which typically signal a market low.

2. 2019 marks the third year of Donald Trump's term which, as the above chart shows, historically results in the highest US stock market returns. Past presidents have tried to clean up their "dirty laundry" (i.e. trade war with China) by the end of year three to look good for the election in year four.

3. Historically, stock bull runs pause when investors perceive a trend of rising rates as the Federal Reserve Board initially moves away from the "emergency" interest rates of a recession. In the past three economic cycles, the initial increase to bring interest rates closer to the Fed's desired "neutral rate" did not lead to recessions and has been three to six years premature for investors to move to cash.

Initial rate moves	Dow return	Subsequent return	Years to recession
1984	-3.74%	27.66%	6
1994	2.14%	33.45%	6
2005	-0.61%	16.29%	3
2018	-1.19% (mid-Dec)	?	?

Stock markets had been concerned that interest rates would keep on rising, but as long-time clients know, we need a yield curve inversion - when the fed funds rate is higher than 5-year bonds - to have a recession. However, three more interest rate hikes could invert the curve.

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In a speech to the Economic Club of New York, Federal Reserve Board Chairman Jerome Powell stated that current rates are "just below" the so-called neutral rate. In the minutes of the November 7-8 meeting, the Fed disclosed it would "stay flexible in responding to changing economic circumstances," thus alluding to a potential pause in rate increases in 2019.

With corporate profits up 22% in 2018 and stocks flat or even down on the year, the valuation of stocks is much more compelling than it was a year ago. We started 2018 at 18 times earnings; this has now dropped to 15 times earnings, below historical valuations. When coupled with a likely Fed pause in tightening interest rates and a president with an interest in resolving some "dirty laundry" in advance of an election year, the outlook for 2019 is looking up.

Sincerely,

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