



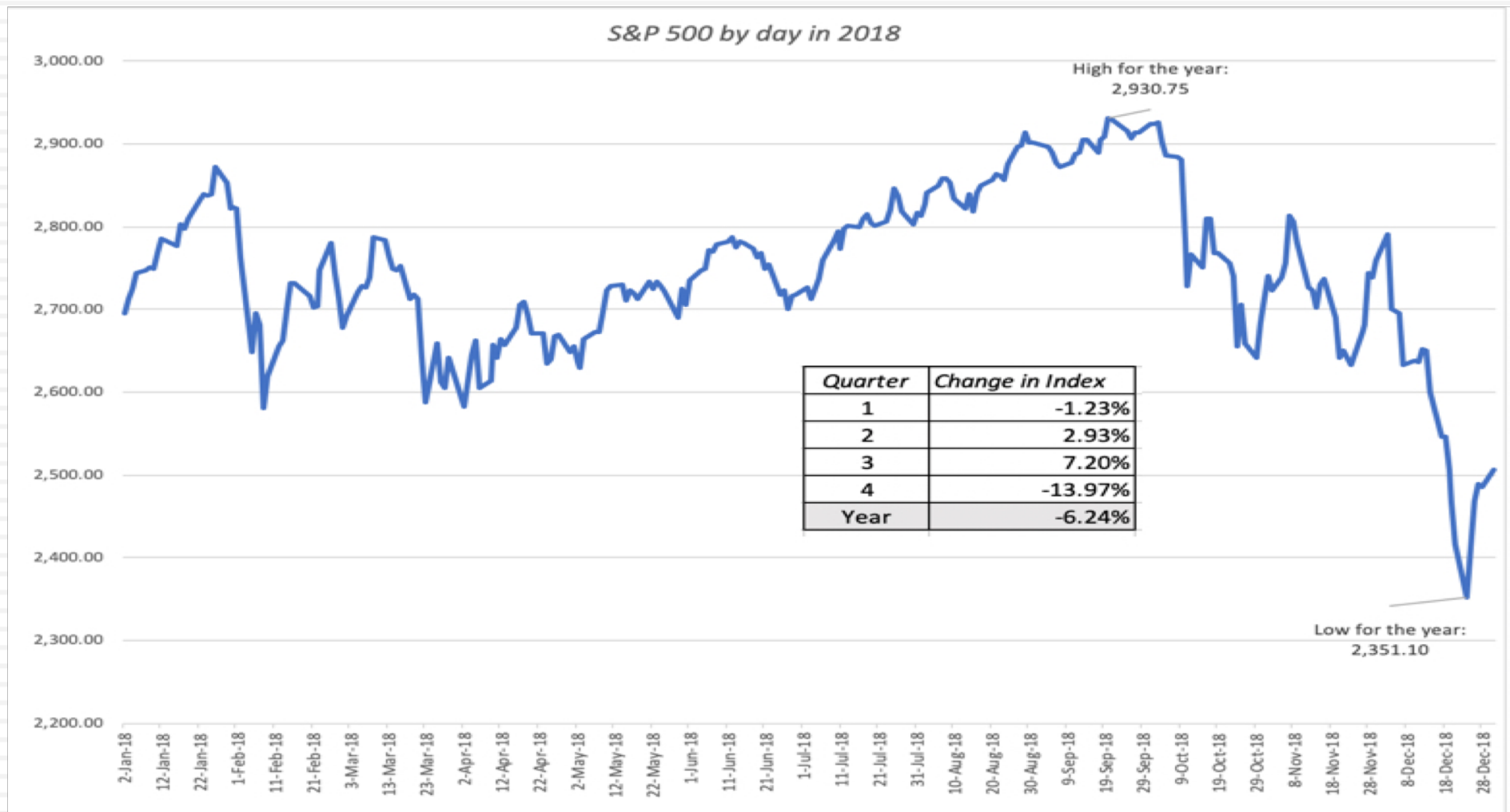
JANUARY 2019 DATA UPDATE 1: STOCKS ARE RISKY!

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Equity Risk: A Market Reminder

- In bull markets, investors, both professional and amateur, often pay lip service to the notion of risk, but blithely ignore its relevance in both asset allocation and stock selection, convinced that every dip in stock prices is a buying opportunity and soothed by bromides that stocks always win in the long term.
- It is therefore healthy, albeit painful, to be reminded that the risk in stocks is real, and that there is a reason why investors earn a premium for investing in equities, as opposed to safer investments, and that is the message that markets around the world delivered in the last quarter of 2018.

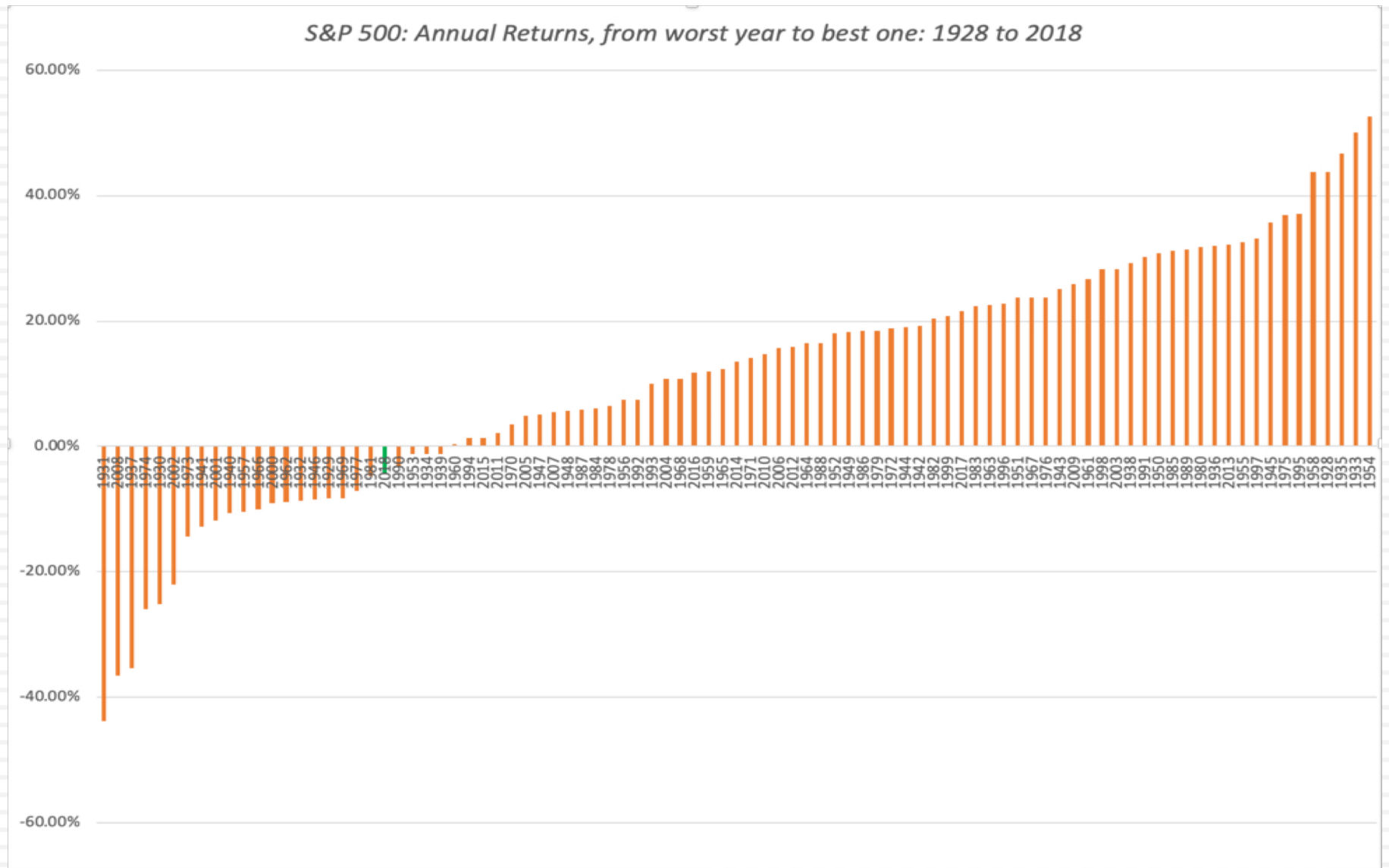
Stocks in 2018



Broad Based Pain

	<i>12/31/17</i>	<i>12/31/18</i>	<i>% Change</i>
Dow 30	24719	23327	-5.63%
S&P 500	2673.61	2506.85	-6.24%
S&P 600 (Small cap)	936.26	844.94	-9.75%
NASDAQ	7137	6635	-7.03%

Some historical Perspective

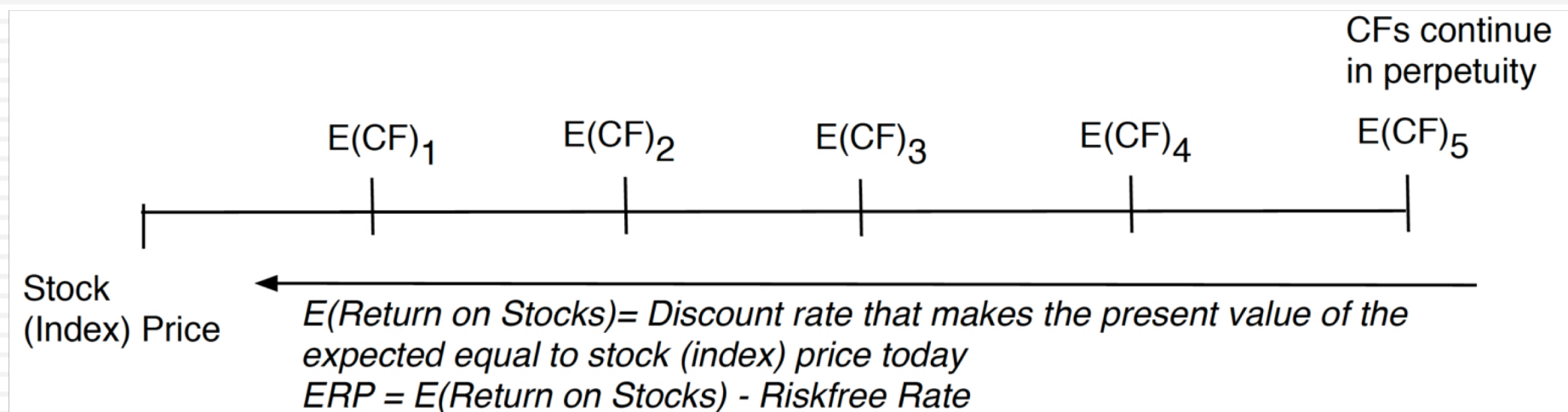


So, why did it feel worse?

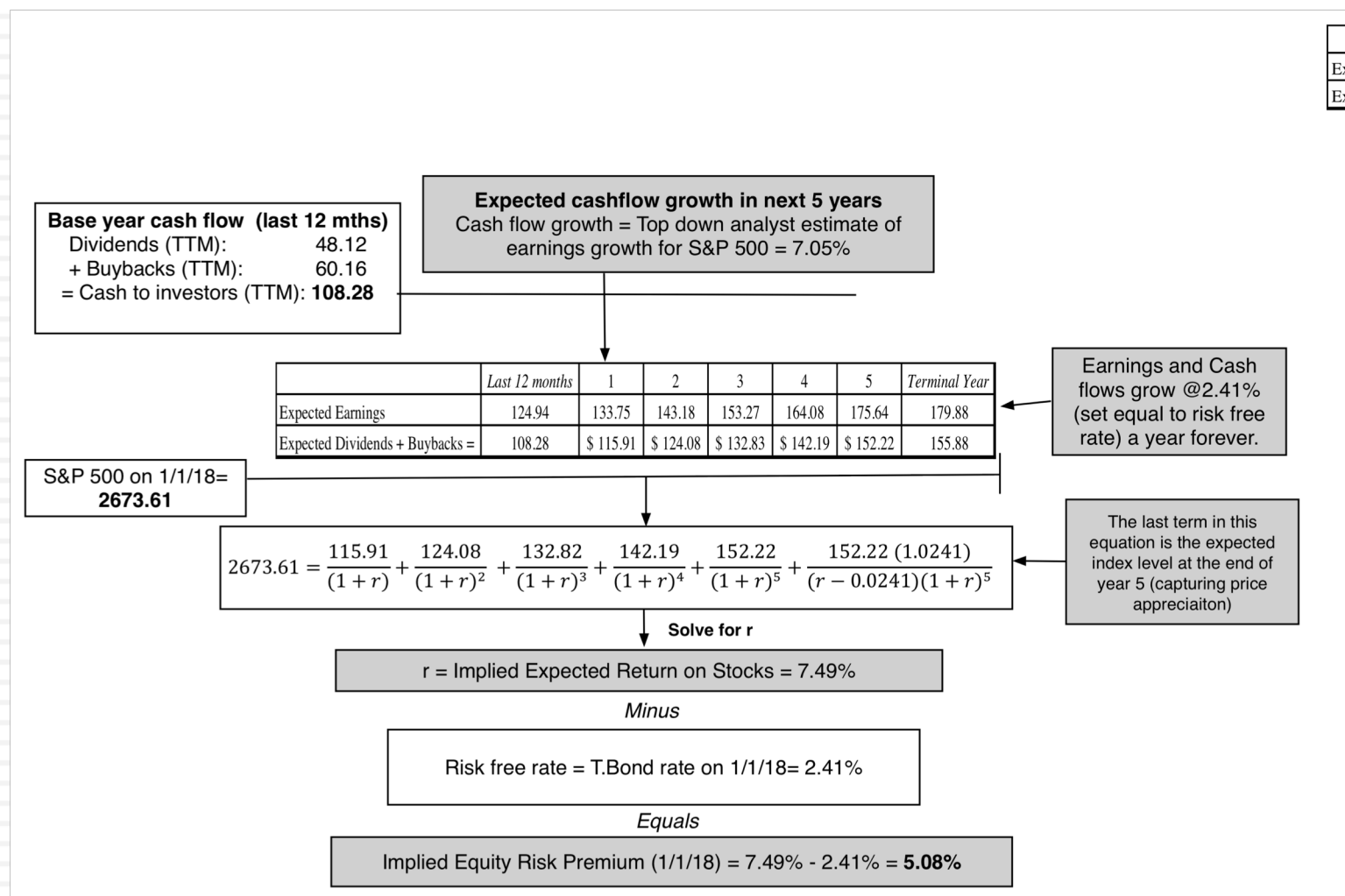
1. Spoiled by a bull market: After nine good years for the market, investors were lulled into a false sense of complacency about the capacity of stocks to keep delivering positive returns.
2. Back ended bad news: The negative returns were all in the last quarter of the year, making the hit seem larger (from the highs of September 2018) and more immediate.
3. Intraday Price Swings: The intraday and day-to-day volatility exacerbated the fear factor, and those investors who reacted by trading faced far larger losses.

The Equity Risk Premium!

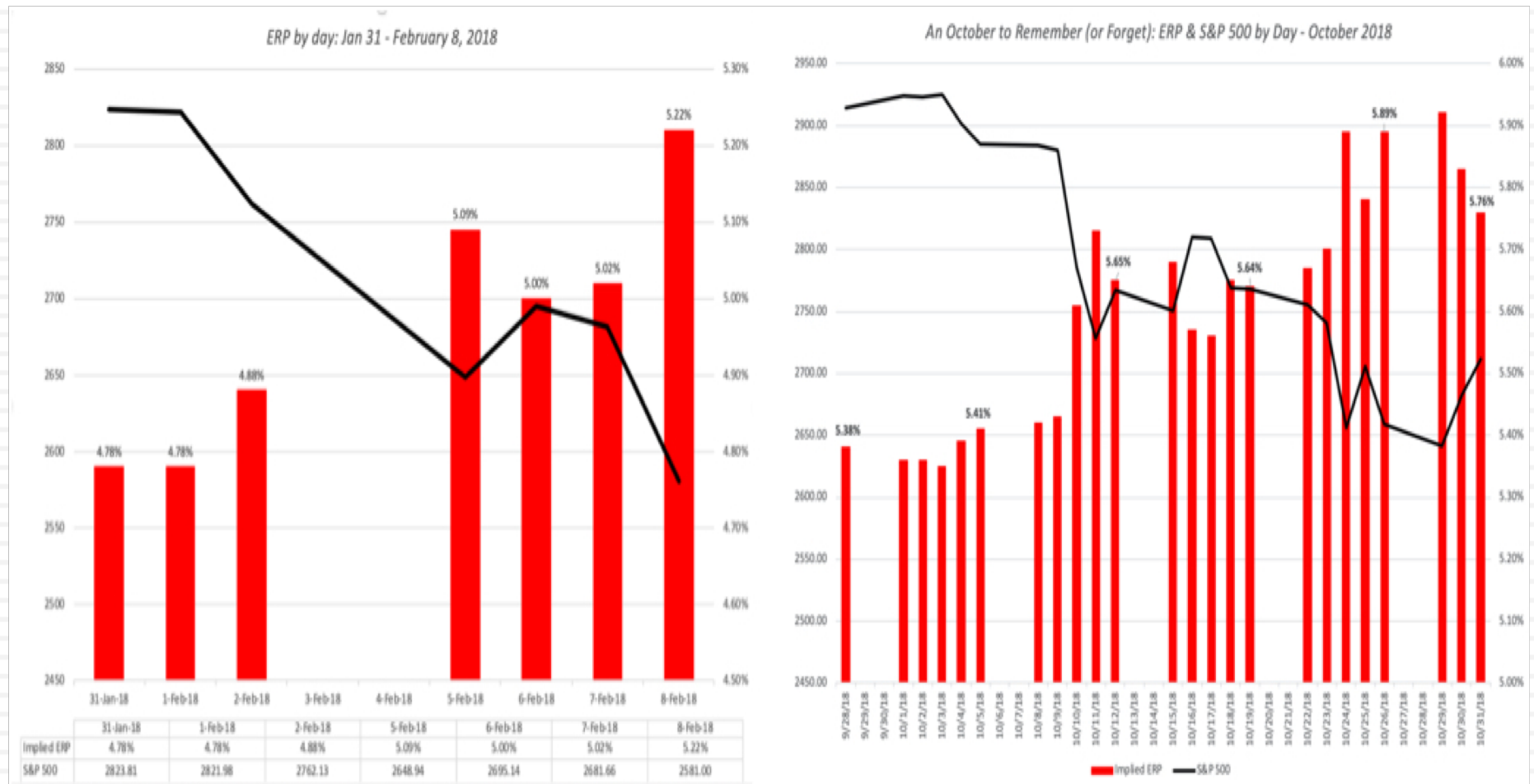
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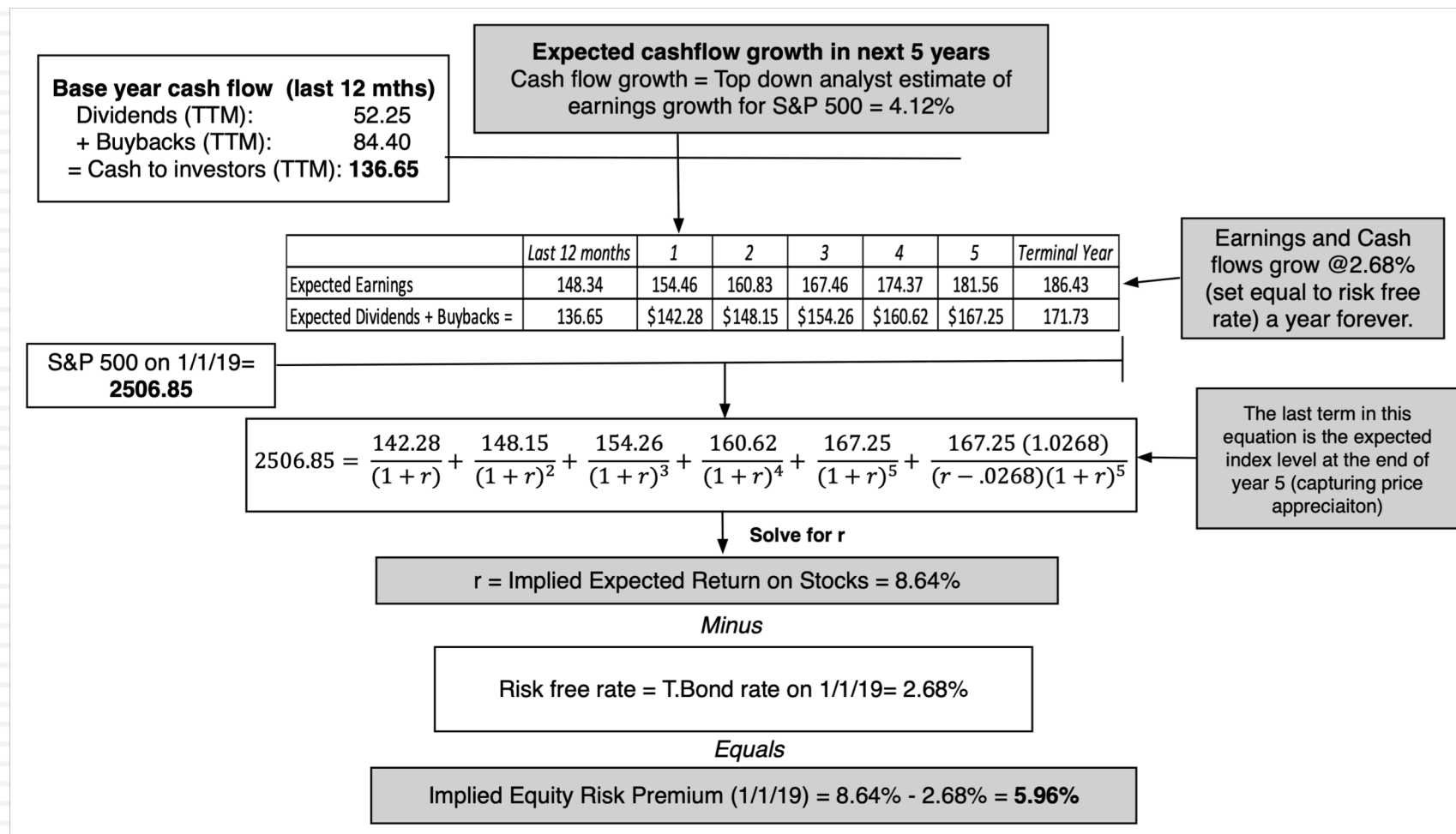
At the start of 2018



During 2018: Two Periods



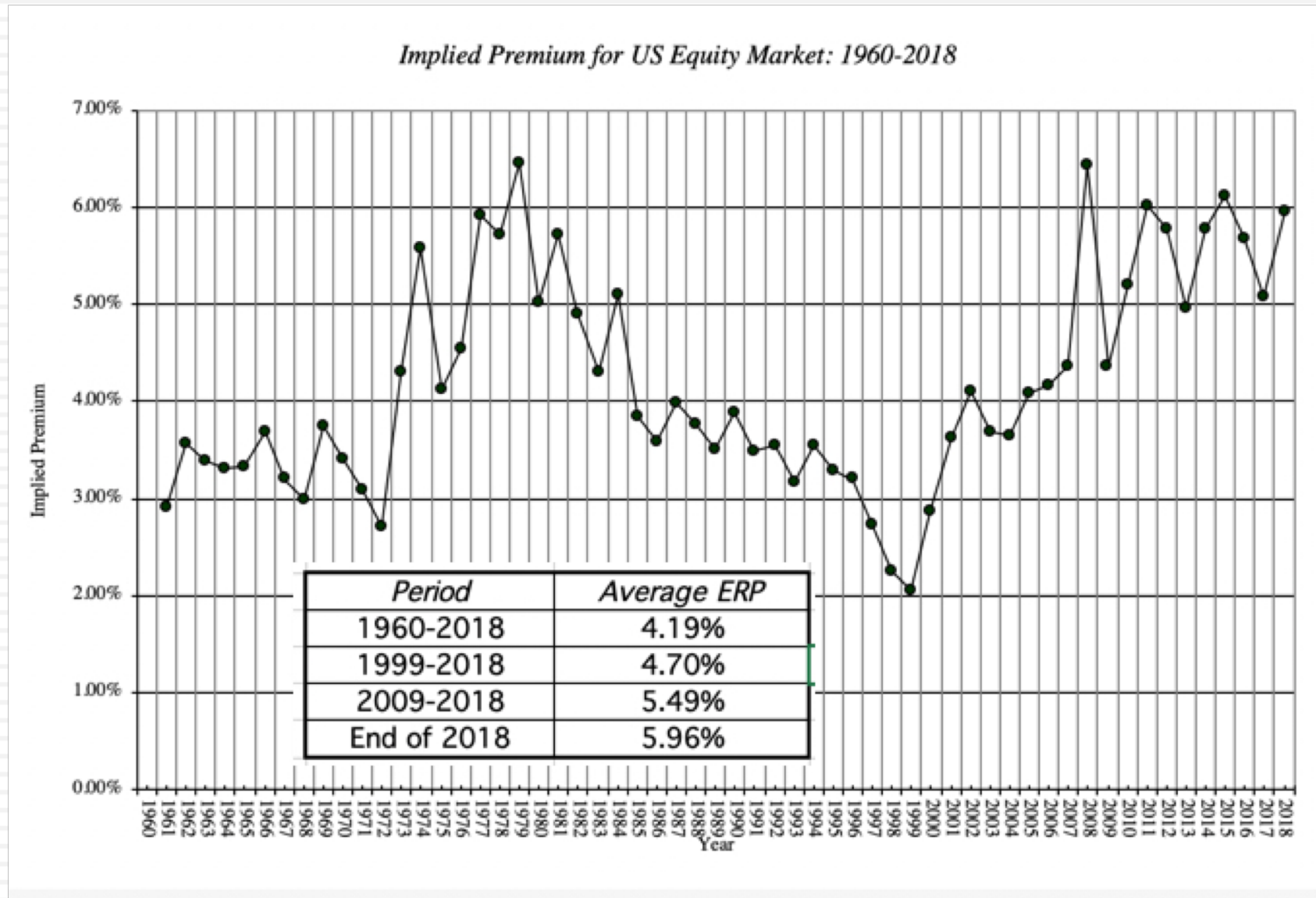
ERP at the start of 2019



Input comparison: 2018 vs 2019

<i>Input</i>	<i>Start of 2018</i>	<i>Start of 2019</i>	<i>Reasons</i>
S&P 500	2673.61	2506.85	Fourth quarter meltdown in stocks
Base year cash flows	108.28	136.65	Continued increase in buybacks, triggered partly by new tax law release of trapped cash.
Expected growth in earnings	7.09%	4.12%	Pessimism about future global growth and possibility of US recession.
T. Bond Rate	2.41%	2.68%	Fear of the Fed?
Expected return on stocks (ERP)	7.49% (5.08%)	8.64% (5.96%)	Lower growth fears + Political and Economic Crisis worries?

Historical Implied ERP



The biggest danger: Lower growth

- While there was almost no talk about a possible recession either globally or in the US, at the start of 2018, some analysts, albeit a minority, are raising the possibility that the economy would slow down enough to push it into recession, at the start of 2019.

Expected growth next 5 years	ERP
-3.00%	4.31%
-1.00%	4.74%
0%	4.96%
1.00%	5.19%
3.00%	5.68%

Other Dangers

- Higher interest rates: There is the possibility that higher inflation and economic growth rate can push this number higher, but it is difficult to see how this would happen if recession fears pan out.
- Pullback on cash flows: In 2018, for instance, dividends and buybacks amounted to 92% of aggregate earnings, higher than the 84.60% paid out, on average, between 2009 and 2018. Assuming that the payout will adjust over time to 85.07%, reflecting expected long term growth, lowers the ERP to 5.55%, still well above historical levels.
- Political and Economic Crises: The trade war and the Brexit mess will play out this year and each has the potential to scare markets enough to justify the higher ERP that we are observing. In addition, it goes without saying that there will be at least a crisis or two that are not on the radar right now that will hit markets, an unwanted side effect of globalization.

Bottom Line

- It is better to be transparently wrong than opaquely right, when making investment forecasts.
- In keeping with my own advice, I believe that stocks are more likely to go up in 2019, than down, given the information that I have now.
- That said, if I am wrong, it will be because I have underestimated how much economic growth will slow in the coming year and the magnitude of economic crises.
- Odds are that I will see the tell tale signs too late to protect myself fully against any resulting market corrections, but that is not my game anyway.