Quarterly Review and Outlook – 4th Quarter 2017

“Don’t just do something, stand there.”

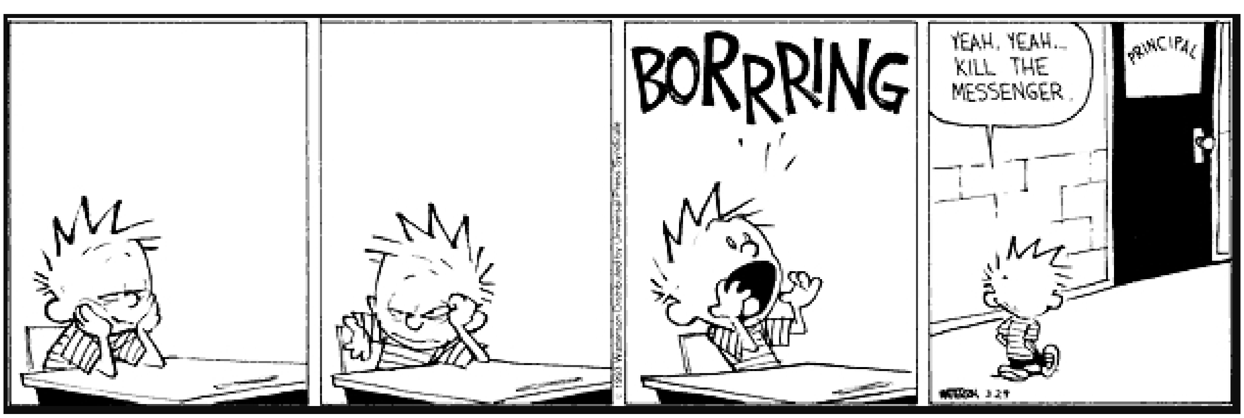
- Martin Gabel

We find it challenging to form a well-reasoned outlook for 2018 that defies conventional wisdom. Growth is steady and balanced, unemployment is low, and corporate earnings are expected to continue growing. There are pockets of concern, but nothing large enough to threaten a diversified economy. Politics can be deafening, but the populist tendencies of the new administration have so far been all tweet and no peck.

Nothing magical about calendar year-end requires a dramatic shift in views, so we are tempted to say “as you were” and move on. Still, the unusual market calmness of the previous year brings to mind a lesson from high school physics.

Boiling water is straightforward. Place a pot of water on a hot stove and the water temperature will steadily rise to the boiling point. Steam bubbles form and escape at the surface. The process is dangerous but orderly. Under certain conditions, though, water can rise above its boiling point without showing the normal signs of boiling over.

This phenomenon is called superheating and happens when, say, a new coffee mug is left in the microwave too long. Superheated water is unstable, and particularly dangerous because it looks so calm. Energy ordinarily released in a vigorous boil remains trapped in still water. A slight jostle releases this energy, at once, with an inescapable suddenness and force. Water explodes.



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The current expansion and corresponding market strength began from an unusually deep trough—a financial crisis and the largest recession since the Great Depression—and the scarring remains severe. Fiscal restraint and a tight regulatory vise were a governor on the U.S. economic engine, limiting the speed of the recovery yet preventing imbalances from recurring. A decade removed, preconditions for a major crisis are hard to spot.

Investors have grown accustomed to an unusual dynamic—a boring market punctuated by crisis. In that context, normal cyclical pressures are easily glossed over, but here we are. Tax cuts and looser spending caps are set to reverse the trend in government spending, which, adjusted for inflation, has declined since 2010. Regulation is being pared back. Geopolitical unrest amid a tight oil market could send false signals to a reworked and untested Federal Reserve. And all of this in an economy near full capacity.

Recessions are rarely inevitable, but rather the consequences of policy mistakes made under a fog of uncertainty. No one has perfect information, and at least mistakes are not all created equal. In 2006-07 the economy was superheated by households leveraging real estate to rapid wealth creation. Policy responded too slowly and a small shock to subprime sparked a devastating chain reaction.

Today's economy is more like a pot of water on the stovetop. Small steam bubbles are forming and rising to the surface. We must keep a watchful eye, but we can afford to be patient, ever aware that markets can always move faster and further than we expect.

Grand unified theory of 2017

The S&P 500 rose 21%, the index's ninth consecutive calendar year gain. More remarkable was the lack of realized volatility. The largest peak-to-trough drawdown was 2.8%, the smallest since the index was created in 1923.

Index-based investing has been an unmitigated boon for investors, but owning an index can feel intangible, even boring. This feeling is a mirage, a figment of our inborn urge to always be doing something. Underneath the surface, the S&P 500 is a dynamic portfolio constantly reinventing itself. Nothing reveals this dynamism like Facebook.

The social network IPO'd in 2012 (not even six years ago!) and in 2013 earned $1.5 billion. In 2018, the company is expected to earn $20 billion. Facebook *barely existed* at the March 2009 bottom and is now a top five index holding and one of the most valuable companies in the world. Google and other tech giants have similar stories. Never have such large companies grown so rapidly, with such dominant market positions.

We believe investors should own foreign stocks. It is a big, beautiful world and we would rather not dismiss 60% of it for arbitrary reasons. But the dominant social network in Europe is Facebook. The dominant search provider is Google. Nobody owns an index, they own the companies inside the index, and gaining exposure to the most important global trend of the last ten years required owning U.S. companies.

Will the next decade look like the last? If you know for sure, we are hiring.

Tales from the cryptocurrency

Finally, it has not gone unnoticed that the speculative mania surrounding bitcoin is occurring in the midst of the most boring stock market in history. We are intrigued, but cryptocurrency market behavior closely resembles that of other speculative bubbles. For instance, Dogecoin launched as a joke and recently boasted a $1 billion capitalization[1].

Cryptocurrencies differ from other technologies in at least one critical way: They can be bought and sold. Their primary use, as of today, is satisfying that utterly human desire to get rich quickly by buying a thing today and selling it tomorrow, higher, to a greater fool.

The internet bubble was unsustainable, but the internet itself was real. Blockchain may follow a similar path, with similarly enormous effects. We are skeptical, but we are also humbled by how quickly the unimaginable becomes reality. Ten years ago Apple released the first iPhone, and today Kenyan farmers access real-time livestock feeding prices on handheld devices. Technology moves in dogeyears.

We will keep digging. The next revolution may produce a business model less friendly to equity investors, the anti-Facebook. Disciplined asset management is a delicate balance between keeping an open mind, but not so open your brain falls out. We currently see no prudent way to get involved with blockchain, but this could change. Fortunately, we are not jealous types, so we are comfortable watching from the sidelines.

Clay McDaniel
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[1] Billion with a B.