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Dolphin

# Optimism pays

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The last few years haven't been especially easy for investors. We've had to navigate unprecedented global lockdowns, the re-opening of the economy, rapidly rising inflation, and a step change in interest rates.

It has also been immensely challenging for the businesses we invest in, whether we own them directly or via funds. Management teams have had to navigate multiple environments and one of the 'weirdest' business cycles in history, and they're still having to do so.

As the economy reacted to interest rates we hadn't seen since the global financial crisis, avid market watchers may recall the absolute certainty financial media had at the end of 2022 that we would see a recession in 2023.

There was a very clear consensus that the only way central banks could get inflation under control was to create a recession and 'slack' in the economy. The price would have to be paid for fiscal and monetary policy largesse, to paraphrase the oddly sacrificial tone of the time.

Yet there hasn't been a recession in the U.S., the world's most important economy, which continues to positively surprise.

## Why were so many people so wrong?

It's easy to throw out answers, but perhaps before assessing why the economy has been so resilient, we should reflect on whether it's ever really possible to time the economic cycle.

The economy is complex, and it's important to recognise this, predicting the future is a risky business.

Perhaps we can augment our approach along the way, but the real value is in staying invested for the long term.

Whilst this may not be all that insightful, the acceptance of unpredictability is central to our approach and ultimately, long-term investing success, at least in our view.

This is why we place so much emphasis on quality and durability. If we want to enjoy good long terms, we need to be able to endure difficult markets.

Quite simply, it is much easier to look through downturns, and take advantage of them, when we invest in higher quality assets.

Looking back at our view in late 2022, we did not offer certainty. We assigned a probability to recession, but we also recognised this was an entirely unique cycle.

We've never shut down the entire economy, cut interest rates to zero, introduced massive fiscal stimulus and re-opened the economy over a two-year period before.

Offering definite views in such an environment seemed irresponsible to us. Sure, be cautious if it's right for you, but accept that you simply couldn't know what would happen.

However, we did know the consumer in the developed world was in a very strong position, and we knew

that businesses had been preparing for a downturn. Governments were also taking a much more active role in the economy, via fiscal stimulus, a notable change from the post-financial crisis years.

Whilst the rise in interest rates was impacting more leveraged parts of the economy, our analysis suggested this was unlikely to cause a wider or systemic problem beyond a slowing economy.

The apparent resilience of the economy and the simple fact the market had already experienced around a 20% decline in 2022 gave us grounds for optimism. We debated whether the prevailing pessimism was priced in.

Valuations were also much improved at the end of 2022, and future returns looked pretty good across asset classes.

As it turned out, inflation also came down quite rapidly from its more troublesome highs. Whilst it hopefully has further to decline, prevailing levels have not previously been problematic for equity market valuations.

## AI leads the way

We've also seen an investment boom in artificial intelligence (AI), which is leading to real earnings growth across the technology sector. We're not saying we know how this plays out from here, but the move so far seems rational, and we certainly don't believe it's a bubble.

As we've discussed before, businesses that can leverage their proprietary data sets look especially well positioned to benefit from advances in AI. This is a focus for us.

## All eyes on interest rates

With respect to interest rates, we've seen a step change from the very low rates of the past decade, and we need to reflect on how this impacts the economy and the valuation of assets.

Private individuals have successfully deleveraged over the past 10 to 15 years and are now in quite a strong financial position. Prevailing interest rates are arguably consistent with the current growth of the economy and while rates are likely to fall over the coming year, it seems very unlikely that we'll return to the ultra-low rates of the 2010s.

This is a big adjustment for more leveraged sectors of the economy, and it's been a problem for owners

of government bonds over the past three years. However, the challenges seem manageable and looking forward, government bonds now offer much better potential returns compared to the last decade.

## The path forwards

Overall, it does seem to us that nominal growth, inflation and interest rates will end up being higher this decade than the last. The level of interest rates and bond yields we see today are consistent with this view and we don't believe they present a challenge to equity valuation when set against higher growth. In stating this, we should again recognise the challenge of prediction and our investment success shouldn't be dependent on this view.

The devil's advocate to my point on leverage sustainability, is the high level of government debt and whether this, at some point, will cause a problem. It may well do.

In our view, if you are concerned about this, we suggest you should own some assets, as history tells us governments tend to inflate away their debts. Today's euros are very unlikely to have the same purchasing power in a decade's time.

Today, we think we're actually in a pretty good position. Whilst equity market valuations have risen somewhat, it's reasonable to believe earnings growth will support this, as the overall economic picture looks fairly sound.

No doubt there is plenty to be concerned about, not least the geopolitical situation, but I can't recall a time when we didn't have geopolitical concerns.

A correction for equity markets also wouldn't surprise us. Markets have been quite strong over the past few months and to see some retracement of those gains would be entirely consistent with normal market behaviour. With our longer-term hats on, we would welcome some market weakness.

When we look out longer term, we are optimistic. For as long as I've been writing this commentary, I've described ourselves as pragmatic optimists and we really try to stay true to this. It wasn't easy to stay optimistic through 2022. Visions of the inflationary 1970s environment loomed large and filled our inbox.

However, we endeavoured to stay rational and to trust our process. We've also learned a lot from the experience of the last few years and reflected on how we can improve.

Our optimism isn't based on a naive sense of hope, it's based on logic and history. We believe the capitalist system will continue to generate growth and create wealth, which will in turn support future growth and wealth.

The best way to protect and grow our clients' capital is to invest in assets that support and benefit from this system. No doubt we'll face future challenges, but if we face them with humility, process, and optimism, we are confident we'll endure and deliver on our clients' objectives.

That may seem a touch dramatic, but it has been a pretty remarkable few years, so please forgive me if I indulge in a little drama.

As always, please do not hesitate to contact us to discuss our views further.

**Ian Quigley**

**T:** +353 1 2600080

**E:** [ian.quigley@brewin.ie](mailto:ian.quigley@brewin.ie)

**[www.brewin.ie](http://www.brewin.ie)**

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