Lynx Capital Group Ltd

Disciplined Strategic Investment Management

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Market Outlook as of January 2020

"The intelligent investor is a realist who sells to optimists and buys from pessimists."

"The essence of investment management is the management of risks, not the management of returns."

Benjamin Graham (1894 – 1976) was a British-born American investor, economist and professor. He is widely known as the "father of value investing". His investment philosophy stressed investor psychology, minimal debt, buy-and-hold investing, fundamental analysis, concentrated diversification, buying within the margin of safety, activist investing and contrarian mindsets. Warren Buffett credits Graham as grounding him with a sound intellectual investment framework.

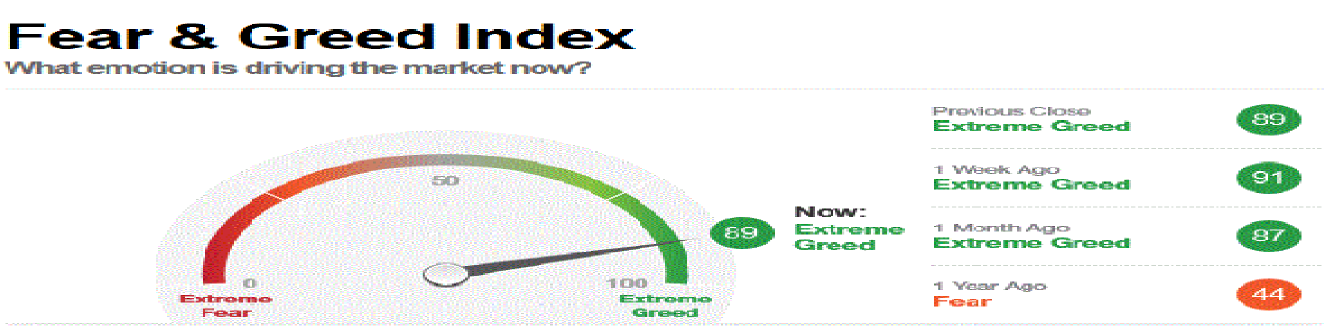
Our Key Observations

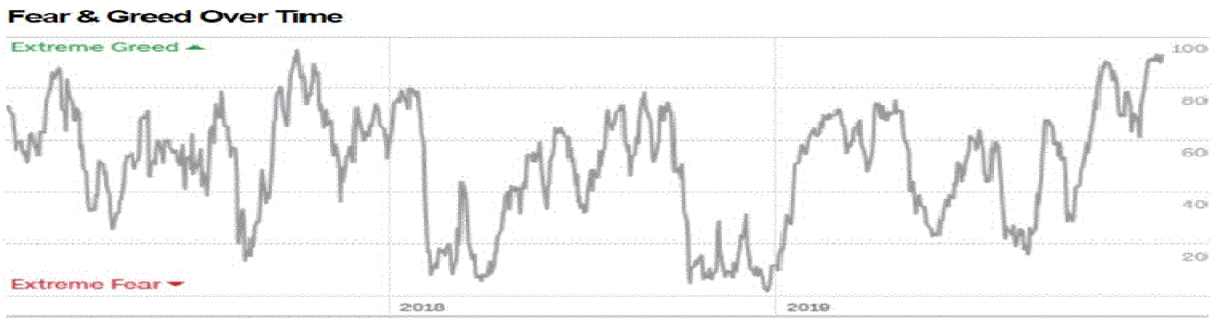
Following what was the worst December for stocks since 1931, most investors and commentator's annual outlook was cautious at best, yet 2019 turned out to be one of the best years. The Federal Reserve cut interest rates three times in 2019 and created a near mirror image of 2018 when it raised rates 4 times.

While annual outlooks provide an opportunity to handicap the most likely future, often the most difficult part is <u>getting the timing right for the occurrences to arise</u>. Our efforts for our clients is to anticipate the strongest financial or economic forces going forward, then calibrate our risks and portfolio setup to ensure we don't let our emotions of fear or greed drive short actions while forsaking long term goals.

Last year's stellar performance was largely driven by Price/Earnings (p/e) expansion (investors willingness to pay more for the same company) and stock buy backs (around $960 billion) as earnings were relatively flat year over year. Earnings growth is expected to come in roughly 5% or 6% higher this year. Many companies (about half) borrowed money and increased their debt to finance their buy-backs.

Investors are currently VERY euphoric, due to an accommodative Federal Reserve and more certainty with China as phase one of a deal just got completed.

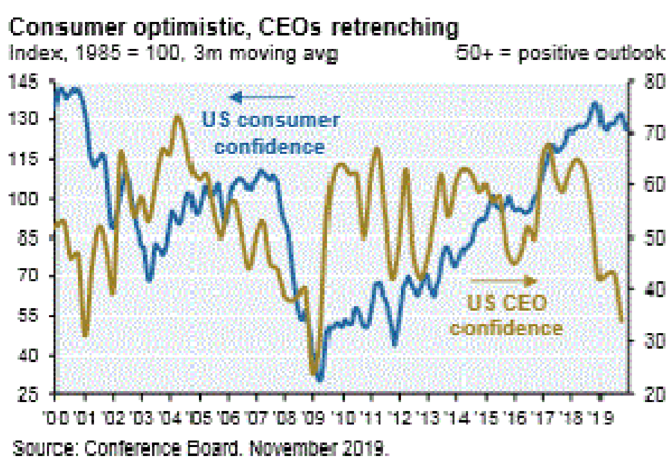


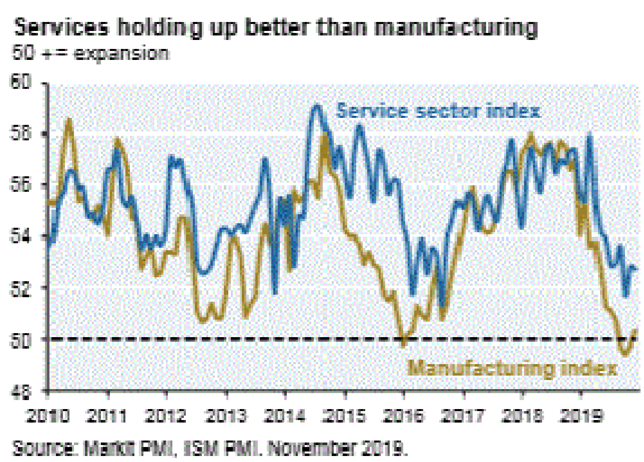


As shown in the chart above, extreme fear was rampant at the end of 2018. 2019 turned out to be a good year while greed is presently pervasive.

The current bull market and economic expansion is now the longest on record and will certainly end at some point. The key is how much longer. Currently unemployment is at an all-time low, the consumer is spending and there are early signs that global growth especially from Europe and Emerging markets are starting to gain traction.

We do however have a **tale of two economies**, with a healthy services sector and consumer spending against lackluster manufacturing and business investment. The ISM manufacturing index is at a 10-year low. CEO's forward-looking confidence is at the lowest since 2009 while consumer outlook is at historic highs. Currently U.S. manufactures are expected to reduce capital spending in 2020. (See Charts Below) Even with phase one completed with China, tariffs deals still need to be worked out with Europe and Japan. Time will tell if China actually follows through with what has been agreed to so far.





Easy Money and the FED: The world's four largest economies (U.S, Europe, Japan and China) are all printing tons of money to prop up or stimulate their economies, resulting in an explosion of debt. During 2019 the Federal Reserve cut rates three times as "insurance" against any further deterioration of the economy. The short term effects are that "easy money" is pushed into markets and inflates asset prices. Unfortunately, we don't see excessive government spending ending any time soon as unfunded Baby Boomers retirement will require even more spending.

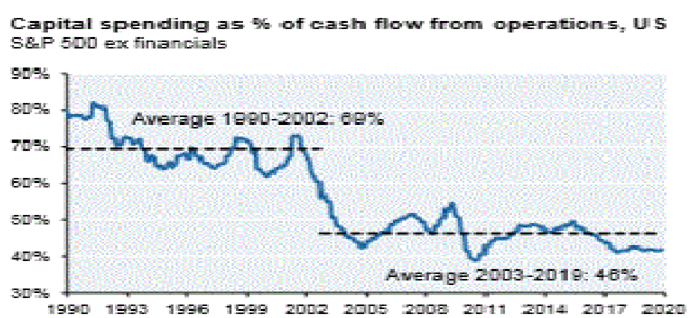
Image by Catherine Song. © The Balance 2019

While the vast majority of **election years** are up, we strongly expect to see volatile markets, both up (as we are now experiencing) and down this year due to many contentious issues and a divided Congress. When one of the Democratic candidates becomes the official nominee, markets could react to even more spending plans such as Medicare for all, wealth taxes and tighter regulations. The wealthy will in turn react by pulling funds from the market. We think the Democratic candidates and President Trump will continue to attack rising drug prices, putting pressure on the pharmaceutical sector. The stocks already underperformed in 2019, and will continue to be under pressure.

Valuations matter as they leave less room for error when they are elevated. Most valuation measures including P/E's, are elevated and now require corporate earnings to grow and catch up to market expectations. (See charts below)

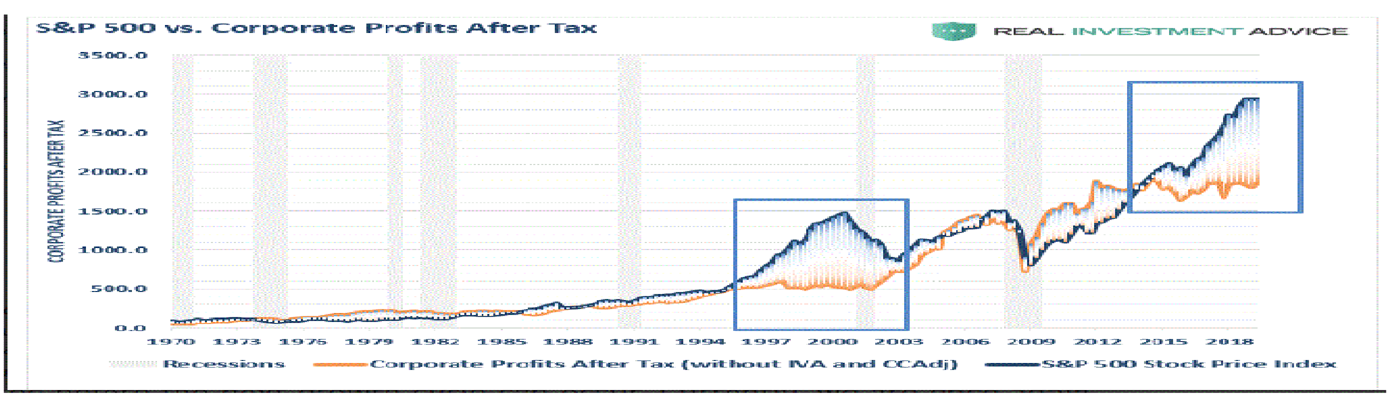
S&P 500 valuation metric	Current	Historical percentile
US market cap / GDP	189%	99th
Enterprise value / Sales	2.5x	99th
Enterprise value / EBITDA	12.7x	93rd
Price / Book	3.6x	90th
Cyclically adjusted P/E	27.8x	89th
Forward P/E	18.4x	88th
Cash flow yield	7.2%	85th
Free cash flow yield	4.1%	53rd
S&P earnings yield – 10Y UST	362 bps	28th
Median metric		89th

Source: Goldman Sachs Investment Research. EBITDA – earnings before interest, tax, depreciation, and amortization. December 15, 2019.



Source: Goldman Sachs Investment Research. November 2019.

The chart below shows what profits were actually reported compared to what companies release to the public quarterly as "earnings after accounting adjustments."



Continued easy money and low interest rates should provide a supportive environment for 2020, but investors need to brace for volatility. Due to a strong consumer and low unemployment, it is unlikely that a recession will start any time soon.

Currently due to excessive sentiment and valuations we are neutral to cautious, but will use downside volatility to add new funds and rebalance portfolios towards long term targets and goals. The business cycle is extended, and we are into new territory. How long it will last is anyone guess, but at some point, the buildup of debt will take its toll.

We pride ourselves on investing with a price discipline and maintaining a long term view. History and our own experience has shown that investing with a value bias, while adopting a longer term diversified view, helps navigate through market turbulences. Due to the longevity of the economic expansion and the bull market, calibrating ones risk tolerance will become more important.

We continually look for great companies with compelling valuations, quality balance sheets, strong cash flows, sustainable competitive advantages and growing dividends that are better able to weather a recession. We are confident that longer term, level-headed investors who stay the course should be rewarded over time, but we also expect market volatility to continue. We remain committed to diversified portfolios, with overweighting in areas that we believe offer value. Diversified portfolios have the drawback of underperforming in concentrated times, but more than make up with better downside protection when markets correct, move sideways or rotate into value which we think is currently the case.

It is always advisable to review ones individual circumstances and tolerance for risk. If any of your financial circumstances have changed, or you want to adjust your portfolios risk profile we always encourage your input should you want to make any changes to your portfolio allocation.

As always, please feel free to contact us with any questions or concerns.

Brian Chait
President, January 20th 2020

Each year Lynx Capital Group files a Form ADV Part 2A. The Form ADV Part 2A defines our business, key personnel and business relationships. If you wish to receive our Form ADV Part 2A and or a copy of our Privacy Policy, please contact us and we will gladly mail or email you a copy.