The Long Run

INVESTMENT LETTER | JANUARY 2020

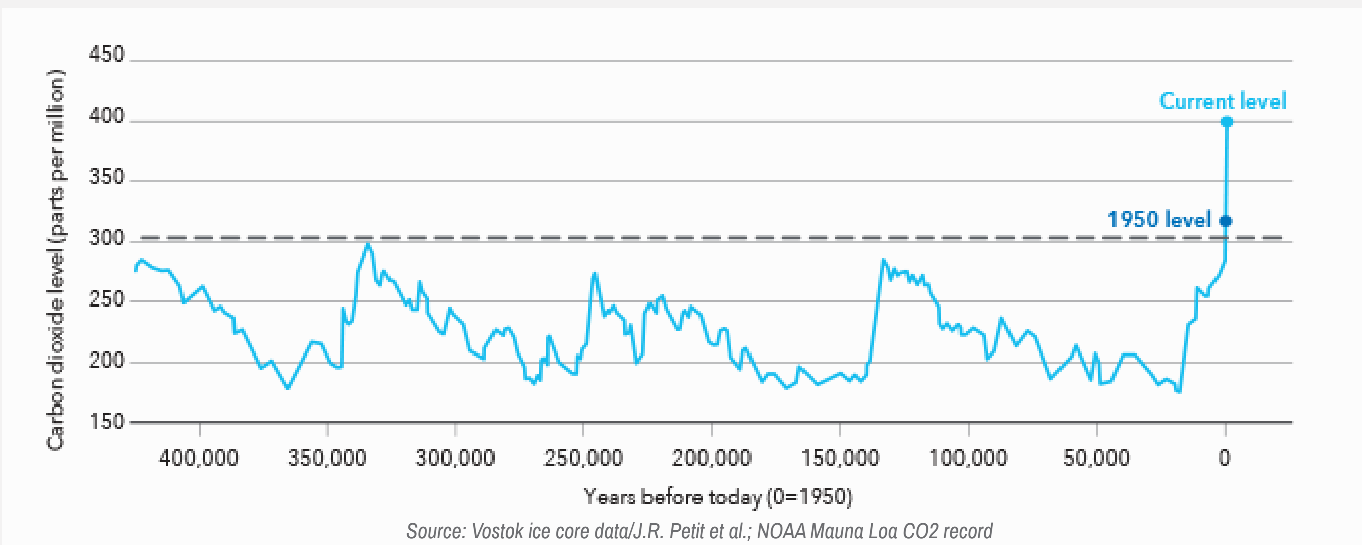
Yes yes — dear dear
Perhaps next year
Or maybe even never
- *Reasons to be Cheerful* by Ian Dury

Welcome to the cheerless recovery! Despite the economy continuing with a record 11 years of expansion, a recent survey found 97% of CFOs expecting a slowdown, or recession, this year. Despite stock prices reaching new all-time highs, investor sentiment remains at below average levels. And, despite the unemployment rate being at a 50-year low, Americans are less optimistic than they were at the beginning of 2019. The "Wall of Worry" seems intact.

Our outlook for the coming year has not changed significantly and remains somewhat closer to cheery than dour. We do believe the economy will continue to grow at a slow, although somewhat, faster pace than last year. Progress in trade negotiations with China – and some rebound in Europe – are likely to help our industrial sector bounce off near-recessionary levels. Corporate earnings should expand a little faster than consensus expectations. If inflation remains low, the Federal Reserve will not raise interest rates. And, while stock valuations clearly aren't cheap, they are only slightly above the level you would expect in an environment of 2% inflation and 2-3% GDP growth. It would, therefore, not surprise us to see the cheerless recovery continue for another year.

Perhaps most interesting to address are some of the issues that appear to be accounting for the sullen attitudes during this time of relative economic prosperity. Three issues in particular – climate change, growing financial debt, and the rise of passive investing – appear to be creating a broad sense of unease. This is not because we know what changes they will bring, but more because of the uncertainty they foster.

CO2 level during the last three glacial cycles (reconstructed from ice cores)

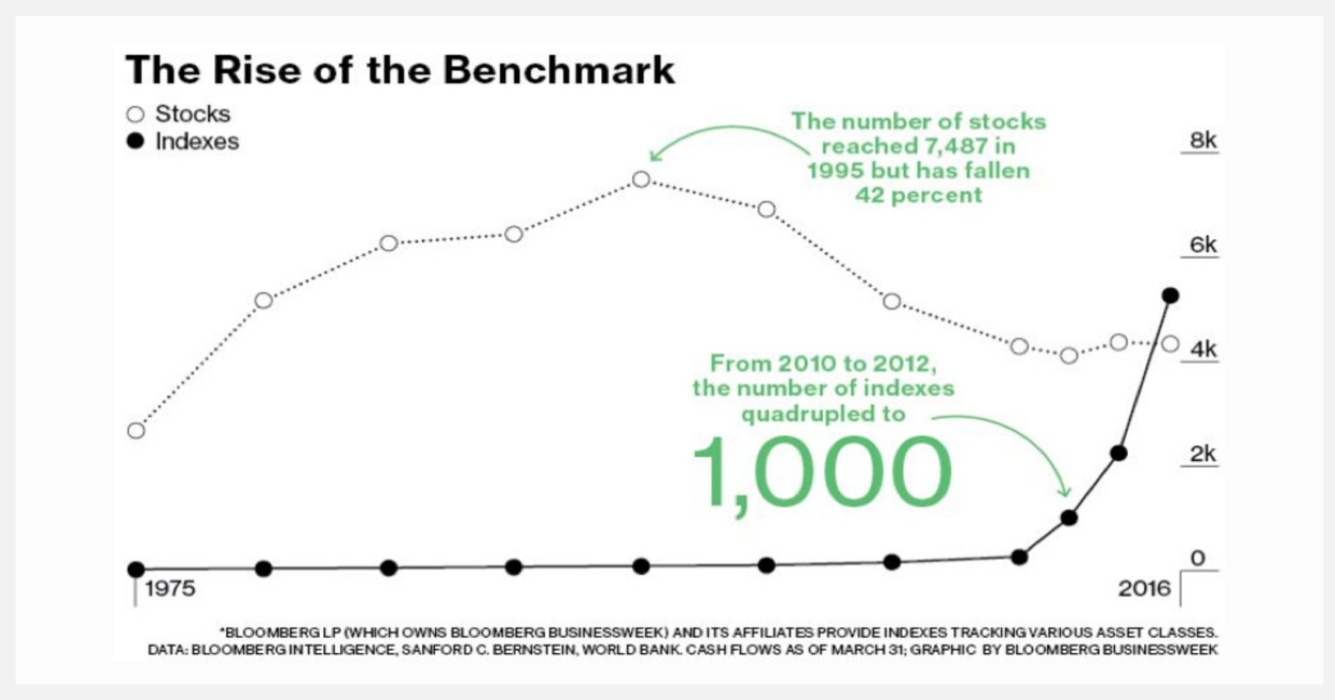


Source: Vostok ice core data/J.R. Petit et al.; NOAA Mauna Loa CO2 record

The above chart is perhaps the most worrisome image we can ponder. It illustrates that, in past periods of global weather change, levels of carbon dioxide in the atmosphere have followed regular paths. In this cycle, people have clearly altered these historical patterns and carbon emissions are at extreme levels. Given that CO2 concentrations and temperature have been highly correlated over the past 800,000 years, this sends a very troubling signal for the future. While most predictions of imminent demise have yet to be proven true, there is a clear sense of unease that something is, indeed, amiss. Research compiled by David Mackie from J.P. Morgan shows that the number of extreme worldwide weather events has approximately doubled from around 400 per year in 2000 to over 800 last year.

Extreme events are also being seen with the amount of debt being taken on by the U.S. government, corporations and individuals. A few days ago, we learned that the federal deficit grew by over $1 trillion in 2019, an increase of 28% over the previous year and more than twice what it was in 2015. Corporate and individual debt are also at record levels. Deficit increases are typical during periods of recessions, but quite unusual during periods of expansion. With interest rates extremely low and revenues growing, debt isn't a current problem. But, it does raise a sense of unease for the future. What happens if the economy doesn't continue to grow, or interest rates aren't this low? Why does it take so much deficit spending to support GDP growth of only 2%?

And, if that isn't extreme enough for you, a recent study by the Index Industry Association found that there are 3.14 million stock market indices in the world as of 2018. This despite the fact that there were only 43,192 publicly traded stocks in existence. This means that there are approximately 70 times the number of indices than stocks. The most recent numbers for the U.S. show over 5,000 indices for around 4,000 stocks. As one observer, Chad Brand of Peridot Capital, has offered, imagine a professional sports league with more teams than actual players. It seems quite odd. What we have seen is more and more of investors' money flowing into index funds – and away from selecting individual stocks to buy. One result of this is that the largest companies attract the largest share of investments. Currently, the five largest companies comprise over 17% of the S&P 500's market value. Given that these five firms are all technology behemoths, it would suggest the investment world may be driving a little too much on autopilot.



We raise these issues partly to provide transparency into risks that we are following, but also to illustrate where we are seeing potential. Our focus has always been to avoid risk and focus on innovative opportunities that can generate sustainable earnings growth. In a world where we must cut carbon emissions, fossil fuels will continue to be losers and renewable energy and electric autos will, over time, thrive. As the risks of excessive debt grow, companies with clean balance sheets will have more sustainable growth opportunities. And, as the world concentrates on a smaller number of large companies through indices, we will continue to seek value in overlooked parts of the economy. This philosophy has served you well throughout the past decade and hopefully will continue to bring good cheer over the coming years.

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