Letter to Clients II
January 2016

What's Going On

Oh, you know we've got to find a way
To bring some understanding here today

Marvin Gaye

Robert Samuelson wrote a sort of helpful column titled "Decoding the market" a few days ago in the Washington Post. It was helpful in that he asked a good question: whether the sell-off in stocks signals an economic slowdown or recession.[1] But it was—in our view, anyway—unhelpful in that 1) he assumed that a market decline must have a discrete and identifiable cause and 2) he seems to have cherry-picked his potential culprits from among the many cross-cutting trends evident in the economy today.

Ben Graham, who invented our way of investing in the 1930's, viewed the stock market as, among other things, a barometer of investor sentiment. As such, it was dangerous to impute too much meaning to its movements. This is particularly true during periods of steep downdraft when emotional investing tends to gather momentum simply from the decline itself. Having said that, clear-eyed analysis of the kernels of truth to which the market might be (overly) responding need to be examined and viewed in proportion to the actual risks that they pose.

Consistent with Graham's thesis, it's important to develop at least a working understanding of the prevailing psychology of market participants. We believe that what we are seeing today is not so much investors responding rationally to the failure of China to sustain its supercharged growth, the strengthening of the U.S. dollar, the decline of oil and gas prices, or even the elevated levels of the stock market itself (all of which Samuelson calls out as possible causes of the turmoil) but rather investors frightened by **disruptions to their expectations** about each of these. Discontinuities are inherently destabilizing from an emotional perspective, and when they cumulate, the impact is amplified. You have—literally and figuratively—disturbed the equilibrium of market participants and they respond the way they have historically done, by selling indiscriminately.

Ironically, the very rosiness of the economic scenario running up to the current choppiness may have set things up for this moment. What looked like smooth sailing after years of post-recession anticipation of a recovery (jobs are being created, wages have started to increase, house prices are steadily rising) led many market participants to bet that the future will be a continuation of the recent past, complete with an endorphin enriched stock market. But just as

[1] The historical answer is simply that sometimes market declines do correctly "predict" recessions and sometimes they don't. As the other Samuelson, Paul, once quipped, "The market has forecast nine out of the last five recessions."

when the dog finally catches the car it's sometimes disappointed in the make and model year, so the U.S. recovery suddenly looks unequal to the challenges posed by global interests that don't care about keeping the American economy and stock market afloat. If you bargained that "status quo plus" would prevail indefinitely into the future, as a lot of people have, then discontinuities like we're seeing today mean that you are suddenly wrong. That's at the core of why people have become angry and frightened—and have then taken it out on the stock market.

Let's take each of the theoretical "causes" Samuelson floats in turn:

China.

It is true that China's slowdown in growth diminishes the near term ability of U.S. companies with a presence there to continue growing at their erstwhile astronomic pace (see, e.g., **YUM! Brands**). It is also true that companies selling commodities and other goods into that market from overseas are having their wings clipped because of substantially diminished demand. Moreover, an economic crisis in a country like China is different from an economic crisis in a country with an elected government (countries often fire leaders who are in power when economic crises occur), so resolving this crisis will provide an interesting test of the current Chinese leadership. Nevertheless, a slowdown of this sort is actually a natural and—dare we say—healthy step along the road toward sustainable, not currency-manipulated, economic growth. A more viable Chinese economy benefits us in the long run. And, notwithstanding what happened in 2008, not all economic slowdowns are catastrophic.

The dollar.

It is also true that a strengthened U.S. dollar makes it harder to find export markets willing to accept the higher prices that a strong dollar commands. But as a country that imports more than it exports (particularly energy), the U.S. can leverage that strong dollar into cheaper sourcing of both commodities and finished goods. This is a good thing.

Oil and other commodities.

Finally, it is true that low commodities prices—and low oil prices in particular—deal a blow to the burgeoning oil exploration and extraction industry in the U.S. This has the obvious knock-on effects of softening demand at the companies serving them, such as (among many others) **Fastenal** and **Union Pacific**. But the market has almost entirely discounted the significant benefits of low oil prices: to the consumer (who, admittedly, has yet to spend it other than on more gas), to industry, and to geopolitics (are you listening, Messrs. Putin and Rouhani?). And while the energy loans on the books of lenders such as **Wells Fargo** and **Goldman Sachs** represent very small and eminently manageable parts of their portfolios, if the price of oil sneezes, the market reacts as though they have a full-blown case of influenza. Separate and apart from the moderate levels of such exposure, the vague bogey man of "counterparty risk" also makes no sense to us given strong capital and careful risk management at those institutions. After much head scratching, we've arrived at the conclusion that an industry that was much smaller in the latter days of last century (when the price of oil was **half** what it is today) has assumed an almost mythical status in the minds of the investing public today; as such, any bad news for it gets amplified beyond any factual justification.

In sum, we believe that the hallmark of an irrational response is absorbing only the negatives while disregarding the countervailing positives (or, of course, vice versa). Abrupt discontinuities in expectations will have this effect. As rational investors, it is incumbent upon us to gird ourselves against such emotional responses and stick to our process, discipline, and analytical framework.

Let's conclude by looking at the fourth potential cause that Samuelson highlights: the excessive loftiness of valuations embedded in the stock market. Here, he might have identified at least a partially rational response by investors. Valuations that exceed the aggregated likely cash flows of a company over time (as discounted back to today) are valuations that are unlikely to stand long term. At some point, those valuations unravel, and perhaps that is what we are seeing today. Lest we grow monotonous on the subject, this is why we take valuation so seriously.

Our advice about how to deal with what's going on? Understand what's real and what's fantasy. Act with equanimity to exploit the misjudgments of the crowd. Be patient and don't pull the trigger before your buy price, with a fat margin of safety embedded in it, has been reached. Don't hesitate to buy when you get your price. And, if the buying opportunities surpass your store of cash, figure out what you'd like to sell (what might be most overpriced, for example) so that you can stock up on the goodies others have impetuously put on sale. All of which we are doing.

Marshfield Associates

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21 Dupont Circle NW, Suite 500 Washington, DC 20036 202.828.6200 (6208 fax) www.marshfieldinc.com