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Investment Timelines and The Value of Perspective

Expectations for 2019

A number of years ago, before dramatic market corrections, profound economic questions, and puzzling political pronouncements complicated investing decisions beyond the usual, my daughter Anaïs offered me perspective that I now look back upon as invaluable.

On what was promising to be another in a series of slow days in the stock market with prices barely nudging higher, and as I was driving her to high school in the morning, I mumbled a complaint, giving voice to my impatience with the investment timeline. I said that the markets were crawling at a snail's pace and making virtually no progress, to which Anaïs calmly replied, "Slow and steady wins the race".

That bit of Aesop's wisdom, which I had read to her in "The Tortoise and the Hare" when she was a child, was spot on then and it is spot on today. It applies equally to individual investors and to stewards of other peoples' wealth. Investments sometimes run fast, and sometimes slow, but in the end keeping steady, patient, and focused helps us to stay on course.

The Age-Old Question: Are We There Yet?

Anyone who has ever taken a journey with a child knows what the recurring refrain will be for the duration of the trip: Are we there yet?

As adults, we have learned to temper our impatience, but we are still subject to that very human instinct. We want to "move a muscle" for relief from forced inertia, boredom, and anticipation and are not completely immune to the "Are we there yet" mentality with regard to our investments. With the backdrop of the recent stock market correction this edge-of-the-seat question is now on the minds on many people when it comes to their portfolios: Are we there yet? Is the correction over?

Also lurking is an even bigger question: Is the great 2009 bull market over?

2018 was a challenging year for long-term, buy-and-hold investors like us. Virtually the entire year was an exercise in finding the best stocks in a market that was correcting from overvalued heights. All the while, the paramount question for market pundits was whether or not we are still in the great bull market of 2009, or if, in fact, the bull market had ended?

While there is no shortage of opinions in the investing world on both sides of that question, positive and negative, my answer once again is, yes, despite the market's near -9% tumble in December and -8% decline in 2018, the great bull market of 2009 remains intact.

Keeping a Long-Term Perspective In A Choppy Stock Market

Over time, the stock market has been a great creator of wealth and has outstripped most other asset classes in long-term returns. Jeremy Siegel, the noted Wharton economist, points out that for the period from 1802 to 2016 the U.S. stock market produced a real (after inflation) return of +6.7% per year, versus +3.5% for long-term bonds, +2.6% for Treasury bills, +0.5% for gold, and -1.4% for the U.S. dollar. During shorter time periods results have varied, some higher, some lower, but these figures from Siegel offer us a good long-term perspective. They help us to stay focused on the long game even in the midst of turbulence and uncertainty

Bear in mind Warren Buffett's great quote, which I have shared with you before: "Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a fly epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497."

The key is to keep a long-term perspective.

Investing genius Peter Lynch who managed Fidelity's Magellan Fund from 1977 to 1990 averaging a 29% per year return over those 13 years, echoes this sentiment, saying "A good stock can take two, three, even five years before it really pays off. It's not two or three weeks. It's not two or three months. My best stocks have been my fifth, sixth, or seventh year. Give your investments time to grow."

Assessing the Factors

While it is impossible to predict precisely when corrections will begin or end, or when longer-term bull markets will run their course, several things can be said with certainty as we assess the stock market's future prospects.

Generally speaking, the fuel that drives stock prices higher is a combination of healthy corporate earnings and low or reasonable interest rates. These are always a good guide to the direction the stock market is likely to take.

When corporate earnings rise, and the prospect for further earnings growth is good, the stock market rises too as investors seek a piece of the corporate earnings pie and are willing to pay for it. When interest rates are low or declining the cost of borrowing is low for corporations, further fueling healthy profit expansion and wider profit margins. The cost of borrowing is also low for investors who wish to buy stocks either on margin or by borrowing money elsewhere and investing it in the markets.

The opposite is true when corporate earnings decline and interest rates rise – the stock market declines as investors seek more stable sources of investment income and growth and borrowing costs for both corporations and investors go up, making borrowing to invest less profitable.

Generally, the market foresees economic turning points months in advance, and is therefore considered a leading indicator of economic activity. Does the market's current downturn signal an impending recession? While I believe there are reasons to be watchful for a slowdown, as I have indicated in past letters, I do not think we are at a recession yet. Here are the key reasons why:

- **Interest rates are rising, but are well below historical averages** - In December, the Fed raised interest rates by 25 basis points to a range of 2.25% to 2.50%. They intend to raise rates possibly another two times in 2019. While I believe that further interest rate hikes are not helpful to the stock market and to equity investors in the short-term, there is something to be said about the signaling effect that these increases have on the world - essentially the Fed is saying that the U.S. economy is strong and can handle rate increases that bring the national interest rate up to "normal", that is, to a point where neither irrational behavior is encouraged (as with ultra low interest rates), or where rates are not so high that they stifle economic growth. Of course it remains to be seen whether or not the Fed has achieved such a balance or if it has gone too far, but that at least is their objective. Ultimately, we as investors need to keep in mind that interest rates are still very low by historical measures and are still accommodative. Some of us remember the days of Fed chairman Paul Volker in the late 1970s when interest rates stood at an all-time high of 20%. By comparison our current rates are historically low. Looking at the Fed's interest rate hike from another angle, raising rates to a "normal" level means that the Fed will have ammunition to fight the next recession when it occurs by lowering rates to stimulate economic growth.

- **Corporate earnings growth continues to be positive and strong.** This bull market's lifespan will depend very much on economic conditions in the United States and globally over the coming months and years. At its core, the stock market's fuel is corporate profits, or earnings. As corporate profits rise and fall, so too does the stock market. Corporate earnings are reflected and foreshadowed in economic statistics, including statistics on consumer sentiment and spending, both of which continue to be strong. Additionally, tax burdens and regulatory burdens on corporations have been reduced at the Federal level, thus creating a positive environment for corporate growth. Lower tax rates and fewer regulations mean that companies can make larger profits with the same or higher sales levels. Higher profit margins lead to higher stock prices. From this perspective, these benefits to corporations can last for several years even if the global economy slows fractionally. Currently, consensus estimates, as tracked by Factset Research, are calling for earnings growth of 20% for all of 2018 when companies report their 2018 results in January and beyond. That figure would be double the average corporate earnings growth rate of 10% during the past eight years - it has been helped by the substantial tax cuts of 2017. Higher up on the income statement, sales growth is expected to register at 8% for calendar 2019, putting it at the exact average sales growth rate of the past eight years. Figures such as these imply continued economic and stock market strength.

Other factors to bear in mind are:

- **Consumer sentiment and spending are healthy**- With the unemployment level at an historically low 3.9% nationally, both consumer sentiment and consumer spending remain robust. Consumer sentiment remained high in December at 98 on the University of Michigan's Consumer Sentiment Index, while consumer spending is in the 3% growth range for 2018.

- **Leading economic indicators are flashing expansion** - The Conference Board's Leading Economic Indicators index stood at 112 in November indicating that the economy is anticipated to grow into the foreseeable future.

- **Global growth, and growth in the U.S. remain positive -** the International Monetary Fund expects worldwide GDP growth to be positive in 2019. They are projecting global economic growth to be 3.7%, matching the 2018 rate. Their forecast for the U.S. economy calls for GDP growth to decelerate slightly from 2.9% in 2018 to 2.7% in 2019, and for China to decline fractionally from 6.6% to 6.2% in the same timeframe from the effects of tariffs. While these figures are not cast in stone, they are helpful in gauging the anticipated direction of economic growth around the world.

- **Investor sentiment is negative, boding well for the stock market** - I am a believer in the long-term predictive power of investor sentiment. If sentiment is too bullish for long periods of time, this sets investors up to make unwise choices as reckless greed sets in and turns long-term investors into short-term traders. If sentiment is too bearish, that can be a sign that a market turning point is not far around the corner, as greed, a persistent sentiment co-existing with fear, propels us to seek the next great profit opportunity. In a recent American Association of Individual Investors (AAII) survey, 43% of respondents said they were bearish on the market's prospects - the historical average for that survey is 31%. And CNN Business's Fear and Greed Index which looks at seven investor sentiment indicators, has been in extreme fear territory for the better part of the recent past.

Some of the potentially negative factors, among many, continue to be the **inverting yield curve**, the **slowdown in the housing market**, the **trade war with China**, **Brexit**, and the increase in

political risk within the United States. None of these factors are yet at levels that are significant enough to outweigh the positives, though, as always, they are very important to watch and will, no doubt, be part of my commentary in future quarters.

Slower Growth Can be a Good Thing

Slower economic growth is rarely welcome news to equity shareholders, except that a slowdown will mean that the factors causing recessions can be made less harmful, and the life of bull markets can be extended. Slower growth can mean slower rates of inflation, less need for interest rate increases, longer economic expansions, and longer bull markets.

The current stock market correction notwithstanding, the resilience and flexibility of American business is an attribute that is probably unmatched anywhere in the world. This should be a source of confidence for the long-term. Our companies have an ability to adapt to changes in the economic environment and to right themselves after storms. When one considers the challenges that we have faced as a nation over the last century, it is not hard to see how our system of capitalism has benefitted corporations, as well as the average consumer, and the average shareholder as well.

What to Expect in 2019

Prognostication is always an imprecise art, but here are a few things I would reasonably expect to happen in 2019 based on what we know today in early January:

1. The 2009 bull market will remain intact even as the current correction continues;
2. Corporate profits will be healthy, but growing at a slower pace than 2018, mostly because of tariffs and the threat of more tension with China;
3. The Fed will limit interest rate increases - they have said two more increases are possible this year, but judging by the stock market's negative reaction to the latest increase in December, the Fed is likely to be more restrained in 2019;
4. The split Congress will result in legislative gridlock which could be a plus for the corporate world as the status quo offers a degree of certainty that CEOs need: and
5. Cash will continue to be a good safety play.

Staying Steady, Patient, and Focused

Perspective is everything in winning the long race for stock market profits. An investor's outlook can make for a successful portfolio, or result in its opposite: rash decisions based on unrealistic views or unsophisticated understanding of how the market works have foiled the best laid plans.

Perspective tells us that the stock market has been a great creator of wealth over time. Sixty six dollars invested in the early 1900s would have turned into more than $11,000 by the end of the century. Granted, that's a long time horizon for most of us, but it does highlight the power of compounding.

In shorter time increments, the stock market can seem chaotic and unpredictable, lacking rhyme or reason. But if we always bring ourselves back to the fundamental, unchanging nature of stock market investing, we can calibrate our expectations to be consistent with what we know to be true and to help us stay on course.

At its most fundamental level, the stock market is a place to invest for the long-term. Stocks represent ownership stakes in individual firms. They have no value on their own apart from the earnings streams of the companies they represent, and their price fluctuations in the short-term may *not* necessarily reflect the true value of their underlying companies.

When viewed as ownership stakes in living, breathing companies, rather than as chips at a roulette table, stocks make sense. Companies are a collection of real human beings who work each day to make products and services that other real human beings can use. More often than not, this collection of people, work efficiently and successfully to produce profits that then accrue to the owners of the company, the shareholders. Profits materialize over time as, first, sales are made, and then expenses are deducted from sales. Sales and expenses represent human activities in a process that takes time and can rarely be rushed for more than a short period.

At the end of the day, all of this effort and activity is reflected in a company's earnings, and earnings in turn drive stock prices over time.

When the stock market is viewed in perspective, the wisdom encapsulated in "slow and steady" becomes apparent. "Slow" bids us to align our fast-paced expectations with the realities of the corporate world, while "steady" should be our resolve as we weather the volatility of the markets and stay on course to reach our goals.

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