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Dear Fellow Investors,

The old year ended with a bang as December's falling stock market had herds of investors running for the exits. As you know by now, we're not followers of the herd, but these inflection points offer a good opportunity to look at the forces that are moving markets. Economic growth is slowing globally, though right now the U.S. is still prospering. The stock market is likely reacting to an increasing amount of uncertainty, something that has made us cautious for several years now, and has led us to position our portfolio more conservatively. Up until December we've done more selling than buying, but that may change if investment prices become more reasonable.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2018	-11.49%	-13.52%	+2.03
2018 Year to Date	-7.71%	-4.38%	-3.33
Annualized Return Since Inception	8.83%	8.92%	-0.09
Total Return Since Inception	143.2%	145.3%	-2.1

Data reflect total returns (including dividends) net of fees as of 12/31/2018. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

Gazing into the Crystal Ball

Are we headed for a recession? If we had a crystal ball here at Midway Capital, that is what we'd ask because that's what clients are asking us. Unfortunately, predicting recessions is more like forecasting the weather than telling the future. The scientists at The Weather Channel are saying that there is a 50% chance of snow on Saturday in Chicago. We're only looking three days into the future and there is a huge degree of uncertainty! There is an equal chance it will snow – or it won't. Looking into the economic forecast for 2019, 2020, and beyond is even more uncertain.

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The hard truth is that no one can predict recessions or stock market prices. If they could, of course, they would be very rich and wouldn't share their secrets. They wouldn't write books or make appearances on CNBC. The people writing the books and making prognostications on television are making their best educated guesses, but these experts are often wrong. Remember that in 2011 the experts were predicting a "double-dip" recession. It didn't come to pass, but publications like *The New York Times* and *The Washington Post* all ran headlines about an impending recession in 2011, leading many to believe that it was a foregone conclusion. Instead, there was a brief slowdown in 2011 before the stock market and the economy really took off over the next six years.

Though we would never have the hubris to predict market movements, we still have to prepare responsibly for the future. If the forecast predicts rain, it's a good idea to take your umbrella and galoshes just in case. Likewise, it is important to keep our finger on the pulse of economic activity so we aren't caught unprepared. We look at all the data and listen to the experts, but take predictions with a grain of salt.

When it comes to documenting economic data (including recession indicators), The Conference Board is the authority. It's a non-profit, non-partisan think tank that tries to use data to predict trends. You may have heard of the Conference Board Leading Economic Index. As the name implies, these data are designed to reveal "turning points" in the business cycle before they happen. In its most recent press release, the conference board was upbeat. It reported "widespread strength" in the leading economic indicators. Specifically, it said:

> The [Leading Economic Indicators] increased slightly in November, but its overall pace of improvement has slowed in the last two months," said Ataman Ozyildirim, Director of Economic Research at The Conference Board. "Despite the recent volatility in stock prices, the strengths among the leading indicators have been widespread. Solid GDP growth at about 2.8% should continue in early 2019, but the LEI suggests the economy is likely to moderate further in the second half of 2019.[1]

In a nutshell, the economy is growing, but the latter half of 2019 might be slower than 2018. The data include ten metrics that have historically been good predictors of future economic activity, like how many building permits are issued (indicates optimism as builders intend to start new projects) and how many people have applied for unemployment benefits (indicates pessimism as businesses get rid of employees). Seven of the ten indicators improved, indicating optimism and growth. Three indicators worsened: unemployment claims, average weekly manufacturing hours, and stock prices. These are mixed signals, but overall the trends are positive.

Now for the experts: *The Wall Street Journal* surveyed 73 economists last week and found that – surprise – opinion was divided.[2] But overall, it was gloomy. 57% of economists expect a recession to start in 2020, and an additional 27% said 2021.

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[1] The Conference Board Press Release on Leading Economic Indicators for the U.S. Released December 20, 2018. https://www.conference-board.org/data/bcicountry.cfm?cid=1

[2] Torry, Harriet. "Economists See U.S. Recession Risk Rising." *The Wall Street Journal*, January 10, 2019.

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To sum up, we can't say for certain whether there will be a recession, but there is a good chance of slowing growth. There are a couple main things that are worrying us: the effects of the tariffs/trade war and slowing growth overseas. We've talked at length in previous letters about our opposition to tariffs. They are hurting consumers, farmers and manufacturers here at home, as well as overseas, and the damage continues to mount. The longer they persist, the more permanent and widespread the damage will be. Our second worry is the slowing growth in other large economies around the globe, most notably China, Japan and Europe. If global demand slows, no one will be immune from the effects.

In past recessions, the Fed and the government played large roles in helping the economy recover from a slump. However, the Fed can't do much with its interest rate policy at this point (rates are only 2% now, so it can't realistically cut rates 4-5% as it has in the past). We worry even more about what the government's response might be. Our leaders are so deeply divided that we wonder if they could agree on any sort of coherent action whatsoever. In theory, the Congress and the President would work together in a recession to create policies that stimulate economic activity. That sort of collaboration may not be possible in today's political climate.

We worry even more about the decisions that go beyond monetary and fiscal policy. Trade restrictions are currently stifling economic growth. Would Washington be willing to call a halt to the trade war in order to help American companies sell their goods overseas? Would we end import tariffs so consumers could buy goods more cheaply? Would we make sure our farmers have access to global markets? The ongoing government shutdown is another example of a government action that is hurting the economy and hurting many Americans. The rationale behind it is political, but it still amounts to economic sabotage. If any large employer suddenly stops paying its employees, they stop paying their bills and they stop buying things. The ripple effect can damage the whole economy. The effects will grow deeper and more permanent the longer the shutdown persists. And the longer it persists, the more we are becoming skeptical that the two parties can put aside their ideological differences and provide responsible government. Both sides believe they are winning points for being intransigent. Meanwhile, they leave a path of devastation for ordinary citizens. This is the original "barn burner," referring to the old Dutchman who was willing to burn down his barns to get rid of the rats.

The Attitude Indicator

Economically speaking, we are flying into some pretty rough weather. What do pilots do when they find themselves in a cloud with zero visibility? They rely on the attitude indicator. An example is pictured here. The alignment of the wings of the yellow "plane" with the white horizon line tells you whether your wings are level and whether you're climbing or descending. Keeping the blue sky above on top, the wings level, and the ball centered means that you can fly the plane on a straight and level course without seeing the actual horizon, sky, or ground. This simple instrument is crucial because when our bodies get misleading signals from our eyes and inner ears about which way is up, we become disoriented. Spatial disorientation ("pilot's vertigo") is a killer. 5-10% of all general aviation accidents involve spatial disorientation and

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90% of those are fatal.[3] Instruments like the attitude indicator enable pilots to cope with this very dangerous phenomenon. Trusting the instruments, and understanding that the usual sensory cues can sometimes be misleading, is key to flying safely.

In the same way, the key to navigating difficult markets is trusting the instruments. We invest in shares of companies that are likely to grow and make a profit. In choosing investments, we look at what the business does, how much money it makes, whether it owes money, and how it is managed. We look at the products it makes or the services it offers and assess whether those products and services are valuable to its customers. Even more important, we ask whether they will still be valuable if there is a recession and whether the company can survive and thrive if the going gets tough. If the answer is yes, it's a potential investment. We do not look at whether the stock price might go up or down or whether other people are buying or selling. Prices will fluctuate. Speculators will buy and sell. What the herd is doing does not affect our data-driven analysis of investments.

It's easy to get swept up in the herd mentality. Like those pilots in the clouds, we are tempted to trust our eyes and ears and not the instruments. It happened in December. The stock market dropped and ordinary investors ran for the exits, dumping $44 billion in funds[4] because it looked like everyone else was running for the exits. However, the herd has been consistently wrong. A twenty year study of investor returns by Dalbar, Inc. found that average investors buy high and sell low and therefore have low returns. During this period, the market averaged a return of 9.85% per year and the average equity fund investor earned 5.19% annually.[5] That's not a trivial difference. An investment of $100,000 would have been worth $655,000 for investors who bought and held. The average investor ended up with $275,000. These data clearly illustrate why we don't rely on the herd for our investing signals. This isn't easy. Most people want to buy when stock prices are soaring and run for the exits when prices fall. The successful investors, however, rely on their instruments.

Your partners in investing,

Rachel Barnard, PhD, Todd Schrade, CPA, and the Midway Capital Team

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[3] Antunano, Melchor J. M.D. "Federal Aviation Administration Medical Facts for Pilots." Publication: AM-400-03/1 http://www.faa.gov/pilots/safety/pilotsafetybrochures/media/spatiald.pdf

[4] Investment Company Institute data for December 2018. https://www.ici.org/research/stats

[5] Data for the 20 years ending 12/31/15 comparing returns for the S&P 500 Index to fund investor returns. "Dalbar Quantitative Analysis of Investor Behavior." https://www.dalbar.com/QAIB/Index

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