MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

How 'Bout Them Cubs!

The US equity market, as measured by the S&P 500 Index, generated a 3.5% total return for the quarter just ended. This is the fourth consecutive quarterly gain for the S&P, bringing its year-over-year total return to 15.4%. This seems impressive, but as we remind ourselves and our clients, "starting points matter". In reality, other measures of stock market performance illustrate what a frustrating period the last two years have been.

The Federal Reserve launched its bond-buying program (known as "Quantitative Easing") in November 2008, and ended it in October 2014. The impact of ending QE on the pace of the economy, corporate profits, and stock market gains (price only) cannot be understated:

	Since End of QE[1] (11/2014 – 9/2016)	During QE[1] (11/2008 – 10/2014)
S&P 500 Index	3.8%	14.7%
Russell 2000 Index[2]	3.4%	16.4%
New York Composite Index	-0.6%	11.8%
Equal-Weighted S&P 500	3.6%	19.8%
S&P 500 Earnings Per Share Growth	-1.3%	9.5%

In an earlier issue of *Consilium* we discussed how the markets and Fed policy had become tethered to each other in a manner that was unlike any prior economic cycle. **The data in the table above illustrates this fact very clearly. At some point the market's addiction to monetary stimulus will end, but until it does, meager growth with high valuations likely will limit potential returns.** Accordingly, we continue to make appropriate adjustments to client portfolios to reduce unnecessary risks.

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Other than speculating about who the Cubs might face in the World Series, of late nothing has consumed more investor attention than the race for the presidency.

We hope we do not disappoint *Consilium* readers by passing on the opportunity to guess the outcome of the baseball playoffs, and the election, but Go Cubs!

Instead, we want to point out that there is a strong tendency on the part of investors to err in gauging the market impact of big, long-anticipated external events. Most recently, the "Brexit" vote – with a much unexpected outcome – led to a sharp but very brief decline in equities that not only was reversed, but followed by a rally to all-time highs in the S&P 500 index less than two weeks later! Months earlier, the Federal Reserve surprised absolutely no one (having warned about it for more than two years) by raising short term interest rates to 0.25%, yet global stock markets sold off very sharply in the aftermath. When a strong consensus forms about the market's likely response to some important future event, the consensus is often wrong, and sometimes spectacularly so.

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Indeed there appears to be such a strong consensus in the professional investment community and among Wall Street strategists that a Clinton victory, representing maintenance of the status quo, would pose no threat to the economic and market outlook. In contrast, a Trump victory would carry with it considerable policy uncertainty. And, since the market abhors "uncertainty", some kind of decline likely would ensue. (We would be the first to agree that investors say that they prefer predictability.) For this reason, more than a few observers have begun pointing out that the equity market appears to perform better when Clinton's poll standing is strong or improving, and worse when Trump's poll standing is strong or improving.

It is important to try to keep an open mind about all potential outcomes in investing, and therefore we suggest that *Consilium* readers consider these **possible**, insufficiently-discussed market scenarios:

1. Clinton wins, but the as-expected result provides no impetus to new buying; the equity market continues to struggle with the interplay between disappointing economic growth, and the Federal Reserve's desire to raise short term interest rates as soon as conditions permit. Clinton is seen as being no more likely to work effectively with a Republican House of Representatives than her predecessor.

2. Trump wins unexpectedly, but after a brief spell of volatility, the equity market moves higher on the belief that he has a better chance of selling his new policy prescriptions to otherwise hesitant Republican lawmakers. "Everyone loves a winner", and Congress proves surprisingly eager to work with the new president.

"Predictions are hard, especially about the future," Yogi Berra is believed to have said. These two scenarios are ***not*** predictions, and in no way do they reflect the preferences of Mid-Continent Capital or its employees. We simply offer them as crucial reminders that the markets frequently fail to respond to new information in the manner most expect. The consensus of the investment community might prove to be correct this November, but wise investors should reflect upon how often the consensus has been wrong.

In addition to not making election predictions, we are not giving in to the temptation to make portfolio adjustments based on who we think might win. Every Wall Street strategist has his or her own list of "what to buy/sell if Clinton/Trump wins". But even at the industry and sector level, the consensus has been equally wrong in assessing the impact of election outcomes. (For example, aerospace and defense stocks have been stalwart performers in President Obama's second term, despite the budget sequester and the wind-down of military engagements overseas. This outcome was foreseen by almost no one.) Success with this approach almost certainly is a matter of luck; we prefer to maintain our focus on investing in high quality companies with good long term growth prospects, durable business models, and solid management teams, trading at reasonable valuations.

The equity markets have provided opportunities to earn good returns under Democrats and Republicans, heroes and villains, Ivy Leaguers and dropouts. There is every reason to believe this will remain the case after November 8. But, in the meantime, **Go Cubs!**

[1] *Average annualized change (%)*
[2] *Small-capitalization stocks*

Sources: FactSet, Baseline