

THE LONG RUN

Reynders, McVeigh Capital Management, October 2016

“As the present now will later be past, the order is rapidly fadin’ . . .”

-- *Bob Dylan*

As stock markets in the United States have risen to new highs, we look at the global economic landscape and wonder if the current pace of world GDP growth will be able to drive significant earnings growth for global companies in the near term. When we add into this picture the lack of significant consumer spending or corporate investment, the fear of stagnant living standards fueling populist political movements at home and abroad, and the likelihood that the U.S. Federal Reserve will raise rates imminently, we see potential for an increase in volatility ahead. We have been trimming equities in balanced accounts through the year to keep clients in line with their long-term equity targets and to lock in some gains. We have also been maintaining high-quality, short maturities in bonds to avoid exposure to weaker credits or to longer maturities that may be vulnerable to a rise in rates. We will likely continue to raise additional cash in response to current equity market strength. We are positioning clients to have a little extra liquidity to carry them through potential choppiness ahead, and we are adding “dry powder” in the form of ready cash to buy selected equities at discounts should markets correct.

This tactical response to current market circumstances should not be confused as a call to exit markets. We still believe equity investments are one of the most attractive places for long-term investors to drive capital growth and income growth over time, and there are many companies already trading at discounts that are well worth owning. We are simply recommending disciplined rebalancing ahead of what we expect might be a period of rough weather. We have written recently about how post-crash (or post-apocalyptic) investors have made mistakes by investing only to avoid volatility or to guard against the factors that contributed to the last crisis in 2008. This rear-view mirror approach has led many to lose their discipline and balance – worse, many have missed out on significant equity gains. A by-product of this fear-fueled investor psychology has been an increase in strategies (and technologies) that offer investors the ability either to reduce or to increase exposures in portfolios rapidly. If August/September of 2015 and the beginning of 2016 are reasonable indicators, this new market dynamic seems to have a significant amount of investment capital moving from “all-in” to “all-out” (and sometimes back to “all-in” again) at any sign of volatility. This makes us expect that corrective swings in equity markets will be larger and will express themselves more rapidly until we are further away from the trauma of 2008, but we also believe that this over-corrective dynamic will lead to significant opportunities for the longer-term investors who can tune out the psychological noise and buy fundamentally sound companies that come on sale.

With so many looking backward to design their investment strategies, it seems to us that too few are looking out ahead to analyze the new risks and opportunities that are emerging as the world economy recovers, adapts, and evolves. The market response to Brexit was a clear example of this. At news of Britain’s vote to leave the Eurozone, global equity markets sold off immediately and dramatically. Many traders felt that a significant challenge to the solidarity of the Eurozone would be precisely the kind of economic broadside that could unmask weaker financial institutions in Europe. The expectation on many fronts was that a Brexit vote could be the kind of catalyst that would lead to a Lehman-like liquidity event at a European bank. When it turned out that the many years of testing and regulatory adjustments in Europe that were designed to guard against the kind of systemic risks that threatened the financial system in the wake of the Lehman collapse in 2008 did in fact maintain liquidity in the European financial system after Britain’s exit vote, traders piled back in driving markets to new highs. For many, that is where the Brexit analysis ends. For us, the most important portion of the Brexit story has not been written yet. Britain and British companies need to redefine and restructure economic regimes and practical logistics across

an enormous range of industries and geographies. These adjustments will likely lead to a slowing of shorter-term economic growth rates in Britain and in a broader Eurozone that is tightly connected to Britain’s economy. Until we know just how significant this slowdown might be, it is hard to have a clear view on potential growth ahead for Britain or the Eurozone – or for global GDP. So, while many investors have gained confidence because Brexit did not trigger a Lehman-type liquidity crisis, we believe that a review of the issues impacting the current pace and design of the global recovery offers a better window into understanding immediate investment prospects.

The Brookings Institution-Financial Times Tiger Index compares many separate indicators of real activity, financial markets and investor confidence with their historical averages for the global economy and for each country separately. The chart below tells two important stories. First, it shows clearly the 2014-15 capitulation of emerging market growth as a primary driver of global growth (as Mr. Dylan might put it: The rapidly fadin’ order). This growth recession in developing economies has been accompanied by an historic advance in the value of the U.S. dollar and a collapse in commodity prices – effectively closing the chapter on an era of investing led by industrial expansion in emerging economies and handing the baton to the developed markets to lead the next chapter of growth. Second, this index chart shows the current weakness in global growth as new and varied policies to drive growth are adopted and adjusted across different world economies.



We believe that the world economy is slowly mending itself but also understand that policy experiments and complex deleveraging processes will make a return to normalized global growth slower than many investors might hope for or expect. The follow-on impacts of Brexit and the likelihood of rising interest rates in the United States bring additional challenges to the tepid developed market growth that is currently leading the global economy. In these changing times, we continue to find investment opportunities in companies and industries that we believe will grow at a faster rate than the world as a whole, and we will look to add to positions as investors – eagerly riding momentum today ahead of economic fundamentals – eventually panic into sell-offs.

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