KLCM Advisors, Inc.

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The Great Unwind

Ten years ago, the capital markets were frozen, and global economies were in free fall. With liquidity at a premium, all asset classes other than US Treasuries were caught in a deepening bear market. The only tool available to staunch the bleeding was cheap and easy money. Central banks across the globe flooded the system with new money to prevent the crisis from spiraling into a global depression. Preventing this was the **ONLY** concern for policymakers. Interest rates were pushed to zero while $700 billion of emergency capital was made available to banks and financial institutions. Money market funds were guaranteed, and giant industrial operations were protected from bankruptcy by government financing. Collectively, these measures became enough to put a bottom in securities markets and stemmed the tide of selling.

The continuation of these policies over the past decade served to suppress volatility and inflate asset prices. The seemingly infinite amount of liquidity infused into the market resulted in investors earning no return in low-risk investments. Over time, investors slowly but surely embraced risk and began to buy stocks. Combined with an elongated economic cycle, this environment favored stocks of growth companies and businesses with stable cash flows over companies with cyclical businesses or variable cash flow streams. As a result, the valuation discrepancy between growth and value stocks began to stretch and recently was as wide as it has been in the past 20 years.

Beginning in 2016, the Federal Reserve started to remove this extraordinary monetary stimulus from the markets. We began this period so insulated with excess liquidity that many participants failed to even notice the change. In fact, despite the start of this process, markets remained sanguine and exhibited the lowest level of volatility in decades in 2017. All this changed in 2018.

What seemed like a roller coaster year compared to the past decade was actually a return to a more normal market environment. As we move forward, the market will have to continue to adapt to monetary tightening. We believe the Federal Reserve will raise rates until they believe rates are at “neutral,” currently “estimated” at 2.5-3.5%.

Markets have experienced many rate cycles. Experienced market participants have known options that each uses to adapt to changes in interest rates. What is different this time is the unwinding of the Federal Reserve’s balance sheet. The Fed pursued this path for the first time during the crisis as part of their important role of liquidity provider of last resort. Presumably, it had a positive effect on markets. They are now tasked with unwinding it, however, and more importantly managing the process. We believe the Fed will continue to shrink its balance sheet from its October 2017 peak of $4.5 trillion. Pulling back too quickly would likely inject too much volatility into the system at once, while waiting too long might prevent a full exit before the next recession. It is a very narrow, uncharted path that must be navigated.

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As the monetary stimulus is removed, economic fundamentals will eventually overtake monetary policy as the primary driver of equity prices. Here it is important to note that the US economy is strong. Economic growth, while somewhat uneven, is solid and the job market is tight. In fact, it is tight enough that wages are rising steadily, which is pulling people back into the labor market. Furthermore, consumers are currently enjoying low energy prices which combined with wage growth should keep them happy and spending. **These are good things!** This environment should continue to provide the type of data the Fed wants to see to continue unwinding the balance sheet.

There will be fits and starts, and that is where asset managers will be tasked with navigating the choppiness. We believe that blue skies and placid seas will no longer be the norm. Economic and market volatility will be the environment that we will navigate, and we are welcoming this change. The previous volatility suppression regime favored good businesses with steady growth. While we acknowledge that many of these are wonderful businesses, some became priced so richly that in our estimation there was zero margin of error in owning them. One example is the trash industry. In the past, we have owned both Waste Management and Republic Services. Both businesses have large scale advantages, consistent free cash flow generation, and solid balance sheets. Historically, we had looked to purchase these companies when they traded around seven times cash flow and to exit them around nine times cash flow. In fact, we made that trade earlier this cycle. This time, as a result of their steady cash flow and suppressed market volatility, investors continued to pay ever higher prices for the stocks. In fact, they currently trade at closer to twelve times cash flow and actually have much weaker balance sheets now than at the beginning of the cycle. These are great businesses, but at the current elevated valuation, risk/reward is severely skewed towards significant short-term capital destruction if valuations would return to historical levels. This example is a reminder of the old saying that price is what you pay and value is what you receive. In many cases today, it is hard to see the value.

If we are correct that volatility is being injected into the system, then the pillars of value investing may once again be rewarded. Our charter will continue to focus on being highly sensitive to valuation and downside protection in an effort first to preserve capital and then to grow it. Companies with good prospects, solid balance sheets, and sustainable free cash flow usually benefit in this environment. The recent market selloff, which reached a crescendo on Christmas Eve, sent stocks of some companies possessing these characteristics to valuation levels that got our attention. We took advantage of the opportunities provided to us and added some new names to the portfolio in January. Our strategy in this environment will be to continue to proactively deploy capital in names that become dislocated from company fundamentals.

We look forward to having more opportunities present themselves as we move through 2019.