The Long & Short of It

Quarterly Newsletter
Third Quarter 2015

Stuck in Low Gear with a Weak Engine

Investors and politicians continue to long for and expect the robust economic growth that we all grew up with. But with an aging population along with a deflationary environment, the great US engine is definitely in need of a 100,000-mile servicing. At Robinson Value Management, we are constantly evaluating how to construct our portfolios in light of this new dynamic. Now, more than ever, risk controls and the art of making money by not losing money are essential.

Finally: A Correction

And there it was. For the first time since 2011, the stock market corrected, dropping 12.5% from top to bottom during the third quarter of 2015. Concerns grew that an increase in Fed Funds would be a policy mistake as weakness in Europe, China, and emerging economies decorated the daily news. For the quarter, domestic large cap stocks dropped about 6% and small cap stocks fell about 10%. The utility sector rose slightly while all other sectors—especially mining and energy—fell. Overseas markets fared even worse as broad international stock indices dropped approximately 10%, with Asian and Latin American indices losing 15-30%.

Harbingers of the current stock market correction began appearing in late 2014 as credit markets showed signs of weakness. High-quality bonds had performed reasonably well but high-yield or “junk” bonds, as measured by the SPDR Barclays High Yield Bond ETF (JNK), declined 6% during the quarter and are now 15% below their June 2014 peak.

At present, the decline in credit appears limited to the mining and energy sectors. However, if this weakness spreads to the broader credit market, the impact on stocks could be significant. Today’s economic fuel of choice is credit. Without a steady supply of credit, the economy and the businesses that comprise it would be severely challenged. The price of a bond is inversely related to the yield (income) it produces. As bond yields rise, bond prices drop and vice versa. If stocks were to see a similar increase in yield, then prices would have to drop another 15-25% from current levels. Needless to say, keeping an eye on credit markets is very important in this low interest rate environment where a slight change has a very large impact.

Life in the Slow Lane

Robert J. Gordon’s *The Demise of U.S. Economic Growth: Restatement, Rebuttal, and Reflections* asserts that the 2% average annual growth rate of real GDP from 1891-2007 will slow to 0.9% in the 25-40 years after 2007. He supports his claim citing four headwinds: 1) demographic shifts (an aging work force and low work force participation), 2) low education attainment, 3) falling real income growth, and 4) a projected long-term increase in the ratio of debt to GDP at all levels of government. Although technological innovation continues to advance, improvements in productivity continue to be more difficult to achieve, so technology will not save us from slow growth.

With slowing growth come lower interest rates. Slower growth hurts stock prices, but lower interest rates help stock prices. So what can we make of equity valuations in this very different world? We looked at valuation in light of an old metric that we do not use, called PEG, which holds that a price-to-earnings ratio that is over the growth rate of earnings means the stock is too expensive. What we found is that the beneficial impact of a decline in one’s assumption about the interest rate is greater than the detrimental impact of an equivalent decline in one’s assumption about the growth rate. So, changes in interest rates have a little more impact than similar changes in growth rates. For the broader market, if interest rates and growth rates generally move together, we see why high P/E ratios persist. With slow growth and low interest rates likely to stay for a while, we will have to get used to seeing high multiples in the market.

But in a low interest rate environment, significantly higher debt balances can be carried at much lower cost than to what most investors are accustomed. In the 1970s, with high interest and growth rates, the challenge of carrying debt was primarily an income statement problem, i.e., being able to cover the interest burden until you could grow out of it. In today's low interest rate environment, it becomes a balance sheet problem. One can cover the cost of insanely high levels of debt, but at those levels and with this slow growth environment, 1) debt covenants may be violated, 2) the debt may never be paid off, and/or 3) any significant slowing in the economy or increase in interest rates could lead to bankruptcy.

Rather than rush like moths to the flame of hot companies with large debt levels and volatile short-term returns, we stick to tried-and-true industry leaders that have clean balance sheets but happen to be temporarily out of favor. Time heals most wounds, especially if you have a clean balance sheet.

The Road Ahead

Looking forward, a significant rise in interest rates appears very unlikely. It will not come unless there is a full-blown currency crisis or a demographic shift toward growth in the labor force. When that changes, rising interest rates will significantly damage equity valuations. Today's zombie companies, the walking dead that survive with too much debt, will finally die off and allow healthier companies to thrive. But that is likely a long way off. Equity valuations will remain elevated for now, barring some exogenous shock.

Despite the economic weakness currently spooking the market, there are reasons for optimism about equities. First, consumers have cleaned up their balance sheets and could drive better economic growth through the end of the current credit cycle. Second, we are moving into a time of year when seasonal influences typically lift equity prices higher. The stock market almost always rises from Thanksgiving to year-end, with ample liquidity available for investment along with waning uncertainty. After all, what politician wants to be labeled a Grinch for proposing something potentially controversial and frightening during the holidays?

But don't break out the champagne just yet. In 2016, we will begin the process of changing administrations after eight years of the same. Whether the policies are better or worse in the long run, the market must first deal with the uncertainty and gnashing of teeth over who, what, how, and when. Have no fear; Robinson Value Management is hard at work finding investments to help our valued clients enjoy good, solid risk-adjusted returns in all market environments. Enjoy your holidays!

Amy Abbey Robinson, CIMA
amy@robinsonvalue.com

Charles W. Robinson III, CFA
charles@robinsonvalue.com

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