April 27, 2015

First Long Island Investors, LLC

March 31, 2015

"One thing we have lost, that we had in the past, is a sense of progress, that things are getting better. There is a sense of volatility, but not of progress."

Daniel Kahneman (Winner of the 2002 Nobel Memorial Prize in Economic Sciences)

The first quarter ended with a whoosh of volatility reflected in a second to last day gain of more than 200 points for the Dow, only to be followed by a loss of 200 points on the last day of the quarter. This sort of volatility permeated the entire quarter, and at the end of the period, the S&P 500 was ever so slightly higher while the Dow suffered a slight loss. International indices did somewhat better on average this quarter, but after underperforming the S&P 500 from January 1, 2008 through December 31, 2014, that is a welcome improvement.

Other markets also suffered from uncomfortable volatility. Oil was down another 10% (falling by more than 50% in the last nine months) while the yield on the 10-Year German Bund (government bond) suffered a drop of almost 60% (declining to a jaw dropping 18 bps). Currency markets also witnessed continued volatility with the Euro dropping to about €1.08 to the U.S. Dollar. Equity markets reached all-time highs while domestic interest rates stayed at very low levels. Unemployment continued to fall, although wage growth remained somewhat anemic. So, what does this all mean and is the volatility overshadowing economic progress?

First, in our opinion, volatility is being caused by the following:

1. The inevitable increase in short-term interest rates by the Federal Reserve continues to be a source of constant speculation and thus volatility. However, an increase in rates will be slow and probably will not be disruptive to the economy or corporate earnings. It will signify that the U.S. economy has almost fully recovered from the great recession.
2. The strengthening dollar is adversely impacting earnings for U.S.-domiciled companies with significant overseas operations. The speed with which the strengthening has occurred and its uncertain impact on earnings is contributing to volatility but does not reflect the strength of operations in local currencies.
3. The precipitous drop in oil and natural gas prices has impacted the earnings projections of oil and gas-related companies. It has also led to layoffs and reduced exploration expenditures in a number of companies. This will have a somewhat negative effect on this sector of the economy. This drop has yet to lead to increased spending by consumers.
4. The terrorist wars in Syria, Iraq, Yemen, and Libya as well as the murders of Christians in parts of Africa coupled with the ongoing negotiations with Iran, which is sponsoring terror throughout the Middle-East, is causing serious uncertainty and domestic political infighting. The headlines of atrocities are affecting the attitudes of retail investors and causing volatility.
5. The impact of Europe's attempt at stemming possible deflation while stimulating the Eurozone through its version of quantitative easing, utilizing bond purchases, has yet to be understood by investors. At the same time, Europe's old economic nemesis, Greece, has once again changed its political leader and is on the cusp of leaving the European Union.
6. Many pundits are worried about stock market valuations and, coupled with slowing earnings growth and a downturn in growth in China, is leading to concerns about virtually all markets.

7. In Washington, the newly elected Republican majority in both Houses of Congress has not relieved the paralysis that has plagued Washington since President Obama took office. So far, the U.S. has not implemented strong fiscal policy to complement our monetary policy, which has been on steroids, leaving us with a continuation of financial repression and little happiness for the average saver and less than optimal economic growth.
8. After six years of a rising stock market, there is skepticism whether equity markets can continue rising. Thus, any bad news, economic or geopolitical, gives rise to fears that the long-awaited correction (or worse, a bear market) is upon us. This is causing volatility.

All of the above gives one cause for concern and certainly explains the current volatility, but one would need to have blinders on to not realize the progress that is begrudgingly being made:

1. The U.S. economy is growing slowly and does not appear to be facing recession anytime soon. Slow GDP growth of 1.5 to 2.5 percent per year, which also reduces inflation risks, seems to be what is in store for us given the lack of fiscal policy initiatives and the strong dollar slowing our exports. Slow growth, low inflation, and continued low interest rates are a sound formula for stock, real estate, and private equity markets to continue to perform reasonably well.
2. Employment continues to grow at a moderate pace. Wage growth, especially for the middle class, is still somewhat anemic, but there are signs of growth at a pace better than inflation. Additionally, many large employers are unilaterally raising minimum salaries paid and several states have passed legislation to raise their state's minimum wages. This is progress, any way you slice it, and will support economic growth.
3. The precipitous drop in gasoline and heating oil prices is a big benefit to virtually all consumers and many businesses. This should more than offset the pain inflicted on oil-related companies. However, up until now there has been very little to no corresponding increase in consumer spending. It is our understanding from our consulting economists that consumer spending increases lag reduced oil prices by at least six months. Thus, we believe there will be a pickup in consumer spending later this year. This will contribute to economic growth and should there be a nuclear arms deal with Iran, more oil supply will come to market down the road as economic sanctions against Iran are lifted. (We have little faith in the Iranians adhering to any deal so this increase in supply might be short lived.)
4. There continues to be monetary easing in Europe, China, and Japan, while in the U.S. we expect some liftoff to short-term interest rates in late summer or early fall. Those policies reflect the fight against deflation, stimulation of economic growth, and the recognition that economic conditions in the U.S. have improved. We would expect a rise in interest rates to increase consumer confidence and, if consumers are more optimistic, that should lead to aggregate demand that would be positive for the businesses and real estate we invest in.
5. Equity values, in our opinion, remain fair and do not resemble the bubble markets of 2000 and 2007. One could argue that some regions of the country are facing unreasonably high real estate valuations, and smart investors are seeking better opportunities in other areas. We also believe that stronger demand for office and residential housing is yielding higher prices. Low interest rates remain a driving force in somewhat higher stock market valuations and support higher real estate values.
6. Bond valuations seem very stretched and that is reflected in unusually low yields. As of March 31, 2015 the 10-year Treasury was at 1.9% and a triple-A 5-year municipal yielded 1.3%. A rise in the short-term rate target from the Federal Reserve may gradually increase those rates, but not by much in our opinion. Our view is that rates will slowly increase. Therefore, low rates might be here for a while unless inflation picks up and that does not seem likely.

So, we believe that volatility is based more on speculation and anticipation, not on well-founded information or Federal Reserve policy at this point.

Investors' concern about many of the issues outlined above, in and of itself, is a source of volatility. At the same time, the improvement of corporate balance sheets since 2007, slow growth, low interest rates, accommodative central bank policy, reasonable stock market valuations, cheap oil, and better employment globally seems to be what will carry the day on a longer-term basis in our opinion.

In considering asset allocations for our clients, we remain tilted towards our defensive strategies, where a significant part of clients' asset allocations should be directed. Defensive strategies seek to reduce the volatility of our investments and help clients weather equity market volatility while still seeking to achieve reasonable appreciation and income. Some bond allocation remains necessary, but with shorter duration. In pursuing real estate-oriented investments, we continue to look for some current return as well as potential appreciation. In all cases, valuation in each asset class is critical. In equity-oriented strategies we continue to focus on high active share (concentrated portfolios) given the slower global growth and the increase in volatility. We never forget that preservation of capital is paramount. This is especially the case in a world where there are many geopolitical and economic factors impacting our investments.

At the end of the day, there are legitimate issues causing volatility but as our quote from a Nobel laureate for economic sciences suggests, the progress being made is not being given the attention it deserves. We believe this will prove to be an opportunity and we expect that the slow but persistent progress, despite the volatility, will make 2015 a positive year for our clients

Please contact any member of our investment team with any questions you might have or to discuss your asset allocation or any other wealth management needs you may have.

Best Regards,

Robert D. Rosenthal
Chairman, Chief Executive Officer
and Chief Investment Officer

*The forecast provided above is based on the reasonable beliefs of First Long Island Investors, LLC and is not a guarantee of future performance. Actual results may differ materially. Past performance statistics may not be indicative of future results.
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