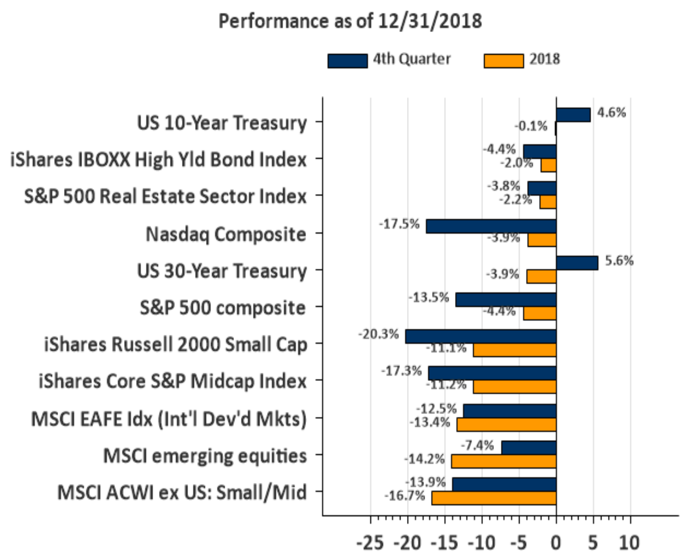
HORAN CAPITAL ADVISORS

Investor Letter

Winter 2018 www.horancapitaladvisors.com

At last year's start, economic and corporate fundamentals were strong. Prior to the Tax Cut and Jobs Act (TCJA), analysts expected S&P 500 earnings to grow 12-13% in 2018. Following its passage, the reduction in corporate tax rates caused analysts to revise their earnings growth expectations higher to nearly 24% for 2018. Given many positives, further upside in equity markets was anticipated in 2018. As fate would have it, not only were equity returns weak, most asset class returns were negative. Data from Lipper showed the Money Market Fund average return was 1.52% in 2018. In other words, cash turned out to be king in 2018 as can be seen in the near table. In a report issued by Robert W. Baird in mid-December, it was noted that 2018 was the first time since at least 1972 that no asset class had a return of 5% or more. To put it mildly, 2018 was a difficult year for investors regardless of asset class.



Source: Thomson Reuters Datastream & HORAN Capital Advisors

For the first nine months of 2018 the U.S. markets had broadly generated positive returns. The S&P 500 Index return through September 30, 2018 was up 10.56%. The fourth quarter reversed course as the S&P 500 Index fell 13.52% and the Dow Jones Industrial Average Index declined 11.31%. Small cap stocks fared the worst and were down 20.10% in the fourth quarter. The total return for the S&P 500 Index for the month of December was the worst since February 2009 during the financial crisis.

The Return of Volatility

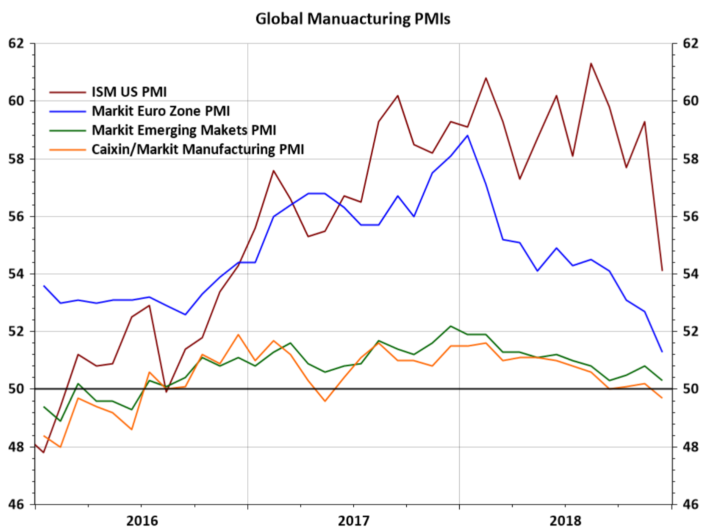
In the conclusion to our Winter Investor Letter a year ago, we noted that investors should expect a higher level of market volatility for 2018. This thought was based in part on the abnormally low level of market volatility in 2016 and 2017. The expectation of higher volatility became reality in 2018 with the S&P 500 Index experiencing 110 trading days with an intraday move of more than 1%. In 2017 only 10 trading days had a move of 1% or more.

One contributing factor to the higher level of market volatility is uncertainty. As 2019 begins, significant events adding to the uncertainty include:

- ongoing trade negotiations and tariffs;
- Brexit scheduled for the end of March;

- a Federal Reserve that continued to tighten monetary policy in December by raising the Fed Funds rate a quarter percent or 25 basis points, the ninth increase since the current tightening cycle began; and as this is written,
- a U.S. government shutdown and a change in the political party controlling the House of Representatives.

As the above events play out, the equity market will react. We do believe a resolution of the trade and tariff issues, primarily unsettled with China, would reduce a large uncertainty that is negatively impacting the market. The increasingly drawn-out nature of a resolution to trade is beginning to weigh on business sentiment as reflected in the release of some recent economic data.

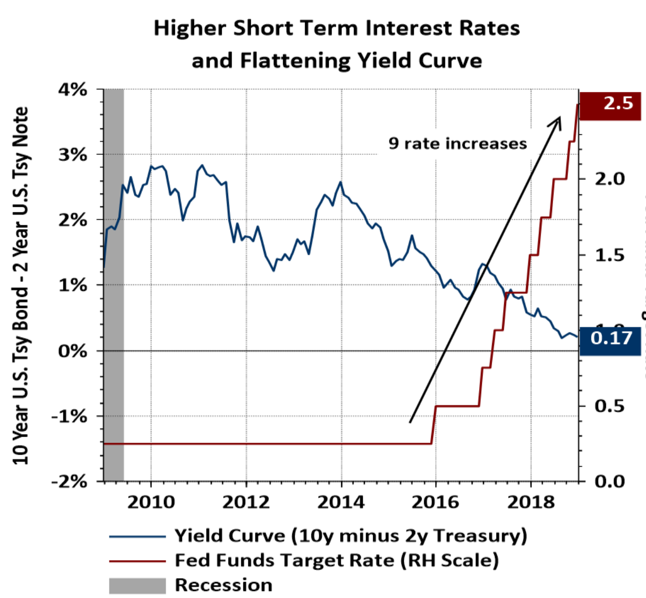


Source: Thomson Reuters Datastream & HORAN Capital Advisors

In our mid-December commentary, we noted that the December sell-off appeared at odds with the strong corporate and economic data. However, on January 2, the private Caixin/Markit Manufacturing PMI for China showed manufacturing contracted in December with the survey reported at 49.7. Subsequent to this report, the release of the December ISM Manufacturing Index in the U.S. showed a decline of more than five percentage points versus November's reading. This was the largest month over month change since the October 2009 reading fell nine percentage points. The overall reading of 54.1 remains at an expansion level though, i.e., greater than 50. Several of the business respondents to the survey did cite Brexit and the China trade issues as factors contributing to weaker survey responses. In short, earlier strong economic underpinnings are now exhibiting weakness.

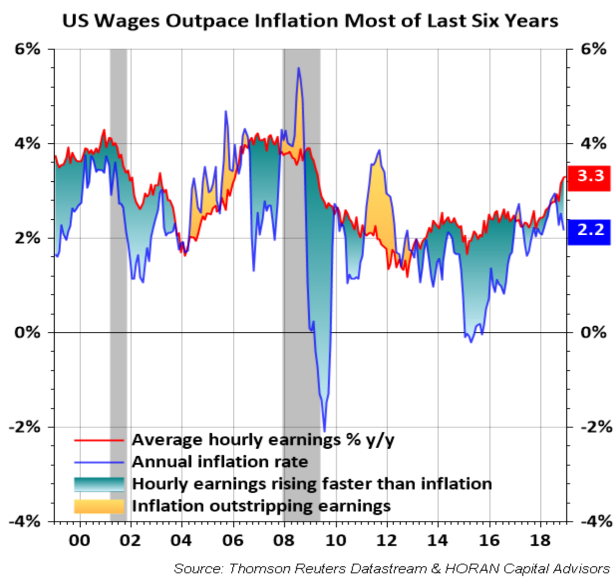
The Fed and Interest Rates

Uncertainty surrounding future Federal Reserve rate increases has likely contributed to the equity market volatility that has increased since early October. On the surface some would suggest this point in the tightening cycle is simply moving the Fed Funds rate back to a neutral level. On the other hand, some strategists believe the magnitude of the overall increase, in excess of 200 basis points or 2 percentage points, contributes to the potential for an economic slowdown. Beyond this, as the near chart shows, the rate increases have been on a steady and consistent trend higher. The risk of this steady rise is the economy is unable to adjust quickly enough to the higher rate level, e.g., the housing market. In the view of a baby boomer, mortgage rates remain low; however, millennials see current mortgage rates as high.



Source: Thomson Reuters Datastream & HORAN Capital Advisors

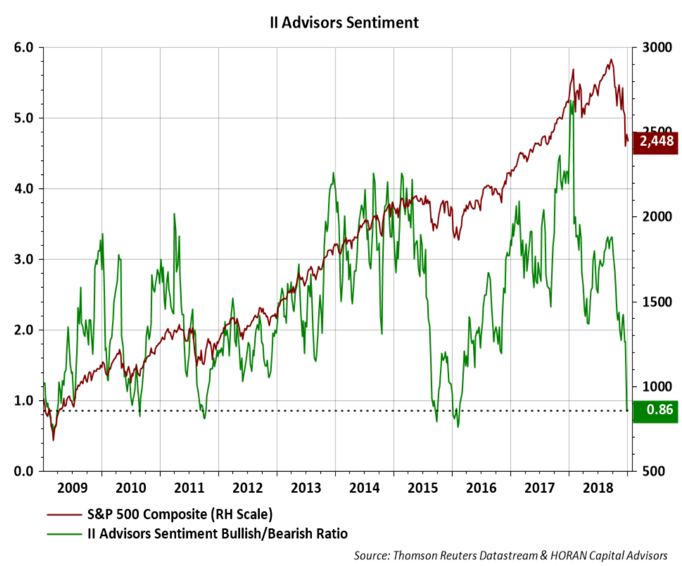
The Fed views its "dual mandate" as promoting an environment that maximizes employment and maintains stable prices, which means an inflation target of around 2%. A positive is the fact the unemployment rate of 3.9% is at a level last seen in 1969. Most of those wanting a job have one. As noted in a prior commentary, over the last several months the number of job openings has exceeded the number of individuals that are unemployed and looking for a job.



A benefit of the tight labor market is rising wages, particularly for hourly level employees. Since October 2012, the growth in average hourly earnings is on a trend higher with the most recent year over year growth rate equaling 3.2%. From the Fed's perspective, growth in wages is a factor that can contribute to higher inflation. If a consumer earns more in wages they tend to spend it, thus increasing demand for goods which can lead to the seller raising prices. This type of cycle can lead to higher inflation in turn leading the Fed to continue to raise the Fed Funds rate. We believe other forces are at play in the economy that are likely to constrain inflationary pressure, like technology improvements, which can be hard to measure.

Sentiment

Perhaps the largest change in 2018 was the shift in attitude across market participants. Investor sentiment was extremely positive to start the year as the TCJA gave new life to markets. The peak in investor sentiment came with a top in the markets for the first half of the year. Strategists view investor sentiment measures as contrarian market signals that are most actionable at extremes. As prices declined, so did investor sentiment throughout the calendar year. Many of the current measures are signaling extreme bearish sentiment, which is viewed as indicative of an oversold market. The chart at right shows the bull/bear ratio of the Investor Intelligence Advisors' Sentiment. The II Advisors' Sentiment Survey studies more than



one hundred independent market newsletters and assesses each author's current stance on the market: bullish, bearish or correction. The end of year ratio of .86, i.e. a high level of bearishness, is at a level reached near the bottom of the financial crisis ten years ago. Other sentiment measures are similarly bearish. This has translated into what may be an oversold equity market.

Conclusion

Despite solid fundamentals heading into the year, 2018 was extremely difficult. The uncertainties faced in 2018 will likely continue to overhang the markets in 2019. However, the events that drove markets lower last year proved to alleviate some of the concerns plaguing investors at the year's start. For example, equity valuations have declined to a more attractive level. In January 2018, the S&P 500 had become the most expensive since 2004 on a forward P/E basis. The S&P 500 Index now trades at a price to earnings ratio of about 15 times which is in-line with its historical average.

Growth and inflation have moderated while staying positive, alleviating concerns of an overheating economy and aggressive interest rate increases from a Hawkish Fed. Fed chair Jerome Powell recently remarked the Fed "will be patient" as they assess the prospects of further rate hikes in 2019.

All said, the risks ahead remain in focus. The prospects for a protracted trade deal resolution, disorderly Brexit and further slowing of U.S. and global growth present risks to the markets. One must assess the likelihood of these events and how much is already priced into the markets. We believe many of the negatives are priced in which should provide better equity returns in 2019. Taking a balanced and long-term approach to investing should continue to reward investors who stick to their discipline.

Thank you for your continued confidence in HORAN Capital Advisors. Please be sure to visit us at www.horancapitaladvisors.com.

Warm regards,

HORAN Capital Advisors