Fourth Quarter 2016 Commentary

Happy new year! We hope that your 2017 is off to a healthy and prosperous start.

The fourth quarter provided an eventful end to an eventful year. The results of the U.S. presidential election surprised most people (more on that below), the Federal Reserve raised interest rates for just the second time in the last decade, and consumer confidence rose to levels last seen at the beginning of the century. U.S. gross domestic product (GDP) rose at an adjusted 3.5% rate in the third quarter, the strongest reading in two years. The unemployment rate has fallen to 4.6%, a level not seen since before the Great Recession in 2007.

These events came on the heels of the earlier points in the roller coaster ride that was 2016: U.S. stock market averages experiencing their worst-ever start to a calendar year, the United Kingdom's decision to leave the European Union, worries about a slowdown in China, and the price of a barrel of oil more than doubling from its low point last January through its prevailing prices at the end of December.

Against that backdrop, the main stock market indices slowly fell in October, shedding about 3% on average. The election results in early November seemed to light a fire under stock pickers, though, sparking sharp rises in both the S&P 500 index and the Dow Jones Industrial Average. The S&P returned a respectable 3.8% during the quarter, while the Dow more than doubled that with a total return of 8.7%.

The Dow actually came within spitting distance of the milestone level of 20,000 near the end of the year, after posting a full-year return of 16.5%, again easily beating the 12.0% return for the S&P 500 over the course of 2016.

He Who Knows Not, and Knows Not That He Knows Not

After much hype, anxiety, and anticipation, the U.S. election took place in early November. While the obvious winner was president-elect Donald Trump, an unlikely loser surfaced this election season: the polling industry.

Just before the election, almost every poll was saying that Hillary Clinton would win the election. She was predicted to win the popular vote by close to 3%. She was also favored to win most of the "swing states," which would have easily given her more than 290 electoral votes, comfortably ahead of the 270 votes needed to secure a victory, since there are 538 electoral votes at stake, and half of 538 is 269, and one more than 269 is 270.

Nate Silver's aptly-named FiveThirtyEight.com, a political analysis website which has been incredibly accurate in its prior forecasts, gave Clinton a 71% probability of winning the election as of the morning of Tuesday November 8. Other prediction models like TheUpshot (from the New York Times) and PredictIt (a New Zealand-based website that allows wagering on political events) had Clinton with winning probabilities between 80% and 90%. The Princeton Election Consortium actually declared Clinton to have a 99% probability—*nearly a certainty*—of winning at the time the polls officially opened.

The forecasted stock market reaction to a Trump win was also almost unanimous, with the consensus belief that it would be bad for the markets. Most analysts and economists predicted that, if Trump prevailed, investors would sell risky assets such as stocks. A piece of research from a Dartmouth economics professor predicted a Trump victory would knock a full 12% off the S&P 500. RBC Capital Markets predicted the index would decline by 10% to 12% on a Trump win, while Barclays expected a 6% drop. Researchers at Citigroup estimated a 5% fall.

These predictions of a poor reaction to a Trump victory were based on market declines when Trump made various statements during the campaign. In the weeks leading up to the election, whenever Trump was gaining a little in the polls, the market would drop, while market averages went up when Clinton's odds improved. Additionally, the market drop after the U.K.'s vote to leave the European Union—which was also a big surprise—played into the forecasts.

And what happened? Not only did Trump win, but stocks rallied! A double whammy of poor prognostication! The pundits missed both the winner of the election *and* the market's reaction to the surprise winner.

When it was evident that Trump was going to win on the evening of the election, futures contracts on the S&P 500 index sank by a stunning 5%. They came back with a vengeance, though, soon after the market opened on Wednesday November 9. And after all was said and done by that Friday, the U.S. stock market had chalked up its best week since 2014—the Dow Jones Industrial Average reached new records after rising almost 5% for the week. In fact, that index was up on five straight days immediately after the election, and gained on 10 out of the first 12 days. On November 22nd, for the first time ever, the Dow closed above 19,000.

Lessons From the Know-Nots

The two most obvious lessons from this election cycle are that (1) nobody really knows what events are going to happen, and (2) no one knows what the stock market's reactions to those events will be. Consider this... in the week of the election, the stock market rose on Monday and Tuesday on the expectation that Clinton was going to win, and then it also rose on Wednesday, Thursday, and Friday, after she had lost. Can you figure that one out?

It has always been our belief that it is a mistake to base investment decisions on macro forecasts; these two lessons have reinforced that belief with concrete and steel rebar. Macro-level investing is incredibly difficult, because two correct forecasts need to be made: the macro event itself, and then the stock market response to that event. And as we have seen, even when one accurately predicts an event, the ramifications for the stock market might be the complete opposite of what we expect. As the legendary investor Howard Marks put it, "While people search the market's behavior for logic, there really doesn't have to be any."

As Jason Zweig pointed out in a recent Wall Street Journal article (*"Afraid of What Comes Next for the Markets and Economy? Read This"*, 11/9/16), many investors correctly predicted that President Barack Obama was going to impose health-care regulations, and they rationally bet against health care stocks because of it. But these very stocks ended up greatly outperforming the

market during his time in office. President George W. Bush's heavy increase in military spending would "obviously" make defense-related companies' fortunes soar, yet those stocks lost 19% in 2001 and nearly 7% in 2002. In the early 1930s it was widely "known" that President Franklin D. Roosevelt was going to be bad for Wall Street. After all, the nation was still reeling from the crash of 1929 and wanted desperately for someone to come in and fix the mess that Hoover had created. Nevertheless, in the first few months following FDR's inauguration the average stock rose 186%, with industrial and investment-related companies leading the way.

Instead of focusing on macro forecasts—such as the timing of changes in interest rates, the growth of GDP in a specific quarter, the level of unemployment, or the winner of a presidential election—we believe it is better to subscribe to Warren Buffett's philosophy of just focusing on individual businesses. Forget the forest, just look at the trees.

In fact, Buffett himself espouses the idea of making an investment under the assumption that the market may be closed for a few years. Focusing on how a company will perform over the long-term, irrespective of how the stock market may react to some macro event in the near term, is a much better way, in our opinion, of approaching the investing game.

Conclusion

Now that the election is over, pundits will turn their attention to trying to predict who the president-elect will choose for his cabinet, or what he will try to accomplish in his first 100 days. They will then try to make predictions on how those things will impact the markets. Please do your best to ignore those prognostications.

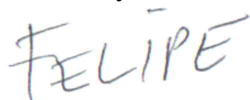
There's an old Chinese proverb that says,

He who knows, and knows that he knows, is wise … follow him.
He who knows, and knows not that he knows, is asleep … awaken him.
He who knows not, and knows that he knows not, is a student … teach him.
He who knows not, and knows not that he knows not, is a fool … avoid him.

Most of these pundits know nothing, yet they do not know that they know nothing. Worse still, they know nothing, but they are convinced that they know something. In those instances, it will prove worthwhile to follow the Chinese proverb and avoid these forecasters. Better yet, run the other way.

We look forward to reporting to you again in three months.

Sincerely,



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