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Investment Management

Market Data Summary

The stock market ended the year at all time high levels after starting from a deep hole after the 2018 sell off. The S&P 500 Index gained +9.07% for the quarter while the international EAFE Index gained +7.81% (in USD terms). Stocks "climbed a wall of worry" during the quarter and the S&P 500 ended the year +31.5% higher, +18.1% for the EAFE index. Stocks made new highs back in June and powered higher in spite of mixed economic and earnings data and ongoing geopolitical uncertainty. Bond markets also provided attractive total returns – if not yields - to investors. The Barclay's Aggregate Bond Index was flat for the fourth quarter as yields were largely unchanged (+0.18%), but the index was +8.72% higher for the year. Bonds were pushed higher for the year by the declining yields triggered by the FOMC's 2018 policy shift.

As is usually the case, the view ahead is cloudy. As we write this commentary, investors face uncertain outcomes in the impeachment process, the US-China trade negotiations, BREXIT resolution and renewed conflicts in the Middle East. If this list weren't enough, 2020 is also a US election year. Our investors won't be surprised that we are going to depend on the fundamentals of our portfolio companies and investing partners and make no substantial changes to our strategy implementation. But we should demonstrate why we don't. Last quarter, we talked about investing in the context of a recession. This quarter, we're tackling investing in the context of a national election.

Special Topic – Investing and National Elections

The upcoming election seems to be unusual – a controversial incumbent president under impeachment, a contentious selection process for a challenger, a deeply divided electorate, significant social inequalities and more. Of course, this election is unique both in its details and where it occurs along the timeline of the American Experiment. As a country, we have faced similarly unique elections in our past. Perhaps there is something to learn from the market's past response to those elections. To understand, we looked at a range of articles on this topic to learn how people think.

Perhaps the most common way that people look at elections and markets is to ask the question: who is better for markets, Republicans or Democrats? Not surprisingly, folks with an embedded bias can find a way to get an answer they like from the data. But intellectually honest research easily confronts the objective truth: the data support no preference for either party in a dependable way. Anne Kates Smith, Executive Editor at Kiplinger, posted an article on February 2016 (*How Presidential Elections Affect the Stock Market*) which summarizes the situation regarding party by noting that

> *"...looking back to 1900, Democrats have been slightly better for stocks, with the Dow up an average of nearly 9% annually when Democrats are in control, compared with nearly 6% per year during Republican administrations."*

These average annual returns seem to indicate that the market is favored by Democratic administrations. However, there is a wide divergence of returns for Democratic and Republican administrations. Year-to-year variations in market return are much greater than the computed difference above. The Kiplinger article continues:

> *"…a focus on which party wins the White House is unwarranted – at least from an investing standpoint."*

More recently, Julian Emanuel of BTIG wrote an article entitled "United We Fall?" to examine the market's preference for divided vs unified government. They looked at periods where the US Congress and Presidency were in the hands of one party, then transferred to some division of government control. For example, the 2016 election flipped the presidency from Democratic to Republican. The House and Senate were both controlled by the Republicans, so the government became "unified". Their analysis (table below) shows that the common idea that investors prefer Washington "grid lock" – that is, divided government – isn't borne out by historical data.

And this comparison cannot stand much scrutiny. The evident hypothesis that preceded this question must be: "Are Republicans good for/Are Democrats bad for the market?". This line of inquiry implies that the platforms and principles of either the Republicans or Democrats have been consistent over the last 120 years. They have not. Asking a Republican/Democrat question for guidance on the future of market prices is a fruitless endeavor.

For me, the most interesting thing about the topic and the current environment is that:

1. Markets *anticipate* division and uncertainty. On the time scale of elections (i.e. a year-ish), the market senses the division and derisks until the uncertainty is resolved. Election results are special in this regard. The key uncertainty is resolved the moment the votes are counted – one candidate wins, one loses. Most of the risks the market has to digest tend to be drug out over long times.
2. Investors are particularly concerned about the current situation. When it comes to anxiety about the future, there is broad unity. Julian Emanuel from BTIG has made the point that the current investor hedging has an unusually long duration – that happens to extend just past the election date, implying that investors are specifically hedging investment risk tied to the election. (As I'm typing this, an email popped into my inbox with big, bold type asking: "Imminent Stock Panic: Are You Prepared?" – evidently, if I just click the link, I can get prepared…)

Our investors should not be surprised that, when it comes to our investors' portfolios, our time is not heavily allocated to election prospects. As a matter of principal, we work to have portfolios that are appropriate for each of our investors' goals and preferences. The next underlying principle, specifically for stock portfolios, is to always have portfolios of stocks of companies with strong fundamentals. I may sound like a broken record, but we want to know what we own and why we own it. We cannot control price volatility – that is a natural feature of the market. But we can improve our client's state of mind by adding confidence to hold through the volatility – and if possible – acquire new positions when cheaper stocks are available to us.

ECONOMIC DATA SUMMARY

The US economy remains on a trajectory of moderated growth with low unemployment and low inflation for the fourth quarter, as did developed economies around the world. Broadly speaking, changing trade policy and the inefficiencies and uncertainty associated with these changes continue to present a headwind to economic growth.

GDP: The advance estimate for Q3 2019 GDP came in at 1.9% and the Q4 estimate is 2.3%. Full year GDP is expected to be about 2.1%. The US economy decelerated during the year because of the ongoing impact of significant and uncertain changes in global trade policy. Additionally, the boost to GDP in 2018 was largely attributable to the TCJA, but that was a one-time boost. Economic growth is stable but continues to require policy accommodation. Acceleration or deceleration are unlikely.

GDP Components: For the quarter, Consumption led the economy forward again. Private investment continued to lag, evidence of managers not making allocation decisions in the face of uncertainty. Government consumption was modestly higher. Most investors are focused on consumption. The thinking is that, as long as consumption continues to grow, even modestly, the US will stay clear of a recession.

Inflation: Through the year, inflation ticked higher. The January rate was 1.5% increasing to 2.28% in December. Inflation has been contained in a narrow band since 2009 and 2019 readings stayed within that band. While low inflation is attractive for people on fixed incomes and consumers, there are problematic pockets of high inflation, particularly US health care, that are offset by pervasive low inflation. There is no apparent force to accelerate inflation more broadly. However, the monetary policy experiment is not fully tested, and we do not know the extent of the impact over long time. Inflation could accelerate.

Labor: Headline job creation results remain positive. The trends in wages, both broadly and internally (wage level, race, gender, education) are trending higher. This is positive for consumption in the near term. Labor participation rate is higher across cohorts, as is job creation. However, growth rates are modest, consistent with the modestly growing economy. There are negatives in the jobs and wage data. Real wages are also growing, but there is evidence that, for the lower half of wage earners, sector inflation presents a challenge for consumers. Modest wage growth is good when there is excess, but when the worker gets behind inflation, there are problems. This is a threat to future consumption (and GDP, and wage growth, etc.).

Rates: Monetary policy loosened around the world. Rates across the curve are at or near historic lows. This is usually good for growth, but this isn't a normal recovery. It appears that the economy requires low rates to sustain the growth trajectory. The recent cuts by the FOMC in the US have had their effect. The FOMC telegraphed that there would be no further cuts unless the data weaken further. We are unconvinced that rates will stay at current levels. There is unusual, political pressure to cut further.

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