THE LONG RUN

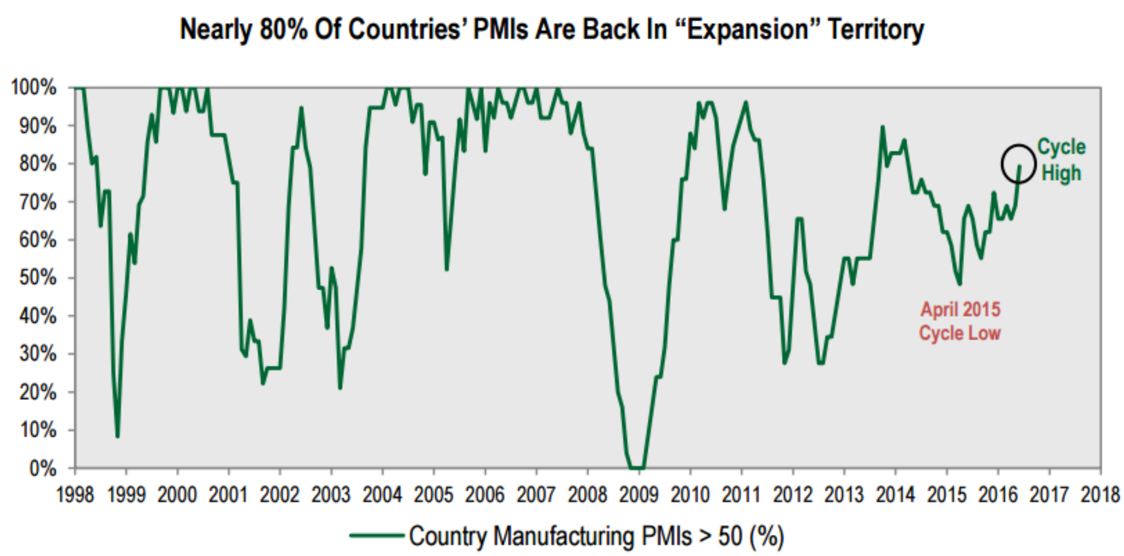
Reynders, McVeigh Capital Management, July 2016

You are not stuck in traffic. You are traffic.
- Kevin Slavin, MIT Media Lab

Before we get philosophical about traffic, let us share some thoughts on the financial markets topic de jour—Brexit (Britain's vote to leave the European Union). Just before the United States celebrated its independence from England with fireworks, parades, and patriotic music, citizens of the United Kingdom voted narrowly to reclaim their own sovereignty from the EU. Wall Street initially showed it was in no festive mood with this decision. On the day after the vote, global equity markets declined by $2 trillion – their most ever. England's currency sank to a thirty-year low. Standard & Poor's stripped the U.K. of its triple-A credit rating. And Goldman Sachs forecasted that Britain would enter a recession. Party poopers all.

Following a two-day hangover, investors awoke more clear-eyed and regretful of their binge behavior. Stocks came bubbling back. Britain's FTSE index reached a ten-month high despite the Brexit hysteria. The S&P 500 enjoyed its best week of the year and finished June with a positive year-to-date total return of 3.84%. While it is still much too early to be drawing too many long-term conclusions from the Brexit vote, we do have some thoughts. Political events like this generally do not change the fundamentals of the world economy or stock markets. England has two years to negotiate its withdrawal from the EU. While a jilted EU is talking about imposing stiff trade tariffs in revenge, we think cooler heads will prevail.

England currently runs a large trade deficit with Europe and this is business that the EU will not want to give up. Agreements will be worked out and business will go on. It would seem most likely that England will follow the path of Switzerland and Norway, two countries that have voted multiple times not to join the EU, yet have negotiated free trade and border agreements.



While financial markets tend to be volatile during periods of uncertainty, they eventually return to focus on fundamentals. We believe the most important of those is that the world economic growth, while modest, is improving and that corporate earnings should improve as well. The chart above from Cornerstone Macro shows that 80% of countries'

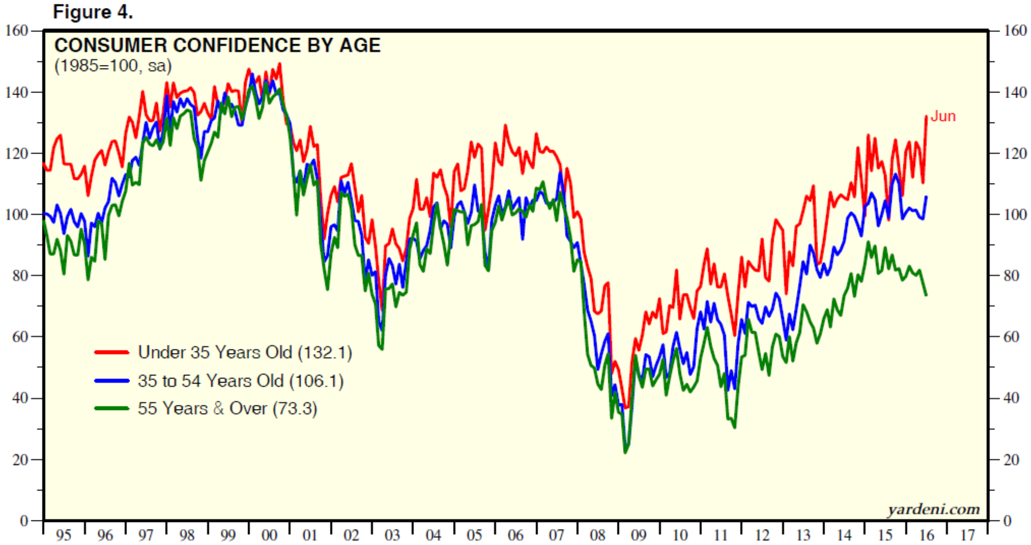
PMIs (purchasing managers' index—an indicator of the economic health of the manufacturing sector) are growing. This marks a two-year high for this measure.

Now back to our moment of Zen on traffic. In 2005, David Foster Wallace gave an extremely thoughtful commencement address to Kenyon College graduates entitled, "This is Water." He discussed for most what has become our default way of thinking and acting, which is often to not think or act. We view the traffic of life as something that is happening to us, not something we are contributing to or have the power to change.

A decade of slow economic growth, ineffectual government, under-funded retirements for some, and college-debt burdened lives for others have resulted in income inequality that has left power concentrated in the hands of too few people. The flow of wealth, the flow of new ideas, and the flow of good government have become stuck in traffic.

Brexit, the U.S. presidential elections, and the rise of populism around the world are all signs that people are no longer willing to sit in traffic because the system no longer feels fair. For some, the escape from traffic is through anger and attacking. For others, it is expressed in designing a new system that invites participation and interaction. Which way this populism erupts is the real opportunity or risk for financial markets. The next clue for the direction of this change is likely to come from the U.S. elections. One of the most surprising statistics we have seen is that young people in the U.S. are the most optimistic portion of our society. As the following chart shows, in the most recent consumer confidence survey, this group is much more confident about the future than the typical citizen. The Consumer Confidence Index (CCI) climbed to 98.0 in June. It has been hovering around its cyclical high of 103.8 reached during January 2015 for nearly two years. Interestingly, the CCI for people under 35 years old jumped to 132.1, the highest since October 2000. On the other hand, it fell for those who are 55 or older to 73.3, the lowest since September 2014.

Figure 4.



Source: The Conference Board.

In the Brexit election, voter turnout for younger voters was a dismal 36%, versus a 72% turnout overall in the country. We would hope to see the optimists in the U.S. express their vision for the future with a high voter turnout. As we continue to see waves of populist sentiment challenging and testing established order around the globe, we recommend staying focused on the underlying economic fundamentals and keeping balanced with investments. Times of uncertainty often give longer-term investors the chance to own powerful franchise companies at reasonable prices.

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