Watermill Group

ONE CRANBERRY HILL
750 MARRETT ROAD, No. 401
LEXINGTON, MA 02421

T 781.891.6660
WATERMILL.COM

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Thinking About the New Normal

When the markets crashed in 2008, and even before, McKinsey started talking about "The New Normal". What they implied by this term was that the Great Recession was not an everyday correction, so that after we held our noses and survived it things would not return to the normal economic and political environments we had been used to since the 1980's.

Since then we have all watched as central banks all over the world, worried about *deflation*, have been stimulating their economies with tons of liquidity and zero interest rates. The ideas behind this policy mix come from learnings from the Great Depression, which was a deflationary era and which turned out to be worse than anything *inflation* would bring. We have all witnessed that in many ways the policies worked and in many ways they did not. Recently, we have seen deflationary pressures wreak havoc on the EU and put heavy pressure on China as commodity prices stubbornly refused to go up and started to slide. This puts pressure on debtors, as the real value of their debt goes up and the expected cash flow in nominal terms go down. In addition and interestingly, the discussion about the value of the dollar has been had with the wrong assumptions. In real terms, the dollar has not moved at all. Because it is the reserve currency, the values of commodities are reflected in dollar terms and everything gets stated in dollar values. As commodity prices go down, the other currencies go too, and the dollar looks higher.

One of the side effects of these policies – the printing of money combined with low interest rates – is that the excess liquidity, which had to go somewhere, went to stock markets and real assets like real estate and private companies. As a result, all of these asset classes saw themselves developing very high valuations. NYC apartments going for hundreds of millions, stock markets at high multiples and P/E purchase prices over 10X projected earnings are manifestations of this.

As I write this, the DOW is at 15993, down $465, which is off the bottom this morning of 1,000 points down! This is after a dismal Friday and a pretty bad summer. China was off 8% today and most global markets were off 4-6%. So, is this the "correction" we have all been waiting for so the bull market can continue, or is it something else? My thoughts are that the times we are in now and have been in for awhile represent the revaluation of artificially inflated assets that resulted from these central bank policies. If I am right, it will take some time before things "normalize", but once they do, we will have a much more solid foundation for growth in the future.

So, what should we do? First, my recommendation is to relax and watch. Fast overreaction always costs money. My second thought is to look for ways to make our operations cost effective in this low commodity priced environment. We should be lean but optimistic. We should invest in real organic

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growth by looking for ways to take market share and grow unit volumes. When others are panicking the times are fertile for taking share.

The good news is that at Watermill we never fell for the artificial price environment in Private Equity. We have been disciplined in paying good prices for assets where we saw real value. As such, our portfolio is not over leveraged and all of our companies have winning strategies which, if implemented well, will provide real value to real customer and enable them to win over time. But we will want to be patient. It's going to be a wild ride for a little while longer.

Happy summer of 2015,

Steve

Steven E. Karol
Managing Partner