THE LONG RUN

"Sometimes it's not enough to know what things mean,
sometimes you have to know what things don't mean."
-- Bob Dylan

Over the last few years, we have been describing the hyperactive U.S. equity market as the adolescent in the room – and characterizing the seemingly immoveable U.S. Treasury market as the grownup. After a 2016 U.S. election that promised tax cuts and reduced regulation to spur growth, the S&P 500 went on a tear, rising almost 35% from the election through the third quarter of 2018. Investors from all over the world came along for the ride, as new policies provided boosts (like sugar injections) to the U.S. economy and lifted immediate-term earnings across the board for most industries. In contrast, the U.S. 10-year Treasury yield – an indicator of longer-term growth prospects – remained vexingly low, suggesting the bond market did not believe the policy-induced growth rates to be sustainable.

A careful review of the relationship between the U.S. 10-year Treasury yield and the S&P 500 over the last two quarters provides important insights to help guide investment thinking. In the chart below, we observe that the 10-year Treasury yield was rising with the S&P 500 through October of last year. Chairman Powell of the Federal Reserve began raising interest rates in March of 2018 and argued, at the time, the need for further rate increases was to avoid having the policy-boosted economy and tight labor markets trigger inflation. His language was aggressive and suggested multiple rate hikes ahead. The equity markets rose with this news, at first, because the rise (albeit modest) in the 10-year Treasury yield seemed to suggest that the grownup in the room was finally considering the rate of economic growth in the U.S. to be sustainable.

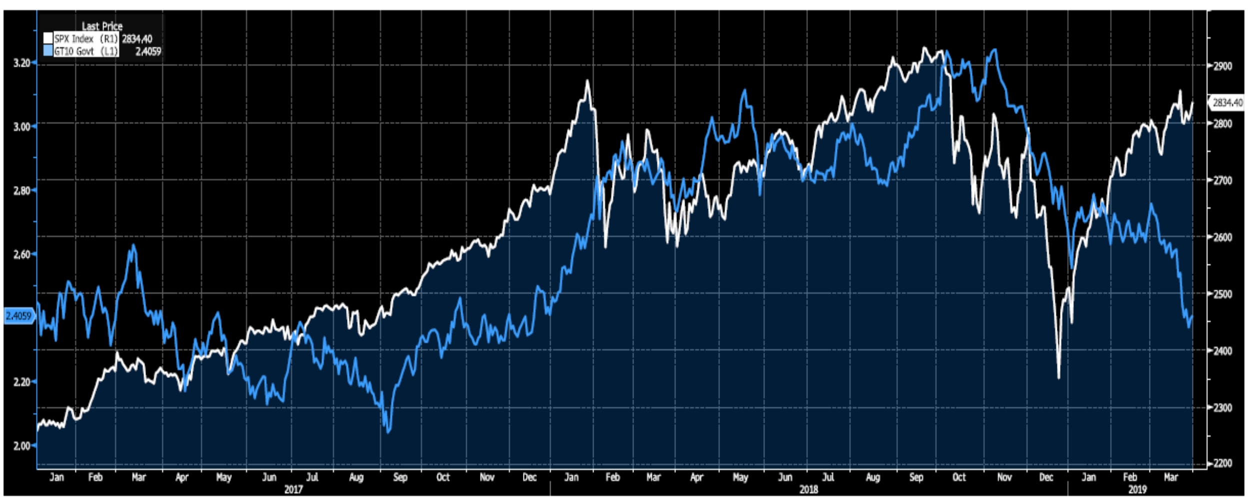

CHART: 10-year UST yield vs. S&P 500 1-1-2018 to 3-31-2019. Source: Bloomberg

The reality is that Powell's lifting of rates did more to unmask weakness in the U.S. economy picture than anything else. To make matters worse, the rest of the world was slumping with slowing GDP growth rates, and earnings estimates for global equities started to drop. By the end of 2018, with the 10-year Treasury rate at five-year highs, Chairman Powell was forced to admit that U.S. growth prospects were more tenuous than he had expected. The S&P 500 fell into a bear market – dropping more than 20% from highs in the fourth quarter of 2018.

By the first quarter of 2019, the 10-year Treasury yield had fallen to 12-month lows. The yield on 2-year Treasury notes, in fact, found itself anchored above the sinking yield for 10-year Treasury notes briefly in the quarter – flashing a recessionary signal known as an inverted yield curve. And yet, U.S. equities recovered nearly all that had been lost in last year's bear market selloff. This is a more natural short-term response in markets than many might expect. Low interest rates provide stimulus, as loans for mortgages and other needs are less expensive. They make comparative equity dividend yields more attractive and discount model pricing for equity and other growth investments more appealing, as well. But what is the longer-term outlook for global equities?

In a recent study, Fidelity's Asset Allocation Research Team predict that global GDP growth will slow to an average of 2.1% annually over the next 20 years – down from an average of 2.7% over the last 20 years. They base their estimates on productivity, population, and demographic data from across 40 countries. This makes sense to our team here at Reynders, McVeigh. Much of the global growth in the last 20 years was fueled by easily-acquired leverage and ever-falling interest rates. Looking ahead, many of the world's largest economies will be working through an extended period of *de*leveraging – and there is little room for interest rates around the world to drop any further.

Slower GDP growth across the globe does not mean no growth, but it does change the way we think investors should be evaluating opportunities. In a slower-growth world, many economies will be running closer to stall speed, suggesting that recessions may be more prevalent. Companies that have been reliant on debt to support operations will likely be disadvantaged, as they find it harder and more expensive to borrow. Investors will need to direct capital to where the growth is – and avoid those companies and industries deeply dependent on outsized macro global growth for their earnings.

Our discipline has always looked beyond the macro trends to find long-term growth opportunities that are less dependent on coordinated, or accelerating, global GDP growth. We tend not to invest in highly-cyclical, or less transparent, industries, or in companies with weak balance sheets. We look for innovative companies that we believe can sustain growth through the broadest range of economic environments.

You might have noticed, starting this month, that the network identifier on the top right of your phone has you tapping into 5G networks. While these are not (yet) the integrated 5G networks that we believe will help to shape a new, dynamic future, it is the first glimpse of an advance that we have been talking about – and investing in – for years. Indeed, innovation is alive and well. Artificial intelligence, machine learning, the genomics revolution, enzymes, autonomous vehicles, new manufacturing processes, financial access and transaction innovation, new materials, new subscription models, and continuing efficiency advances are just some of the opportunities that we believe will drive significant growth in the years ahead.

If 2018 and the beginning of 2019 are prologue to this new era of slower global growth, the seismic shift that has pushed literally trillions of dollars into passive index investments over the last decade may now have investors overly exposed to weaker companies that may not be well positioned for the world in which we live today. Could it be that careful selection – with a focus on companies that tap into long-term growth trends not tethered to coordinated global growth – is coming back into style? We think so.