Waterboarded, Mr. Market Style

November 19, 2018

The markets this quarter haven't been much fun.

In fact, it's felt a little like a waterboarding – a few brutal down days are followed by a single up day reprieve - which allows for a moment to catch one's breath - before the deluge resumes once again.

Rinse, cycle, repeat.

We have had the urge to write earlier, but we also wanted to get through the bulk of earnings season first. We had also hoped that the passage of the midterm elections might remove some uncertainty.

But alas, it has not.

So now is the time that we put our thoughts to writing and try to make sense of what is never much fun. No matter how good it has been - which it most certainly has been over the past three years – negative markets always seem to feel worse than the good feels when markets are going up. Is this the pause that refreshes, the weeding out of the market's weaker players to create more stable ground for tomorrow's ascent or something more sinister and longer-lasting?

For most of the year, the markets have proven resilient to the known headwinds of rising interest rates, trade wars and tariffs. Corporate tax cuts and solid earnings results seemed to keep these concerns at bay for most of the year, at least until this quarter began. Even though the market clearly disagrees with our assessment, from where we sit, corporate earnings have generally been nothing but positive, with only a small handful of companies acknowledging impacts from rising tariffs and interest rates.

Recent action in the markets, at least at the sector level, is beginning to discount the possibility of a recession on the near-term horizon. Defensive sectors of the market like utilities, health care, and consumer staples stocks have outperformed, suggesting more buyers than sellers, while cyclicals have lagged, as has been the case for much of the year.

In recent days, growth stocks have been hammered particularly hard, an event which becomes more common as recession fears simmer and potentially come to a boil. While we have invested through many recessions, we don't have a successful track record of accurately calling them, nor do we know anyone who has. We do know, however, that the graveyard is full of folks who forecast one too many false alarms.

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In times like these, it is crucial to have a game plan. This means focusing on the time horizon for which one has invested his or her funds. It does not mean NEVER selling, but having a sell discipline that will manage the losses and keep them from doing irreparable harm.

Each quarter I digest earnings results for roughly sixty companies, including those that we own. I also maintain basic three-year, discounted cash flow models for all of these companies. This helps me to understand their relative return potential over our investment time horizon, which is three or more years. Obviously, the output is only as good as the inputs are accurate, but that is what we are paid to do; to have an opinion about what the future might bring, and to invest accordingly.

Three years ago at the end of 2015, growth stocks had enjoyed a strong year, while almost every other area of the market had underperformed. It was the time, I believe, that the acronym "FANG" for FANG stocks was first coined. At that time – the beginning of 2016 - I could envision a scenario where cyclical and value stocks might outperform as prospects for the economy improved, following an energy induced credit scare. However, I did not see that improvement as sustaining itself, and thus I stuck with what I believe could grow regardless of the economy. While we suffered a relative dry spell in 2016 as the cyclical areas did indeed outperform for a time, our longer term thesis was warranted, as our relative and absolute results have proven.

While we are sitting on a bit more cash than is normal, this isn't because we can't find stocks to buy, but because we already own full positions in most of them. There are a small handful of new names on our short list, but I really feel like they'd be temporary placeholders rather than longer term investments that will outperform over the next three or more years. In a choice between owning a defensive that has already run or holding cash, we'd rather just hold the cash and wait and see.

As 2018 draws to a close, the situation seems to rhyme with 2016, at least from where we sit. Rather than the economy accelerating sustainably as was hoped for at that time, the question today may be whether or not the economy will decelerate sustainably and perhaps fall into a recession, as the markets may be discounting.

At this time, I can envision a scenario where defensives outperform for an additional time, but not sustainably so. Like the temporary shift in 2016, I don't feel the need to chase a trade, as I might miss the longer term opportunity. Quite simply, I'm not convinced that the thesis has changed.

But, have no illusions, waterboarding is still violent.

Have a blessed and thankful Thanksgiving!

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