Market Outlook: United States: Best of Breed in 2015

(from Novo Capital Management's 4Q14 Letter to Shareholders sent 2/16/15)

What a year for the market in 2014! It was so good that it seems there is general consensus that 2015 cannot be very good. No longer does the market wonder "if" the Federal Reserve will raise rate. The question is "when", and most of the dialogue suggests that a rise in rates will be bad for the stock market.

Federal Reserve Policy Positives

The other question is what, if any, long-term damage has been done by keeping interests rates artificially low for so long. I think the alternative, i.e. raising rates sooner, would have been worse. A more austere monetary strategy would have likely put lots more people out of work and torpedoed consumer sentiment. One could argue that the pain of a more austere monetary policy would have been good for the long-term as we would have pulled out of the deeper economic downturn with more strength and conviction.

Given the economic challenges for the rest of the world, I am not sure how much good it does for the US economy to be much stronger than it already is. We are already head and shoulders above most of the rest of the world. Many of the other major developed countries are beginning to realize that their fiscal and monetary policies have been significantly less successful than ours. They are looking at potential major overhauls while we are most likely looking at some relatively minor course corrections.

This difference is highly impactful to long-term economic growth potential because of its implications on investment decisions in the near and long term.

Challenges Abroad Creates Opportunities at Home

If you were starting a business and could choose anywhere in the world, where would you start it? It is hard to make a straight-faced argument against starting a business in the United States. Accordingly, it is hard to argue against the idea that the most talented business people in the world would want to be in the United States.

Given the current state of affairs in other major developed countries, it is hard to think of a time when it was clearer that the United States was the best place for productive people to live and work. One of the most defining characteristics of the United States is that it is the number one destination for the people willing work as hard as it takes to achieve the highest returns on capital possible. At the same time, we have been one of the least attractive destinations for people looking to be entirely unproductive or focused on terrorism.

Sure, we have seen a rise in terrorism within our borders, but that rise has not been as bad as the rest of the world.

Capitalism May Not Be perfect, But it is The Best

There are valid concerns about the social stability of certain major world powers. I think the lack of fiscal discipline and the pitfalls of socialist economic policies in certain European countries are coming back to haunt them in the form of lower growth and growth potential. A terrible by-product of this lower growth and potential is under-utilization of capital and people. Long-term underemployment is the breeding ground of resentment and discontent, which is exactly where terrorists go to recruit.

The recent terror issues in France are born from the economic weakness caused by the lack of fiscal discipline and the pitfalls of socialist economic policies. These are problems that are difficult to repair (just as it is hard to unspill milk). Those problems are far more easily avoided taking measures early to ensure that those willing to work harder to achieve more are allowed to do so. Redistributing wealth to the point where the most productive people are driven off has lasting consequences. Their departure creates a void of productivity, creativity and leadership.

No doubt that the United States benefits from this trend as well.

I am not sure of the extent of the damage done or the cost to repair in places like France. Perhaps, there is enough economic well-being and production to keep everyone happy long term if not in the short term.

I am sure that the United States continues to pull away from the rest of the world.

In his 1992 book, The End of History and the Last Man, Francis Fukuyama makes the point:

> "What we may be witnessing is not just the end of the Cold War, or the passing of a particular period of post-war history, but the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government."

The experiences of the last 20+ years suggest that Mr. Fukuyama was right and continues to be right.

Uncharted Waters Ahead

In my 1Q13 letter, I wrote that I'm long-term bullish and I don't believe the stock market is in a bubble.

Funny, for 1Q15, I feel pretty much the same way. The current global fiscal, monetary and social policy experimenting is absolutely fascinating. We are in uncharted waters.

No doubt there will be more volatility in the market. Fed tightening is coming – thought I cannot say when I expect it will be after the Fed feels a stronger dollar will not blow up any other major currencies. Effectively, now the Fed needs to keep monetary policy loose now for the rest of the world more than the United States. A sharp rise in rates now would make the dollar even stronger and likely torpedo our exports and put more pressure on struggling economies. No need for us to be a bully here, except with Putin of course where we hardly have a choice.

Whenever the Fed tightening comes, it will be very gradual. Long-term interest rates will not rocket up. We will likely not see much of a change in rates for quite some time, not until more of the global economy (outside of the US) gets back on its feet.

Will Normalcy Return in 2015?

Previously, I've noted that the impact of share buybacks over the past decade plays a role in pushing the market higher. The total number of shares available in US markets is as much as 10% lower, according to some reports, than it was 10 years ago. No doubt the diminished supply of shares means demand is relatively higher and providing support to stocks at least in the near term.

I see this trend changing and the supply demand dynamic shifting back toward a more normal balance. Clearly, supply is on the rise as banks and companies look to cash in on the high valuations. Look at all the IPOs that Wall Street has been rapidly firing already in 2015. Moreover, as global growth slows, firms have less cash to spend on buyback while many have already borrowed heavily to subsidize buybacks.

I do not see the demand for US$-denominated securities waning at all. If anything, it will remain strong. Where else are global investors going to put their money in the near term? This steady demand will help support US markets.

And as long as demand stays high, we can expect Wall Street to appease it with plenty of supply. Consequently, I think the supply/demand situation will improve on the margin but not by much – no major upheavals in sight.

A Winning Strategy

Our strategy remains focused on buying and holding low risk stocks with strong cash flows, high ROIC and cheap valuations. For example, Progressive (PGR), Oracle (ORCL) and Stryker (SYK) continue to be good performers for our portfolio. We continue to find stocks that have strong enough fundamentals to withstand the inevitable market pullbacks we can expect over the next several months. There are still plenty of pockets of opportunity for good long positions.

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