1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

END OF YEAR 2018 INVESTMENT COMMENTARY

REAL WEALTH & MARKET VOLATILITY -- ARE THEY RELATED?

I want to begin this New Year's commentary by wishing everyone a healthy and happy 2019. Even though I am writing this between the Christmas and New Year's holidays, every day feels like Thanksgiving for us at Seven Summits Capital. We never forget how fortunate that we are to work every day for the benefit of our fantastic, intelligent and trusting clients. We appreciate your trust and that trust is of utmost importance during turbulent periods in the financial markets.

Investors have witnessed historically significant daily market price swings as we approached the end of 2018. Technically, U.S. small-cap indices and the technology-heavy Nasdaq 100 index fell into Bear Market territory, dropping over 20% from their previous highs in early October. Both the Dow Jones Industrial and S&P 500 indices narrowly missed experiencing a greater than 20% decline, although for the S&P 500 over 70% of the constituent companies' stocks experienced a decline in excess of 20% by late December. The three-month sell-off in the stock market, here and around the world, was significant and should remind all investors how quickly market sentiment can swing from exuberance to fear.

After 20 years of managing stock portfolios and witnessing stock price gyrations minute by minute virtually every trading day of those 20 years, I long ago decided that stock price volatility alone is not a truly important variable for most investors. Instead, what is critically important is what an investor does in the face of such volatility. Most unsuccessful investors blame 'the crazy market" or some other external factor for their investment failures. When in fact, the "market' does not force an investor to sell stocks after prices have fallen ten or twenty percent, just like the market does not force a person to buy the momentum stocks after they have become unsustainably over-valued. Volatility alone does not affect a person's "real" wealth. Only when investments are bought using borrowed money, also known as using margin, and when price volatility requires the need for liquidating an investment, does volatility directly impact real wealth. For most investors, transitory price volatility of publicly traded investments is a benign event that alone does not impact long-term wealth in the absence of irresponsible or reckless decision-making.

There are ways to benefit from short-term market price volatility, but to benefit, an investor must act contrary to his or her reactionary instinct. A short-term period of significant stock market gains or a long-term period of uninterrupted moderate price appreciation leading to stretched valuations should cause prudent investors to be cautious about adding to stocks. Conversely, when markets fall sharply or persistently decline for a longer period of time, leading to materially below-average valuations, an investor should be thinking about ways to increase their stock exposure. In other words, as Warren Buffett has famously stated, "be fearful when others are greedy and be greedy when others are fearful." Only this approach, in the face of market-induced exuberance or fear, will enable an investor to turn extreme prices movements in the markets into opportunities to improve his or her long-term investment success.

Regarding taking advantage of scary market sell-offs, the legendary investor, Shelby Davis, is quoted saying that from his experience, "you make the most money during Bear Markets, you just don't realize it at the time." I have born witness to the wisdom of this statement many times throughout my career. Whether it has been adding to existing stock holdings during a sharp market correction or increasing overall stock allocation within a portfolio towards the end of a painful Bear Market, buying low valuation quality companies whose stocks are trading at prices well below what they will command once market and investor sentiment improves, is critical to wealth building using equities.

I have been consistent when it comes to acting contrary to market sentiment and taking advantage of significant market sell-offs. Below are some quotes from my investment commentaries going back ten years:

<u>FEBRUARY 2018 COMMENTARY QUOTE:</u>

"The current volatility has precipitated a great opportunity to realign portfolios around high conviction opportunities that the present correction has temporarily put on sale."

(The almost nine-year Bull Market hit a high on January 27, 2018, and then the S&P 500 corrected over 10% over the next eleven days)

The following chart shows the market levels between the January 27th high and the market closing values on December 28th. The markets rallied following the February correction and hit another Bull Market high in early October before selling off hard again. The fourth quarter 2018 market sell-off has thus far resulted in a Bear Market in the Nasdaq and just shy of a 20% drop in the S&P 500 and the Dow Jones.

Line Key: S&P 500 (Red), Nasdaq Composite (Purple), Dow Jones Industrial Average (Blue)

OCTOBER 2011 COMMENTARY QUOTE:

"We are not trying to gloss over risks in the markets. However, we do recognize, as we did at the beginning of the year, when market sentiment was overwhelmingly bullish, or as it is today, overwhelmingly bearish, we need to swim against the current of that sentiment. We are not making a definitive "market call," but we believe that the market has gotten far ahead of the fundamentals which we are observing."

2-Year Chart Following October 3, 2011, the Correction Low for this period of time:
(S&P 500 Corrected 19.4% from 04/28/2011 to 10/03/2011)

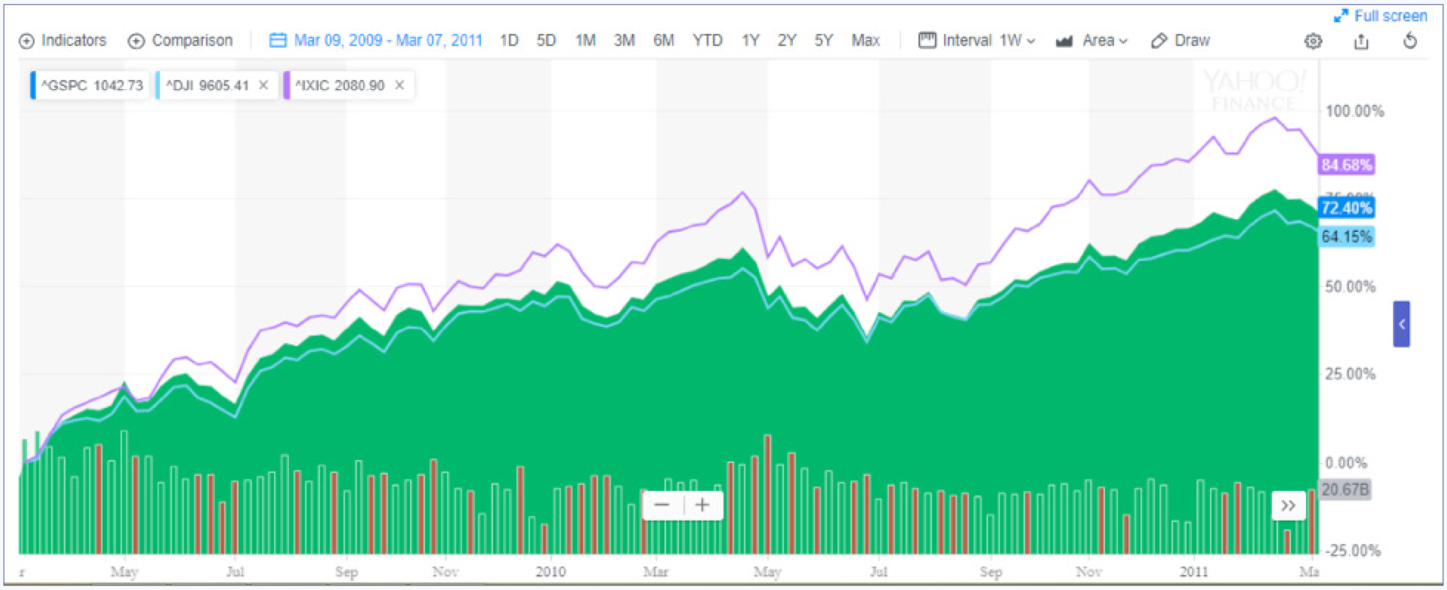
Line Key: S&P 500 (Green), Nasdaq Composite (Purple), Dow Jones Industrial Average (Blue)

FEBRUARY 2009 COMMENTARY QUOTE:

"We are bucking the pessimism spiral that has engulfed the markets and many investors. An investor, by nature, is a buyer of securities, based upon an assessment of the future realization of unappreciated value. We are investors, and we see more value in many of the securities that we own or are buying today than we have ever witnessed in our careers."

2-Year Chart Following March 07, 2009, the Bear Market Low for this period of time:

(The S&P 500 fell 56.24% from the previous Bull Market High on 10/08/2007 to 03/07/2009)



Line Key: S&P 500 (Green), Nasdaq Composite (Purple), Dow Jones Industrial Average (Blue)

Applying this time-tested contrarian approach seems fairly straight-forward; however, it does not come easy for most investors. Emotions get in the way of many investors and lead them to believe that success in stock investing requires being able to time the market inflection points. From my experience, the emotions of greed and fear, combined with a strong instinct to engage in market timing, doom a large percentage of investors to a lifetime of disappointment. Emotionally influenced investors, in the face of significant unexpected market events, either become paralyzed leading to inaction, or they engage in counter-productive trading.

The recent sell-off in stocks has been sharper than I was expecting. However, I cannot say that I find the sell-off unwarranted in spite of there being very few clear signs of material economic weakening or heightened trade war risks. I am more convinced today that markets are finally pricing in the probabilities of varying adverse scenarios resulting from policy and governing uncertainty. Up until October, the markets were remarkably sanguine in the face of an unprecedented level of unorthodox and erratic foreign and domestic policy actions.

There has been a significant amount of debate during this period of market upheaval regarding Federal Reserve policy. The continuation of normalizing short-term interest rates and gradual removal of financial crisis-induced accommodative quantitative easing are occurring at the same time that there is evidence of the waning of the short-term stimulus effects of the 2018 tax cut legislation. The markets appear to be using these early signs of economic deceleration as an excuse to attempt to finally price in the unprecedented level of uncertainty caused by the aforementioned erratic and unorthodox policy-making emanating from Washington. Global markets are reacting to the negative implication of trade brinksmanship and tariff uncertainty and the disruptive Brexit process facing Europe. On the horizon are further worries about the future of NAFTA, which remains unchanged without Congressional approval. The Congressional debate over changes to NAFTA will undoubtedly be contentious, and the eventual conclusion of the ever-deepening Special Counsel investigation of the 2016 Presidential Election could end up inflaming already over-heated political divisions.

Needless to say, the markets going into 2019 have a lot to digest and about which to worry. The market and investing public as a whole is a barometer that measures the degree to which worries are handicapped in real time. Sarah Ponczek and Vildana Hajric wrote an article for Bloomberg on January 3, 2018, titled Bad Stuff That the Stock Market is Worried About is Starting to Happen. The Bloomberg article quotes Alec Young, Managing Director of Global Research from FTSE Russell who stated “The market is the wisdom of all investors -- it was discounting this type of news-flow with the sharp and violent sell-off we got in December, When it makes a big move, up or down, it’s telling you positive or negative things about future developments.” Ponczek and Hjric wrote, “Anything that suggests cracks in the earnings and macro foundation would go down poorly on Wall Street. That’s what was happening Thursday, as Apple’s outlook clouded profit forecasts at everything from semiconductor suppliers to electronics retailers, and the Institute for Supply Management index miss spurred speculation the economy isn’t doing as well as hoped.” We are witnessing the market re-calibrate expectations, and those expectations are being reset daily based upon new information inputs. This is what is causing the large swings in price volatility day to day.

For almost 20 months through August 2018, the market’s expectations were pricing in above-trend economic growth and corporate earnings for 2018 and beyond, low inflation, and muted adverse effects of trade disputes and monetary policy tightening. At the beginning of October, the static market expectations all of a sudden became dynamic again as the overly rosy narrative that had lulled the market into a sense of complacency began to reset. We don’t know how long it will take for this reset to occur, but we do know that the market never resets or corrects in a straight line.

I see no reason to fear that the volatility that we are witnessing is a precursor to another version of the 2008-09 financial crisis. There have been some financial imbalances in both the equity and credit markets over the last couple of years; however, those imbalances do not come close to comparing to the mortgage-backed security market in 2008. Thus, I will treat this period in the market as a significant correction caused by an expectation reset at best or a precursor to a modest, but short recession at worst.

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com