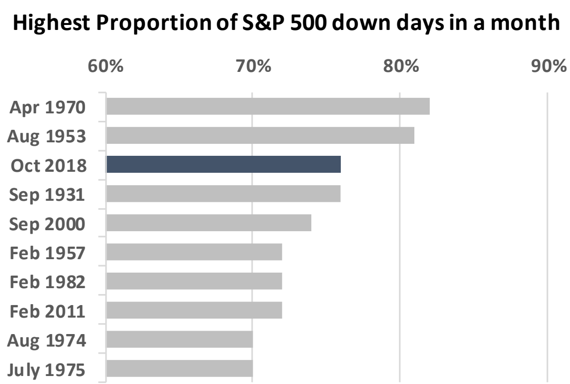
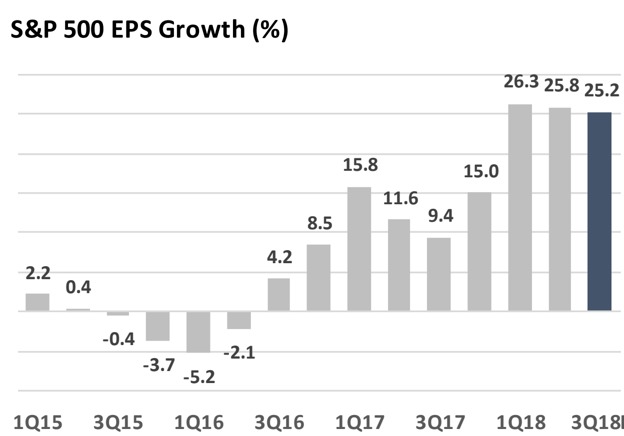
COMMENTARY

November 2018

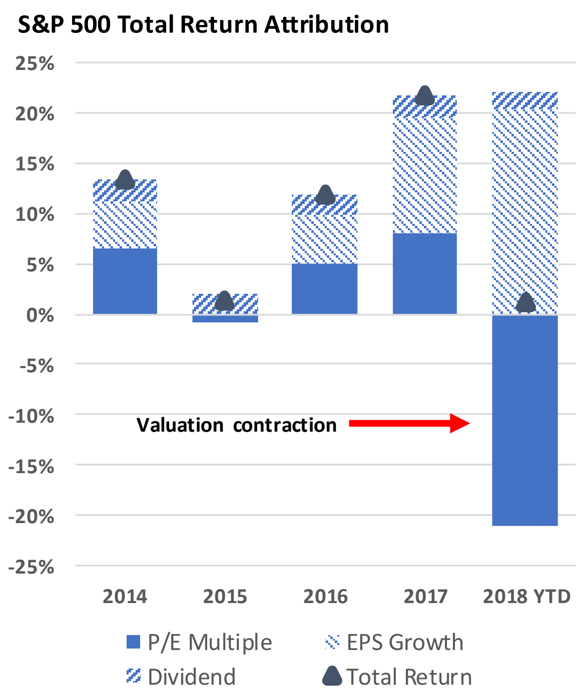
October has come to a close, and not a moment too soon for equity markets around the world. The month was very challenging for stocks, as investors struggled with a host of issues led by rising interest rates and trade worries (as we have written about throughout the year). To put the past month into historical perspective, October marked the first time since October 2008, the peak of the financial crisis, that the proportion of losing trading days was above 70% (16 trading days), and ended up as the 3rd highest month in history (see chart). As of the end of the month, ~20% of S&P 500 companies are trading at least 20% below their 52 week highs, demonstrating that the market has been led by a small number of large companies (as we discussed in our August Commentary). Around the world, the picture has been even more bleak. While the volatility of October brought the US markets down 7% from recent highs, it remains the best performing in the world by a long shot. The FTSE Developed Markets Index (comprising the largest companies of countries such as Japan, UK, France, Canada & Germany) is now down 17% from its 52 week high, and the FTSE Emerging Markets Index (comprising the largest companies of countries such as China, South Korea, Taiwan, India & Brazil) is down 23% from its 52 week high. According to Deutsche Bank, 89% of asset classes worldwide tracked by the bank have negative total returns in USD in 2018, the highest percentage on record going back to 1901.



With so much doom and gloom, one might expect that corporate results are falling off a cliff. On the contrary, with 327 of S&P 500 companies reporting third quarter results through October 31, earnings per share growth has been at a strong 25% rate year over year. This growth has been driven in almost equal parts by growing revenues, increased profitability, and the impact of tax reform according to Credit Suisse. Even removing the one-time impact of tax reform, earnings are growing 17%, well above the results of recent



years. With earnings growing at a high rate, why are total returns on the US market about flat for the year? At a simplified level, the three components that drive returns are as follows: 1) dividends paid to shareholders, 2) earnings growth, and 3) the valuation multiple that the market is willing to pay for those earnings.



As you can see from the chart, the past 4 years have seen positive stock market returns helped by each factor in 3 of the last 4 years (with 2015 only positive due to dividends). 2018 earnings growth has been the strongest of the past 5 years, but it has also coincided with the sharpest valuation contraction. Valuation contractions and expansions (measured by P/E multiples) are more ambiguous than the certainty of a dollar of dividends in your wallet and the growth in earnings recorded in a company's audited financial statements. Forecasting short term market sentiment (aka "timing the market") is a challenging game, one we deemphasize versus the fundamental nature of finding strong companies that we believe have the potential to grow earnings and dividends over the long run.

Moving forward, the question on investors minds is where do we go from here after a brutal month? A recent analysis from Morgan Stanley shows that sharp initial corrections (such as what we just experienced) are hallmarks of run of the mill corrections, whereas bear markets tend to start with more gradual declines as economic data slowly turns negative over time. In 9 of the last 10 largest 35-day selloffs since 1953, stocks bounced back within 6 months on average. We are also now entering a stretch of time that recent history has shown tends to see strong equity gains. Since 1960, the performance of the S&P 500 has been positive every November through April during the 3rd year of a presidential cycle (14 straight occurrences), with an average gain of 15%. It appears that no matter which party is in power in Washington, the markets seem to like putting the uncertainty of the mid-term elections in the rearview mirror. While we never make investment decisions based on historical data patterns, we do believe that progress on clearing up near term uncertainty (whether it is simply getting past the mid-terms or breakthroughs in trade disputes), combined with solid economic fundamentals and corporate results, will ultimately be a positive for equities.