August 2016

The First Half in Summary

After a volatile first quarter, the S&P 500 Index rose 3.8% during the first half of 2016. Early on, the journey was extremely rocky as stock prices got off to their worst ten-day start since the late 19th century. The S&P fell nearly 8%, spooked by a 23% January decline in Chinese equities and tumbling oil prices, which reached a twelve-year low of $26.21 in February. Crude oil has since stabilized near $50 per barrel, and stocks have risen about 15% since the February lows.

According to *The Wall Street Journal*, this rise leaves the S&P 500 index trading at a price-to-earnings (P/E) ratio of 18.57 times estimated earnings for the next twelve months, compared to a historic multiple of around 15. In other words, investors are paying, on average, $18.57 for $1.00 in expected earnings over the next 12 months. The $1.00 in expected earnings divided by the purchase price of $18.57 is a rough proxy for the market's expected return, or "earnings yield," in this case, 5.39%. This earnings yield compares quite favorably to government bond yields, which currently yield 1.58% for ten years and top out at 2.29% for *thirty years.* Indeed, on a strict yield comparison basis, bond yields will have to rise considerably before bonds become competitive with the expected return from stocks. For many yield starved investors, the choice between 5.39% and 1.58% seems easy, and has contributed significantly to the general rise in the equity markets.

Interest Rates and Valuations Go Hand-in-Hand

We see two problems in this simple analysis. First, the Federal Reserve's "zero interest rate policy" (ZIRP) response to the global financial crisis of 2007-2009 has kept bond yields and savings rates at historic and artificial lows. While the idea was to stimulate economic growth by reducing borrowing costs, a corollary effect was to boost stock prices by making them relatively more attractive, as noted above. Meanwhile, earnings have benefitted as companies have refinanced older, higher cost debt or taken on new debt at low rates for capital expansions or acquisitions. In short, by reducing interest rates to artificially low levels, the Fed has enabled corporations to increase earnings through refinancing (versus growth) as well as stimulated investors to pay higher multiples for those earnings.

Secondly, the Federal Reserve deserves credit for heading off a financial catastrophe with its various interventions, but after nearly seven years of stimulus, the question today is how long can rates remain below historical averages? The financial press is obsessed with every utterance by Federal Reserve officials, and any indication that the Fed may or may not raise interest rates is met with outsized reactions. Meanwhile, post-crisis fiscal policy pursued by Congress and the White House designed to stimulate economic growth seems to have produced little more than a doubling of our national debt, which has risen from almost $9 trillion at the end of 2007 to nearly $20 trillion today. Marked from the end of the Great Recession in 2009, the US economy has grown at a meager 2.1% annual rate, ranking the current expansion as the weakest since 1949 and one of the weakest on record. Further, through June, corporate profits have declined for five straight quarters. In short, full throttle fiscal and monetary policies designed to stimulate growth appear to have produced negligible results. They may have produced a bubble in bond prices, however, which move in the opposite direction of bond yields.

What happens when and if the Fed intervention ceases? While difficult to quantify, if rates head upward, the stock price premium conferred by these artificially lower interest rates may vanish quickly. Over a

year ago, Berkshire Hathaway Chairman Warren Buffett said, "If interest rates normalize, we'll look back and say stocks weren't so cheap."

Interest Rates and the Federal Debt

We admit to being somewhat surprised by the coexistence of massive governmental borrowing, low inflation rates, low economic growth and low interest rates. Theoretically, insatiable governmental borrowing and money printing ought to drive up both inflation and the cost of money, but it has not happened and a different explanation is required. In recent years, some economists have concluded that the heavy weight of massive, unfunded governmental spending subtracts from long-term economic growth, in part because such expenditures lack the discipline of private sector rate-of-return requirements. Moreover, it is argued that governmental expenditures for social services dis-incentivizes saving for retirement and health care. Since capital investment must approximate savings over time, unfunded governmental expenditures result in a misallocation of capital to social services over growth-producing private sector investment. These theorists believe that we may have crossed a federal debt threshold condemning us to low growth and low interest rates for the long-term, arguing that rates will stay "lower for longer." The current rate environment is surreal, unlike any we have ever seen. It is even more peculiar in other parts of the developed world, especially the Eurozone and Japan, where rates are not only low, but have gone *negative*. The German government recently sold ten-year bonds that pay zero interest and mature in 2026 for less than their purchase price. In this world of upside down interest rates, we must be prepared for a range of outcomes if rates ultimately revert to historical patterns.

As of July 31, the average cost of our national debt was 2.26%. If long term interest rates rose to the 5% level that generally prevailed from the pre-crisis period of 2001-2007, federal interest rate payments would eventually more than double to $1 trillion from 2015's $402 billion. This would consume more than a quarter of the federal budget and the incremental $600 billion would have to be funded via additional borrowings or a meat cleaver approach to the budget. The current 30-year US Treasury bond, which yields 2.29%, would decline in price by more than 40% from a little under $100 to around $57.50. The stock market would also decline as higher yielding bonds provided stiffer competition for equities.

Our Perspective

We are not predicting that interest rates are going to rise imminently. Deflationary signals are abundant and rates have trended downward for 35 years, so we are not about to call the bottom. As conservators of your capital we have to think clearly about risks, particularly amid signs of investor complacency after seven and a half years of a bull market partially supported by interest rates that may be artificially low. While the lower-for-longer argument may be a good one, it leaves no room for error. If it is right and rates stay low, nothing much happens. If it is wrong and rates rise to historic norms, the damage could be significant.

Your portfolio is not immune to an interest rate shock. A sudden upward rate shift would cause the market value of your businesses to decline until the market adjusts to the new reality. What is more important, though, is that the majority of your businesses have some inherently defensive attributes. They possess superior economic characteristics and are run by superior capital allocators. A significant amount of the cash flows generated by your portfolio companies is predictable and growing. This should remain the case even in a challenging interest rate or economic environment. Our investments in wireless towers, data centers and fiber optics, as well as energy infrastructure, fit into this category. Meanwhile, our holding in a discount retailer, whose customer is often on a tight budget, flourished during the last downturn and should continue to do so. Moreover, gifted managers and capital allocators often do some of their best work in bad markets and we won't be disappointed by the results of the capital they deploy in the higher return environment implied by lower prices. These businesses are what we call "compounders."

To an extent, higher rates are a double-edged sword. The property and casualty insurers in your portfolio would actually benefit in one aspect: insurers invest premium dollars into large bond portfolios until claims are paid. These portfolios would experience a boost in interest income. Lastly, since higher inflation often accompanies higher interest rates, businesses with significant operating leverage would welcome the opportunity to sell their products at a higher price.

Concluding Remarks

Avenir's mission is to preserve your capital and increase the purchasing power of your capital by achieving a return that exceeds the rate of inflation. Preserving capital requires a clear understanding of risks, both present and latent. While we do not have an opinion on the direction of interest rates, common sense has us paying attention to the potentially serious consequences of an interest rate normalization.

We have witnessed the 1987 Crash, the dot-com bust, 9-11 and the global financial crisis, not to mention a number of lesser, now-forgotten market shocks that briefly captured investor attention. They turned out to be outstanding times to buy shares of great businesses. In time, the stock market, affectionately referred to as "Mr. Market" by Benjamin Graham, will provide us with other terrific opportunities, and one may arise from a sharp change in the interest rate environment. When that will happen is unknown but after a long bull run, partly due to Fed intervention, the time is closer. Our best advice is simple: be ready to put more cash to work when "Mr. Market" presents opportunities. Meanwhile, you should rest easy knowing that you and we own terrific businesses run by outstanding, ethical managers.

Respectfully,

Peter C. Keefe　　　　James H. Rooney

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