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State of the Union

Fourteen years after the Declaration of Independence, George Washington delivered the first State of the Union Address to a joint session of the United States Congress in 1790. This week's speech, initially delayed by the government shutdown, laid bare the US President's priorities and diagnosis of the economy. It was an uplifting economic summary:

"…we have launched an unprecedented economic boom – a boom that has rarely been seen before…Unemployment has reached the lowest rate in half a century…for the first time in 65 years, we are a net exporter of energy."

With the above backdrop for the world's largest economy, a fair question for those that are investing alongside us in QV funds is, why continue to proceed with care? Isn't it time to throw caution to the proverbial wind and let the good times roll? In short, we don't think so. It is dangerous to base long-term investment decisions on recent economic performance. Strong employment does not translate directly into future gains for investors, especially if future expectations assume this backdrop will continue well into the future.

This year's speech was a stark contrast to President Gerald Ford's 1975 address, which occurred shortly after the Watergate scandal and a period of stagflation (a recession laced with inflation). President Ford stated:

"…I must say to you that the state of the union is not good: Millions of Americans are out of work. Recession and inflation are eroding the money of millions more…We depend on others for essential energy."

While these speeches paint vastly different pictures, the biggest contrast to me is what was left unsaid. Ford clearly articulated that the fiscal deficit and national debt were at uncomfortable levels. Annual deficits at that time were expected to rise from $30 billion to $45 billion, and national debt was $500 billion.

Today, the annual deficit is approaching $1 trillion and national debt is nearly $22 trillion, yet there was no mention of debt or deficits in this year's State of the Union Address.

I highlight these contrasting speeches because positive recent economic experience does not directly translate into outsized long-term returns. Our experience has led us to believe quite the opposite. Despite President Ford's dire delivery, the investment stage was set for its most spectacular performance. His speech came at the doorstep of the greatest bull market in our history. The Dow Jones Industrial Average (DJIA) went on to increase more than 15-fold over the next twenty-five years. During the 1975-2000 period, earnings growth was not far from historic long-term annual averages. What drove outperformance was the starting point of low valuations combined with multiple expansion over time. The DJIA started that timeframe with a trailing P/E ratio of close to 7x and ended with a ratio above 20x.

Today, we sit closer to 20x trailing earnings for the DJIA. Interest rates and inflation in developed economies remain low by historical standards, and debt levels continue to compound at rates that far exceed economic growth.

We simply don't have the same levers today that existed in 1975. With little left in the tank for valuation expansion or economic acceleration over the long-term, it is warranted to proceed with investment caution. A collective lack of concern (at both the presidential and individual level) towards balance sheet strength is also worrisome. However, this doesn't mean all is lost. We expect earnings growth and dividends to be a larger contributor to returns over the long-term and we don't expect multiple expansion to be an important driver. We move forward with a focus on businesses with strong foundations, offering reasonable value, with healthy balance sheets and opportunities to grow. We will continue to assess our investments not solely based on today's environment, but also stressed for a more challenging state of the union.