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# “By The Way”

January 2020

“It seems one can hedge away profits at least as easily as losses.”

2019 was a great year to participate in financial markets, the S&P 500 rose 31.2% over the course of the 12 months. Although over half of that return was needed just to compensate for the ugly 14% decline experienced in the 4th quarter of 2018. A good portion of the overall increase can be found in the impressive performance of technology stocks, in particular the large cap companies. The tech heavy NASDAQ 100 ETF (QQQ) was up 39%, and the Technology Sector ETF (XLK) rose 49.9%. Two stocks, Apple and Microsoft, make up 40% of the XLK and they gained 89% and 58% respectively. Even the worst performing S&P sector ETF, namely energy, was up 11.7%. One thing that surprised me was the price of oil was up in excess of 30%, although that is very date sensitive given the volatility of that commodity. Goldman Sachs analyzed the makeup of the S&P return and observed only 10% came from growth in earnings per share and the remaining 90% was the result of an expansion in the price-earnings multiple from 14x forward estimates to 19x during the year. That is unlikely to be repeated in 2020 so we will be more dependent on better earnings if this market is to move significantly higher. On that note forward looking economic indicators remain mixed with manufacturing data weak, but the service sectors continue to be strong. While history would suggest the overall economy would eventually follow the manufacturing reports lower, that may no longer be the case. In the modern world, especially the U.S., economies are much more service oriented. On the earnings front, estimates for 2020 center around 5-6% which is good but not sufficient to fuel much stronger markets.

Global equities were almost universally profitable. Using the relevant U.S. dollar-based ETFs for ease of comparison; Canada (EXC) was up 27.5%; EAFE (EFA, the Developed Markets of Europe, Australasia and the Far East) up 22%; and even emerging markets (EEM) advanced 18.2% in aggregate. Fixed income returns were less gaudy than those for stocks but were still positive although hurt by a weakening trend into year-end. The Total Bond Market ETF (BND) was up 8.8% and 20+ year US Treasury ETF (TLT) rose 14.1%

An old investment axiom states that often the more money will be made not by buying strong and growing assets, but rather those managing to step back from the abyss. In 2019 we had two examples; Russia (RSX) was the top performing developed country ETF - up 40.8%, closely followed by Greece (GREK) at 37%. Russia suffered from U.S. imposed sanctions and widespread internal protests, but the country's central bank cut rates 5 times last year and with the recovery in oil prices as someone wrote, “the patient is out of the recovery room”. Greece was forced to pay 24% as recently as 2012 to borrow funds and remain solvent, but today rates have come down to around 2% and the European Central Bank is making adequate short-term liquidity available.

One other thing I found interesting about last year was that despite all the impressive increases in the global equity markets, the average hedge fund return was only 8½%. It seems one can hedge away profits at least as easily as losses.

Enough about history, what can we expect to see in 2020? I consider myself a card-carrying contrarian always looking for reasons to take the opposite course from the consensus. There are two problems with this strategy; one, its not always easy to divine what exactly is consensus. (Although I think I can safely say in the present market the majority of investors are bullish or at least are buyers of stocks.) The second problem is one of timing, for the most part contrarians will be too early to act. I read a recent observation on Twitter that I believe sums up the issue perfectly: “Near term the prevailing narrative is usually right. Longer term something other than the prevailing narrative is always right”. In my mind after 10 years and an almost 400% increase in the S&P 500, it is prudent to be watchful and aware of what might change the narrative.

Having said that but not wanting to be the contrarian referenced above that acts too early, I reflected on reasons to remain bullish. Oddly what came to mind was Newton’s first law of motion; a body in motion will remain in motion unless acted upon by an outside force. Call it inertia or momentum, whatever, the S&P 500 has lots of it and there seems at least for the present no outside force strong enough to disrupt the advance. 2019 saw negative economic and earnings reports and lots of geopolitical upheavals but any blip to the downside was just another opportunity to buy stocks. 2020 appears to be starting in the same way as a heightened risk of increased hostilities in the Middle East was quickly shrugged off and another new high reached.

This reflects an investor psychology that is not concerned with losses, and has become convinced, and rightly so given the experience of the last decade, to “buy the dip”. As long as all the major central banks of the developed world stand ready to act at any sign of economic or financial market weakness it seems unnecessary to worry about a market retreat. While I don’t know what event will reverse that psychology there are many strong candidates; economic disappointment, a change in Fed policy, the U.S. election, impeachment, and trade or currency wars. Obviously, no one can accurately predict the future but a change in investor attitude will happen eventually, and as we experienced during the last quarter of 2018, losses can be fast and painful.

In summary, while fundamentals like economic and earnings growth will matter someday, for the time being we are riding the crest of a wave that has no break in sight, but all waves do break eventually. For those in a strong financial place, enjoy the ride. If, however your ability to survive a significant loss of capital or the time to recover from such a loss, I would advise lowering the risk in your portfolio and protecting your asset base.

## Forward Looking Information and Disclaimer

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