THE LONG RUN

Reynders, McVeigh Capital Management, April 2015

"Everybody gets so much information all day long that they lose their common sense."

~ Gertrude Stein

Welcome back volatility. After an extraordinary run of more than three-and-a-half years without a correction and six consecutive years of gains, the S&P 500 swooned in January, surged in February, and fell again in March – a great deal of sound and fury signifying little as the index ended up modestly ahead for this last quarter. This manic movement, however, does reflect investor concern that U.S. economic growth and the grind upward in U.S. equity markets could fall prey to the many powerful economic cross-currents sweeping the globe today.

In several *Long Run* letters over the past few years, we have described our concern over imbalances in China that we felt could have a corrosive effect on a global economic system geared toward fueling the hyper-industrial "miracle" that the Chinese government had engineered. Over the past year, a serious adjustment in the outlook for China has catalyzed a rout in commodity prices, and many currencies linked to the commodity trade – including, the Russian ruble, the Brazilian real, the Chilean peso, the Australian dollar and the Canadian dollar – have cratered. While the S&P 500 was up more than 13% in 2014, overseas markets fell.

In addition to the corrections in commodity-based economies, both the European Union and Japan have initiated large quantitative easing programs in an attempt to stimulate growth, purchasing assets through central bank balance sheets and forcing interest rates down dramatically. Readers may be surprised to know that, as of this writing, the yield on Italian ten-year sovereign debt is 1.24% versus a yield of 1.93% for U.S. treasuries. The yield on Japanese ten-year government bond is a dismal 0.36%. This relative weakness around the globe has led to another large factor change: The U.S. dollar has become a safe-haven currency and has been rising in value against most other global currencies at a rapid rate. This change has hurt the earnings of many U.S. companies that have meaningful sales in other parts of the world. It has also squeezed many foreign countries that have built large piles of dollar-denominated debt and now have to pay more and more in their local currencies to meet the same U.S. dollar obligations.

With such extraordinary adjustments going on around the world, it is no wonder that U.S. investors are beginning to look over their shoulders. To add fuel to the fire, price-to-earnings ratios for U.S. stocks have risen from just over fifteen five years ago to just over eighteen today, suggesting that the market is already pricing in reasonable earnings growth. And yet, a backdrop of low interest rates is a very sturdy support for equity markets, corporate balance sheets (for the most part) are flush with cash, and very few other asset classes offer the return prospects that equities do in this environment. This short-term push and pull between a healthy backdrop and the potential for global issues to slow or even derail U.S. growth will likely fuel more volatility in the U.S. markets through 2015.

Volatility, of course, is not in itself a bad thing. It is in the nature of marketplaces to spike and dive as they try to find fair prices, and it is in the psyche of the investing herd to overshoot to both optimistic and pessimistic extremes. Importantly, volatility shakes shorter-term speculators out of the markets and opens opportunities for patient investors to purchase equities at reasonable discounts to longer-term prospects. We work to invest in superior companies that weather well through rough patches in the market and take full advantage of upcycles. We do this by investing in companies with strong balance sheets and durable growth prospects. By focusing on the quality of the holdings we place in portfolios, we seek to avoid any potential for permanent loss of capital, and we find companies that gain market share in hard times as weaker competitors falter. So, while volatility frays the nerves of retail investors, we see it as our friend.

As we look out into the year ahead and beyond, we expect to see a continued decline in economic coordination around the world as different spheres of influence work at cross purposes. We are reminded of the 1990s. A look at the history of the global economy in the late 1990s presents a startling portrait of global economic volatility – features of which might seem oddly familiar. In 1997, after years of extraordinary infrastructure growth fueled by government investment, economies and currencies collapsed in Asia as foreign investors fled the economic shell game. This implosion in Asia created massive disruption across the world. The decline in demand for oil and industrial metals from Asia severely impacted Russian exports and financial reserves, and ultimately led to a Russian default and currency devaluation in 1998. Brazil also felt the sting of lower demand for commodities from Asia and raised rates to defend its currency, choking the economy which ultimately succumbed to a 35% drop in the value of the Real. Debt-ridden Argentina fell into what is known now as the Argentine Great Depression in the third quarter of 1998. And, as if the sense of contagion was not palpable enough, a firm called Long-Term Capital Management (a large hedge fund led by Nobel Prize-winning economists and renowned Wall Street traders) nearly collapsed the global financial system in 1998 as a result of highly levered arbitrage trading strategies gone wrong.

Over these tumultuous years, the S&P 500 suffered numerous setbacks. In 1997, the market had two corrections of over 10% each. In 1998, the market had a correction of just under 20%. And yet, if observers take a step back, they will see that the S&P 500 enjoyed five consecutive years of positive gains from 1995 to 1999. By most accounts, investors look back on the 1990s as a highly productive time to have been invested in the market. In fact, an investment in the S&P 500 in the beginning of 1995 would have been up 207% (with the reinvestment of dividends) by the end of 1999. The point here is not to suggest that 1990's-type returns will be found again in this environment (though they would not be unwelcome), but rather that volatility is a normal characteristic of the market and that investments can be productive even in periods of turbulence.

Looking forward, we see both volatility and promise ahead. We expect to see some natural corrective or consolidating action in the U.S. markets before too long, but we also see exciting innovations driving new industries and evolving economic forces creating new channels of demand. Valuations in parts of Europe look very interesting. As always, we will focus on careful selection and take advantage of pricing opportunities as they come in order to deliver sustainable long-term growth.

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