Earnings Voids and the Emergence of Plausible Risk August 21, 2015

We had put the finishing touches on a market update celebrating our first ten years in business, but were rudely interrupted by the first violence in the markets we've seen in nearly a year.

Yes, a year.

We don't want to minimize the severity or swiftness with which many stocks have been hit in the last two days, but would remind people that just about a year ago, the markets broke their technical support levels and declined by some ten percent.

What were the causes of last year's decline? Let's review.

About a year ago, the decline in oil prices that we had seen during the second half of the summer became a bit more severe, to the point where investors started to become concerned that the declines in the oil patch would or could be severe enough to derail the U.S. economy as a whole. Such risks and fears had a plausible basis in reality, as a considerable amount of the growth in our domestic economy in recent years had come from the energy and manufacturing renaissance theme prevalent in the economy. Forty-two dollars a barrel seemed to be the point at which falling oil prices no longer were viewed as being good for the economy and consumer, but potentially contagious and bad.

Fast forward to today. A week or so ago, after rebounding to $65 or so in late spring, oil prices plunged all the way back to $42, even flirting with lower prices. We have been espousing the view that there is productivity in the oil patch and that domestic supplies are far more recoverable and sustainable at lower prices than most, even the Saudis, realize. (By the way, if you want to see what we read on a day to day basis, friend us on our Broadleaf Facebook page, Twitter, or LinkedIn so you can follow our recommended daily reading.) While we wouldn't be shocked to see oil revisit an inflation adjusted level of $10 or so seen in the 1990's, at the very best, we do see oil staying lower for longer. But these are the issues that affect price from a *supply* perspective. What about *demand*?

Well, we also have espoused the view that China is a disaster in the making. And in addition to oil prices falling back down to $42 again, this summer has proven to be the Summer of Worries for all things China related. From closing their markets, to questioning Chinese economic data, to allowing their currency to fall, investors have rightly been concerned about what is happening in China. The infatuation with all things China – like tech, housing and private equity asset classes before them – has come home to roost. These concerns have likely weighed on the demand side of the equation for the price of oil in recent weeks, as China has been a massive consumer of most of the incremental commodity demand over the past ten to fifteen years. Similar to oil, while we believe things could get much uglier for China, at the very least, it wouldn't surprise us if at the best, it stayed lower for longer. To us, the Chinese situation appears similar to Japan in the late 80's after its massive and prolonged period of industrialization.

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But again, the point of this discussion is to remind readers that last year's decline in oil and the contagion oriented concerns that suddenly brought the market down with it proved temporary. In spite of last year's decline, the market recovered and the NASDAQ even went on to reclaim its pre tech wreck 5000 level highs, levels that even after fifteen years, we were still surprised to see.

On another market related note, I've got an idea I've started to espouse, which I call the Theory of Plausible Risk. In recent years, as soon as quarterly earnings season winds to a close and the last of individual companies hosts their earnings related conference calls, an information chasm or void is exposed and a lava flow of plausible risks begins to emerge, usually of the macroeconomic variety. Without the constant psychological affirmation of earnings related data, it's as though the entire driver of the markets shifts gears as a meekness in buyers and a boldness in both natural and short sellers appears to emerge.

As an example, let's look at Apple. Apple reported record results just a few weeks ago and they were outstanding, particularly for the largest company in the world. In my earnings related notes, I marveled at the purity of Apple's earnings results (Gaap vs. Non Gaap) and in particular the rate of revenue and earnings growth, which made it look far more like a teenager than the middle aged parent it truly is. But today, a few weeks later, an earnings void has been exposed and with it, the plausible risks of a slowdown in China have emerged, and the weight of selling in Apple's shares has become manifest. No one can argue with the idea that Apple's results in China could come under pressure, but to what extent remains unanswerable. So stocks like Apple decline.

In addition to the emergence of plausible risks associated with earnings voids, the type of risks that seem to emerge most often are of the macro oriented variety which, over the past few years, have been all about the Fed. I maintain an elaborate database of our daily performance since the inception of our firm and every now and then, I'll google the dates associated with recent market highs or lows to see if there were any clues as to their cause. Invariably, the inflection's been related to a Fed announcement, right down to the 2pm hour they're almost always released. It's truly been uncanny, I swear.

The Fed's minutes from last month were released two days ago and in these, investors generally felt the probability of a rate increase next month had declined given uncertainties in China, Greece, and the commodity markets and their potential to influence U.S. inflation. We believe the whole concern over the timing of rate increases is a tad silly and honestly feel the Fed should just start to move. The longer they wait, the more violent their rate path may look in the future. My very own Google searches suggest that the Fed may indeed be a hindrance to growth in the economy at this point in time rather than the savior of it.

Does the fact the Fed's body language seemed more dovish mean that the Fed knows something we don't? Honestly, I don't think the Fed's economists have been any better than most in recent years. We're all human, after all - even economists. But whether the Fed waits another quarter or not, one thing is for sure, zero rates aren't the norm. Eventually, rates will go up even if they too, stay lower for longer.

We've written before that 1994 may be a decent reminder of what could happen when the Fed starts to raise interest rates. At that time, the market was hit around ten percent with many high growth names getting hit even more. I remember, only because it was my first experience

realizing that high growers like Cisco and Parametric could decline by 40-50% even though nothing had apparently changed in the fundamentals. But once the six or seven rate increases were over during those months in 1994, these stocks and those like them went on to create a ton of wealth for investors over the next five years.

But I will also point out one difference between now and 1994. In 1994, Greenspan was raising rates because he feared growth could become inflationary. Today, with the U.S. muddling along a 2% growth path, Europe a complete mish mash, and China even weaker, I just don't think the stage is set for rate hikes to reflect concerns about budding inflationary pressures. The productivity gains associated with the sharing economy have improved asset efficiencies in a whole host of industries and along with the slowdown in emerging market economies and China, it is hard to envision a reflationary scare of any sustained duration. If anything, we believe deflation remains the greater trend based risk.

A slow growth economy marked by stable prices is often among the best environments for the stock market. With the boil coming off the commodity markets and China looking like it could follow Japan's path for quite sometime, lower for longer is a good thing, not a bad thing, for the U.S. consumer.

We do not see a recession on the horizon for the United States but do believe the economic cycle is apt to be more muted, maxing out at 2-3% growth. This means investors will probably be a tad more skittish any time macro oriented risks surface, because it theoretically wouldn't take much of a growth slowdown to cause GDP to go negative for a quarter or two. That may have happened with the oil decline last year and may now likely be occurring with China related concerns today.

The key for me, given where we invest, is earnings and earnings related power. While a few stragglers remain, the average revenue and earnings growth for our portfolio of companies has been stellar and certainly much higher than the 2% GDP type gains we've been experiencing as a nation as a whole. Like 1994, the stock market and growth stocks in particular may experience a reset in valuations – they are after all the longest duration assets - but I also suspect people will keep some powder dry to then invest in what could prove to be the next decade of tomorrow's winners, just as names like Google and Amazon were following the tech wreck.

Remember, just in the past week, housing starts returned to levels over a million, an area they hadn't seen since 2007 even in an environment where credit availability has remained subpar. This implies that those who are buying homes today are in better financial condition than the buyers during the bubble years. Both Home Depot and Lowe's reported results that suggested a slower housing cycle than in prior recoveries, but also a more sustainable one. I suspect earnings related comments from Lennar next month to reflect a similar sentiment.

As a final point and perhaps as evidence of the Theory of Plausible Risk, let's take a look at Salesforce.com's stock today. On a day when the stocks of other similar fast growers are getting blasted, Salesforce.com's stock, at this moment, is up 3%. Why? Because they had the luxury of a later earnings report. They had a news event and so, for this one day, they buck the trend of the rest of the market which is more focused on the macro risks of China and the Fed's next moves.

So yes, it is entirely plausible that the markets could remain under pressure during this most recent earnings void. But at the end of the day, we suspect results next quarter to be fine, particularly for the types of companies we own, whose near and intermediate term destiny is far less tied to the ebbs and flows of the overall economy than the innovation trends which will drive growth in the coming decade. As for the Fed? They should just get started. I don't think there will ever be a day when the world is all rainbows and puppy dogs.

When the dust settles, there are going to be some great buys. Get your powder ready and call if we can help.

Kindest Regards,

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P.S. Happy Birthday to my beautiful wife, Lisa!