J.W. Burns & Company

Investment Counsel

Quarterly Update - January 2019

Bears Sound Smarter But Bulls Make More Money

"The single greatest edge an investor can have is a long-term orientation." - Seth Klarman

Dear Clients and Friends,

As Charles Dickens wrote, "It was the best of times, it was the worst of times."

For the first three quarters of 2018, it was the best of times for stock investors, as the S&P 500 Index hit an all-time high, and the Dow Jones Industrial Average almost touched 27,000. However, the fourth quarter of last year produced what seemed like the worst of times, with the S&P 500 sinking 13.5%, including a steep 9% drop in the month of December alone.

"When equities fall swiftly, most investors wonder - is this the big one?"

As a result, for the full year of 2018, the S&P 500 Index finished down -4.38%, the Lipper Balanced Index down -4.48%, and international stocks, as measured by the MSCI All World ex-USA Index, fell more than 14%. In addition, small cap stocks, as measured by the Russell 2000 Small Cap Index, fell 11% while oil fared even worse, losing nearly 25% for the year.

In our letter to you a year ago, I stated that we should expect heightened volatility and even several corrections. But perhaps the most important point in the February 2018 letter was that ***"…it is important to point out that stocks go down a lot faster than they go up. This catches a lot of investors by surprise and can scare them out of their long term investment plan."***

Well, the fourth quarter's broad based and severe decline exemplifies this point. When equities fall swiftly, most investors wonder – even if just in the back of their minds – "Is this the big one?"

Of course, one never knows, but history has clearly shown that eventually the economy and markets regain their footing, the last bear sells out, and stocks resume their upward climb. As I have mentioned previously, when I began in the investment business over 30 years ago, the Dow Jones Industrial Average stood at around 2,000. As I write this, the Dow is just under 24,000 and that does not include dividends! ***Stocks have been the best wealth creating investment known to man, and the greatest edge is to ignore the intense gyrations and maintain a long-term orientation.***

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There is an old Wall Street saying: "Stocks climb the stairs, but go down the elevator." Accepting this fact, and more importantly, being psychologically prepared for it, can make market declines somewhat easier to handle and prevent the worst of actions – the rash selling of great businesses, with great managements, selling at attractive prices. Which is exactly what you own.

As I sit here writing this in early January of 2019, the market has already begun to rebound, up more than 5% for the month. However, we have not yet entered the "meat" of fourth quarter earnings season, so I wouldn't be surprised if volatility were to ratchet back up again, and we encourage clients to be ready emotionally. Nevertheless, at J.W. Burns & Company, we are constructive on stocks for this year, as we believe investors repriced markets in the down 4th quarter, as if forecasting a worst case scenario to unfold in the global economy in 2019. ***We think otherwise!***

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First, historically, bull markets end when either 1) a recession occurs or 2) the Federal Reserve begins raising rates aggressively and investors anticipate a recession. On October 3rd, Federal Reserve Chairman, Jerome Powell, stated the Fed's goal was to raise interest rates to neutral and that he believed that we still were "a long way from neutral."

Considering that any Fed officials comments are intensely examined, parsed, and evaluated by investors worldwide, Powell's comments were blunt and unnerving.

The fourth quarter market decline was underway. Investors would eagerly await the December 10th Federal Reserve meeting where they raised interest rates another 25 basis points (as expected). But in his comments after the meeting, considering the growing concerns about the financial markets, trade, and the global economy, Chairman Powell remained relatively hawkish on interest rates.

However, at a January 4th economic conference with former Chairs Bernanke and Yellen, Powell seemed to pivot, promising that the Fed would now be "flexible, patient, and data dependent" with future rate hikes.

Chairman Powell's public relations missteps were clearly a major issue behind the market pullback in the 4th quarter, and markets had begun pricing in a future recession. So, this less aggressive tone was music to the ears of investors, sending the Dow Jones Industrial Average higher by 747 points later on the afternoon of January 4th.

And if the Fed goes down the path of patience and flexibility – which I now expect – this would be a significant plus for equities in 2019. Currently, the real federal funds rate sits near zero, and with rates at this level, the U.S. economy has never fallen into recession.[1]

Along with a more dovish tone from the Fed, investors cheered the first jobs report of 2019, which renewed confidence in the U.S. economy and helped quell fears of a slowdown or recession. In the month of December, the U.S. economy added 312,000 jobs, blowing away estimates of 180,000. Additionally, the holiday season of 2018 delivered the strongest holiday retail sales in six years. Overall, consumers forked over $850 billion this holiday season. So, despite the volatility plaguing Wall Street, consumer spending and overall sentiment were clearly unaffected.

GDP estimates for 2019 sit in a healthy 2.0%-2.5% range, down from 2018's 3% growth rate, but still implying chances of an impending recession to be quite low. Furthermore, the Conference Board Leading Economic Index (LEI), which measures economic strength, portrayed a healthy economy, led by record employment numbers, healthy wage growth, solid manufacturing orders, and strong consumer confidence.[1]

Remember, earnings growth for S&P 500 companies were exceptional in 2018, up over 20%, and yet equities were down for the year. As a result, the multiples on stocks have come down to a very reasonable 14 times 2019 earnings. So, while companies' earnings should grow at a less rapid pace this year –say 4-5% – they will nevertheless continue to grow.

A moderate but still growing economy, with low inflation and stable interest rates, is an excellent backdrop for stock price appreciation. 2019 will certainly have its surprises, but we are bullish for the year ahead.

In 2019, we enter the third year of a presidential cycle, which is historically by far the best performing year for the stock market. In fact, the average returns in this year come in at an impressive 17.8%. Additionally, the chart below depicts how big drops in stock market prices are historically followed by strong rallies, which we believe looks to be the case for 2019.

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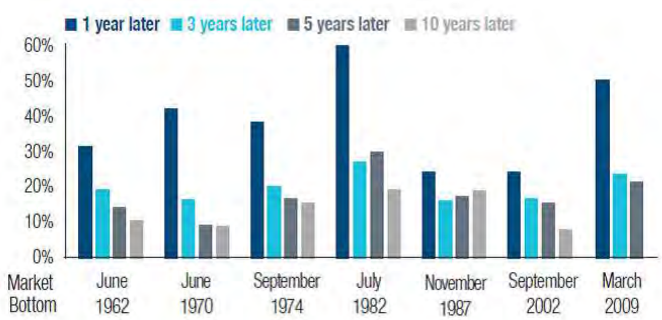
Recoveries From Bear Markets



Average Return After Bear Market	
1 Year Later	38.4%
3 Years Later	19.8%
5 Years Later	17.7%
10 Years Later	13.5%

Source: T. Rowe Price, data from 12-31-61 to 12-31-17

Of course, there are several primary risks to stocks in 2019. Obviously, the trade war has been a lingering thorn in the side of the bull market for roughly the last year, and it has already negatively affected global economic growth. However, while no formal deal has been reached yet, the delegations did agree to advance the negotiations onto cabinet-level officials, indicating that significant progress has been made.

It is likely, in our view, that some agreement eventually will be reached, even it if occurs beyond the March deadline. However, if negotiations really breakdown, be prepared for sharp volatility and a short-term sell off.

Additionally, there is the government shutdown which is distressing for all to watch, but, at this time, we believe it is unlikely to significantly impact the economy. However, similar to the trade war, the shut down on the whole is a negative for growth.

There also remains risk in certain geopolitical issues around the world. Currently, Brexit has turned into a complete fiasco, causing uncertainty about Britain's future status with the European Union. We believe this, along with Italy's financial crisis, could pose risks to markets in 2019. Finally, there is always the risk of some unexpected "black swan" event.

However, in my 30+ years of investment counsel, I know that the primary drivers of stock market performance are **earnings, the economy, valuations, and interest rates.** From where we stand today, the risk-reward profile for equities in 2019 looks good.

As many of you know, I am not very shy about pointing out when I have been correct in our predictions or forecasts. But I can man up when I am off target. In my client letter in early 2018, I forecasted a 7-11% return for stocks – and I was obviously wrong. While the earnings growth came in as strong as I expected, I underestimated the impact of the U.S. - China trade tensions, and rising interest rates.

So, for 2019, with multiples lower and corporate earnings still growing, I am going to stay right there – a solid 7-11% or so return for our stocks in 2019. I know this is a relatively “safe” call, but I will add that if the above mentioned risks generally moderate, which I think they will, our returns could be higher.

In 2019, J.W. Burns & Company will celebrate its 45th year in the investment counseling profession. A lot has changed over the last 45 years, however, our successful investment philosophy as well as our dedication to serving your financial needs has not.

On a day in and day out basis, we remain focused on ensuring your money is being deployed into only the highest quality stocks. As we continue our relentless review of your current portfolio holdings, as well as new opportunities, you will likely see some adjustments from time to time.

I wish you all a safe and prosperous New Year!

Jim

Best wishes,

James C. Burns, CFA
President

J.W. BURNS & COMPANY, INC.

INVESTMENT COUNSEL

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1 Haverford Investment Trust, 2019 Outlook