What If? February 8, 2016

After a brief upswing, the markets were caught in a downdraft last week with many of the innovative growth companies we own coming under significantly greater selling pressure. In the past, I've noticed that growth stocks, particularly those that are innovators and less susceptible to economic pressures, tend to do well in all types of economic environments other than recessions. With these stocks now under pressure, it has me wondering if the market is now anticipating an all out economic recession as opposed to a more benign and temporary market correction. While reported earnings have been decent this quarter, expectations of forward growth for some companies have come down, leading to a collapse in the stocks of almost all companies, including those that have not forecast a slowdown in their growth expectations.

This situation has me thinking a great deal lately of the question, What If? What if expectations of no recession are off the mark?

There is plenty of news that suggests the economy is doing okay in spite of the international headwinds, currency weakness in everything other than the dollar, and the implosion in commodities, particularly oil. Domestic employment levels continue to improve, with the official unemployment rate returning to post Great Recession lows. Average hourly earnings have continued to tick up and certain areas associated with the consumer economy continue to perform well, even in areas like China where the industrial economy is exceedingly weak. The unemployment rate, of course, is always near all time lows when recessions hit, leading the skeptic in me to wonder if we've maxed out in terms of an economic rebound.

Curious to know more, I've gone back to look at the most recent two recessions to see where current events might rhyme with the environments just prior to the last two. While the markets have declined nearly double digits this year and the average market corrections in the last twenty or so years has been 15%, the average recession often sees even greater distress, with an average decline of 30% for the S&P 500. In these environments, those of recessions, selling pressure consumes all areas of the economy, not just those where there were specific sources of fundamental distress.

What are the evidence and parallels for recessions? I've tended to find three. First, an analysis of the tech bubble and the housing crash support the idea that weakness in those specific sectors of the economy were evident one to two years ahead of the overall collapse in the economy and the onset of an all out recession. In the tech induced economic recession, dotcom stocks plummeted nearly a year ahead of the general stock market and economy. Tech stocks with real earnings enjoyed a nice one year rebound after the dotcom implosion, only to crash a year later and take the entire economy down with it.

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In the housing and banking recession, housing stocks forecasted relative weakness in a similar fashion, nearly two years ahead of the overall economy and general market indices. I recall that in 2006, our portfolio underperformed the markets significantly because we owned no banking stocks, an area which had enjoyed an unusually stellar year. (In hindsight an unusually stellar year of making exceedingly poor loans.) Housing stocks had peaked and were acting horribly that year or at least were acting with a heightened level of anxiety. As we all know, after a strong yet volatile 2007, the stock markets were decimated in 2008 as the Great Recession took hold of the overall economy. What is the parallel to today? Over the last eighteen months, energy stocks have been hit hard and along with it, the markets of economies largely tied to natural resource production – namely emerging markets.

Second, it appears to be the case that the stock market, as measured by the S&P 500 index, tended to have difficulty reaching new highs twelve to eighteen months ahead of the prior two recessions. In hindsight, the labored behavior of the S&P 500 could be attributed to weakness in the areas of the economy under specific distress. As mentioned in our last update, tech stocks were nearly 34% of the market in the year 2000, so weakness there made it very difficult for the overall index to hit new highs in the absence of other areas picking up the slack. Similarly, while housing stocks were not a very large portion of the index to cause much worry in 2007, when credit related problems at the banks were added to the equation, the environment became destructive enough to give rise to a run on the banks type atmosphere reminiscent of the Great Depression. The Great Recession followed. Today, I have noticed that the S&P 500 has felt tired for most of the last eighteen months, finding it very difficult to achieve new highs. Anxiety from the oil patch, concerns about China and trickle through effects on multinationals have made further progress difficult and labored.

Finally, there appears to be a situation in past recessions that I would call a last hurrah. In the year 2000, profitable tech companies took the performance baton from the dot coms for roughly one year following the latter's implosion. (I remember this clearly, as I was on the cover of Barron's for having the best performing tech fund following the dotcom implosion.) In 2007, there was a similar phenomenon following weakness in housing stocks. At that time, commodity oriented companies and the industrial sectors experienced a surge of their own, a last hurrah on the backs of continued strength in emerging markets. Last year, we experienced what may prove to be another last hurrah, with outperformance largely concentrated in the so called FANG stocks and companies like them which are less sensitive to the vagaries of the overall economy.

This gets us to today. I cannot intellectually deny the idea that the characteristics of the market's performance increasingly rhyme with those of the last two recessions. About eighteen months ago, energy stocks started to come under pressure as oil prices began to collapse and growth in China, though still positive on an official "published" basis, started to decline. In other words, we've experienced a sector specific collapse similar to that which occurred in dotcom and housing stocks in decades past.

This time around, we as well as others have argued that declining energy prices are a good thing since lower energy prices tend to benefit consumers. Such a statement couldn't necessarily or on a direct causal basis be said of the collapse of dot com and telecom companies or the initial slowing in the housing sector. This factor has made others, including ourselves,

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hopeful that the energy specific weakness would be a net benefit to the economy as opposed to the typical sector-induced, recessionary drag.

While valuations weren't a large concern with housing stocks that never sold for much more than 14x earnings, they were a concern for profitable tech stocks as a whole that were selling at an average of 100x earnings. Ultimately, it wasn't the valuations in either situation that catalyzed their ultimate decline, but valuations coupled with changing fundamentals for both sectors. For tech stocks a slowdown in anticipated earnings growth tied to the implosion of the dot com crowd and several greenfield telecom carriers carried them lower. EBay, I recall, was chock full of used networking and computer gear for sale, associated with dot coms gone bust. For housing, it was slowing earnings growth in what proved to ultimately be an immense earnings bubble. The leverage at banks that supported the housing boom proved every bit as devastating to stock prices as absolute valuations in the tech sector contributed to the magnitude of their own decline. While there was no leverage to speak of during the buildup of the tech bubble, there had been a rush of equity investments from VC firms and average Joes. Fund Flows Gone Wild, I like to say.

Today, we're all waiting for an event in the energy industry to show us that while it is an area under structural weakness, it is contained enough not to ruin the overall economy at large. At this point, credit issues in the bond market continue to point to troubles largely contained to that sector, but we have not yet seen any high profile bankruptcies. Last week, however, Conoco Phillips decision to cut its dividend by 70%, something that the company said it would not do as recently as eight weeks ago, may have served as a shot across the bow. When pressed for the reason behind their seemingly quick change in attitude, they pointed to the further slide in energy prices this year. They also now believe, as we have for quite some time that energy prices will be lower for longer and a recovery likely delayed until 2017.

As we mentioned earlier, the S&P 500 has exhibited attributes of being tired for most of the past eighteen months, making little new progress in terms of new highs in spite of strength in a narrower group of growth stocks similar to those that we own. While the declines were broad based last week, they were focused on areas that had done well in the past year, reminding us that they too may represent another last hurrah. While we own the companies that continue to put up solid growth in their underlying fundamentals, history has shown that in the past, the rates of earnings growth in these areas of the economy also slows as the onslaught of all out recession arrives.

To me, the market is sending very strong signals that we are on the precipice of something perhaps much larger in the overall scheme of things than simply just weakness in the commodity space. The markets, of course, could be wrong, as they've often been said to have accurately predicted ten of the last two recessions. But I cannot deny that the rolling nature of the three factors discussed earlier are unique and have me more worried than usual. The question as always is do I pull the trigger and sell in anticipation of something more or hope that this is a passing correction no different than those of the last few years?

It isn't so much the decline in the index that has me worried as much as the underlying characteristics of the indices we are seeing today coupled with a lack of areas that might pick up the slack. The three factors are worrisome as they rhyme with what has happened in the

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past. When people can't sell the areas that are under specific fundamental pressures, they often turn to the areas they can sell – including those areas exhibiting fundamental strength. In spite of continued fundamental growth at Apple during 2008, its shares finally succumbed to overall economic weakness, falling some 54%.

Which gets me to the title of this piece, What If?

What if we are on the precipice of an all out recession? If we are going into a recession, what could it mean for stocks from this point forward? History, as I said earlier, has suggested the stock market declines 30% in an average recession. In the last two, it's been far worse, to the tune of fifty percent from market peak to market trough. Healthier areas of the market in both cases came under significant pressure during the recessions and perhaps even more so as these former strongholds caught up to the areas of the market that had already experienced fundamental weakness. If we are going into a recession, it is reasonable to expect additional downside in the S&P 500 of as much as 20%, with former areas of strength, like Apple in 2008, declining even more than that in spite of their longer term fundamentals. When the economy catches flu and experiences a recession, all areas catch the bug in equal opportunity fashion, not just those that sparked the initial declines. So first, the downside could be severe from here.

Which gets me to my second question. What happens after the decline? How long does it last? What areas of the economy and what stocks tend to bounce back first once the damage is over? This question gets to the essence of a personalized financial plan. If we are on the precipice of something greater, the biggest question to ask yourself is how much of your investment portfolio do you really need over the next five years? Generally speaking, five years is my starting point for dollars allocated to the stock market. You shouldn't need it for five years, because over any given period of time less than five years, cash might be the better bet using history as a guide.

Our analysis of the prior two recessions shows that the initial declines in the troubled areas of the economy – tech stocks and financials/housing stocks – lasts for three years before finding a bottom. We are eighteen months into the decline in energy related stocks, which would imply firm bottom isn't found for another eighteen months. These initial declines in troubled areas of the market – eighteen months or so – were later joined by declines in all areas of the economy during the recessions, sending a tired index to new lows.

But, then, after the bottom is in, we've also seen something interesting. Typcially, those companies that maintained a degree of fundamental strength before and during the downturn, usually emerged first and outperformed in the upturn, typically one year out. I won't highlight every stock in our portfolio, but will stick to Apple for illustrative purposes. In 2008, Apple's stock joined the rest of the economy under recessionary pressures, falling 54% that year. But a year later, Apple's stock was among the first to experience a rebound that also sustained itself into the future. Apple's stock surged 147% in 2009 and then continued a strong run for several more years, along with other similar innovators like Amazon and Google.

What is more interesting is that the areas of initial weakness that were responsible for sparking the overall recession, though similarly experiencing a rebound off all time lows, couldn't carry

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it forward as Apple and others did. In both cases, tech and housing/financial stocks experienced three subsequent years of relative underperformance and flattish overall results. In other words, the initial strength or bounce encountered further selling pressures that minimized the sectors' gains relative to areas of the market that had sector specific fundamental strengths going into said declines.

I am confident that even if we do fall into a recession we own the types of companies while likely to come under significant pressure, will also prove to be those of more sustainable value in an eventual rebound. I will also add that no two recessions are exactly alike, even though they may rhyme. I still believe that we are in an era of lower for longer. This recession may prove shallower than most simply because we've never truly experienced the feeling of gains associated with prior recoveries and expansions post Great Recession. Cheaper energy is a benefit to the consumer, regardless of whether or not they spend it or save it as they may be doing now. It is also healthier that consumers have largely been paying down debt rather than taking more on. The consumer remains a strong point at this point in the cycle, but I also know that some consumers are employed by the sectors that have had the highest employment gains in recent years – the energy and manufacturing sectors.

What we really need is a barfing up type of event to settle the market's anxieties. We need a few high profile bankruptcies in the energy, materials and industrial space to get past the fear so we can build for the future. Only when we have that, will we likely be able to move through the anxiety and chart the course for higher highs in the overall markets. Energy is not the same significance to the economy that housing, financials, and tech were during the prior troubled times, but coupled with the foreign economic weakness, currency problems, and Fed rate hikes, neither is it irrelevant.

Rockier times may be ahead, but I do take comfort in the idea that we own the best companies for the other side. If you don't need your investments for the next twenty four months, I would point out that the types of companies we own, in spite of gut wrenching catch up declines, often got back to all time highs well ahead of the indices in the past. I don't want to cause panic, but intend to steer our portfolio through the storm using our selling discipline as a prudent guide. I have faith in the markets and our capitalist system to right the ship over the longer term. This has always been the case in the past, even during the Great Recession, and I see no reason to expect otherwise this go around.

So in conclusion, yes, I feel the likelihood of a recession is significantly elevated, but I'm also invested with monies I don't need tomorrow, enabling me to benefit from the gains that still lie five, ten and twenty years into the future. Evidence and experience teach me that recessions are an inevitable reality of a capitalist economy, but because we have a political system that allows for adapting to the times, we often experience a better future than our past.

I have long budgeted my personal financial needs on a five year forward basis. With significant college expenses coming down the pike, I've kept a lot more powder dry than I have in the past, but this balance affords me the opportunity to more effectively ride through the market's storms, not panicking where there is no true fundamental need.

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We need not fear when we are prepared for the inevitable and able to look to the horizon at better days.

Kindest Regards,

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