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INVESTMENT ADVISORS

Perspectives

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In and about the pond

Ponds are lovely.

This is especially true this time of year, when a refreshing outdoor plunge restores both energy and perspective. Ponds are also a rich source of metaphor, a notion which we will put to the test (together with your patience perhaps) in this summer edition of our quarterly investment newsletter. Brace yourself as we survey the political scene, overseas opportunities, the economy, the stock market, and end with a brief homily - all within an overall aquatic motif.

Swamp life: Recess time in Washington.
There is an old saying in Washington DC that if you want a friend, get yourself a dog. So far as we know, President Trump does not yet have a dog. It perhaps follows, then, that friends seem to be in short supply. President Trump ran on a platform of "draining the (political) swamp" inside the beltway – a laudable objective in the minds of virtually everyone with the exception of swamp denizens themselves. To date however, the swamp seems to be winning.

Of the President's long list of economic policy initiatives – healthcare reform, tax reform, regulatory rollbacks, and trade negotiations – there is no legislative progress, as of yet, and comparatively little regulatory reforms have been made. And the prospect of tax reform, a stock market favorite, seems to be receding into next year. Cynics of the Washington policy dynamic, which may include much of the citizenry, may shrug their shoulders or even laud the lack of progress. Yet reform on some of these issues is important if the economy is to pick up to a targeted 3% pace from the relatively lackluster 2% growth rate of recent years.

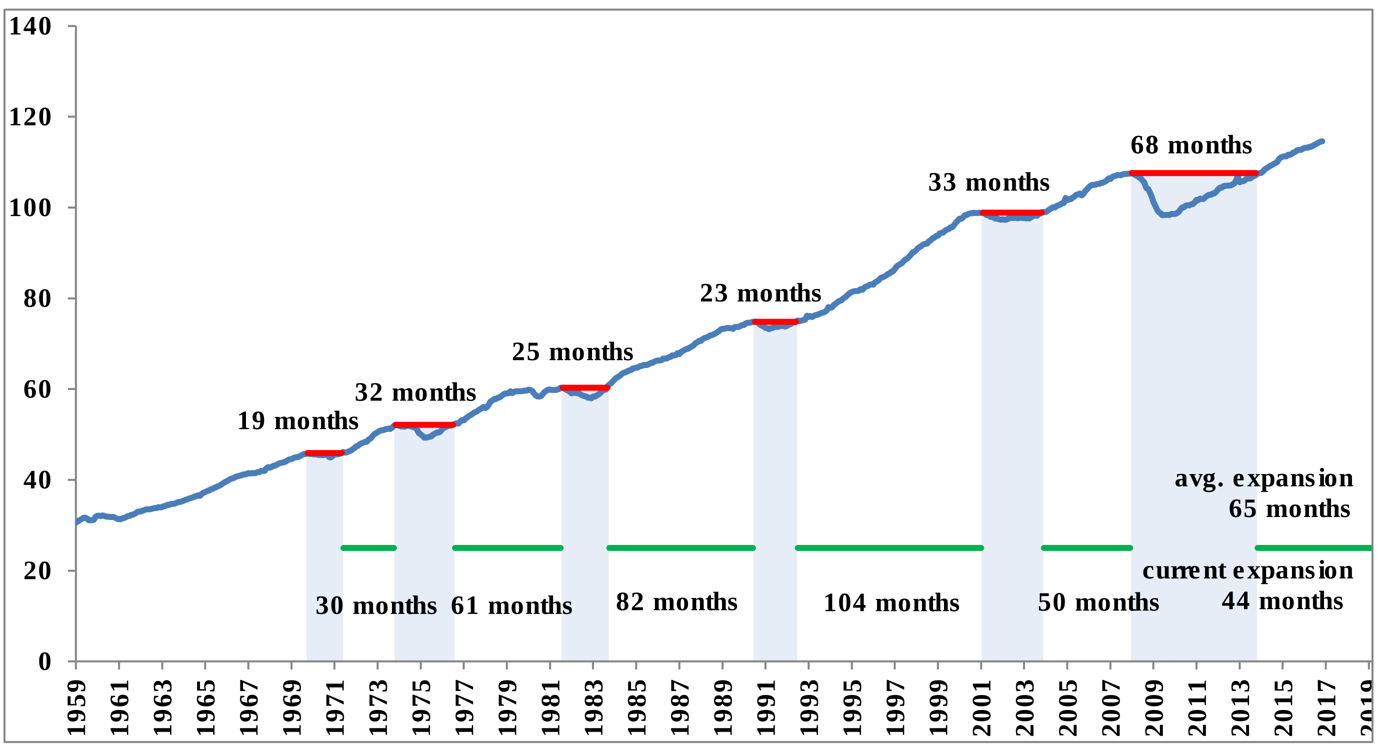
The other side of the pond: Europe making a splash.
Notwithstanding political turmoil, Europe is finally growing at a somewhat faster pace than before, a cheery prospect for Europeans and their stock markets alike. European stocks have been huge laggards relative to the US market, and still represent a source of opportunity in our opinion, to find high quality companies – many with significant US operations – that are cheaper than their domestic counterparts. Somewhat ironically, a diffident attitude toward the US is prompting closer European integration on political, defense and even social issues. This may inure to the benefit of certain economic sectors. We have purchased several European stocks recently, and will spend more time in the coming months looking for values across the pond.

Big fish in the pond: US economy still a standout.
At a circa 2% growth rate, the US still enjoys higher economic growth than Europe. While 2% may seem disappointing relative to the economic growth of the 1990s, it has its virtues. These include low inflation, little pressure on long-term interest rates, and perhaps most importantly, the prospect of a record period of economic expansion.

The graph below suggests the potential durability of the current expansion. The blue line shows the progress of a government measure called *coincident economic indicators* (i.e., payrolls, industrial production), which go up and down directly with the economy. The red lines show the time between the onset of a recession and the time at which the economy gets back to where it was before the recession. The green lines show the expansions that take place after we catch up to where we were.

A shallow recovery yields a prolonged expansion
Coincident economic indicators, 1959-2016

[Red span = contraction + recovery]
[Green span = expansion beyond pre-recession level]



So, it took 68 months to fall into, and then get out of, the 2008 recessionary hole…far longer than any other experience in our lifetimes. The current period of forging ahead, at 44 months, is way short of the 65-month average. If history is any guide, our economy should keep growing through mid-2019. This is especially welcome news for stock market investors, as bear markets (declines of 20% or more) only rarely take place outside of recessions.

Placid waters: The eerie calm of the stock market.
With the prospect of a relatively long runway for growth, and notwithstanding the noise out of Washington DC, the US stock market has been remarkably quiet and has shown strong performance, with the S&P 500 up 9% in 2017 at the time of this writing. Measures of volatility continue to stand at record low levels, and a decided calm has descended on stock markets around the world. We'll take calm, although we profess that it makes us somewhat nervous.

We are unsettled perhaps because, beneath the relatively placid surface, there is significant turmoil. The energy and retail sectors – beset by plunging oil prices and Amazon's worldwide retail takeover respectively – are but two examples of areas where there is significant stock price volatility. As we monitor developments in both sectors, and elsewhere, we look for both an opportunity to buy oversold stocks and to manage the risk of our client portfolios. We firmly believe that our stock valuation work and industry/company expertise puts us in a position to capitalize on price volatility. That is not to say that we welcome it, but we certainly work with it.

In the last few months we have worked to "de-risk" portfolios through a combination of partial 'sell-downs', opportunistic 'trade-downs', and even some 'get out-of-towns'. Let's take them in order:

a) 'sell-downs' – in order to lessen risk, particularly for stocks that have appreciated significantly, we have in recent months halved our positions and reinvested in a stock with similar end market exposure but perhaps less risk owing to both valuation and the particulars of their business model. We have done this now both in semiconductor equipment and in the data center/cybersecurity areas;

b) 'trade-downs' – we never trade-down to an inferior company, but we do trade-down in terms of valuation in an effort to reduce risk. Today's stock market is characterized by a high degree of 'reactivity' – meaning companies that are perceived to have disappointed on short-term results are highly penalized. For companies with good long-term prospects, this affords an opportunity in some cases, and we have been the beneficiary in a number of instances of this in recent months; and

c) 'get out-of-towns' – the US remains the 'best house on the block' in terms of the tradeoff between economic opportunity and risk. But US stock market valuations are relatively rich, and there are some good values to be had looking overseas. This also has the benefit of reducing overall portfolio risk as we spread holdings into other countries. We work hard to understand the risks of foreign companies, just as we do for domestic investments, and we will continue to make changes in the coming months to position portfolios for a balance of both safety and opportunity.

Walden Pond: Time for reflection.
Thoreau's classic is a great summer time read, more likely a re-read for many of you. It is a reminder of the benefits of the contemplative life, of living in the moment, and of tuning out distraction. For better or worse, we have a surfeit of distraction in today's world, and a worrying rift in our country.

But we can all be a part of the solution to this problem – reaching out to others and lending an understanding ear. Like the concentric ripples from a pebble tossed into a pond, our actions can have a broader impact than we might credit them. End of homily.

We hope that you have a restful and enjoyable Independence Day holiday, and are able to spend some time "pond-side" this summer. We look forward to speaking with you soon.

Paul Collins
President

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