

THE LONG RUN

Reynders, McVeigh Capital Management, October 2017

"Well she was an American girl, raised on promises. She couldn't help thinkin' that there was a little more to life somewhere else. After all, it was a great big world with lots of places to run to." -Tom Petty

Much of this year's boom in global equity markets seems to have been fueled by the notion that promises of reduced regulation, lower taxes, and increased infrastructure spending in the United States will become reality -- driving more growth in the world's largest economy. But many of these promises are proving hard for this administration to keep. From Russia investigations to cabinet resignations to the threat of conflict with North Korea, distractions conspire against this growth agenda. To add fuel to the fire, the current political environment does not seem to be providing fertile ground for passage of any new legislation any time soon. It wouldn't surprise us to find readers suffering from a form of cognitive whiplash when they turn from threatening front-page stories of nuclear brinksmanship, political dysfunction, and the dangerous expansion of uncompromising populism around the globe only to find financial articles celebrating new stock market highs in exchanges across the world.

The reality underneath the political headlines is that global growth has been stronger than expected over the last nine months with Japan and Europe showing increasing GDP growth numbers, the U.S. managing reasonably steady GDP growth in the face of the Federal Reserve raising rates, and emerging economies stabilizing. Earnings, too, have exceeded expectations thus far in 2017. In the U.S., large multinationals benefitted from a weaker dollar improving sales, and many historically cyclical industries, particularly technology and manufacturing, saw significant acceleration in sales and earnings. (We note, though, that the overhyped "Trump trades" in financial and energy sectors that soared after the election have trailed the S&P 500 in 2017.) The biggest story might be that developed equity markets *outside* the United States, having underperformed for one of the longest periods in modern history, are significantly outperforming in 2017.

Are market participants simply putting their heads in the sand and ignoring global risks to ride the momentum of equity markets at any cost? Could it be that global interest rates are so low that investors find that there are few investment choices outside of equities? Or is there something else going on? After all, this is a great big world. While we recognize that there are some areas of the market where valuations are well out ahead of reality on the ground, investors need to realize that we are currently experiencing innovation boomlets in numerous industries that are creating new markets and potential for significant growth. Under the political noise, there are amazing opportunities taking shape. We have discussed in past letters the revolution that genomic sequencing technology is creating in healthcare, the new opportunities that automation and technologies like 3-D printing are creating in manufacturing, and the rapid adoption of electronic payment networks supporting online commerce and the shared economy -- among other innovations. As we look ahead, we see multiple additional opportunities that excite the imagination:

- New 5G networks are scheduled to be launched by 2020. 5G connections will be lightning fast. One telecom is achieving data transmission speeds that are 14 times faster than the fastest 4G connection. Latency periods (the time one data packet takes to get from one point to another) are expected to be reduced by 50 times. These extraordinary improvements in capacity and speed open the door to expansive new market opportunities including autonomous cars and the Internet of Things (IoT). With the latency of a 4G network, an autonomous car traveling at 100 km/h still moves 1.4 meters from the time it finds an obstacle to the time when the braking

command is executed. Under the same conditions, but with the improved latency of the 5G network, the car will move just 2.8 centimeters before the braking command is executed. The arrival of 5G will lead to the installation of an estimated 22.5 billion IoT devices in 2021, up from around 16 billion estimated installations in 2020. 5G connections are expected to reach 1.1 billion by 2025 -- approximately 12% of total mobile connections.

- Artificial Intelligence (AI) is the development of computer systems capable of performing tasks that currently require human intelligence. While still in its infancy, the demand for AI solutions is growing rapidly across many industries. The AI market is expected to grow at more than 60% annually from 2016 to 2022, and software sales for AI applications are expected to reach more than \$50 billion by 2025. Robots on manufacturing floors can be taught to interact with humans or to make self-adjustments to improve efficiency. Machines will be able to perform predictive maintenance and achieve a 60% or greater reduction in system downtime. The healthcare industry could recognize \$54 billion in annual cost savings by better connection of data points, decreased procedural costs, and reducing failed drug discovery. Autonomous driving will be made possible by GPU computer chips that can analyze data generated by sensors located throughout the car such as cameras, lidar, and radar. Two GPUs can deliver 24 trillion deep learnings operations per second. Autonomous driving could save lives as more than 90% of accidents are currently caused by driver error. AI is already helping to improve accuracy and speed in fraud detection across the financial services industry.
- CAR-T cell therapy works by removing T-cells from a patient that has cancer. The T-cells are engineered to have protein receptors on their surface that are attracted to certain proteins on the surface of cancer cells. The T-cells are returned to the patient and attack the cancer cells. CAR-T cell therapy has proven to be remarkably effective in treating blood-borne cancers. In one study of pediatric and young adult patients who had failed prior treatment for B-cell acute lymphoblastic leukemia, 83% of patients achieved complete remission (no sign of cancer) or complete remission with incomplete blood count recovery within three months of infusion. In another study of patients with aggressive non-Hodgkin lymphoma who had failed prior treatments, 39% of patients achieved a complete response (no sign of cancer) after 8.7 months of treatment. Major blood-borne cancers are expected to cause the death of more than 58,000 people this year. If medical advancements can lead to CAR-T therapy proving to be effective on solid tumors, the addressable market could expand significantly. The National Cancer Institute says that 595,690 people died from cancer last year in the U.S. alone.

Some of the promise of these and other new technologies is already in the current price of equities in the markets. Some is not. So, we continue to see opportunities for select investments today. That said, we clearly expect more volatility ahead for markets in this accident-prone geopolitical environment. While the threat of nuclear conflict has not seemed to dent the armor of upward-moving global markets, something unpredictable will -- and we will have a much-needed pricing correction. When this time eventually comes, we will take the opportunity to invest further into some of the powerful currents of innovative technology that we believe will drive growth in the years and decades to come.

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