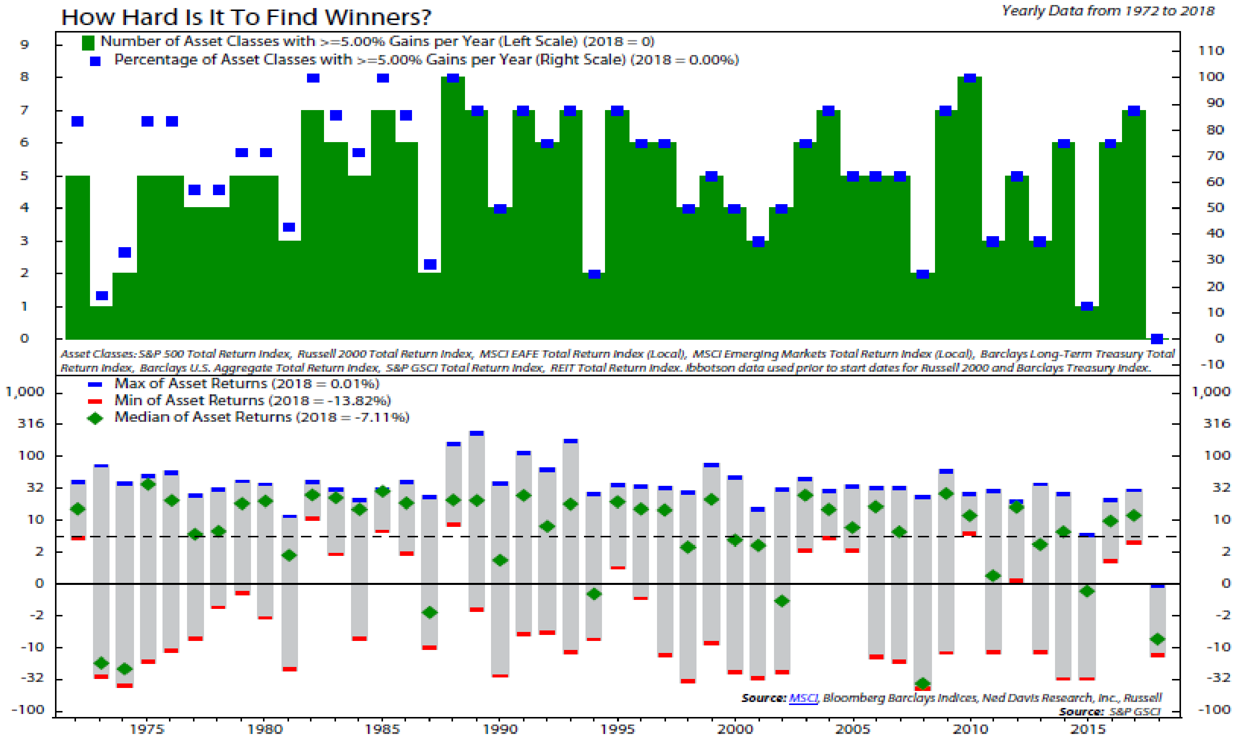
2019 Outlook

"Skate to where the puck is going, not where it has been." – ***Wayne Gretzky***

What a difference a year makes! The largest drop in 2017 was less than 3%, while 2018 experienced the largest drop since 2009 at nearly 20%. In 2017, December saw near record highs while December of 2018 was the worst on record (except 1931, The Great Depression); Christmas Eve was the worst in history. Stocks were not the only problem investment: nearly every major asset class was negative for the year with the exception of the aggregate bond index which was up 0.01%. The chart below shows that among the eight largest asset classes, none gained more than 5% for the first time since 1972 (see chart below). 2018 was a major anomaly and will go down in history as a tough year for investors.

Last year saw record low unemployment, increased wage growth for employees, good economic growth, massive earnings growth for public companies and historic tax cuts. So what went wrong? Nothing. The lesson to be learned is that the market is forward looking. 2017 experienced extraordinary returns in anticipation of what was to come in 2018. However, as the year played out, the outlook changed to "How can it get any better than this!" Optimism quickly turned to pessimism as rising interest rates, trade wars, earning growth declines and political instability intervened. As of today (1/16/19), stocks have made a major recovery - over 11% - which brings up another investing lesson: the Wayne Gretzky quote above. To paraphrase: don't let what has already happened dictate where you are going. Moving forward, the question is have we seen the short term bottom? The short answer is we don't know, but with uncertainty continuing, volatility is likely to remain with us through the first quarter.



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Looking Forward to 2019

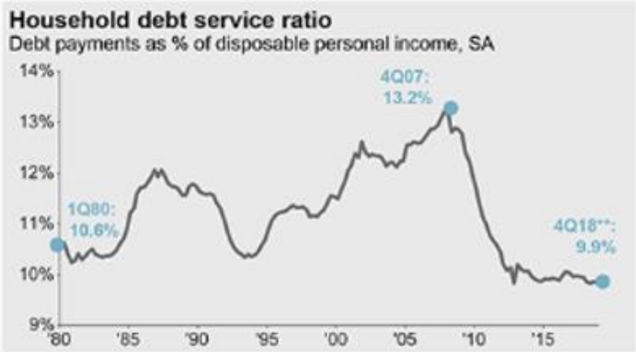
As we alluded to in the beginning of this letter, stock market returns tend to be forward looking. So as we head into 2019, will stock markets reflect continuing deterioration of our economy's fundamentals (worst case)? Do markets believe that the slowdown will occur, but it has already been priced in, and stocks are now fairly valued (base case)? Or do markets believe that things aren't as bad as they seem and the slowdown won't be as bad as predicted (best case)? Let's look at the positives and negatives heading into 2019 to help guide us as we consider which scenario is most likely:

<u>The Negatives</u>:

- Continued Slow Global Growth: GDP across the globe is forecast to continue its decline through 2023 according the International Monetary Fund (IMF).
- Central Banks around the world are tightening financial conditions. The end of low interest rates and easy money appears to be headed for the door.
- Declining corporate profit growth rates (see chart below). Most earnings have yet to hit but early indications from companies and even the Trump administration are warning investors of earnings forecast misses and reduced guidance.
- Political Instability across the globe: U.S. government shutdown, trade wars, the BREXIT mess and a continued rise in nationalistic populism just to name a few.
- Souring Corporate Sentiment: Half of the CFO's surveyed in a recent study by Duke University believe that a recession will start within a year and 80% think a recession will hit by the end of 2020.

<u>The Positives</u>:

- The consumer's balance sheet still looks great. The global financial crisis of just a decade ago seems to have provided a harsh lesson to consumers – whether voluntary or not.
- While inflation has picked up, it's still relatively muted. Combined with the rise in interest rates, the Fed has some ammo left to provide a life line to the markets should things continue to disappoint.
- Investor sentiment is extremely pessimistic and as we all know, this is a contrarian indicator.



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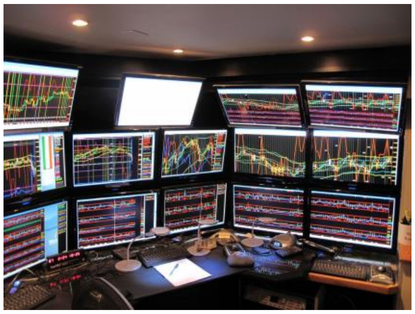
- Because of the recent market drop, valuations have come back in line with historical averages and depending upon the indicator, stocks are either fairly valued or cheap in some cases.
- Years 3 and 4 of a President's term are historically the best years for the market as the President tends to focus on getting re-elected. If Trump is able to come to an agreement on trade and the shutdown, it could be good for markets and in turn, good for his re-election campaign.

In our view, the base case posited above is the most likely: a slowdown will occur but won't trigger a recession quite yet. We think that stocks have already priced in much of the expected weakness in the economy. This is not to say that we can't go down further or that there won't be continued volatility, but unless something unexpected happens, we don't think this is the end of the bull market just yet.

Are the Computers Controlling the Market?

Much of the recent volatility has been blamed on computerized trading. According to the Wall Street Journal, "Roughly 85% of all trading is on autopilot – controlled by machines, models, or passive investing formulas, creating an unprecedented trading herd that moves in unison and is blazingly fast." Let's discuss the various computerized traders in the market place:

- *Quantitative Hedge Funds* – According to the Tabb Group, 28.7% of trading comes from Quantitative Hedge Funds. These funds build algorithms that trade on various signals for example:
    - *Momentum* – These strategies look at what is performing well and are programmed to buy more of that security. If Apple has a higher return than Microsoft over the past 30 days, buy Apple. If stocks have outperformed bonds, buy stocks. Momentum cuts both ways: when markets start a decline these models start to sell and many of the programs will also short stocks.



    - *Fundamentals* – Sometimes these funds will trade on other variables, such as interest rate, currency and commodity moves.
- *Index Funds* – Passive Investing (simply buying a representative basket of stocks and not trading) has become a large part of the investing marketplace. The most popular strategies simply buy an index, such as the S&P 500. However, there are many "factor strategies" that buy a basket of companies based on certain characteristics. For example, the companies in the market with the highest free cash flow and lowest debt. These strategies rebalance monthly, quarterly or annually and can add to an already volatile market when stocks are moving in unison. Because of the large influx of investment dollars into index funds, many experts argue that there are fewer individual buyers and sellers in the marketplace, which can make the highs and lows more pronounced.

- *Trend Followers (CTAs)* – Trend followers don't care about a company's profits or future outlook, they only care about price. If the trend is up, they buy and if it is down they short. Trend followers play in all financial markets and are one of the reasons why oil saw such a large decline at the end of last year.

There is no doubt that the speed of the declines can be linked to computerized trading strategies. However, we have had a very solid 10 years of returns with the same players in the marketplace. Over those 10 years, stocks are up over 250%, despite investors having to endure 3 corrections of between 13 and 20%. Historically, declines of 10%-20% are very normal and are a part of the emotional price we all pay to build long term wealth. As investment managers, our biggest challenge is to get the big picture correct. In order to do this we need to have our investors' allocations adjusted before these corrections occur as it is a very dangerous game to be trading in the middle of these occasional large swings. A wrong move at an inopportune time can compound an already bad situation and make losses permanent.

Thanks for reading and as always, please don't hesitate to contact us with any changes to your personal situation, investment goals or risk tolerance.

Sincerely,

Canal Capital Management

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