September 2019

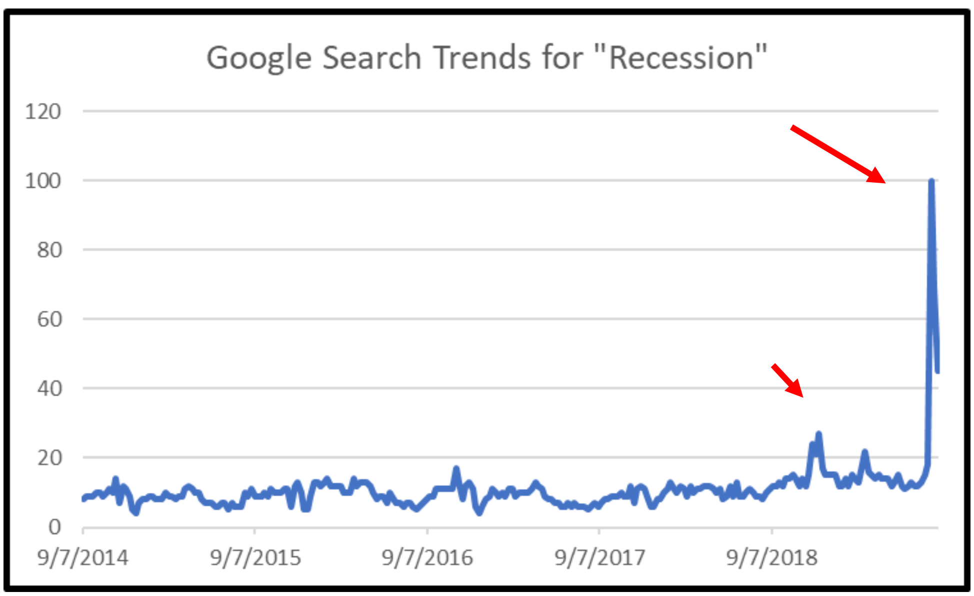
Bring on the Recession

Summary: The financial media remains focused on fear-related themes and potential for a recession, but we believe economic weakness can actually be good, if you're invested in the right companies. On the other hand, the U.S. consumer remains very strong, and consumer spending is more than two-thirds of the U.S. economy. U.S. companies also remain very innovative and ability to raise capital is good. The main risk to global growth seems to be trade disputes between the world's two largest economies, but, in our opinion, this is a war *in name only*. We continue to think it makes more sense to position for a positive resolution.

Money Managers All Want to Anticipate the Next Recession

People are freaking out -- at least on Google. The stock market's movement on any given day is driven by the back and forth buying and selling of hedge fund managers, large mutual funds, computer-driven trading programs, day-trading firms, individual investors and money flow (whether investors are adding or removing funds in equities). These groups have different time horizons and strategies and thus react differently to the day's economic data and corporate earnings releases, as well as other big picture information (political events, for example). Over the last decade, the relative size and influence of these groups has shifted, giving computer-driven and "passive" strategies (which frequently just attempt to mirror market performance) a larger share of daily trading volumes. This has come at the expense of "active" funds which employ a team of professional investors that make decisions to buy or sell stocks. Index funds, ETFs and passive strategies are now estimated

Figure 1. 5-year chart of Google searches for the term recession. Mid-August saw a dramatic spike in searches. Why?



to control about half of U.S. equity funds. This is nearly double the share these strategies had a decade ago, according to Bank of America Merrill Lynch and Morningstar. If we add in trading by other computer driven strategies, we can easily say that *more than half of market activity* on most days is produced by computerized orders, rather than humans.

This does not mean that human reactions or the actions of professional money managers have become irrelevant. Human investors are still setting the prices for individual stocks and frequently establishing the reaction to the day's economic or political news. The shift to passive investing has served, we believe, to amplify moves made by professionals, many of whom were already operating with short-term outlooks.

Recently, we believe, media coverage on the trade spat with China, and bearishness among bond market investors has spiked recession concerns among individual investors. We can see this represented in Figure 1 (previous page) which shows a chart of searches on Google for the term recession. It jumped in December 2018 (when the yield curve inverted, click here to read our explanation of yield curve inversion) but then more recently to an even greater extent. As we look back over the last year, the market's largest swings have been produced by professional investors trying to sell in front of a potential recession, and then buying back stocks when the clouds cleared, with passive strategies following along. It is natural for investors to fear economic weakness, but the gyrations of the market demonstrate how difficult it is to predict the cycle as well as the lack of advantage provided by indexing and passive strategies.

We take a Different View on Investing During Recessions:

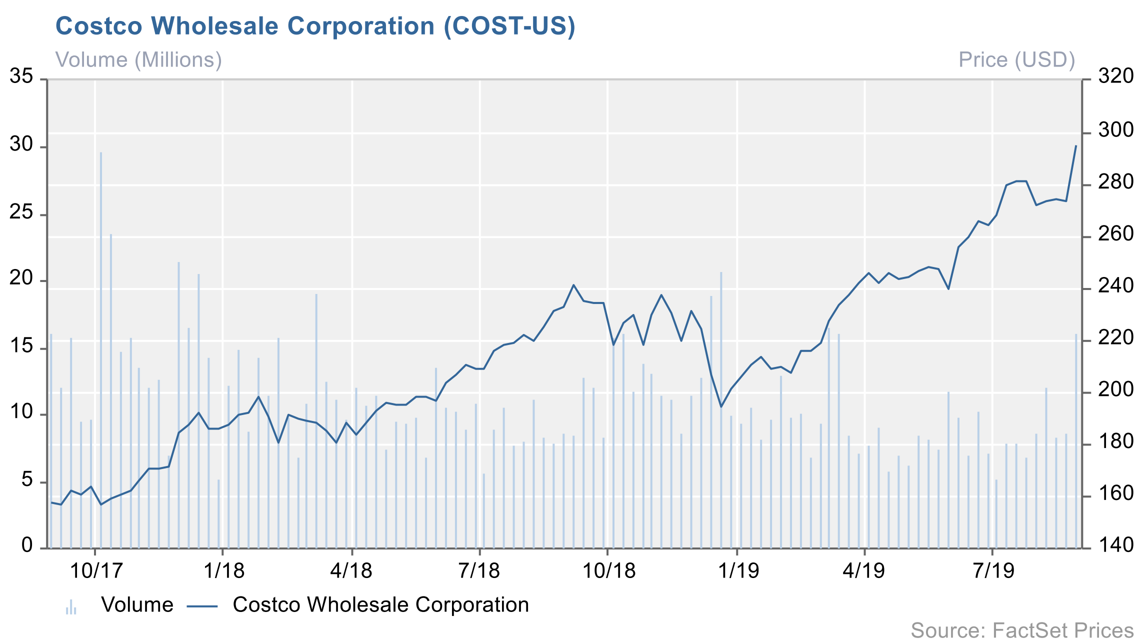
If your time horizon is longer than this year's bonus cycle, you can see the positive effects of a recession. If the U.S. economy shifts from expansion to contraction, lots of negative things will happen. These include higher unemployment, lower corporate earnings, and declines in stock prices. Actively managed funds with less than a one-year time horizon (typically how managers and analysts get paid) will try to sell equities and reduce exposure to stocks ahead of a recession. However, more difficult business conditions and reduced access to capital will also cause weaker firms to fail and fewer new companies to receive funding. Recessionary conditions thereby reduce competition. Which companies benefit? Those with the best business models, good management, and solid balance sheets. *Net, **while the stock prices of the best companies may go down with the market during times of economic difficultly, these companies will likely exit a recession in an even stronger position than they entered**.* Our message*: If your investing time horizon is sufficiently long, and you own stocks in the best companies, then you **don't need to worry** about the economic cycle.*

Selection from our Model Portfolio: Costco Corp. (COST)

Costco Wholesale Corporation (COST): Long before Chinese consumers went cuckoo for Costco, it was already a great stock. COST operates large, no-frills stores, stocks a very limited selection of items, which it offers in very large quantities, and sells at a modest fixed mark-up. The average number of items in a Costco Warehouse is around 4,000 vs. apx. 150,000 in a Walmart Supercenter. Costco's normal mark-up on goods it sells is 8-10%. This compares to the practice of many retailers that start with markups of 50% before discounts and promotions. COST considers itself to be a "buying agent" for its customers, comprised mostly of both small business owners and families. These customers pay the company an annual membership fee for the privilege of shopping at its locations and taking advantage of its attractive pricing. The practice of offering goods at low prices, operating spartan stores, and driving volume is known as the "productivity loop" which is a phrase coined by Walmart but applies well here. COST has been operating this way for years. Accordingly, it is not a name favored by smarty-pants hedge fund analysts as the story is already *known*. It's hard to have a differentiated point of view on COST or to think you know something about the company that isn't already appreciated by others in the market. We own the stock, not because we have a special unique thesis, but because we like COST for exactly what it is: a very strong company with a great consumer offer and the ability to grow and take market share. Further, should the U.S. enter a recession, we understand that COST may experience some short-term sales weakness associated with consumers cutting back or small business customers failing and cutting memberships. However, we feel confident that COST will survive the cycle, while many competitors will not, setting the company up for accelerated sales growth in the following recovery.

Last week, Costco opened its first store in China, in Shanghai. In an environment of supposed trade "war" between the U.S. and China, excitement around the American retailer opening was so great that the store was forced to close early due to huge crowds and demand. This helped the stock gain 7% or nearly $9B in market capitalization last week on the way to a new all-time high. Should COST shares be worth $9B more because it has one store in China? Maybe not, but we feel good owning it, regardless of economic situation in the U.S. and the trade relations with China.

Figure 2. COST shares are up 45% year-to-date. See a two-year chart of COST's price per share below.



This month starts with a visit to the metropolitan center of Columbus, OH. In Columbus I will attend the L Brands (parent of Victoria's Secret and Bath & Body Works) analyst day. You can read comments I made about the event published in a Forbes article by clicking here. I will also be swinging through New York. Later in the month, I am heading to the Eastern Mediterranean to attend the Cyprus Value Investors' Conference. I will present an investment idea at the conference. The month will wrap up with the Paris-Versailles race, which, you guessed it, starts in Paris under the Eiffel Tower and finishes at the Palace of Versailles. It's only 16 KM (10.2 miles) but includes 173m (567 ft) of elevation change jammed into about 2 KM of the race, representing a 7% grade. Here is the official site for the race. Lastly, check out our recent quotes in the Style section of New York Times on fashion "drops" and Target's strategy to make designer brands available in limited quantities in its stores.

Do you already have enough ETFs and mutual funds? If you are looking for a more concentrated, thoughtful portfolio constructed by a manager available to answer your questions, please get in touch. An archive of our past newsletters can be found on our website by clicking this link .

Yours,

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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and Oxford University. He has followed U.S consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor and research boutique, in 2017 and works from New York and Paris, France.

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The analyst who is the author of this report has a long position in Costco Wholesale Corporation (COST) and L Brands (LB). Quo Vadis prohibits analysts from trading in a way that is inconsistent with opinions expressed in reports [subject to exceptions for unanticipated significant changes in the personal financial circumstances of the analyst].

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