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"By The Way"

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One of the basic principles of investing is to focus on the long term and ignore the short-term volatility, or as it is often called, the noise. There is no doubt of the importance of the concept, but it offers little comfort when the noise wipes out a significant portion of the value of ones portfolio. From the September high to the recent low, the S&P 500 dropped 18% and even after the recent rally is still down 13%. I wrote last month that if the market did break down from its trading range it could "go south in a hurry", but I was in no way prepared for an 11% decline within two weeks. The suddenness of the decline may have been a surprise, but as we all know markets don't go up forever. Although I also wrote that we should get prepared, unfortunately I didn't leave enough time to do it. We can't change the past, but we can develop an outlook and a framework to help deal with the challenges of the future. One thing I think we can count on is a continuation of the recent high volatility across all financial markets. I also believe the support level that was broken when the S&P 500 declined will now prove to be an area of significant resistance. Until the S&P climbs back through that resistance at the 2600 to 2650 level with strong momentum and broad-based participation, I recommend using defensive strategies and owning quality companies with good balance sheets. Since the financial crisis of 2008 and the market lows of 2009, the war between fear and greed had been won by greed. Bad news only provided opportunity to "buy the dip" as markets subsequently moved to new highs. In my opinion that is no longer the case given the high level of uncertainty, and a more conservative approach is necessary. I will be prepared to modify that outlook and profits can still be available within such a market, but they will be harder to find.

As expected, the FED raised rates at the December meeting, but tried to soften the blow by taking a more dovish stance on the expected number of future increases. Evidently not dovish enough as markets were less than impressed. In particular the bond market, which seemed to imply that the FED had screwed up and pushed the economy toward a recession. The U.S. Treasury 10-year bond, which earlier this year was yielding in excess of 3%, fell to 2.65% indicating a rush to safety. In addition, the spread between the Treasury bond and high-yield corporate debt has more than doubled since August, signalling a strong aversion to risk. The FED remains "data dependent" which unfortunately only reveals what has already happened. If you drive looking in the rear-view mirror, accidents will happen. After a year in office, FED Chairman Powell has shown little concern for the effect of FED policy on markets; that's not his job of course but we will hope that his attitude will change in 2019.

Are there signs that the bond market is correct and there are reasons to be concerned about growth? We have long been proponents of using the Purchasing Manager's Indices (PMI) as an indicator of the direction of global economic growth. Those managers are on the leading edge of the production process and as such, can provide an early warning signal of a slowdown. The survey

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recommends itself by the simplicity of its methods. The managers are asked to merely indicate if business is better, worse, or the same. The results are collated and a result of over 50 indicates growth and conversely less than 50 deterioration. The December number for the U.S. came in at 54.1. Nine times out of ten one would be pleased by such a strong number, but because the previous month came in at 59.3, there is concern about the slowing rate of growth. Overall the Americas are positive with the exception of a flat Mexico; Europe is for the most part around neutral; and the Far East is neutral to even some developing economies in decline. Other indicators such as consumer spending and consumer and business confidence are also subject to interpretation, but nowhere is there a definitive answer. Almost unanimously reports are weaker than earlier in 2018, but for the most part remain positive. So yes there are reasons for concern but by no means do the numbers suggest we are on the verge of a recession.

On the political front, I have tried to overlook President Trump's rude and crude delivery on the basis that many of his economic policies actually made sense, but it is becoming increasingly impossible. His departure is becoming more likely in my opinion whether by resignation or impeachment. Keep in mind it is not just the Mueller investigation but also the Southern District of New York probe, and inquiries by U.S. attorneys in D.C. and Eastern Virginia that could lead to his downfall. Now that the Democrats are in control of the House of Representatives, we can expect an increase likelihood of impeachment and continuing disturbances like the current partial Government shutdown. During the debate over the debt ceiling this spring the Democrats will have the opportunity to advance proposals such as repealing tax cuts and reinstituting corporate regulations; almost all could be market negatives. The big one on the horizon but already making headlines is who will win the 2020 election? The middle ground is no longer a winning political strategy suggesting another outlier will win and his or her party will control the narrative. Elizabeth Warren seems a nice person, but her policies should strike fear in the hearts of investors.

In summary, I will need to be convinced before I again become fully on board with this market. There are however things that would make me more positive:

1. A FED pause
2. A trade accord
3. Fiscal stimulus that helps the economies of China and Europe
4. Most of all the market itself tells me there's improvement

Two other positives to keep in mind, since 1946 the S&P 500 has always been higher 12 months after a midterm election, and 2019 is the Chinese year of the Pig which is a symbol of wealth and good fortune.

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