

NICHOLAS INVESTMENT PARTNERS

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Investment Insights: Uncertainty Leads to Volatility

What's driving the current volatility? Rather than one or two factors like economic health or the direction of interest rates, investors are feeling uncertain about a number of things whose aggregate potential impact on stocks could be highly unfavorable.

A powerful combination of market drivers

These are the factors that we believe are collectively driving market volatility:

Fed concerns. The Fed has tightened monetary policy in the past few years to reduce the odds that economic growth will overheat and lead to rising inflation. Investors naturally worry that too much tightening will push the economy into recession.

Trade wars. Investors are concerned about the effect that President Trump's stance on trade might have on global economic growth. Supply chains—many of which include companies in our smaller cap investment universe—are feeling pain as tariffs make their way through the system. Anecdotal evidence, furthermore, suggests that even the most financially sophisticated companies are unable to model how the trade wars will play out, which is a challenge for stocks.

Decelerating global growth. The synchronized global economic growth that spurred investor confidence just 18 months ago has transitioned to a greater dispersion among nations. 2019 US GDP forecasts, for example, are dropping from the 3-4% range to 2-3%. Germany, long the economic anchor of Europe, just experienced its first quarterly economic contraction in three years. Japan also reported a third-quarter contraction (-1.2% annualized), its second quarterly loss of the year. Growth in China also continues to slow, impacting emerging markets.

China's economic deceleration. The Chinese economy, a source of outsize demand for products and materials produced elsewhere in the world, is slowing down, with domestic factors and US tariffs largely responsible. Third-quarter YoY Chinese GDP growth was 6.5%, the weakest such pace since the first quarter of 2009. Corporate CFOs are saying that they'll make decisions more conservatively if the tariffs persist and China's growth continues to fall.

Falling oil prices. The price of oil is plummeting, primarily based on the build-up of global supplies and uncertainty about whether Saudi Arabia will cut its production to cushion the fall. Energy stocks have been hit hard. While cheaper oil usually is considered a type of tax cut for non-energy companies, this time it seems to reflect concern that global economic growth is softening.

Geopolitical instability. US investors are paying attention to developments overseas, especially in the Middle East and Europe. The Middle East is rife with political and/or military tensions, while in Europe, the economic fallout both from Brexit and Italy's unchecked spending could possibly affect other regions as well.



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INVESTOR WORRIES DRIVING MARKET VOLATILITY

- Fed concerns
- Trade wars
- Decelerating global growth
- China's economic deceleration
- Falling oil prices
- Geopolitical instability
- Simmering debt bubbles



Simmering debt bubbles. With so many other sources of volatility to think about, there are potential debt bubbles—historically a harbinger of financial and economic upheaval—that are flying under the radar. While these are perhaps most glaring in China and Italy, where sovereign obligations are massive and credit quality is weakening, the US has its own mountain of public and corporate debt that could become an economic albatross if rates continue to rise.

Our approach: Staying focused on the long term

The market's current volatility, while understandably worrisome, is neither new nor extreme. We've seen it over the years. If anything, it reinforces our conviction in the essential nature of what we do: We buy innovative companies whose success—as measured by future revenues, earnings and/or price appreciation—we expect to materialize over a period of one-to-two years, not months.

That said, we recognize that revenue and earnings visibility for stocks could be low in the near term and, as part of our normal investment process, we have made some adjustments to reduce risk across our portfolios.

A benefit of the market downturn is that we're finding more of the type of companies we favor available at attractive valuations. These are companies whose competitive catalysts—notably innovation, disruption and rapid change—should fuel earnings growth that not only outpaces most other companies, but also accelerates while doing so.

The bottom line: We remain confident in the stocks we own and seek to take advantage of more attractive valuations to position the portfolio for future gains.

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Nicholas Investment Partners, L.P. is an independent, employee-owned and majority women-owned investment boutique focused on investing in dynamic, less efficient markets such as US small- and mid-cap equities and convertible bonds. We believe that change creates opportunity. We invest in dynamic companies with accelerating revenue and/or earnings growth in which our research confirms the company's growth is sustainable and the company's stock is a timely investment. Our edge comes from combining fundamental equity and credit research with the objectivity and efficiency of quantitative analytics. We have a results-driven and client-centric culture centered on building lasting and value-added relationships with a select group of institutional and private wealth clients and consultants.

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