

THE LONG RUN

Reynders, McVeigh Capital Management, April 2017

“We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten.” Bill Gates

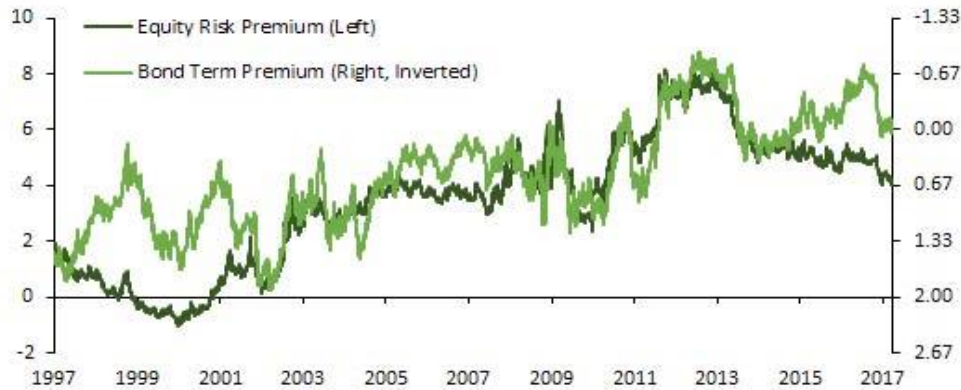
In his campaign and in the early months of his presidency, Donald Trump laid out a series of promises that excited markets, citizens, and businesses alike with the prospect of a return to meaningful GDP growth in America. Lower taxes, less regulation, infrastructure spending, and other pro-growth policies would clear the way for a return of GDP growth of 4% or better. After his election, consumer confidence broke out to new highs that the country had not seen for twenty years. The NFIB Small Business Optimism Index, after hovering in the nineties for more than a decade, spiked from 95 to 104 -- near the top of its historic range. And the apparent awakening of these Keynesian “animal spirits” drove U.S. equity markets -- already fueled by extraordinary stimulus in the form of low interest rates and energy prices -- to new highs.

As we enter the second quarter of the Trump presidency, however, the gap between promise and reality seems to be widening. Consumer confidence may be at extraordinary highs, but it is not translating into economic activity. Consumer spending, which accounts for nearly 70% of U.S. economic activity, edged up just 0.1% in March. Small businesses are key drivers of employment growth, and yet -- despite the brimming confidence in the surveys -- nonfarm payrolls grew by just 98,000 in March -- not the 180,000 in job growth expected by economists. Previous reports of payroll growth in January and February were revised downward. And GDP growth in the United States remains mired below 2%.

The notion that the White House, backed by Republican majorities in the House and the Senate, would have a clear path to enacting their prescribed policies has also come into question. The failure to repeal or replace the Affordable Care Act -- a shared goal for most Republicans -- was a stark reminder of the dysfunction in Washington, but it also shined a bright light on the broad divides that plague the lawmakers who are supposed to deliver on the President’s pro-growth policies. Suddenly, tax reform doesn’t seem to be as straightforward a prospect as it was in the campaign speeches with budget hawks now looming over the process. And it doesn’t seem to be coming as quickly as people might expect. Initially promising tax reform by August, the Trump administration is now reworking their tax reform plan, and Senate Majority Leader Mitch McConnell has said openly that tax reform will likely take longer than August. If tax reform is subject to such compromise and delay, it is hard to imagine how the White House and Congress will find their way to funding the “huge” infrastructure projects that are on the President’s agenda. Forays in Syria and North Korea have only added to the distraction.

Reviewing this backdrop, we have some concerns that the U.S. equity indices have priced in significant economic growth that might not be immediately on the horizon. Recent history suggests that we should be careful about our expectations. In late 2014, the Federal reserve -- buoyed by two quarters of powerful GDP growth and strong surveys -- initiated conversations about raising rates. Interest rates bounced up, and U.S. markets soared as economists projected that the economy was finally reaching “escape velocity.” Alas, the underlying business and consumer confidence that should have led to investment and spending in the real economy was less deep than the confidence presented in the surveys. The tightening created by the lift in interest rates and by a rebound in energy prices in early 2015 was enough to squelch GDP growth. The slowdown surprised equity markets and led to two significant market corrections in the fall of 2015 and in January of 2016. While we would like to see the encouraging “soft” data points translate into real economic growth this time around, we haven’t seen clear evidence that this is happening yet.

Marketplaces can function like barometers. They process a great deal of information, and they price in opportunities and risks. While they can't predict the future, they are excellent distillers of economic expectations. Usually, we see consistency across many different marketplaces, but occasionally different markets will present markedly different expectations. These are circumstances that investors should take note of -- and we are in such a period right now. The chart below shows that the equity markets and the bond markets are pricing in very different expectations for economic growth. Equity investors are taking more risk and expecting more economic growth, and bond holders are taking less risk and expecting less economic growth.



Source: Cornerstone Macro

When market expectations diverge, it has historically been the bond market that prevails. The last time we saw such divergence between the expectations of the equity market and the bond market was in the late 1990s during the technology bubble. To keep up with the momentum of the indices then, investors were forced to invest in the large technology companies at astronomical price-to-earnings ratios. Momentum continued for two years in these high-priced technology stocks until the bottom dropped out in 2000. We are seeing similar signs of poor leadership in the equity markets now. In 2015, the top ten contributors to the performance of the S&P 500 had an average price-to-earnings ratio of more than 40. In 2016, investors chased into financial stocks and into energy stocks expecting immediate gratification from the Trump administration's pro-growth policies – only to see these two sectors fall back as two of the worst performers thus far in 2017. Even with the inclusion of many bank stocks trading at price-to-earnings ratios of between 15 to 20 (which is not particularly inexpensive for bank shares), the average price-to-earnings ratio for the top 20 contributors to performance in the S&P 500 was a startling 35 by the end of 2016. Just as was the case in the late 1990s, index investors today are chasing momentum, and, interestingly, margin borrowing has expanded to record levels.

In the late 1990s, there were highly productive places to make investments at reasonable valuations outside of the technology stocks that dominated the indices. The same is true today. Pockets of reasonable valuations exist in many areas of the market that we believe offer potential for attractive and sustainable investment growth over the long term. We have been looking more at discounted stocks in Europe. We contend that the combination of demographic forces and innovation make investments in health care attractive at current prices. We continue to believe that investments in efficient processes and productivity offer promise. We are confident that the expansion of the middle class in developing economies represents a significant investment opportunity over the next decade. And we remain firm in our convictions that the best investment prospects are most often found where the herd is not looking and that the best investments are rooted in fundamentally sound, long-term analysis – and not driven by short-term noise.

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