Broadleaf Partners, LLC

In The End, Time Is Everything

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If you recall, the S&P 500 got hit 5% at the end of January this year, falling from 1850 to about 1750 in two weeks. There were a lot of concerns at that time about the earnings outlook given subpar economic releases related to the horrific weather we were experiencing around the country. Once earnings season got underway, things turned around for the market as people became more comfortable with the temporary nature of the weather excuse and actual earnings didn't turn out so bad in spite of generally lackluster economic releases.

Since March 18th, the markets have once again been under pressure, with the S&P 500 falling about 3% but the growth heavy NASDAQ falling a more significant 8-9% from its recent highs. As we mentioned in our First Quarter Performance Commentary, the significance of the 18th date was likely related to the Fed's more hawkish tone and the possibility that given improving economic conditions interest rate increases could be on the horizon.

After five years of generally stimulative Fed policy actions, investors have been reminded that at some point, interest rate policy will be normalized. This has ushered in a period similar to 1994, when interest rate normalization moves by the Federal Reserve caused a disruption in the stock market, or a valuation reset for a period of a few months. During this time, the market's highest growth names were also hit the hardest, but once investors realized that the rate increases were associated with an improving economy and not an overheating economy, the markets turned, and growth stocks enjoyed several years of very strong results.

We believe a similar outcome will occur this time around. Any future move by the Fed will ultimately represent a normalization of interest rates rather than restrictive policy moves intended to ward off inflation by essentially choking off economic growth. Anxiety levels have increased in the markets because the idea of change is on the horizon. Change always breeds uncertainty, particularly after so many years of "easy" Fed policy. It's important to note, that while rates will increase at some point by some unknown amount, it hasn't actually happened yet. Since March 18th, the ten year treasury yield has actually fallen, suggesting that the bond market isn't nearly as concerned about Fed policy changes as the stock market.

At the same time, it also strikes me that the ups and down of the market could relate to the existence of an information vacuum that comes along once each quarter after earnings season has drawn to a close. In a high trading volume, data starved financial world confronted with a potential change in Fed policy, perhaps markets swoon from hunger induced by the lack of "earnings release data" and forced to subsist on the scraps of Fed Economic releases alone.

Speaking of which, a host of macroeconomic data, including the most recent unemployment claims release, suggests that the economy has clearly turned the corner at perhaps an accelerating pace. If that is indeed the case and we take the Fed at their word that future policy decisions will be data dependent, then we might also expect that the markets will remain fixed on the prospect for higher interest rates this year even though they may not actually occur.

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At the same time, it could also be the case that recent macroeconomic data appears to have accelerated to the positive side partly as a function of a natural "bounce" following such poor winter weather. In this case, perhaps the economy is still improving, but not to the extent that the stock market generally fears or, in other words, at a rate of growth which would cause the Fed to raise rates sooner rather than later.

In either case, we believe this period for the markets will ultimately look like 1994. At some point interest rates *will be* increased by the Fed and *this will* cause a valuation reset for the markets. We've done all sorts of regressions on historical economic data in recent weeks, seeking out the historical correlations between stock prices, earnings, interest rates, inflation, and credit spreads. While the Fed Funds rate does generally have a negative correlation with stocks, meaning that when rates go down, stocks generally go up, we were surprised to see that the correlation was mildly positive in periods of rising Fed Fund rates. In other words, while a weak relationship, when the Fed Funds rate is going up, stock prices have similarly trended up.

Why might this be the case? Well, occasionally the Fed increases rates to fight fears of rising inflation. Typically when this is the case, the rate increases are initiated to slow the economy down. Sometimes the Fed overshoots and rather than achieving a soft landing, the economy slows too much and goes into a recession, which is bad for stock prices. However, the Fed can also raise interest rates for another reason – to take more stimulative policy measures into neutral gear and not to try to slow the economy and fight inflationary pressures. In these situations, stocks can do well because the economy continues to do well and earnings grow.

Over the long run, during periods of rising and falling Fed Fund rates, interest rates may be important to stock prices, but earnings are ALWAYS important, at least over the thirty years of our study. At the end of the day this makes sense; earnings are what powers company dividends, stock buybacks and corporate capital expenditures and growth initiatives. While interest rates do influence multiples and stock market valuations, inflation appears to be the more important variable, perhaps because an inflation concern changes the intent of any Fed policy move.

Next week we head into earnings season. While actual earnings could assuage near term concerns and the valuation reset, it is equally as possible that it may not. Our analysis, however, clearly suggests that over the long run earnings matter the most to stock prices and only during certain types of Fed Fund rate increases do interest rate changes matter. As we forecasted in our 2014 Playbook earlier this year, we suspect we'll look back and see a period much like 1994; some initial turbulence followed by a number of years of solid economic growth.

A local homebuilder just started to clear a forty acre parcel of land next to our house this week, a project he had sidelined for nearly five years given the economic downturn. While he could be top ticking the market, I doubt it. This is the first building in my area that I've seen in years.

I've been through lots of these environments, many more than I care to remember – 1994's mid cycle slowdown, the 2000-2001 Tech Wreck, and 2008's Great Recession. As gut wrenching as each period has been, I remind myself that I've come out of them just fine and that our investment portfolio has eventually gone on to new highs.

Is money important? Absolutely, but it isn't everything if you don't need to access it for another ten or twenty years. As a concentrated growth manager, we often get hit harder than most money managers during times of uncertainty. While some will claim that valuations are to blame for the large selloff in growth stocks, high growth stocks almost always have premium valuations. In some sectors of the market, we've found that it makes more financial sense to pay up for a company of the future than to pay down for one in the past. As Warren Buffet has said, "Price is what you pay, but value is what you get."

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Kindest Regards,

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