Ben Hecht, the screenwriter best known for *Gone with the Wind*, once said that "trying to determine what is going on in the world by reading the daily newspaper is like trying to tell the time by watching the second hand of a clock." When it comes to investing, we are generally in complete agreement. However, every once in a while a single edition of a paper can provide important perspective by way of contrasting headlines. With 2017 nearly halfway over, the June 28 edition of the *Wall Street Journal* provided us with one of those rare opportunities.

A story on the first page of the Business & Finance section reported that Apollo Global Management had just raised the largest-ever leveraged buyout fund, a staggering $23.5 billion. Buried on page 3 of the same section, the Journal reported that Nestlé announced a $20.8 billion stock buyback. (The latter had the greatest immediate interest to us, as we invested in Nestlé in January and the shares have already advanced more than 20%). These pieces reflect two aspects of a long-term trend that has had significant impact on stock markets around the world.

Corporations and financial buyers have been using borrowed funds to acquire their own shares or entire businesses. One of the reasons they have been both able and motivated to do so is that the extended period of historically low interest rates has afforded companies access to low-cost borrowing. Since 2010, U.S. companies alone have spent over $3 trillion buying back their own shares, according to economic researcher Cornerstone Macro. These buybacks were largely financed with borrowed funds, as companies increased their total debt by nearly $2.5 trillion in the same period. During that period, North American companies completed mergers or acquisitions with a total value of $10.8 trillion, according to *FactSet*. It is reasonable to estimate that at least half of that amount was funded with borrowed money.

Borrowed funds had a meaningful impact on both the demand for, and supply of, equities. Corporations and financial buyers have been by far the biggest buyers of stocks during this bull market. By comparison, equity mutual funds and exchange-traded funds have had net inflows of one tenth as much, less than $250 billion over the same period of time. At the same time, mergers, acquisitions, buyouts and buybacks have reduced the supply of available investments. Twenty years ago, there were 7,300 publicly traded companies in the U.S. Today, only half as many remain (approximately 3,700). The increase in demand and decrease in supply go a long way to explaining the rise in stock prices. It is important to ask if this has introduced a new element of risk to investors. Despite the eye-catching statistics, it is not clear to us that this trend has reached the point of being dangerously unsustainable.

We do not believe this is another credit bubble like the one that precipitated the financial crisis. Public companies in the U.S. spend a much smaller percentage of their cash flow on debt service than they did five, ten or even twenty years ago. We think using low-cost debt to fund stock purchases is likely to continue; however, like any trend, it cannot last forever. It

147 EAST 48TH STREET, NEW YORK, NY, 10017 SPEARSABACUS.COM
T 212-230-9855 F 212-230-9861

will end for one of two reasons. Either companies will reach or (more likely) exceed their borrowing capacity and will no longer be able to finance their acquisitions and buybacks with debt, or interest rates will rise, increasing borrowing costs and making debt a less attractive option.

Engineering an orderly rise in rates, before a bubble forms, is a responsibility that falls on the shoulders of central bankers. This observation brings us back to that very same edition of the *Wall Street Journal*. On the front page was a story about the likelihood of higher interest rates in the Eurozone as the European Central Bank (ECB) follows the U.S. Federal Reserve Bank in winding down its longstanding program of monetary stimulus. In prepared remarks at an annual economic policy conference in Portugal, ECB President Mario Draghi said that "all the signs now point to a strengthening and broadening recovery in the euro area." Market reaction was swift and certain. The rates on ten-year government bonds from Italy to Germany rose dramatically. The euro itself rose 1.4% versus the dollar, the biggest one-day move in over a year.

This does not necessarily herald a new era of steadily rising rates. Markets are not like light bulbs that suddenly switch from on to off. Short-term movements are notoriously poor predictors of long-term trends. But today, we are undeniably closer to a more normal environment of higher interest rates.

Looking Back

The eerie stability of stock prices that we noted in our last Investment Perspectives continued in the second quarter. Once again, there were only two trading days when the S&P 500 moved more than 1%. Common measures of volatility achieved multi-year lows. Every sector exhibited positive returns with the exception of energy, which followed the falling prices of crude oil and natural gas (10% and 5% respectively). Fortunately, our investments in this sector are modest, having little impact on portfolios.

On the other hand, we had meaningful positive contributions from both high and low tech. One-time laggard, Oracle (enterprise software) and Ball Corp (aluminum cans and bottles) were significant outperformers. Financials, led by Citigroup and CIT Group, rebounded from a subpar first quarter. As noted earlier, our new position in Nestlé has provided immediate returns. Shortly before the company announced the stock buyback, activist investor Third Point Capital disclosed that it had amassed a $3.5 billion position and is working closely with management to enhance the stock price. Other standouts in the quarter included Whirlpool, Delta Airlines and Alphabet.

Fixed-income markets in the U.S. also continued trends established in the first quarter. In bondspeak, the curve flattened as short-term interest rates rose while longer term rates fell slightly. The one-month Treasury Bill began the year with a yield of 0.42% and closed 0.84% (+42 basis points) at the end of June. Conversely, the yield on the 30-year Treasury Bond fell from 3.07% to 2.84% (-23 basis points). Corporate bonds outperformed U.S Treasury debt in the second quarter and year to date, reflecting investor confidence in overall credit quality. Despite the well-publicized budget struggles of Puerto Rico, Illinois and Connecticut, municipal bonds also exhibited positive rates of return. In general, bond portfolios collected interest and experienced stable to slightly rising principal in the quarter.

Looking Forward – the Bond Market is in Charge

The global economy is made up of complex organisms. As is always the case, there are many countervailing forces at play. Optimism in Europe is balanced by emerging concerns among U.S. investors. Historically, a flattening yield curve has been a warning sign of a slowing economy, predicting five out of the last seven recessions. But, our sense is that the bond market is not currently a harbinger of troubled times ahead. We think there is likely a different explanation for the modest decline in longer term rates. It is an accepted wisdom that money seeks the highest return. Currently, U.S. government bonds are the highest yielding among developed markets:

Country	10-Year Yield-to-Maturity
US	2.39%
UK	1.29%
Germany	0.57%
Japan	0.08%

U.S. bonds are more attractive than foreign alternatives. While yields are still low on an absolute basis, we believe that the offshore interest in our debt will not abate in the foreseeable future. Demand from global investors is likely to keep a lid on longer term rates, even as the Fed moves farther away from the zero interest-rate policy in place since the financial crisis.

We cannot say for sure how long it will take to reach an interest-rate inflection point. When it does come, the transition may not be a gentle one. The preternaturally smooth market activity is likely to give way to above-average daily volatility. In case that environment comes sooner rather than later we continue to (1) hold larger than usual cash reserves and (2) position our bond portfolios to be conservative in terms of their sensitivity to sharply higher interest rates and inherently safe in terms of their exposure to fragile credits.

That being said, even if we have seen the lows in bond yields, companies and private-equity firms will not change their ways overnight. For the foreseeable future, it seems likely that relatively easy credit will enable strategic and financial buyers to finance large-scale stock purchases with debt. For now, this should continue to provide an important source of demand for equities. But financial engineering alone cannot be counted on to boost stock prices forever. We have a high degree of confidence in the companies in which we have invested, and we feel that we have appropriately balanced opportunity and risk.

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