The Long Run

INVESTMENT LETTER
OCTOBER 2023

REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

"Because these things will change.
Can you feel it now?"
—Taylor Swift

IS GOOD NEWS ACTUALLY GOOD NEWS AGAIN?

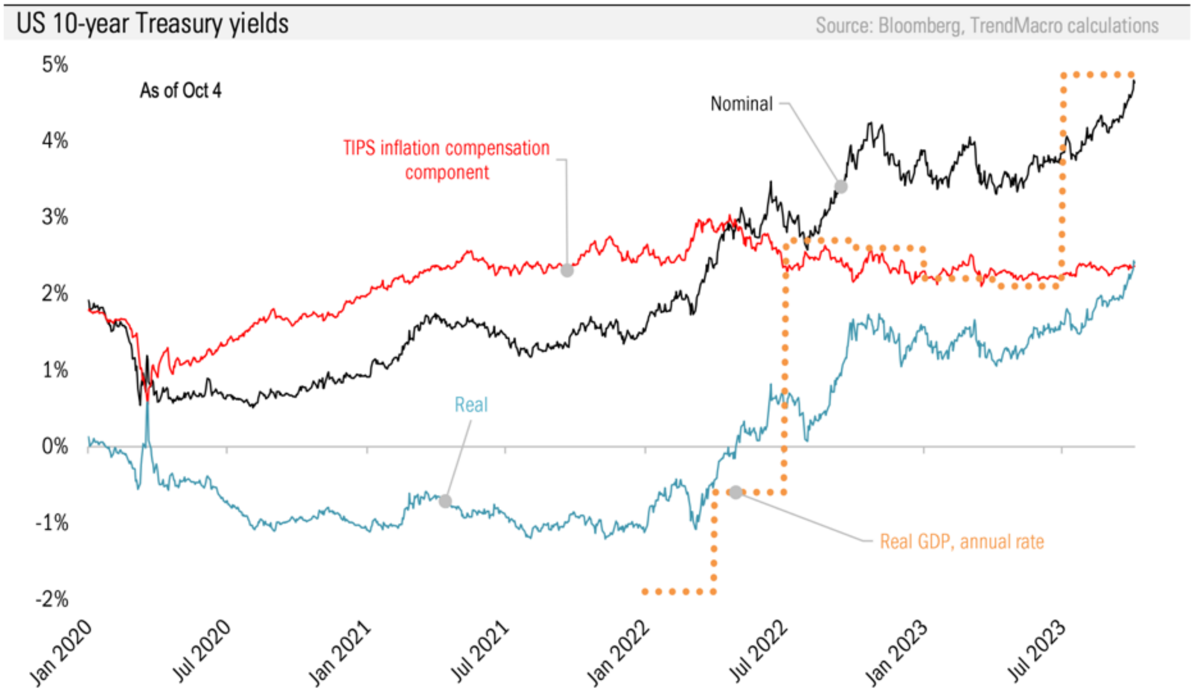
Over nearly 15 years, investors have grown accustomed to a "new normal" of zero interest rate policies. These policies, when first initiated in response to the Global Financial Crisis, were an emergency remedy for economic collapse. Aging populations, subpar productivity growth, and chronically weak demand in the United States, Europe, and Japan muted GDP growth, and kept rates stuck at ultralow levels for most of the decade following the crisis. When the Fed returned its benchmark borrowing rate to near zero and resumed large-scale buying of corporate and government securities in 2020—in response to a once-in-a-century global health scare—economists predicted that it would be at least another decade before interest rates could return to levels seen in the 1990s and early 2000s.

Of course, a prolonged period of low interest rates is not normal. Keeping rates near zero hurts savers and encourages excessive risk taking. An extended period of low interest rates can damage the profitability of banks and life insurers, and force pension plans to take larger risks. Over time, the expansion of (effectively) free leverage in the system leads to significant distortions in financial markets. How many companies pushed to optimize operations for a low-interest-rate environment by using bank loans for core operating functions like payroll? How many pensions levered their portfolios to meet long-term targets that had formerly seemed out of reach? How much risk did banks take to find higher yielding loans? It looks as though we are about to find out.

TRACKING THE YIELD CURVE

Observers have been concerned for some time that the Federal Reserve's startlingly rapid increase in its short-term lending rates—from near zero to over 5%—could throw the economy into recession. Many point to the negative yield curve, a result of short-term borrowing rates being higher than longer term borrowing rates, as a clear signal of impending recession. Historically, the Fed "gives up" after higher rates begin to slow economic activity in earnest—reversing direction and reducing short-term rates to take pressure off the flagging economy and flattening the yield curve again. This happened as recently as 2019 when the Fed started to cut its lending rates in the face of economic concerns stemming from our trade conflicts with China. This time, however, the Federal Reserve has been able to hold its ground because the economy does not seem to be slowing down—even as inflation measures begin to calm. To the surprise of many, the yield curve has been flattening not because the Federal Reserve is planning to step back, but rather because longer term yields are rising on the back of surging GDP growth and a strong job market.

As the Trend Macro chart shows, longer rates (as measured by 10-year Treasuries) have risen dramatically in response to continued surprising growth in GDP. Real yields (nominal yield minus inflation) have jumped into the positive in almost perfect correlation with the ten-year Treasury. Surprisingly, inflation expectations (as measured by the Treasury's Inflation Protected Securities Index)

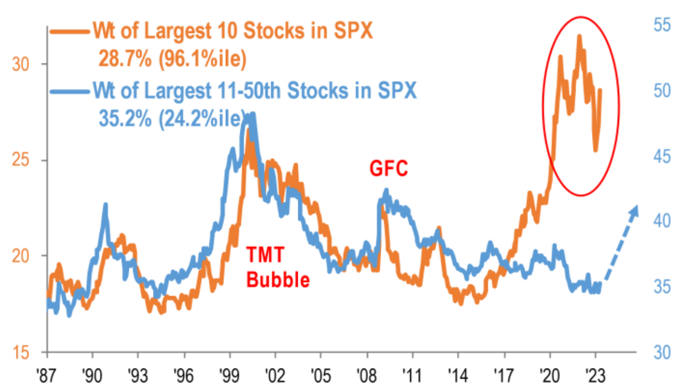


peaked in early 2022. This suggests that the bond market believes that economic growth is strong enough to hold up to the squeeze of higher interest rates in longer maturities. This can impact huge swaths of the economy, from mortgages to insurance premiums to the discount cash flow models that inform Wall Street earnings estimates. If—through a combination of continued economic resilience, job growth, and/or mounting government bond issuance requirements—longer term interest rates normalize at these higher levels, it could signal a return to pre-crisis norms when the bond market demanded a reasonable cost of capital to support a more serious pricing of risk—and of leverage. Taylor Swift might wonder if a new era has just emerged.

A return to this more Darwinian "old normal" would spell trouble for investors who do not recognize how powerful an impact a lasting increase in long-term interest rates can have. Take the example of an investor who might have fairly bet on the potential for recession by purchasing a 30-year Treasury note two years ago. That investment is now more than 40% underwater. We are already seeing a raft of projects that require longer-term development financing being canceled, for example, because the new, suddenly higher interest rate inputs drain the profitability out of models that made good business sense just eighteen months ago. Commercial real estate holders who need to refinance their debt are handing their building keys to their lenders rather than locking in losses with new, more expensive financing. It is becoming clear that many who are out of position today have accepted that rates will be higher for longer across the yield curve. And we suspect that there will be more breakage ahead for businesses that are too reliant on debt to support their operational performance.

POST-PANDEMIC INVESTOR PSYCHOLOGY

Over the last four years, markets have been subjected to a global pandemic, a resulting global recession, an extraordinary fiscal response with trillions of dollars sent directly into the hands of consumers—which drove excessive speculative fervor and ignited inflation—and, most recently, a global tightening cycle that saw an extremely rapid rise in interest rates to temper growth and slow inflation. This whipsawing based on external forces and policy has left many investors exhausted. The result is a generation of investors—many of them new to the markets as of 2020—who believe more in the power and direction of current momentum than they do in investment fundamentals.



We are living through an historic period of investor concentration in the largest capitalized stocks in the world. As of this writing, the "Magnificent Seven" (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla) represent just under 30% of the total capitalization of the S&P 500—and are responsible for nearly all the gain in the index this year. The promise of AI has reinforced this trade recently, but the trend started nearly a decade ago. As was the case in the late 1990s, investors are paying higher and higher prices to participate in the momentum and can only keep up with index performance if they match the expanding index weightings in these largest stocks. As the chart from the Financial Times illustrates, we were at the 96th percentile for the weight of the top ten stocks in the S&P 500's history in the beginning of 2023—and we haven't seen as large a gap between the weightings of the top ten holdings and the weighting of the next forty largest holdings in the S&P 500 in at least fifty years.

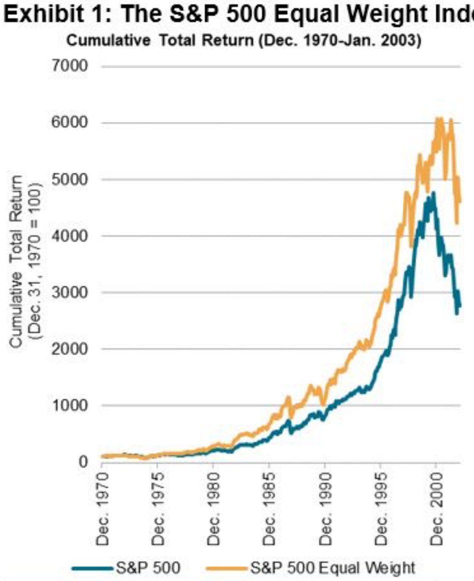
Don't get us wrong. We invest in some Magnificent Seven names and believe that select, large-platform technology stocks offer continued promise as leaders of innovation, but we would not be overweighting these opportunities at this time. A look at the numbers suggests that—even for the best companies—the math gets harder as capitalization increases. Companies have difficulty maintaining high growth rates off increasingly larger bases. Analysis from asset management firm Dimensional shows that, between 1927 and 2021, the average annualized outperformance of a company before becoming a top 10 market cap stock was 11.3% in the decade before, 20% in the five years before, and 26.3% in the three years before. Contrast that with the relative performance against the index in the three, five and 10 years after becoming a top 10 stock: up 0.7%, down 0.6%, and down 1.5%, respectively.

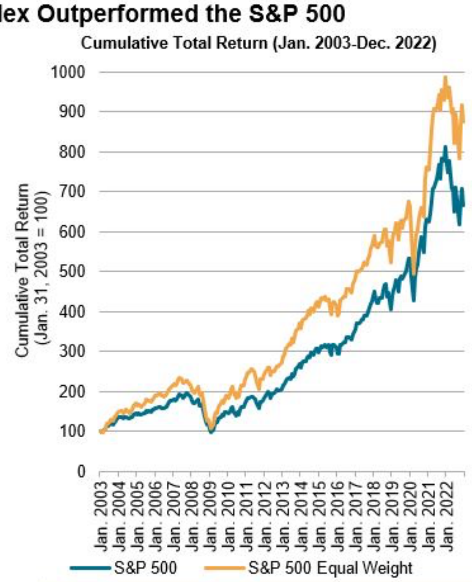
AWAY FROM THE MADDING CROWD

Clients are often surprised to learn that the equal-weight S&P 500 index outperforms the cap-weighted S&P 500 index over longer market cycles. It seems almost impossible considering the market we are experiencing today, but the Dow Jones charts show that, from 2003 through 2022, the equal-weight S&P 500 index returned 11.5% annually while the cap-weighted S&P 500 delivered 9.99%. From the end of 1970 to the beginning of 2003, the equal-weight S&P 500 index returned 12.69% annually, while the cap-weighted S&P 500 delivered 10.92%.

Many extraordinary long-term growth opportunities exist outside the most popular, best-known companies in the S&P 500. As price-to-earnings (P/E) ratios have been rising for the largest stocks, they have been falling for other companies—many of whom are finding their own traction for growth in this uneven economic environment. Lipper Alpha Insights estimates that the forward four-quarter P/E ratio for the Magnificent Seven is 28.6x compared to an S&P 500 index forward P/E of 18.2x. (When excluding the Magnificent Seven from the S&P 500, the forward P/E declines from 18.2x to 15.9x.) Yardeni research estimates that the forward P/E of the S&P 400 Mid-Cap index is only 12.9x and that the forward P/E on the S&P 600 Small-Cap index is below that at 12.1x.

Exhibit 1: The S&P 500 Equal Weight Index Outperformed the S&P 500





December 1970-January 2003	Return (Annualized, %)
S&P 500 Equal Weight Index	12.69
S&P 500	10.92
Difference	1.77

January 2003-December 2022	Return (Annualized, %)
S&P 500 Equal Weight Index	11.50
S&P 500	9.99
Difference	1.51

Source: S&P Dow Jones Indices LLC. Charts show cumulative total returns for the S&P 500 Equal Weight Index and the S&P 500, based on monthly total returns in USD between December 1970 and December 2022. Figures in tables are annualized. The S&P 500 Equal Weight Index was launched Jan. 8, 2003. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of future results. Charts and tables are provided for illustrative purposes and reflect hypothetical historical performance. Please see the Performance Disclosure linked at the end of this post for more information regarding the inherent limitations associated with back-tested performance.

OUR APPROACH

Throughout our long history, we have relied on our careful research to find the companies that have the business models, the leadership, and the vision to sustain and grow their earnings through even the darkest economic storms. In the long run, fundamentals matter. This is a time to recognize that diversification, valuation, and a focus on underlying quality are all critical elements in any portfolio that seeks to deliver sustainable growth over full market cycles. While some companies are just beginning to find their way toward a post pandemic recovery, and others face new challenges as the cost of capital rises, we are unearthing many companies trading at reasonable prices that have delivered strong operating performance on the ground in recent years—increasing revenues, lifting profits, and improving margins. We will continue to plant seeds in this fertile investment ground—away from the herd—where we believe the best opportunities for future returns will take root.

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