The Market in Review

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This week's articles and insights

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"What's wrong with knowing what you know now and not knowing what you don't know now until later?"

- ***Winnie the Pooh***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	24,002	+ 2.43%	+ 2.89%
S&P 500	2,597	+ 2.56%	+ 3.58% (+0.49% in $CDN)
TSX	14,903	+ 3.31%	+ 4.05%

Captain Chicken

Years ago, there existed in the Victoria phone book someone named Captain Chicken. None of us – young stockbrokers cold calling for new accounts – ever called him so I can't say if he truly existed or not. But there in the white pages he was, for the public to see.

Was he a military officer, and what kind of leader was he? He became a sort of storied character to us. We imagined him cheering on his troops with such inspired rally cries as "*Over the top, boys – I'm right behind you!*" or "*Some of you won't make it back, but that's a sacrifice I'm willing to make.*"

Whatever his past, one truth remains: to retire safely to Victoria and be listed in the phone book, Captain Chicken was a survivor. If he led from the rear, it worked.

Which describes our approach to this current market. From the peak in September to the low on Christmas Eve, US markets fell 20% and Canadian ones declined 15%. Since the lows, US stocks are now up over 9% with Canada right behind at 7%. We went from the worst performance for the market on Christmas Eve ever, to one of the best Santa Claus rallies (December 26th to January 3rd) ever. The decline brought fears of impending recession, but the strong rebound suggests it was just a brief scare. Which is it?

And, more importantly, what would Captain Chicken do?

Well, he'd start by viewing everything with a cautious eye. For example:

- In October, analysts expected US corporate earnings to rise 10% in 2019. Thanks to recent warnings by Apple (**NASDAQ AAPL**), Fed-Ex (**NYSE FDX**), Samsung, and others, expectations have been sliced back to just 6.8%.
- The Brexit dilemma – Britain's exit from the European Union – is still unsettled.
- As much as we love big rallies, the biggest occur during corrections or downturns. In other words, there may be more rough weather ahead.

However, Captain Chicken would also be forced to note the positives this week:

- The December jobs reports were exceptionally strong in both the US and Canada. These are not symptomatic of an impending recession.
- Oil has stopped falling, and has risen 14% since Christmas Eve. Oil prices are a good indicator of oil demand and global growth.

- The stock market's "buying surge" has been exceptionally powerful. Past episodes like this, when buyers return in force, are good indicators of higher prices down the road.

Like the good Captain, we are thankful for the rally, but still lean to the cautious side. Global growth is not reversing, but it is slowing.

As one money manager put it, *we are now in a lower growth, sideways, boring economy.*

We don't think it is time to take more risk – small company stocks, junior mining and oil companies, or economically-sensitive companies like airlines. As one bond analyst mentioned recently, if the economy <u>is</u> okay, the US Federal Reserve is going to hike rates. This is not great for stocks. If the economy is <u>not</u> okay, this is also not great for stocks.

Boring, to us, has always been beautiful. Banks, utilities, and other big dividend-payers – all of which suffered last year - should be safe havens for the year ahead.

Like the infamous Captain Chicken demonstrated, you don't always have to be a hero to win. You just have to survive.

Worst to First

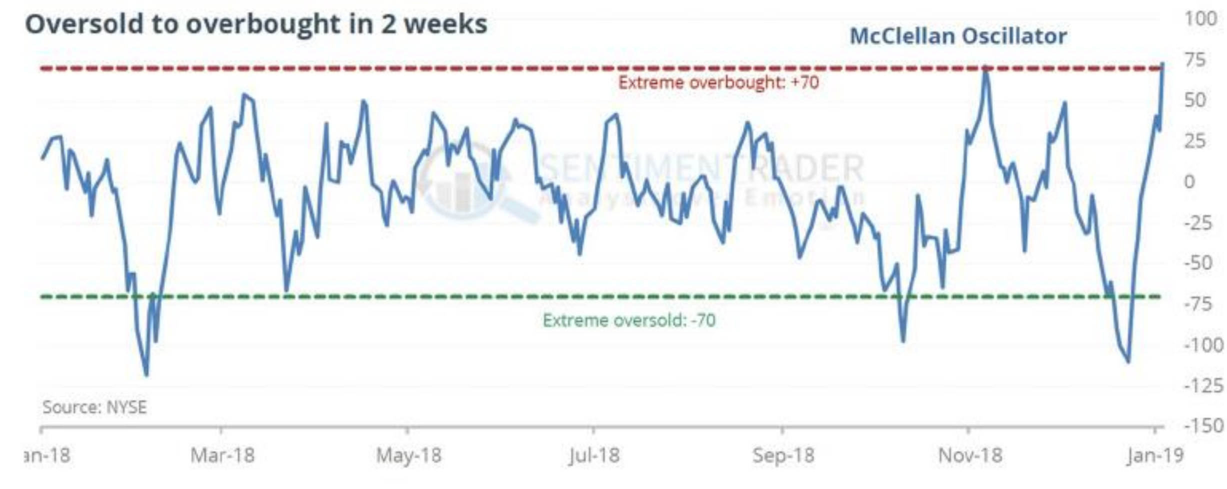
Last year, 90% of asset classes had negative returns, the largest such percentage since 1901.

So long 2018 – we won't miss you. Don't let the door hit you on the way out.

Last month saw markets fall to extremely oversold levels, intensified by machine-based algorithms and a multitude of fears. Everything from fears of a trade war to falling diesel prices (yes, that's a recession indicator) were signaling that the economy is not in good shape.

Then to confuse everyone, the US Jobs report showed 312,000 more people employed, compared to an average month of 220,000. Analysts were only predicting about 160,000 new jobs. Even Canada joined in, adding 9,300 jobs when only 5,500 were expected. Employment like this is <u>not</u> indicative of a recession.

So, after the worst Christmas Eve performance in history, and the worst December since the 1930s, we have had one heck of a bounce since then. The US market is up almost 10%, making it the best start to a new year in 13 years. Most importantly, the intensity of the buying since the low before Christmas indicates that this may be the bottom – at least for some time.



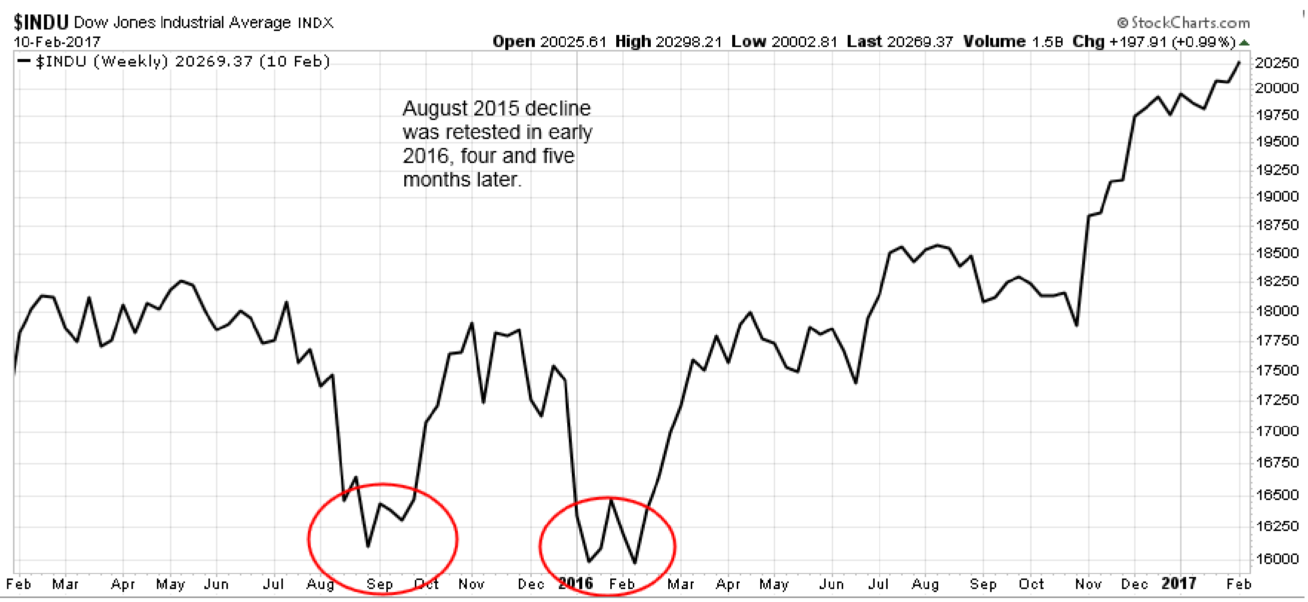
Source: SentimenTrader

To put this recent decline into perspective, we believe it matches both 2011 and 2015 more closely than the big one (which got worse) in 2008.

The 2011 decline for the Dow Jones Industrial Average was -19.4% compared to -19.8% last month. Both were followed by days of powerful buying. In both 2011 and 2016, the market was at new highs five months later.

2011:

2015:



As mentioned in our last letter, we still expect the December lows to be "tested" with another decline, as this is a common occurrence. No predictions about hitting new highs in five months.

Predictions for 2019

So, where to from here?

Here's a list of what we wanted for Christmas and what we've received so far.

The Bulls' 2018 Christmas List

All I want for Christmas is for...	*Santa's response?*
1. The Fed to stop raising rates.	☑ Powell's Jan. 4 comments
2. The U.S. to avoid the global recession.	? Dec. jobs report good start
3. China and the U.S. to resolve their trade war.	☒ Talks ongoing
4. A Brexit resolution.	☒ Could be anything. Unknown
5. Oil to stop crashing.	☑ +14% since 12/24
6. Market breadth to improve.	☑ Breadth thrust
7. Analysts to be reasonable about earnings.	? Getting there

Ned Davis Research, Inc. *T_SSF19_01.1*

Three of seven "problems" have seen definite improvement, and two more are headed in the right direction. Just two remain in the uncertain column.

What do the economists and analysts say?

Prediction is difficult- particularly when it involves the future.

- Mark Twain

While predictions are done in earnest, they are, for the most part, just entertainment. Consider the scary predictions about jobs losses due to machines taking over.

"Consider the ATM. If you had to point to a technology that looked as though it would replace people, the ATM might look like a good bet; it is, after all, an automated teller machine. And yet, there are more tellers now than when ATMs were widely released. How can this be? Simple: ATMs lowered the cost of opening bank branches, and banks responded by opening more, which required hiring more tellers."

- Byron Reese

Brokerage analysts are notoriously optimistic. Last year, the average expectation for US markets was a +10% return. This compares to the -5% the S&P 500 actually delivered, and almost no one predicted a loss for the year.

Our strategists at Raymond James are hopeful for 2019, once again. Even more so about Canada, as it turns out, which is a bit of a surprise:

"The Canadian market is trading at steep discounts from historical levels. Some of this discount is warranted due to consumer debt levels, housing market concerns and a commodity-sensitive economy, but current levels appear abnormally cheap once the global growth picture improves. Canadian corporate earnings will need to be revised lower to reflect weakness in the commodity complex and there is no doubt Canada has its structural issues that will need to be addressed, but there is clearly value here."

Our S&P/TSX Composite Index 2019 price target is 15,600. If realized, this would equate to an 8.9% price return plus a dividend of 3.5%, which equates to a total return of 12.4%.

Kraft Heinz (by Lincoln Jiang)

We mentioned safe and boring as a theme above, so we thought we would include an example. While not yet in our own dividend portfolios, Kraft Heinz (NYSE KHC) has certainly fallen enough for us to be actively considering it. The shares are held in the dividend portfolios of both Connor Clark & Lunn and Bissett & Associates, which are outside managers we use.

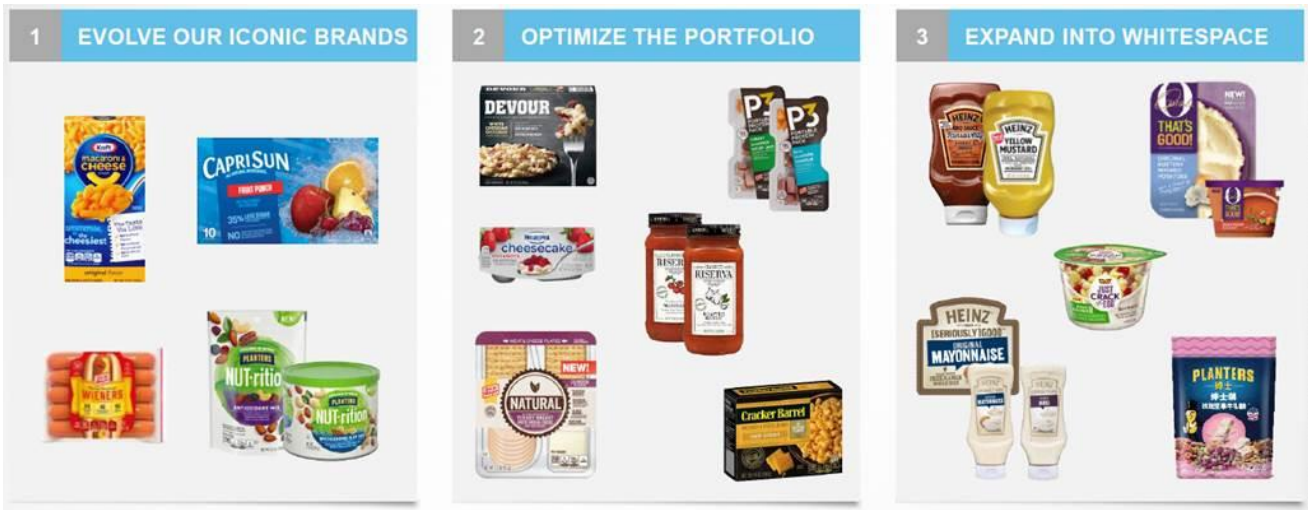
Kraft Heinz (**NYSE KHC**) is the 5th largest food and beverage manufacturer in the world. It was created with a Warren Buffet and 3G (the folks behind Tim Horton's and Burger King) backed merger back in July 2015.

The idea at the time was to find efficiencies from two complementary companies. Investors cheered the merger for the first couple of years, as the stock increased from $60 to nearly $100.

Recently, a number of factors have impacted both the stock as well as the sector and have caused the stock to fall more than 50%. Primarily, the market perceives the cost-cutting as being too aggressive and at the expense of market position, and revenue growth has slowed. Additionally, the food sector was valued above the rest of the market because of the defensive nature of these companies. This has reversed sharply since 2017, and the entire industry now trades at a discount to the market. Finally, the debt they issued to merge has weighed on the stock price.

We think the company has some new launches that will improve revenues. When the market recognizes that they are no longer in decline, the valuations should improve. Many of these consumer product companies were priced at 20-25x earnings and are now back to 12-15x. The actual earnings outlook has not changed meaningfully, but food company shares are not the darlings they once were.

Kraft still has a leading portfolio of brands, and they recognize that they have been slow to shift to newer investor tastes including e-commerce and “better for you” brands. Where they are succeeding is growing these household names into new markets and we’ve seen that with double-digit revenue growth in developing markets. They are also quietly expanding into food service, a higher margin space with significant growth opportunities.



Kraft Heinz offers a dividend yield of 5.5%, among the highest available in the space. The company has long-term debt, but ample interest coverage. Kraft Heinz recently received an upgrade to its credit rating from BBB- to BBB (investment grade) from S&P, signaling that rating agencies buy into the company's deleveraging progress. The risk will be if the company makes another big purchase (which had been mused in 2017), but we think the management team recognizes how that will be unfavourably treated by the market.

What gives us comfort in making a case at today's price is the valuation cushion and margin of safety we get for these prices. In Kraft Heinz's 20-year history, it has reached a trough valuation of 11-12x forward p/e three times in its history. March 2000, November 2002, and March 2009. Each time investors were rewarded with 1-year returns in excess of 20%. KHC is once again trading at a forward p/e of 12x.

Ultimately, we feel the intrinsic value of the company is around $55, suggesting it is around 20% undervalued at today's price of $45. In the short-term, a poor market could push it slightly lower, but we feel confident that the trends surrounding the company are stable. In other words, the bad news is already priced in.

Thank you for your referrals this month! They are always handled with great care and discretion.

The Art of Not Looking

We have often said that humans are wired wrong for investing. Our brains are programmed to run when we sense danger, and we see that in the way we process losses. People feel the pain of a loss approximately 3 times as much as they feel pleasure from a gain. Markets are often erratic in the short-term – witness the US market decline of 19.8% from the peak in September to the low on Christmas Eve – they outperform almost all investments in the long-term. US large company stocks have outperformed bonds by a factor of 350 times since 1926, and yet bonds still remain exceptionally popular (source: Ibbotson SBBI).

Despite their short-term gyrations, the irony is that the longer we hold stock investments, the less risky they become.

"In the short run, the market is a voting machine but in the long run it is a weighing machine."

- Benjamin Graham

In typical 5-year periods, we will experience one great year, three average years, and one poor year in terms of returns. Investors will pour money in after the good year, and take money out following the bad year. Statistics show this to be the case, time after time. It is why investors make far less than the average even when holding the best-performing mutual funds. They buy high and sell low too frequently.

Part of the problem is our own regulators. In an effort to be more transparent, we have moved from quarterly statements to monthly ones, and now offer daily access through websites. Many on-line services now show portfolio valuations by the second. People look at their net worth monthly, daily, and even hourly. All of these activities stimulate our brains into the flight response when we see losses.

Studies show that we view our time horizon in the same frequency as we view our statements. If we look at things annually, we adopt a one-year time horizon, even though we may live another twenty years or more. Looking daily shortens our viewpoint even more, which often leads to irrational selling and buying. In other words, the more often you check, the more likely you are to be disappointed.

"The longer the investor intends to hold the asset, the more attractive the risky asset will appear, as long as the investment is not evaluated frequently."

- Benartzi and Thaler, "Myopic Loss Aversion and the Equity Premium Puzzle"

Now, as much as we disparage bonds, they do have a place as we age. To gain the confidence to not look as frequently, we need to have portfolios that we know will fall less in poor markets (including ones like 2018, when even many bonds declined). This means adding more bonds as retirement approaches.

http://www.dividendvaluepartners.com

We thank you for your business and your referrals and we hope you find our site user friendly and informative. We would welcome your comments.

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Prices shown are as of close January 11th, 2018.

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