THE LONG RUN

Reynders, McVeigh Capital Management, January 2016

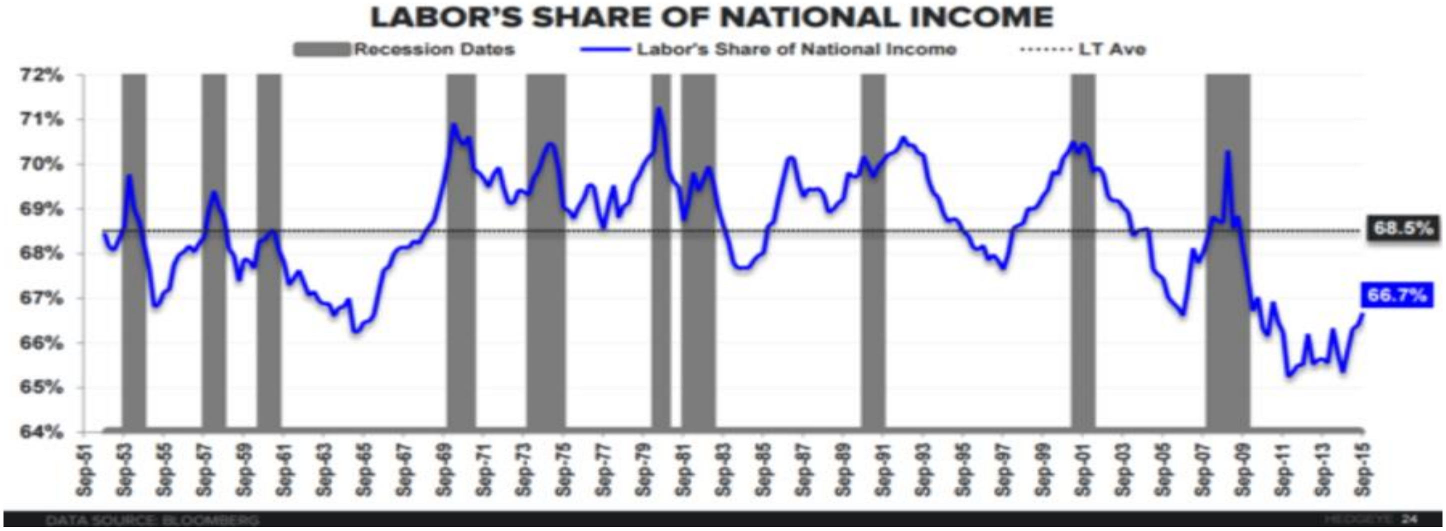
There is a crack in everything, that's how the light gets in.
– Leonard Cohen

Following an uninspiring 2015, Wall Street's mood has certainly darkened further in 2016. The press has made no secret of the fact that the year opened with the stock market's worst two weeks in history. (Though they fail to mention that the last time the market started like this, stocks finished up 43% for the year.) The 8% decline in the S&P 500 to start the year is on top of most investors experiencing some drop last year. While the headline results for 2015 show flattish results, most stocks fell in price. For example, within the S&P 500, the ten largest companies increased in price by an average of 17%, while the other 490 stocks declined by an average of 5%.

For a number of years, we have discussed the structural weaknesses that Wall Street seems so suddenly consumed with – China's slowing economy, massive amounts of global debt, aging populations, political instability, and terrorism. While we are not about to diminish the long-term risks that these present, to some extent we think the bleakness of this picture is reflected in the market. According to at least one survey (AAII poll), investors have not been this bearish since 1992.

We have attempted to keep appropriate balance in each client's account over the past four years – selling energy, emerging markets and commodity-related investments when they were in favor, and trimming growth stocks as their valuations soared. While remaining cognizant of these structural problems (slowing growth and rising debt), we also want to look for contrarian opportunities as sentiment grows darker. Is there a crack in this story that could let enough light in to change the gloomy outlook?

As the election season heats up and populist rhetoric builds, the phrase, "What is good for Main Street is bad for Wall Street" and vice versa is more commonly heard. As the following chart shows, labor's share of national



Source: Hedgeye.com

income reached a peak in 1980 and is now sitting near its all-time low. At the same time, corporate profit margins have reached an all-time high. Workers have been receiving less of each dollar of sales while corporations have been keeping more. This trend, to the surprise of many, began to change last year. Corporate earnings are expected to decline by about 1% while wages will grow by 2.5%, their fastest twelve-month pace in this recovery. Fourteen states begin this year with higher minimum wages. Even Wal-Mart is raising its minimum wage to $10 per hour. Though many assume this recovery has been made up of part-time jobs, the reality is that over the past year, 2.5 million full-time jobs have been created while part-time jobs have declined by 11%.

Wall Street assumes that higher pay for Main Street is a bad thing and is one reason stocks have been volatile. We would argue the opposite, however. For example, in both the 1980s and 1990s, sustained outperformance of stocks and corporate earnings was associated with rising wages. In our opinion, a major factor for the slow economic growth we have experienced over the past decade had been the widening inequality in our country and the loss of the middle class. Improved wage and employment growth are key ingredients to building a more sustainable recovery. With energy prices down significantly, unemployment at 5% and the economy having created over 200,000 full-time jobs per month in 2015, the consumer, which makes up 70% of the U.S. economy, should still be a source of strength.

This year is likely to continue a transition in the world economy where growth is uneven and excess debt poses risks. These global shifts offer significant potential for investors. For example, 2015 was the first time in history that carbon emissions fell even as the world economy grew and renewable energy accounted for half of all new global power generation. Opportunities to benefit from the transition to sustainability continue to unfold. Meanwhile, those who have spent large sums developing costly and dirty sources of energy, such as coal and oil sands, saw demand for these products fall off the cliff.

Fortunately or unfortunately, stock market corrections happen and we are experiencing one at this time. The decline in equity prices does give us an opportunity to purchase quality companies in your portfolio at reduced prices. While we do not believe the United States will enter a recession, we will stay vigilant to that possibility as a foreign financial crisis could certainly impact our economy.

We recommend keeping balance in your investment approach and encourage you to contact us if you have any questions or want to discuss this further. We will continue to look for the cracks of opportunity in the current market environment.

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In company news, we welcome Tiffany Brown, Lisa Chioffi, and Mary Elizabeth Conlon-Kesse to the company. Tiffany joins us from Resource Generation while Lisa and Mary Elizabeth have been a well-established portfolio management team in the Boston area. Lisa also serves as the President of the Boston Economics Club. For a company started by two men, we are pleased to see that women now make up a slight majority of our employees.

At year-end, we made a special gift to the favorite non-profit of each employee in recognition of their involvement. Let us know if you would like to see the list of these groups.