

# AVENIR CORPORATION

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## INVESTMENT MANAGERS

August 2019

Dear Friends and Fellow Investors,

### Midyear Review

Benefitting from rising earnings, declining interest rates and low inflation, equity prices rose sharply in the first seven months of 2019 before experiencing a significant bout of volatility in August, induced by our trade war with China and fears of recession, and compounded by controversial presidential tweets. Stock indices remain up in the mid-teens year-to-date as of this writing.

A bigger story that doesn't get the same headlines as the gyrating Dow Jones Industrial Average or provocative tweets is the unheard-of behavior in the credit markets, where interest rates have collapsed to record lows around the globe. *Bloomberg* reports that as of August 20<sup>th</sup>, more than \$16.4 trillion of global debt, about a quarter of all global debt outstanding, traded at a *negative* yield. The negative yielding debt is mostly governmental but includes some corporate bonds. All German and Dutch government bonds have negative yields. French and Japanese government yields are all negative except for their 30-year bonds but the champion issuer is Switzerland, which has a negative yield even on its 50-year maturity. In Denmark, homeowners can obtain mortgages with negative interest rates, where the bank *pays* the borrowing homeowner. U.S. Treasury yields, which currently peak out at a little over 2%, are disproportionately high by comparison. Left rubbing their eyes are those who remember former Federal Reserve Board Chairman Paul Volcker's inflation-killing federal funds rate which peaked at 20% in June of 1981. Today's fed funds target rate is 2.00-2.25%, after 8 *increases* from the lows of 2015 and one modest quarter-point decrease this July. The highly-respected *Grant's Interest Rate Observer* reports that interest rates for the highest quality government issuers haven't been this low since the Middle Ages.

Negative interest rates are counterintuitive. They fly in the face of what most of us have taken as gospel for years, which is that uncontrolled government deficit spending, concomitant borrowing, and money printing (such as that which occurred in the wake of the Global Financial Crisis) would result in surging inflation and interest rates. Today's United States government debt of \$22 trillion is roughly double the amount outstanding ten years ago. This increase was achieved during the longest U.S. economic expansion on record. Classical Keynesian economic theory (as well as kitchen table economics) argue for paying down debt during periods of prosperity in order to mitigate inflationary pressures and rising interest rates, but the opposite has occurred.

So much for classical economics, but the current low interest rate environment is important because interest rates act as the "North Star" for stocks. The value of any financial asset is essentially based on a comparison to the "riskless rate of return" obtainable from U.S. Treasury securities, generally considered the safest investments in the world. For instance, an investor who can get only 1.5% from a 10-year US government bond, without fear of default, might find the stock market's 9-10% hundred-year average rate of return an appealing alternative. In the 90 years between 1928 and 2018, stocks returned almost 4.7% above the average 10-year U.S. Treasury note, a figure often referred to as the "risk premium," or the additional return required to induce an investor to take the risks of equity ownership, which include market volatility, exposure to a fluctuating economy, company-specific and industry problems, managerial missteps, and Wall Street's fickleness, among many others. Adding that 4.7% risk premium to the August 20<sup>th</sup> 10-year yield of 1.5% translates into a required return of 6.2%. A required return of 6.2% implies a market price-to-earnings ratio of roughly 16, which is about the level at which the market trades today. In other words, if the credit markets currently have it right, then stocks are not overvalued.

Other credit market oddities include government bonds issued by countries far less creditworthy than the U.S. but which carry yields considerably lower than the corresponding U.S. Treasury bond. For example, Spanish and Italian 10-year government bonds yield 0.1% and 1.4% respectively, compared to 1.5% in the U.S. This is analogous to student loan-saddled graduates on their first job getting a lower mortgage rate than their higher-earning parents. We are also at a loss to explain the difference in yields between certain other countries. The Spanish and Italian yields are an example. Both are denominated in Euros and, as the Greek debt crisis proved, are effectively equally creditworthy as they are essentially backed by the European Central Bank.

As long term, fundamental investors, we do not have a defined view on the near-term direction of interest rates, or even the stock market, and instead focus on the knowable, which is the state of the businesses we choose to own. For more than a generation, it has been a fool's errand to call the bottom in interest rates. Yields have been dropping consistently *since 1981*, meaning that the bull market in bonds is in its 38<sup>th</sup> year. We are acutely aware that distortions in the credit markets can get magnified in the stock market, a linkage that was at the core of the 2007-2008 stock market meltdown. We are also aware that an economy set up to operate on essentially free money is especially vulnerable to unpredictable interest rate and inflation shocks.

We deal with this uncertainty by investing in a handful of simple, powerful business models that do not require us to risk a bet on interest rates or inflation. These are honestly managed businesses whose models we can reasonably assume will remain intact for at least 5-10 years while compounding our capital at significantly above-average rates. We see no reason to believe that stock prices will not continue to compound at their historic average of 9-10% per year, interrupted occasionally by major deviations both up and down (such as this year's 20% year-to-date market return). That said, we are comfortable holding an amount of cash that would permit us to establish new positions and build on others to the extent they become bargains.

### **A Word on Tariffs**

The Trump administration has imposed a wide variety of tariffs, mostly directed towards China (and perplexingly, towards clear allies such as Canada), and we applaud the effort to enforce greater protections for the owners of American intellectual property and believe that forced technology transfers as a condition of trade are repugnant. That said, tariffs are being used far more broadly as a blunt political instrument and their cost is being largely absorbed by American producers, including farmers, and American consumers. To this extent, they are an overreach that will undoubtedly continue to have adverse economic effects.

### **Concluding Thoughts**

We have enjoyed a decade of rising stock prices in the wake of the Global Financial Crisis. Rising corporate earnings have benefitted from the tailwind of declining interest rates, which have also boosted the multiple paid for those earnings. Our portfolio is not "cheap" by historical standards, but our businesses and managers generally find a way to compound per share value in nearly every environment. They have earned our trust.

We remain grateful for the privilege of working for you. Give us a call. We would love to hear from you.

Best regards,

Peter C. Keefe

James H. Rooney

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