THE LONG RUN

Reynders, McVeigh Capital Management, April 2016

Change is the law of life. And those who look only to the past or present are certain to miss the future.
- John F. Kennedy

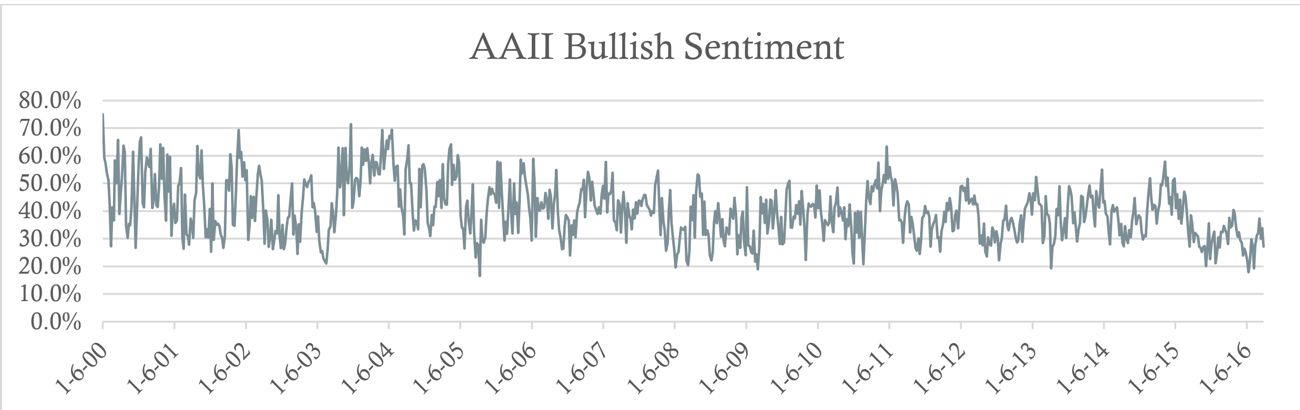
My mother taught me that a good farmer doesn't plow a field looking backward. The temptation is to look back to be sure that your plow line is straight which only assures that you will take your eyes off of your critical navigation targets ahead and drift off course. This seems to be exactly what the investing herd has been doing for the last seven years – to great disadvantage.

We point first to the great twin investment theses that grew out of the wreckage of the tech crash in 2001: The emergence of China as an economic powerhouse and the related commodity super cycle. For more than a decade, these macro investment plays have dominated institutional investment architectures. Fifteen years ago, the highly progressive endowments at Harvard and Yale had less than five percent of their assets committed to emerging market equities. By 2009, that allocation had more than doubled. Commodities, once a sleepy back-haven investment providing stability against volatility and perceived protection against inflation, became the darlings of the investment world – drawing enormous money flows into a constantly expanding mix of new ETFs, funds, and futures strategies. Much of this excitement was built on the notion that industrial opportunities could support double-digit GDP growth in China as far as the eye could see and that China's extraordinary demand for industrial commodities would keep pricing high for decades to come. This led to familiar arguments (like "peak oil") that suggested that global supply-and-demand structures had shifted permanently.

After the great recession of 2008-9, many investors reached back to the familiar stories of growth in China and found comfort in the well-trodden arguments that commodity prices had to rise in the face of ever-expanding global demand. Indeed, stimulus measures in China excited a 50% gain in the Shanghai composite in 2009, and WTI oil prices rose by more than 55% from the lows in early 2009 to highs in the spring of 2010. Little did these investors know that they were providing the final inflation that would ultimately burst two investment bubbles. As we have noted in these pages, the China growth story was built on an ever-increasing spending program that was eating up a higher and higher percentage of the country's GDP. At some point, as happened to Thailand, Malaysia, and Indonesia in 1997, the infrastructure investments in China would become inefficient -- no longer driving additional growth, and China would be forced into a long and painful rebalancing of its economy. Over the last four years, we have seen severe financial retrenching in China, related emerging markets, and in industrial commodities. For much of the last decade, the value of the U.S. dollar has been compressed like a coiled spring under the weight of high commodity prices. The extraordinarily sharp 25% rise in the value of the dollar against a global basket of currencies in a nine-month period beginning in the summer of 2014 was, to us, a clear sign of capitulation on the China industrial dream and resulting commodity super cycle. And we expect that it will take many years for the enormous amounts of capital invested in these trades to bleed out.

The (much overdue) correction in U.S. markets that started in late summer of 2015 has certainly been a follow-through impact of these popping bubbles. Concern over China's ability to contribute meaningfully to global GDP growth, combined with fear that the unexpected lows in oil prices were signaling deeper problems below the surface of the world economy, led to a global growth scare. Investors questioned whether the developed markets were healthy enough to drive growth in the face of a weak China. When the U.S. dollar spike then forced major multinationals to report weaker profits in the end of 2015 due to foreign currency adjustments, fear turned into panic. This brings us to our second example of how investors have been looking backward only to lose their bearing: We are living in a post-apocalyptic market mindset. Haunted by 2008-9, investors mistake natural market volatility for a likelihood of permanent capital loss, and they continue to have an "all in" or "all out" mentality when it comes to equity investments – losing sight of the importance of balance and the value of maintaining and rebalancing around long-term asset allocations.

The chart below plotting the American Association of Individual Investors (AAII) Survey of bullish sentiment shows that bullishness in January reached its lowest point in more than a decade – lower than any level reached in the depths of 2008-9. With the exception of a single weekly reading in 2005, you would have to go back to 1992 to find another reading in the AAII Survey with as low a percentage of individual investors believing that equities could rise. The January 15th AAII bullish sentiment reading was, in fact, two standard deviations below the historic mean. Investor sentiment, as many of our readers know, is a contrarian indicator. The AAII looked at its survey history from mid-1987 to mid-2013 and found only 16 instances when bullishness had been 2 standard deviations below the mean. The average S&P 500 return for the six months following each of these observations was 14%. The average return for the 12 months following each of these observations was 20.7 percent.



Finally, 2015 was a notable year in the market for the narrowness of its leadership. Peter Atwater of Financial Insyghts pointed out that in 2015 the top 10 stocks in the S&P 500 were up 13.9 percent on average while the other 490 were down 5.8 percent — the largest spread since the late 1990s when investors could only keep up with index returns by piling into technology stocks trading at extraordinarily high valuations. In 2015, Investors once again looked back to find their course by investing in stocks with uninterrupted upward momentum – no matter what price they had to pay. To give you an idea of just how expensive a proposition this was: The top 10 contributors to return in the S&P 500 in 2015 had an average trailing price-to-earnings (p/e) ratio of 132 while the S&P 500 as a whole had a trailing p/e of 18. Even stripping out Amazon – the top contributor to S&P 500 return in 2015 and most expensive stock in the mix, the trailing average p/e ratio for the remaining top contributors was still a lofty 38 times. Thus far, 2016 has not been kind to the higher p/e stocks that led the way last year, and we suspect that there will be continued corrective action in store for many of these expensive high-flyers – even as the many stocks that already endured corrections in 2015 now recover.

Throughout these many years of upward market trajectory without correction, we have taken in gains and maintained our balance. While many others sold when fear morphed into panic in 2016, we used some of our dry powder (in the form of ready cash) to invest in select companies that we have wanted to own for some time as they finally came on sale. We look ahead now at the field before us with recognition that – even in this slow-growth world, and even with the sometimes disconcerting volatility that is a natural component of equity markets – there is fertile soil to till, and there are many opportunities to invest for sustainable, compounding returns at reasonable prices.

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