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Update on Current Market Conditions

Mark Burkhardt, Portfolio Manager — February 4th, 2014

Over the last two weeks, global financial markets have come under significant selling pressure and I would like to take this opportunity to address any concerns that you may have as well as explain how I intend to navigate the increasingly choppy financial markets in the coming weeks. In order to fully explain the current situation let me review a number of relevant factors. As many of us know, the US Federal Reserve began in September 2012, its third iteration of its policy of “Quantitative Easing”. Since the Federal Reserve has already set short term interest rates at zero, this is a continuation of their efforts to keep long term interest rates artificially low as well. As I had discussed in my last letter, the efforts by the Federal Reserve to force interest rates to artificially low levels is a double edged sword. On one hand you allow borrowers and debtors to make the money they borrow easier to repay. On the other hand, these actions also punished savers as the income on their investments and deposits are reduced to a mere fraction of what they once earned. The other goal of this policy of printing money was to devalue the currency and move the inflation rate back to the Fed’s goal of 2% per year. While inflation of 2% doesn’t sound so bad, that rate over just a ten year timeframe destroys nearly 22% of your dollar’s value. Remember, inflation is a debtor’s best friend but a saver’s worst enemy.

When any country devalues their currency and artificially suppresses interest rates, those actions compel investors to take their money and seek higher rates of return elsewhere. Over the last four years, the biggest beneficiary of those money inflows have been the group of countries called the “Emerging Markets”. These are not the developed nations of Western Europe, Japan or the United States, they are the nations that are undergoing rapid economic growth and industrialization. The best examples would be countries such as China, India, Russia and the regions of Latin America, Eastern Europe and Southeast Asia. While the economies of the developed nations, which were the epicenter of the recent financial crisis, have remained stagnant, it has been the growth in the emerging markets that have kept the global economy on a positive footing. These countries saw massive inflows of capital as investors seeking growth and higher rates of return than they could earn in the developed economies, invested hundreds of billions of dollars. Unfortunately the announced reduction in the printing of money by our central bank could reverse these trends and that fear has triggered the recent selloffs in stocks, bonds and currencies in many of these emerging markets.

From the market's perspective, this is the beginning of the end of the cheap, easy monetary policy that our central bank has embraced since the financial crisis began in 2008. Even though the Fed has promised to keep interest rates low for an extended period of time, they have decided to gradually end their policy of printing $85 billion per month. The best analogy, I can think of, to help visualize this change in sentiment is this. We have all sat on the beach, watching the tide come in. Every wave moving slowly further up the sand, but at some point, and you might not even notice it initially, there comes a wave that doesn't carry as far as the one that preceded it. And then the next wave also now falls short of the last one. The tide has reversed and it is now going out. Subtle at first, it is nevertheless a change in sentiment that is now underway as investors begin to pull assets out of the emerging markets. Where will all that money go? Most of it will come back home to the more developed markets of the West as those economies finally begin to gain momentum and show sustainable growth. Just like the tides of the oceans, that process while gradual, can be very powerful.

Why are these emerging markets important to us as investors? Over the last five years that is where most of the world's economic growth has taken place. Many companies, especially the large global multinationals have focused on growing there because of the weak economic conditions in the world's more mature markets. Any slowdown in these emerging market countries will have an impact on corporate earnings as a number of US based companies, like Johnson & Johnson and Coca-Cola, derive the majority of their revenues from these overseas sales. The recent declines in global stock markets reflect the growing concern that the more mature economies, while growing slowly, may not be able to offset the weakness in these emerging markets. Therefore estimates for 2014 global growth, and by extension, corporate earnings are being called into question as they may end up being overly optimistic.

This is where proactive portfolio management becomes essential in navigating these increasingly volatile financial waters. As I had mentioned last month, I was growing increasingly concerned that the stock market had become too complacent and that patience was therefore warranted. There were, at that time a number of companies and sectors whose shares were trading at valuations that I considered to be too rich and therefore would be vulnerable to any change in market sentiment. While there are some names to be avoided there are also going to be a number of compelling values that we will want to take advantage of. Rising markets often allow weaker companies to blend in and hide in a herd of stronger rivals so it takes a market decline to reveal a company's true value. While market selloffs will always be unnerving for investors, they also present unique opportunities to buy the biggest and best names that rarely ever go on sale. As always, I will continue to focus on the highest quality companies that I feel best represent each sector's most compelling combination of value, income and long term growth.