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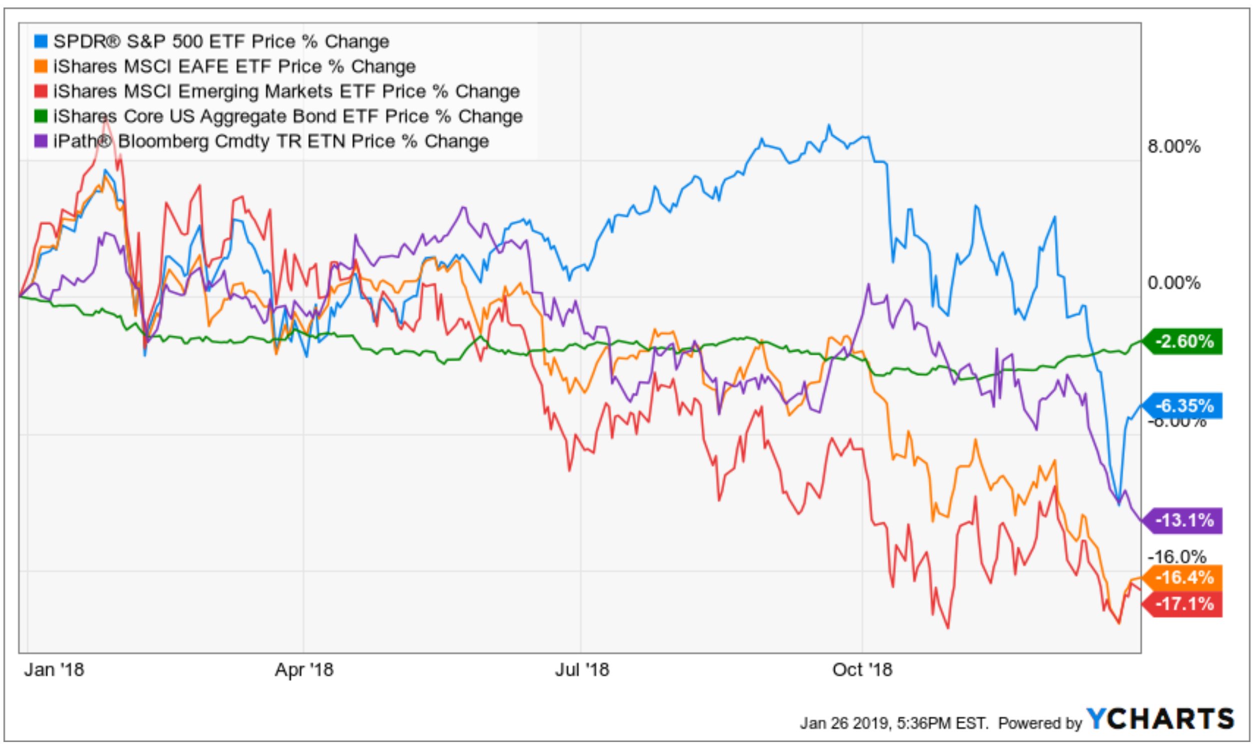
2018 Year-End Review and Forecast

The Year in Review

After a very good year in 2017, characterized by low volatility and very good equity market returns, I suppose we had to pay a price and sure enough in 2018 we experienced a substantial sell-off in global investment markets, especially in the last quarter of the year.

The chart below shows the performance of various types of markets over the course of 2018. Here is a key to what each curve represents:

- SPY (blue): US Stocks (S&P500 index)
- EFA (orange): Non-US Developed Market Stocks (MSCI EAFE index)
- EEM (red): Emerging Market Stocks (MSCI Emerging Market index)
- AGG (green): US Bonds (Barclays Aggregate Bond Index)
- DJP (purple): Commodities (Dow Jones – AIG Commodity index)



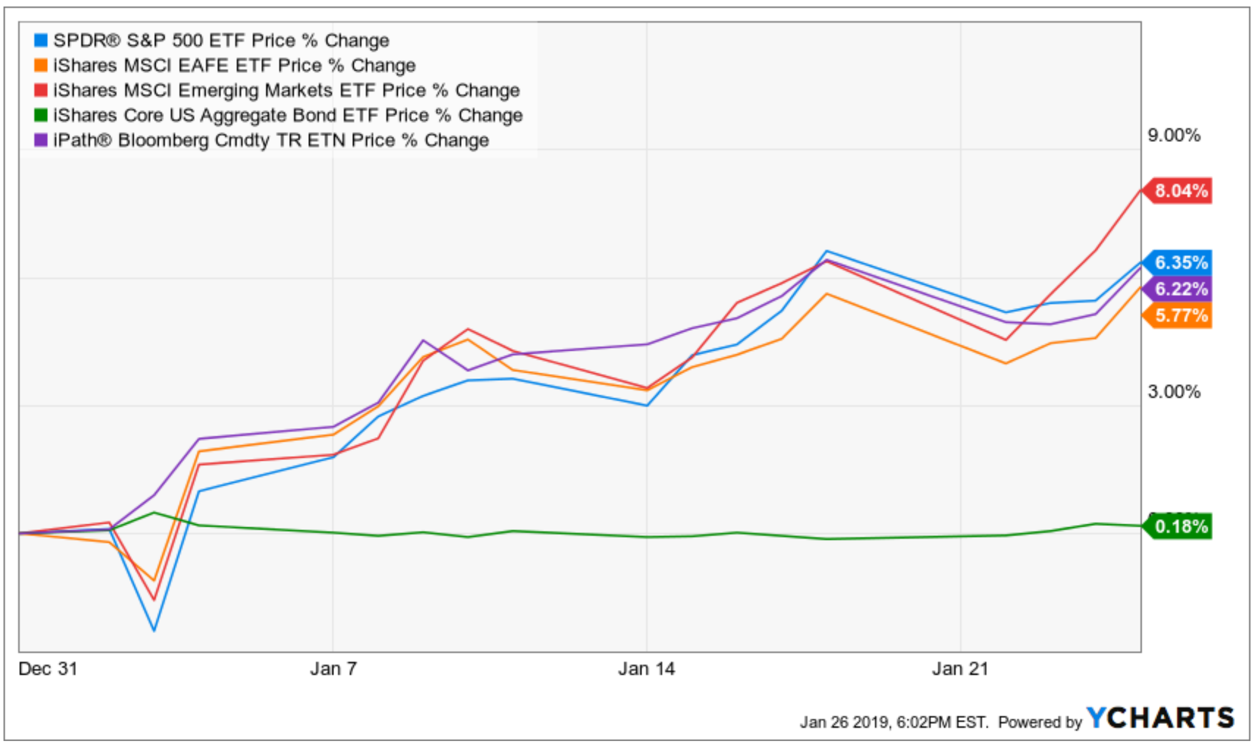
As you can see, stock markets were down between 6% and 17%, commodities, as a group, were down 13%, and even relatively conservative bonds were down a bit from a capital gains perspective.

In fact the US stock market did pretty well for a while, supported by a generally strengthening US Dollar, a healthy economy, and concerns in other investment markets. However, the bottom fell out in October and then again in December as the broad US stock market fell 20% in three months from beginning of October to Christmas, underperforming most other equity markets. In comparison, emerging markets were down "only" 10% over this three-month period.

Clearly, having a diversified investment portfolio didn't help much in a year like 2018 where most asset classes were down. It is in fact rare to have a year where stocks, bonds, and commodities suffer negative returns.

The suddenness of the downturn in the fourth quarter didn't allow much of an opportunity to employ hedging strategies. As an aside, it was also the worst year since 2008 for the hedge fund industry apparently, with an average loss of about 4%, which is significant for an industry that employs strategies that bet on the downside as well as the upside of a market.

There is some good news because since the beginning of 2019 markets have recovered some of their losses, as can be seen below:



In 2019 developed equity markets and commodities are up about 6% and emerging markets 8%, bonds have been relatively flat through the first three weeks of January.

This extreme volatility underlines an important principle when it comes to managing investment portfolios, which is that you don't want to buy high and sell low. It seems obvious and yet when an investment portfolio drops by maybe 10% or 15% in three months it's easy to panic and sell everything. Having done that, the issue becomes when to buy back in because cash isn't paying much these days. That usually happens once the investment market recovers substantially because quite often after such a dramatic downturn there is also a pretty quick bounce back. It is very difficult to time such movements successfully and many studies have shown that investors who try to time the market usually end up worse off than investors who just ignore such movements and stick to their strategy.

Having said that, I do not advocate a buy-and-hold strategy entirely. I believe there are times when we should be more cautious and times when we should focus on growth. Our strategy is to look at what is driving the investment markets – quite often it is what we refer to as "news", as opposed to what we would call "fundamentals". The last quarter of 2018 was a news-driven downturn in my opinion. There was one bad news event after another: The China-US trade wars, UK Brexit negotiations not going well, a slowdown in the Chinese economy, increasing interest rates in the USA. These last two items could be considered "fundamental" except for the fact that they were blown way out of proportion. Since we considered this to be a news-driven downturn, we didn't change our investment strategy. We shall see how this works out but the bounce-back in 2019 seems encouraging.

What would prompt us to change our investment strategy? What would we consider a "fundamental" change that merits a more conservative stance? Primarily we look at leading economic indicators. I have mentioned these a number of times in various quarterly reports. There are leading, coincident, and lagging economic indicators for all the major economies and many emerging markets. We had 13 months of increasing leading economic indicators in the USA to December. Just recently (January 24th) it was announced that the US leading indictor for December had declined. One month of decline doesn't mean much, especially when the stock market has a really poor month like it did in December, since stock market performance is one of the leading indicators. However, it does mean we need to be more vigilant and that perhaps we should focus more on choosing specific investments we believe in and that have limited downside rather than betting on the market as a whole using mutual funds or index funds.

We are currently employing just such a strategy in Europe, where leading indicators have been consistently positive for the Euro area as a whole but mixed for particular countries. For example, the German leading indicator has been negative four of the last five months.

In the USA, much of the increase in the broad market index over the last few years can be attributed to certain sectors or even certain companies that have a disproportionate influence on the broad market indices. For example, the S&P 500 index is weighted approximately 20% to information technology companies and only about 3% to materials companies. Below is a list of the top ten companies in the S&P500 index ETF (SPY), along with their percentage weight in the index. As you can see, info tech companies such as Microsoft, Apple, Facebook, Amazon, and Google (Alphabet), dominate. After years of outperformance in the industry and with these companies, they have become the dominant drivers of the performance of the S&P500 index.

Microsoft Corp	3.68
Apple Inc	3.16
Amazon.com Inc	3.05
Berkshire Hathaway Inc B	1.75
Facebook Inc A	1.59
JPMorgan Chase & Co	1.53
Johnson & Johnson	1.53
Alphabet Inc Class C	1.49
Alphabet Inc A	1.46
Exxon Mobil Corp	1.35

I always find it interesting when I hear some investors speak of how they prefer so-called "passive" investment strategies, where they just do asset allocation and employ indexing through investment vehicles such as the S&P500 ETF, to more active management involving individual investment selection. Such passive investors often cite the benefits of broader diversification and betting on the whole market rather than specific companies or industries. Clearly though this isn't the case; as we can see from the data above a bet on the S&P500 index is a bet on specific industries, and indeed specific companies that have a disproportionate influence on the index.

All this to say, that it shouldn't be surprising that when a leading sector, or leading companies, fall out of favor, we see a dramatic decrease in such an index. This was in fact a large driver of the downturn in the US market in Q4, as the infotech sector was the second worst performing sector, after energy, down over 17% for the quarter. Apple and Amazon were down 30% and 25% respectively in Q418.

Sectors also play an important role in countries other than the USA. For example, the MSCI United Kingdom ETF has a 20% exposure to financials and less than 1% to infotech. The Swiss ETF has a 30% exposure to healthcare, and a 19% exposure to just one company, Nestle. The South Korea ETF has a 30% exposure to infotech as a result of a 20% weighting in Samsung.

So-called "passive" investors, who consider indexing to be an investment in a broad market, should be aware that quite often this is not the case and that many indices are weighted heavily towards certain industries and companies. Furthermore, people working in industries such as technology, should consider whether they want to have their investments weighted to the industry in which they work, since a downturn in that industry would then affect not only their investments but possibly their career situation as well.

So what will the year ahead hold for investors? Every year in this annual review I make some sort of a forecast and last year I thought 2018 would be a decent year for equity investors, although not as good as 2017. I also expected non-US markets to outperform US markets. I did get a few things right, such as the strengthening of the US Dollar and continuing increases in interest rates affecting bond returns, and I also said that I expected a rotation out of some of the companies that had outperformed over the last few years, but

I have to admit it wasn't the most accurate of forecasts last year. Nevertheless, here's what I'm thinking now:

The Year Ahead

We have already seen a substantial bounce-back from the lows in late December and I think this recovery in stock prices may continue for a while, although at a slower and less certain pace. My basis for this thinking is that just as much of the downturn in Q418 was driven by what I call "news events" rather than fundamentals, I think it is likely we now receive some good news. For example, as I write this China has announced an economic stimulus, another announcement recently has been that there may be a détente in the China-US trade war, it also seems like perhaps the worst-case Brexit scenario has now been baked into markets.

Economic fundamentals in the USA are still positive and inflation is low, which is an ideal scenario on the face of it. However, the recent month-long US government shutdown and the China-US trade war will have a negative economic effect and it does feel like we are now late in the economic cycle. With this in mind, I believe there is much uncertainty ahead and forecasting is especially difficult. I would suggest riding this market bounce-back for perhaps a few months until end of March or April and then re-evaluating. The May to October months are historically the worst part of the year for stock market returns, so this may be a good time to get more conservative.

Finally, there is good value in many companies that have not participated in the large gains we have seen in some industry leaders over the last few years so it may be a good time to look at value rather than growth companies and at dividend-paying investments such as preferred shares which also suffered during the Q4 selloff but are likely to return to par values over time.

Until next quarter,

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President
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