Monthly Commentary 8th January 2019

December was a horrible month for financial markets, capping a horrible year. The US equity market, which in most of 2018 held up much better than its peers in the rest of the world had its worst December since 1931, falling more than 9%. For the year, the massive declines were everywhere: Shanghai was down a whopping 24% in 2018, Germany's Dax fell 18%, and the UK and Japanese major markets all declined by more than 12%.

There were not too many places to hide in 2018 as investment-grade corporate bonds fell between 1.25% and 2.5%, commodities as measured by the CRB index slipped more than 12%, and Hedge Funds (as measured by the HFRX Global Index) fell more than 7%. Even gold, perceived by many to be a safe haven, lost value last year.

Why didn't Elgin predict the fall in markets in 2018 (and thus sell before the drop)?
This is probably the single most common question we get from clients. Thankfully, we are not the only recipients of such a question, and are in good company together with all the world's largest and smallest private banks and fund managers, who also incidentally did not sell. Of course the media might selectively point to a handful of fund managers (among the tens of thousands) who had sold some of their holdings, but they are statistically insignificant, much like some others were before the financial crisis.
The graphic on the next page illustrates the market-timing issue very clearly. It is the Bloomberg index of the worlds 500 biggest billionaires' net worth. It can be argued that they are not managing other people's money, but mostly invest their own money. Being the world's richest people, they are quite savvy investors and they constantly have a pulse on the markets and their investments. Did they "see the falls of 2018 coming"? Apparently not.

Since January 27th of last year, the world equity market peak, their combined holdings fell by 15.75%, just narrowly beating the world index by almost 1%.

More importantly, we stress two points. First, each investor should invest based on their expected returns and their tolerance to risk. Like any professional manager, at Elgin we allocate various assets in our client portfolios to reflect their profile. Second, we try as much as possible to buy quality assets in the most cost-effective way. It has been well documented that markets tend to rise over time, and after falls, quality assets recover to surpass their previous highs. What we cannot control is the length of time it will take to recover.

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	.RICH1221 Index		-15.75%	-15.75%	.99%	-17.46%
2)	MXWD Index	USD	-18.67%	-16.74%		-18.54%
3)						

Is it the end of the world as we know it?

So is the financial world coming to an end, with a lot more pain ahead and no light at the end of this dark tunnel? Judging by the plethora of negative opinions on this, one would be tempted to think so. History be dammed. It's different this time.

We beg to differ. Yes, the world economy is not going to grow as fast this year as it did last year. And yes, there is an endless list of challenges that we are facing. But there have been similar challenges every single year in the last 100 years, whether the markets were rising or falling. And what drives market growth? Corporate earnings growth, which are in turn driven by economic growth.

So let's look at the biggest contributors to world economic growth - the US and China.

In the US, employment figures are still very strong and expected to remain so. With the consumer accounting for 70% of the economy, it is difficult to see how the US can fall into a recession this year, and thus be a drag on markets. Valuations have come down to reasonable levels again, and investor sentiment is extremely bearish – a contrarian indicator. Earnings growth slowed considerably but it is still expected to be positive this year. So it is hard to make a case for another big leg down.

As for China, it surely has many challenges. Its current focus on deleveraging and caution on local government spending will inevitably lower growth levels. Still, it has successfully rebalanced its economy away from exports towards domestic consumption and can sustainably grow its economy at 5% annually for the next 5 years, accounting for more than 30% of worldwide growth. It has huge fiscal capacity for more stimulus and massive reserves to bail out its banks if need be. Being a command-economy, the Chinese can also lower interest rates, provide housing support and cut taxes. So their policy toolkit is well stocked.

Another big worry is China-US trade issues, which have almost single-handedly had the biggest downward effect on financial markets. Will the US escalate its trade war with China? While we cannot predict with certainty what the final outcome will be, we should keep in mind that the US is entering the beginning of the long presidential election campaign. Despite his unpredictability, one has to ask which course of action is likely to get Trump re-elected: Signing a trade deal with China or raising tariffs to higher levels? Would he be willing to risk a backlash from his base of tens of millions of Walmart shoppers (who will have much lower purchasing power if further tariffs are imposed) to bring China down? We think not. Finally, Trump seems obsessed with how the stock market is doing, seeing it as a reflection on his presidency. He surely knows that a trade deal will be welcome by the markets.

Timing the markets

There is a human tendency to want to "time the markets", i.e. sell before they drop and buy before they rise. We are not aware of any trader or professional investor who has consistently been able to do this. It is not just about selling at the right time, but also getting back in at the right time. So having in mind that we hold quality assets, we are always mindful of the graphic below. It shows the return of the S&P 500 each decade if an investor just buys and holds (middle column) versus if they miss the 10 best days of the decade (right column). While extreme, this is a very strong reason why trying to time the markets is futile and almost always results in far worse performance.

Decade	Price return	Excluding best 10d per decade
1930	-42%	-79%
1940	35%	-14%
1950	257%	167%
1960	54%	14%
1970	17%	-20%
1980	227%	108%
1990	316%	186%
2000	-24%	-62%
2010	156%	75%
Since 1930	**13,189%**	**72%**

Note: Latest decade as of 8/6/2018

Source: S&P, BofA Merrill Lynch US Equity & Quant Strategy

Valuation as a predictor of future performance

With regards to valuation, as we mentioned above, markets are generally much cheaper than they were a year ago. For example, the Euro area and UK markets are trading at a forward P/E ratio of 11.3 and 11.6 respectively, versus the average of the last 7 years being 13.6 and 13.95. So one can argue that these markets are on sale.

Based on extensive research, Merrill Lynch has concluded that current valuation is not a good predictor of short-term market direction, but is a very good predictor of long-term performance. Based on the latest valuation of the US market, Merrill predicts that for the next 10 years, the total annual return of the S&P 500 (including dividends) is almost 8% per year. Not too bad if one holds quality assets.

The Elgin Analysts' Team