The Long Run

INVESTMENT LETTER
APRIL 2024

REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

"You can't always get what you want
But if you try sometimes you'll find
You get what you need"
—The Rolling Stones

In life, 90% of disappointment lies in unmet expectations. In mid-2023, fears that high interest rates were leading the U.S. economy into imminent recession created a significant selloff in U.S. equity markets. This, in turn, initiated a drumbeat of calls for the Federal Reserve to rapidly cut rates. Attracted by 5% yields on risk-free cash holdings, many concerned investors escaped equities altogether in the 2023 selloff — only to see stronger-than-expected U.S. economic performance and tame inflation news drive a 25% advance in the S&P 500 in just six months.

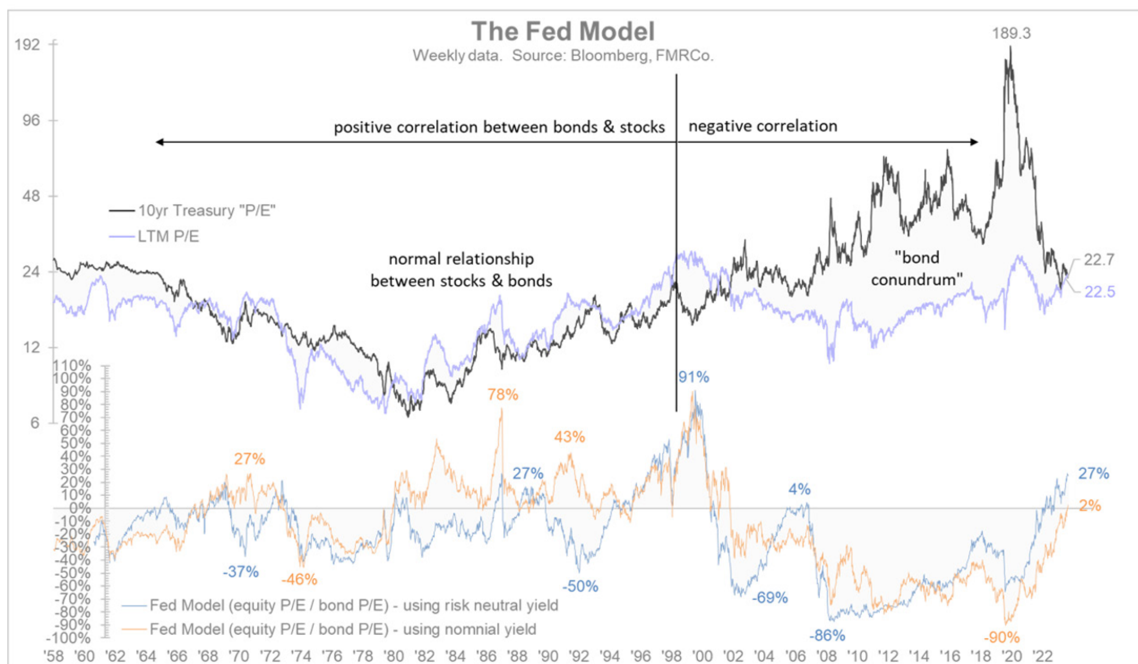
As we entered 2024, the script flipped. Equity investors, excited by a powerful bounce from 2023 lows, desired a soft landing and "immaculate" disinflation. Interest rates in the system were high enough to mute economic growth, slow the labor market, and choke off inflation without causing a recession. The expectation was that rates would fall off predictably as the economy slowed and inflation waned. The hope was that equities would then be able to continue their upward rally as we returned to the slow-growth/low-rate environment that dominated markets in the 2000s. Instead, investors have been surprised by strong economic growth in the U.S. that has kept rates and prices higher than most expected. An expanding job market suggests this current growth in economic activity is both broad-based and sustainable.

We believe that interest rates are higher now for the right reasons — and that the U.S. economy could very likely handle higher rates for longer without falling into recession. The gross domestic product ("GDP") strength that we are currently experiencing here in the U.S. and in many other countries around the world may be signaling that we have moved beyond some of the need for extreme central banking interventions. In fact, we may be moving toward more independent market function and self-regulation. Central banks have spent so many years helping to dig weakened economies out of crises by easing financial conditions that we have forgotten what it looks like when economic strength drives policy.

Through many chapters of our history, companies have experienced substantial profit growth, reinvested in their businesses, expanded operations, and created job opportunities beyond our expectations. These periods of economic expansion have resulted in increased consumer spending, higher demand for goods and services, and overall economic stability. To prevent overheating and inflationary pressures in these periods, it makes sense that central banks and bond market investors would opt to maintain higher interest rates. This, in turn, helps to moderate the pace of economic growth and ensure its sustainability.

Investors will need to come to grips with the idea that we may be heading into a new economic regime. From 2001 to 2020, a period that starts just after the internet bubble crash and winds through the global financial crisis and its aftermath, inflation averaged 2.05% annually. During that same period, GDP in the United States grew at only a 1.74% average annual rate, and the yield on the U.S. 10-year Treasury dropped to its lowest level in nearly 70 years. A better corollary to today's post-pandemic economy might be found in the 18 years following the 1982 recession. As you may remember, this was created by Paul Volcker's Federal Reserve after it raised interest rates to record highs to stamp out the inflation that dominated the economy in the 1970s. From 1983 through the popping of the tech bubble in 2000, inflation averaged 3.28% and GDP in the United States grew at a 3.73% clip. The lowest level the 10-year yield reached in that much faster-growing 18-year period was 4.44% — just a fraction below where the 10-year yield is today.

Jurrien Timmer, Director of Global Macro at Fidelity, points out that bonds have also returned to a more natural equilibrium with equities — a balance that endured for decades before the emergency policies of the last 20 years warped the relationship. Here is how he introduces his chart: “We can see below that the ‘Fed Model’ (which compares the equity P/E to the bond ‘P/E’) is back in balance, much like it was prior to the 2000s when bonds became negatively correlated to equities. Note how tightly aligned the valuation of equities and bonds were for decades, until the 2000s. That may well be where we are headed again.”



Data source: FMRCo, Bloomberg, Haver Analytics, FactSet. Data as of 04/07/2024. Past performance is no guarantee of future results. Model forecasts are for illustrative and educational purposes only and should not be construed as prediction or projection of future value or a recommendation.

If the bond market can once again act as a powerful regulating force for the economy (and, by extension, the equity markets) on its own — effectively breaking from the policies of the last 20 years, we will regain an important stabilizing market element as the economy gets back into gear. While geopolitical and other risks will always cloud the horizon, we see an era of innovative growth emerging on the rails of artificial intelligence, the global energy transition, medical discovery, and automation, among other expanding opportunities. (Please take the time to read our recent research paper on electrification if you haven’t had the chance.) As the economy reaccelerates to meet these generational opportunities, we may have gotten what we needed in a bond market that will help keep growth on a sustainable path. RM

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