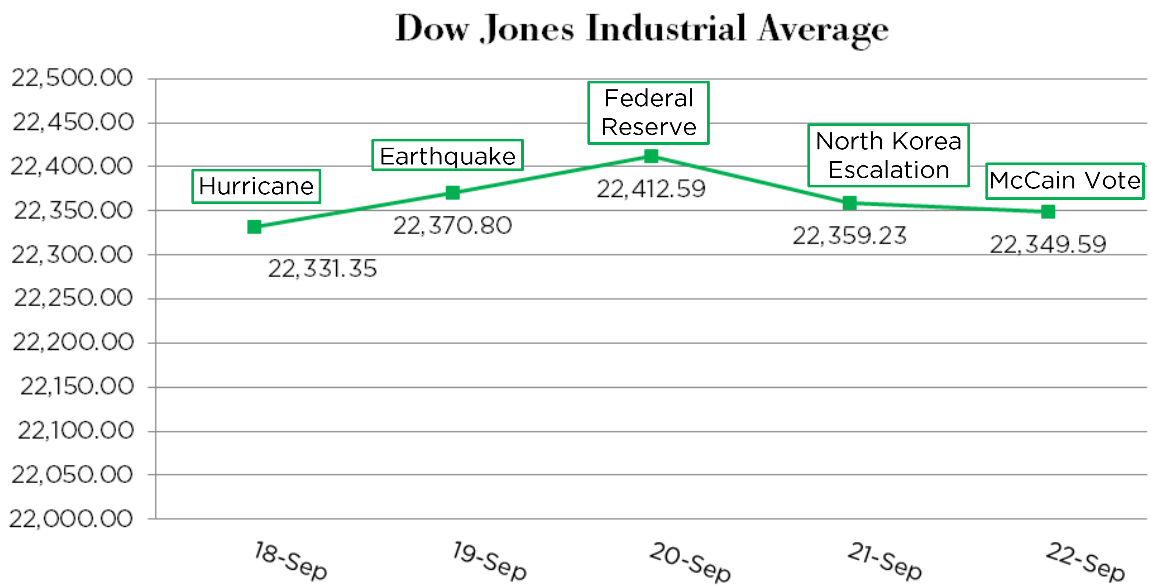
Overview

The disconnect between stock prices and world events reached what surely must be an all-time high during the third week of September. In the face of extraordinary natural disasters, nuclear sabre rattling, contentious U.S. healthcare legislation and the beginning of the end of quantitative easing in the U.S., the Dow Jones Industrial Average moved all of 18 points. It was the smallest weekly move (on a percentage basis) since Richard Nixon was in his first presidential term.



In general, investors hate surprises. Most of the news that week came with little or no warning. The earthquake in Mexico occurred out of the blue. There was only a small window to prepare for Hurricane Maria. Not even a casual observer could have been surprised that North Korea's nuclear campaign would be a central topic at the United Nations General Assembly. However, the level of vitriol exchanged by President Trump and Chairman Kim was unsettling. John McCain kept Beltway analysts guessing most of the week before announcing that he would not support the Graham-Cassidy healthcare legislation.

One event was undeniably of interest to investors: the Federal Reserve indicated that it would begin shrinking its bond holdings in October and would likely raise short-term interest rates again in December. Had Chairwoman Yellen's remarks taken investors by surprise, the market reaction would have been swift and intense. The collective yawn was testament to how well the "news" had been telegraphed ahead of the official announcement.

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As long as the environment favors borrowers (easy credit at relatively low rates), we believe corporations and other financial players will continue to be a steady source of demand for stocks. As we noted in our commentary last quarter, we estimate that corporate buying (in the form of mergers, acquisitions, leveraged buyouts and stock buybacks) has had a meaningfully positive impact on the level of the market as a whole.

There are likely other contributors to market stability. Chief among them the relative good health of global economies. Each of the three major economic blocs (the U.S., Europe and China) are experiencing steady if not spectacular growth. The emergence of Europe from post-crisis malaise registers somewhere between pleasant surprise and relief. In a sign of real investor confidence, Austria was able to float 100-year government bonds at a yield of 2.1%. More surprisingly, Argentina also found buyers for 100-year debt, though at a substantially higher yield (nearly 8%). Even former trouble spots (Brazil, Mexico and South Africa) have seen their currencies rally.

Looking Forward

The Merriam-Webster Dictionary defines *complacent* as "marked by self-satisfaction especially when accompanied by unawareness of actual dangers or deficiencies." We wonder every day whether markets fit that description. As is often the case, we can muster logical arguments for both positive and negative conclusions.

It is possible that we are underestimating the potential for an escalation in hostilities between North Korea and most of the rest of the world. There does not need to be an actual nuclear war to have a negative impact on asset prices. Today, few believe that rhetoric will lead to action. If doubts find their way into mainstream thinking, investors will shift money out of stocks and into safe havens like Treasury bills or even gold. We find this unlikely, though admittedly very difficult to credibly analyze.

According to official statistics, the Chinese economy has continued to grow at a rapid rate. Because of its sheer size and frustrating opacity, it holds the potential to surprise investors with bad news. There are plenty of China skeptics; we are not currently among them. Neither do we think that investing in Chinese companies is a sure ticket to untold riches. An unforeseen financial accident in China could spook investors and dampen enthusiasm for long-term assets in general.

At the risk of sounding like a broken record, we think the availability of cheap and easy credit is a big deal. As long as companies can grow their earnings by borrowing money and buying existing businesses or their own stock, they will do so. We believe this can continue to provide steady demand for stocks. Ironically, when rates do start in earnest to creep higher, this "borrow and buy" phenomenon may actually pick up speed, as companies race to take advantage of the opportunity before the window closes.

A rise in inflation, though eventually inevitable, still seems beyond the horizon. While wages are finally seeing some upward pressure (which we view as a positive), it is hard to argue that other major components like food and energy will rise significantly from current levels. As long as the CPI does not grow much faster than the well-established target of 2%, the Fed should continue to have the freedom to unwind the unprecedented monetary stimulus in an orderly and transparent manner.

As the year progresses, there is one wild card to which we will pay attention. A month or so ago, no one would have considered a sweeping tax overhaul likely or even possible to succeed. Investors seem to have slipped into a general state of doubt about the ability of the current Congress to get anything done. The administration has offered a rough outline of a tax bill that it would like to see passed. As always, there are potential negatives, positives and unintended consequences. So far, there are more questions than answers.

As always, we must factor major fiscal policy initiatives into our thinking. Our real work, however, will continue to be analyzing the specifics of the businesses in which we have invested. If the overall environment becomes more challenging, we will look to the margin of safety provided by strong balance sheets, competitive strength and astute management. By design, we believe these are the hallmark characteristics of our holdings.

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