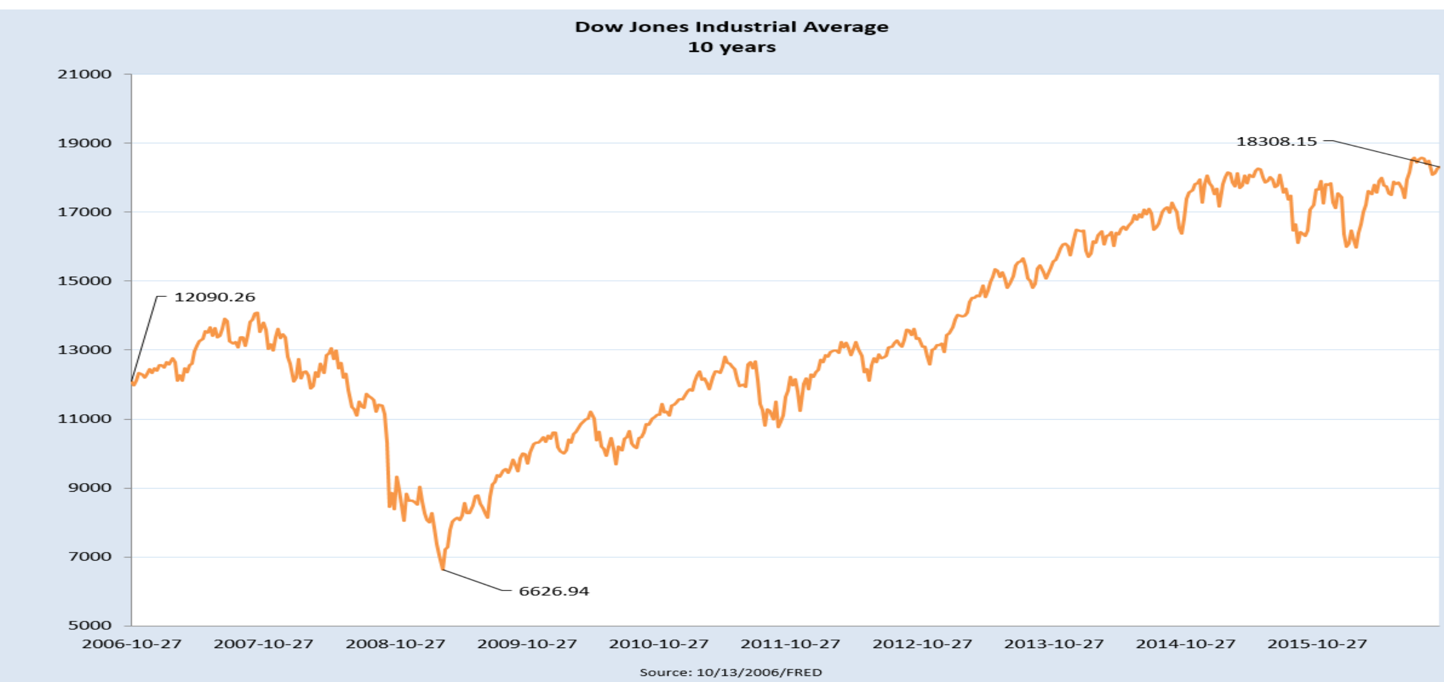
Equities & Election 2016

William "Chip" Corley, MBA, RFC *Q4-2016 Letter to Investors* **October 5, 2016**

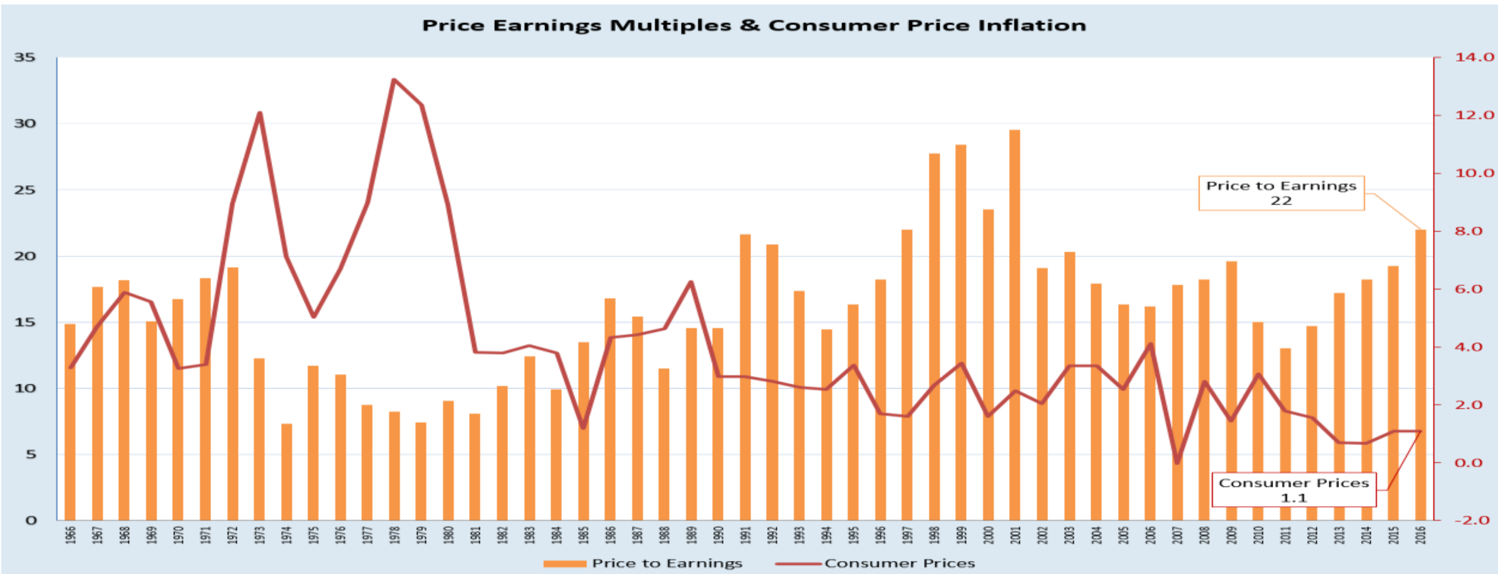
On November 8, 2016, citizens of our nation will arrive at their respective precincts to vote for the President of the United States. Warren Buffett, the undisputed greatest investor of all time, states, "The most important thing you can do is vote." Buffett goes on to say that the odds of him being born in the U.S. in 1930 were better than 30:1, a real long shot by anyone's bet, and he openly expresses his gratitude to have been born here. In 2006, Buffett made a decision to give 99% of his wealth to philanthropy. He said that his riches stemmed from a living in America, genes, and compound interest. According to The World Bank there are nearly 2.1 billion people on the planet living on less than $3.10 a day. Pause for a moment to think about it; that's $1,131.50 for the entire year. Warren is right; we are lucky to be Americans. The central issues surrounding this election are: economic growth, taxation, federal debt, health policy, defense, inequality, infrastructure development and entitlement reform. America is governed by its people, for its people - you and me. We are the electorate, the people of this land entitled to vote. Our voices are heard and accounted for the moment we cast our ballots.

The DJIA opened the year at 17,425, and later fell 10 percentage points due to forecasted interest rate hikes, slower global economic growth, stalled industrial output, tepid demand, and the unexpected vote by Brits to exit the European Union. After the correction, the venerable Dow Jones Average clawed its way back to positive territory for the year, currently trading in the 18,300 range. Since 1900, the DJIA has averaged a positive 7.4% net return during presidential election years; as of now, the market looks to be on course. The markets in 2016 have been supported by historically low interest rates and accommodative monetary policy. How will the market react to the outcome of this November's election, and what does it mean for investors?

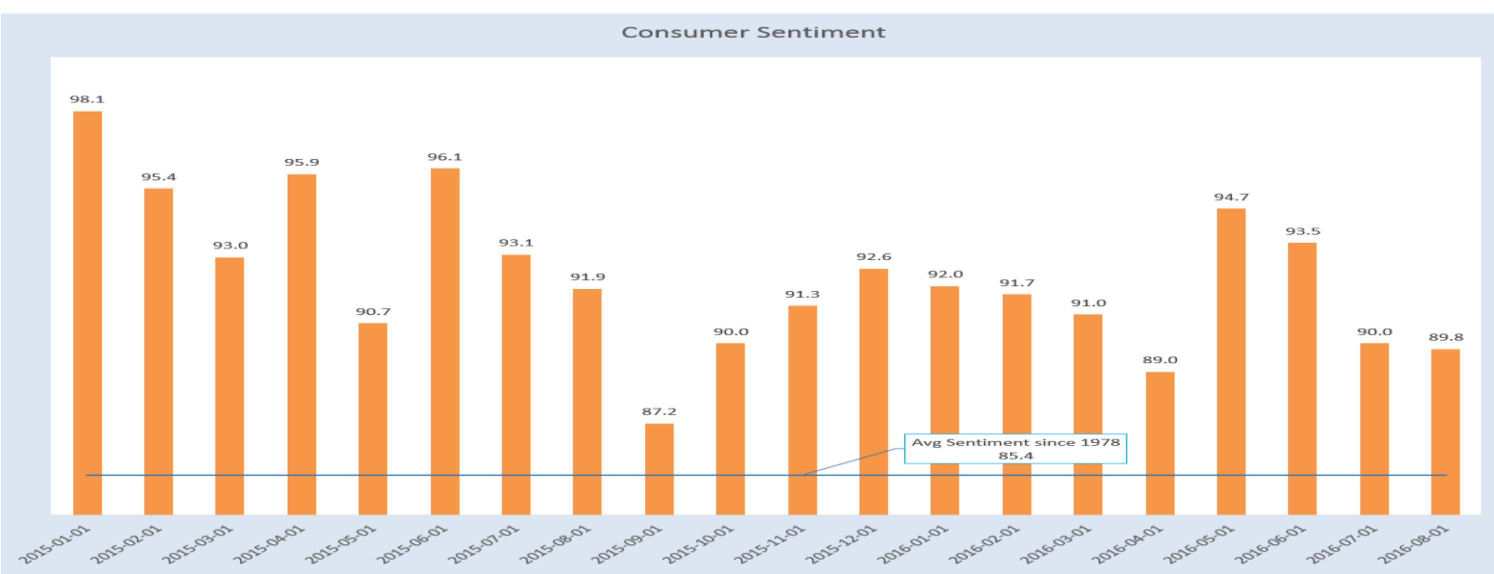


(To enlarge all charts hover over and use Ctrl + click)

Equity valuations are a bi-product of economic growth, corporate profits, consumer sentiment, and monetary and fiscal policy. During bouts of low inflation, stock valuations, when accompanied by modest growth, tend to be higher than normal. Higher price inflation, which raises the cost of inputs and outputs, is likely to suppress values. Presently, broad based stock valuations look dearly priced, trading with its trailing twelve month operating earnings PE Ratio at 22 times, as compared to 16 times for its 50 year average. Concurrently, inflation measured by the CPI is at 1.1 percent, far below its 50 year norm of 4 percent (shown in chart below). So what gives?



Consensus estimates are calling for a slight decrease in corporate operating profits for the 3rd quarter; this would be the fifth consecutive quarterly report of earnings decline. What's notable, Q3 is expected to be the trough in earnings declines, and growth is forecasted to turn positive the remainder of the year. Energy has been the biggest drag on earnings overall, but as of this writing prices have been boosted by OPEC talks of curtailing production by 700,000 barrels per day. The energy sector is sure to get a positive jolt if OPEC acts accordingly. For 2017, earnings expansion is anticipated to pick up smartly. When it comes to pricing asset values from a top down perspective, I use three criteria: 1) valuation, 2) fundamentals, and 3) behavioral economics. I've touched on the first two criteria, which leaves behavioral economics. The University of Michigan's Consumer Survey is currently at 89.8, compared to 85.4, its long-term average. How consumers feel about their prospects in today's marketplace is vitally important to the economy overall. Gross Domestic Product is growing at 1.4%; consumer spending was the GDP's strongest component growing by 2.8% in the most recent period. Without question, the ongoing success of our economy is contingent on a healthy and vibrant consumer sector.



Now for the election outcome. The Maven of Manhattan, Sam Stovall, informs investors that more often than not, the stock market foretells election results during the months preceding the election. If equities are up from July 31st through October 31st, the party in power remains in power 82% of the time. If equities are down during these dates, the incumbent party is replaced 86% of the time. Will the market continue to predict the outcome, or will this election be as unexpected as Britain's annexation earlier this year? We will get the answer to these questions soon enough. In closing, so called experts on both sides of the political aisle are pointing to unnerving consequences for equity holders if their party fails to win. To that I say, oh really? As Sam reminds us, since World War II the stock market has posted an average gain of 2 percent during the final two months of the year after the election. If history repeats itself, regardless of which party wins the election, equity owners are apt to win before the new year.

May the polls lean in your favor!

—Chip