SCHAFER | CULLEN
CAPITAL MANAGEMENT

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Market Comments

# 2020 Market Outlook

Starting this year we thought the most important factor for the market was that it is an election year for a sitting president looking to get reelected and the economy would be the main focus. **Meanwhile, out of the blue has come a black swan in the form of the Coronavirus, which has changed the dynamics and raised questions about the economy and the election.**

**History shows that following past black swan events, the damage and uncertainty caused tends to be pretty much forgotten by the market a year later**. Two black swan events we will mention here are 1) Donald Trump's presidential election, where the market one year later was surprisingly sharply higher and 2) the 9/11 terrorist attacks, from which it took longer to recover, but the market did so none the less.

## Coronavirus

The news on the Coronavirus may get worse and it could become a global pandemic. There is currently no vaccine available. Other virus scares like SARS, Ebola and the Swine Flu did not have a big impact on the market; however, because of the severe experience in China we felt it important to look at what can happen in a worst case scenario. We went back to the 1918-1919 influenza pandemic known as the Spanish Flu. **This flu infected one-third of the world's population and resulted in an estimated 20-50 million deaths**. Also, the infection rate was very high in the United States, where 675,000 fatalities occurred.

In looking at this time in history, it was surprising how short a period the virus lasted and how most of the fatalities occurred over a nine month period from September 1918 to April 1919. **Also shocking was that the market only dropped 10% over that time. Upon closer examination, the reason was that the market then was only selling at about 8x earnings as opposed to our present situation where we are selling at closer to 20x earnings.**

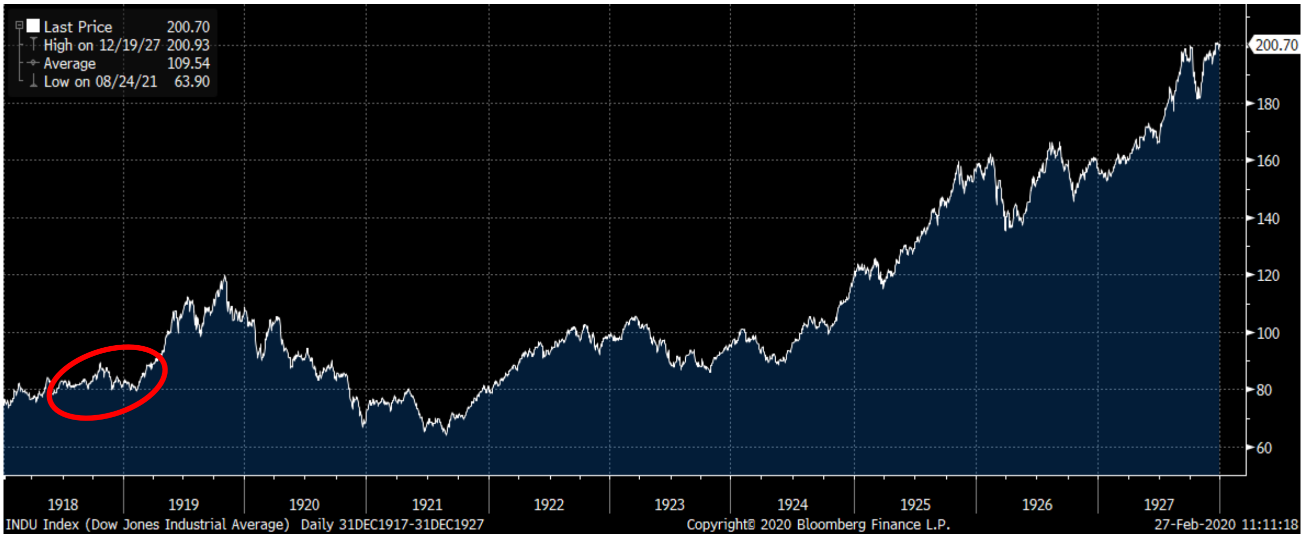
Below we are presenting two charts showing how the market reacted to the crisis. In the first we highlight the nine month period when the virus was at its most serious level and how the market surprisingly bounced back after that. Of course then, like now, there were a lot of extraneous factors at play. A couple of major events at that time were the end of World War I and the start of Prohibition.

**Dow Jones Industrial Average**
**1918 – 1919**


*Source: Bloomberg, 2020*

The next chart shows how the market peaked in the end of 1919, as there was an economic recession, mainly caused by the deflation from the economy adjusting to the massive return of war veterans. Then in 1921, confidence returned and we witnessed the beginning of the "Roaring 20's".

## Dow Jones Industrial Average
## 1918 – 1927




*Source: Bloomberg, 2020*

No period is ever exactly the same, and how a market performs has a lot to do with the valuation level of the market at the time a crisis hits. **Looking back on this history of the Spanish Flu, it is shocking how bad it was, how quickly it played out and how it didn't have a major impact on the market.** Today, we have a lot of outside factors but we also have a much more expensive market, as a result of it being propped up by an easy monetary policy.

## Presidential Election Cycle

Getting back to the election cycle, we mentioned in our last market letter that while the pre-election year is the best year for a president looking for reelection, the second best year in the four year election cycle is the election year itself. Based on that, going back over the last seventy years, while the average annual return for the S&P 500 in the pre-election year was +23.8%, the election year return was +11.8%.

**Sticking with the election cycle, it is worth mentioning that 50% of the years following the election over the last seventy years were down years for the market. Also, of the sixteen economic recessions that have occurred over that period, more than half of them started in the year after the election.**

## A Time for Value?

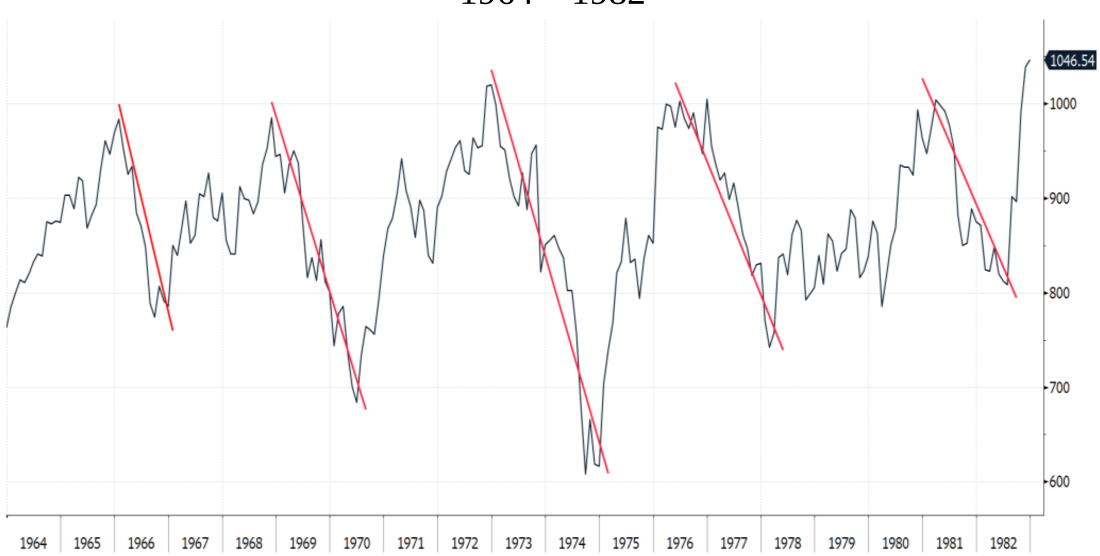
**Following the election, the landscape may change. A study we did on the post-election year comparing value vs. growth shows that in the years after an election, value's performance dramatically overwhelmed growth over that time.**

Seeing a more challenging economic environment after the election year would not be a surprise, especially with many global markets like China and possibly Europe going into a recession. In addition, when government debt as a percent of Gross National Product gets over 100% that has usually resulted in a period of slower economic growth. **In a more challenging environment, this is when earnings and dividends wind up being the main factors versus momentum and speculation.**

Two examples of tougher markets are reviewed below:

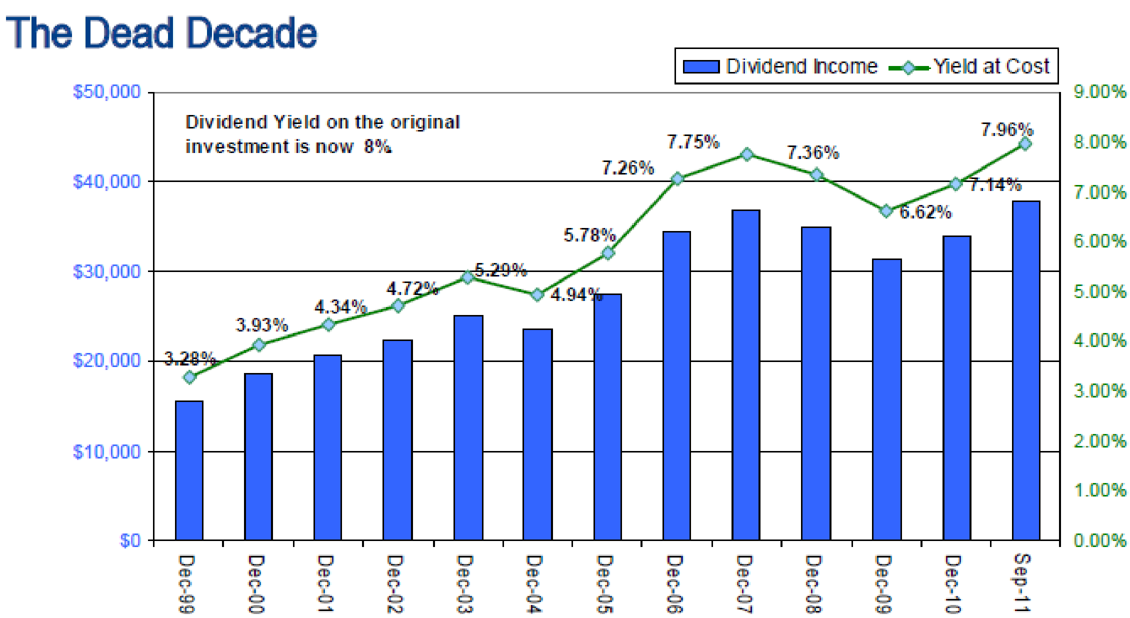
**First is a chart of the market between 1964 and 1982. The Dow Jones, which was the leading index at the time, spent fourteen years trying to break through 1,000.** As that period drove on, we were surprised that the market would go that long without making new highs because history shows that markets tend to go up over time because earnings tend to go up over time. **Upon closer examination, it turned out that over this time period earnings went up 300% while the Dow Jones index, which had been inflated by the Nifty Fifty growth stocks, was flat but the value stocks (the bottom 20% of S&P 500 stocks on a P/E basis) went up over 1,000% over the same time period**. So what happened during this period was that the index slowly corrected its overpriced level and meanwhile the cheaper value stocks were going up as a reaction to increases in earnings and dividends.

Dow Jones Industrial Average
1964 – 1982




*Source: Bloomberg, SCCM Research*

A second example is a more recent period that we have presented in earlier letters and is called the Dead Decade, which was the worst decade in market history (2000 to 2010). During this time, we experienced the end of the Tech Bubble, the 9/11 terrorist attacks and the financial crisis. **The result, as you can see in study below, was that the market index (S&P 500) was actually down 5% during that period however our high dividend strategy doubled because of the dividend yield and dividend growth.**




Cumulative Total Return

| | |
|---|---|
| High Dividend Value Equity | +94.01 |
| S&P 500 | -4.48 |

Source: SCCM Representative Account, September 2011. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS**. For illustrative purposes only and investors cannot invest directly in an index.

## Summary

**The Coronavirus news may get worse and the economy may struggle to deal with some of its after-effects, but for long term value investors, we may start to see the beginning of a return back to value.**

Jim Cullen

| | Q4 | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Since Incept* |
|---|---|---|---|---|---|---|---|
| High Dividend Value Equity (gross) | 5.7 | 21.1 | 21.1 | 11.2 | 9.0 | 11.9 | 10.5 |
| High Dividend Value Equity (net) | 5.6 | 20.7 | 20.7 | 10.8 | 8.6 | 11.4 | 9.9 |
| Russell 1000 Value Index | 7.4 | 26.6 | 26.6 | 9.7 | 8.3 | 11.8 | 9.6 |
| S&P 500 Index | 9.1 | 31.5 | 31.5 | 15.3 | 11.7 | 13.6 | 9.9 |

*12/31/1993. Performance is as of 12/31/2019. Performance for periods greater than 1 year annualized.
**Past Performance is no guarantee of future results.**

Returns are expressed in U.S. dollars. Gross of fee performance is calculated gross of management fees and custodian fees and net of transaction costs. Net of fee performance is calculated net of actual management fees and transaction costs but gross of custodian fees. Past performance does not guarantee future results. Individual account performance will not match the composite and will depend upon various factors including market condition at the time of investment. Returns reflect the reinvestment of dividends and other earnings. It should not be assumed that recommendations made in the future will be as profitable or surpass the historical performance of the securities in the composite. The primary benchmarks used for comparison purposes are the total return indices for the S&P 500 Index and the Russell 1000 Value Index.

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