

President’s Letter & Market Commentary – Q2 2015

“The dynamism embedded in our market economy will continue to work its magic. Gains won’t come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America’s best days lie ahead.”

- Warren Buffett, 2014 Berkshire Hathaway Shareholders Letter

One of Warren Buffett’s greatest legacies lies in his ability to provide the proper context for issues that are impacting the markets. As investors we are faced with a challenge. We live in a world where news and information is prevalent, and short term focused, but our investment goals are not. We must comprehend the current state of affairs, but with a broader understanding of how that will impact us over a longer period of time. Not always an easy thing to do.

If we survey the landscape today, the issue that the market is most concerned with relates to the potential actions of the Federal Reserve. When will they start raising rates, and by how much? Not a new discussion by any means, and certainly one that is overdue. The economy has recovered from the damage done from the Great Recession and can now stand on its own two feet. The support provided by the Fed over the last six years was meant to be temporary not permanent. That all sounds pretty good to me. The market has taken a different view. Talk of higher rates has been seen in a negative light leading to market selloffs.

Why are higher rates and an improving economy being viewed negatively by the market? The most logical reason is that borrowing costs will rise, which in turn will make it more expensive to borrow money and therefore lead to less borrowing and lower growth. A reasonable explanation, but is that the whole story? What the chart below shows is that over the last six Fed tightening cycles the market has shown positive performance both leading into and after the first rate hikes. On average the market is up 7.7% six months after the first rate increase and 5.4% twelve months after the rate hike.

S&P 500 Performance Before and After Fed Tightening					
Date of First Raise	-6 Mos.	-3 Mos.	+3 Mos.	+6 Mos.	+12 Mos.
03/31/1983	27.0%	8.8%	9.9%	8.6%	4.1%
01/05/1987	0.2%	7.9%	19.1%	21.2%	2.6%
03/30/1988	-19.8%	4.1%	6.0%	5.4%	13.3%
01/04/1994	4.7%	2.7%	-3.9%	-2.4%	1.9%
06/30/1999	11.7%	6.7%	-6.6%	7.0%	6.0%
06/30/2004	2.6%	1.3%	-2.3%	6.2%	4.4%
Average	4.4%	5.2%	3.7%	7.7%	5.4%

Source: Bloomberg Finance, LLP

While we know that past performance is no indication of future results, the past tightening actions have shown that an economy as dynamic as ours has the ability to adapt to the changes in the rate environment and ultimately push higher. Setbacks can be expected, and some areas will ultimately do better than others. What may eventually determine how bumpy the road is after the initial rate hike is what further increases look like. Taking stock today, we see very low levels of inflation in the system - due in part to a strong dollar (which decreases the costs of imported goods) and low energy prices. This combined with generally modest increases in wage growth, could serve to limit how far the Fed goes in trying to return rates to more normal levels (around 3.75%). Remember that the Fed has two stated objectives, to keep tabs on inflation and to obtain full employment.

Ultimately, time will tell how the Fed acts, and how the market and economy react. But in the meantime, we need to keep our focus on finding quality companies that can prosper during times of transition. Because, while the specific actions that the Fed takes are not totally clear, the need for a change in monetary policy (i.e. higher rates) seems to be on the horizon.

Sincerely,



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