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Investing vs. Trading

To Our Valued Clients,

In a year marred by acts of man and acts of nature, the prices for assets including equities, real estate, art and cryptocurrencies marched to record highs in 2017. This growth in US equities has been accompanied by surprisingly little drama and without even a 5% correction for over fourteen months. On the surface it would appear the world suffers from a severe case of cognitive dissonance. A closer look at the global economic data – low unemployment, improving trade, housing and consumer trends and rising corporate profits – would suggest that optimism is not misplaced, however. Although not always efficient, the market is an effective discounting machine capable of separating meaningful signals from distracting noise. Our job is similar: to identify securities that are improperly reflecting future prospects and trading with a Margin of Safety relative to Private Market Values (PMV).

Absolute returns in (y)our portfolios were strong in 2017, and we look forward to an acceleration in earnings growth and deal activity in 2018. Volatility, while present in many industrial stocks but absent in the general market, will at some point return, driven by real or imagined noise. Market corrections and economic recessions are inevitable and indeed necessary for the proper functioning of our capitalist system. We remain alert and prepared for most eventualities and believe our PMV with a Catalyst™ approach will continue to deliver superior risk-adjusted results over the long term.

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The Political Economy of 2017

State of the Consumer

After a sluggish start to the year, the US economy grew at a faster than anticipated 3.1% and 3.3% in the second and third quarters, respectively. At 4.1%, unemployment stands at a ten-year low while consumer wealth of nearly $97 trillion is at an all-time high. Housing starts of 1.3 million units continue their steady increase, but remain comfortably below the prior peak of 2.2 million units. The US is in its ninth year of economic expansion, making this the third longest expansion at 101 months, trailing only 1961-1969 and 1991-2001 (those expansions were 106 and 120 months, respectively). Perhaps as important, the global economy is in synchronized expansion. For all of 2017, the Eurozone is set to grow 2.2%, its fastest since 2007 while Japan has accelerated to 1.5%; China (by design), is likely to post growth of 6.7%. All of this bodes well for US exporters and their employees.

State of the "Swamp"

Last year we wrote that the "Trump bump" in the market was premised on (a) tax reform (b) deregulation and (c) fiscal stimulus. To date, the Trump administration appears to be delivering on the first two objectives, with an infrastructure bill planned for early 2018. Deregulation in the energy, financial and media/telecom sectors has already unleashed corporate animal spirits. A change to the existing tax regime – we will resist calling the imperfect bill "reform" – should make US corporate taxes more competitive with other OECD countries. Many individuals will see lower taxes with reduced rates and an increased standard deduction, but higher income households in higher state and local tax (SALT) geographies could see an increase. The government has picked a new set of winners and losers (tax lawyers remain winners). The impact this change in taxes could have on the economy is dependent on myriad factors: Will the marginal propensity to spend of the "winners" offset that of the "losers"? How will corporations redeploy increased cash flow? Will lower corporate taxes be competed away, lowering prices to customers but also profits to companies? Will increased

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government deficits cause interest rates to rise, "crowding out" other investment? For now, we would put these factors in the knowable unknowns category.

All else being equal, corporate earnings would rise in 2018 as a result of lower tax rates. However, the market likely anticipated most of this increase in the 30% rally since the November 2016 election. In addition, all else is never equal and depending on the answers to the questions posed above, growth could either accelerate or slow. Long term, demographics and productivity growth, neither of which are necessarily altered by corporate tax regimes, are far more important drivers of GDP. That being said, in the near term, higher profits and a higher market are the base case and fortunately, (y)our portfolio is well positioned to capture the benefits of lower corporate taxes as it includes a disproportionate weighting of small and mid-sized US firms who are currently paying higher effective rates and whose revenues are centered on domestic operations.

State of the Fed

Notwithstanding excitement about potential tax windfalls, the most powerful market levitating force from Washington over the last decade did not originate from the White House or the Capitol, but from the Eccles Building, home to the Federal Reserve. Through open market activity and three rounds of quantitative easing (QE), the Fed slashed short-term interest rates from 4.5% before the 2008-09 financial crisis to nearly zero, lifting asset prices everywhere. The Fed began tapping the brakes by tapering QE in October 2014 and has now raised rates five times, the latest of which took the Fed Funds rate to a range of 1.25-1.50% in December 2017. The Fed started shrinking its balance sheet with current expectations for three additional increases in each of 2018 and 2019, which would ratchet the Fed Funds rate to 3.0%, still well below prior peak. Newly appointed Fed Chair Jerome H. ("Jay") Powell, a centrist and former banker, will likely continue this path.

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Over the long term, the Fed's "normalization" of rates is healthy for the economy, but the timing of this process has been the subject of debate given a lack of inflation. The last two rate hike cycles ended in market dislocations in 2001 and 2007, but the circumstances in each were very different from today. A future recession may be unavoidable, but it need not be triggered by the Fed anytime soon. What is unquestionably unavoidable is that monetary policy has gone from being a tailwind to being a headwind for the economy and the market.

Mr. Market

Global Stocks

To date the S&P 500 index is up 20%. Since the March 9, 2009 low, the US market is up 360%. At approximately 18x forward earnings, the market is not cheap by historical standards. Taken in the context of low interest rates with the added prospect of lesser-taxed earnings, valuation seems less stretched. Importantly, we are not buying "the market" on your behalf. We pick individual stocks and we can still uncover bargains, though admittedly with the need to turn over more stones than a few years ago.

Among the areas that worked in (y)our portfolios were industrials that benefitted from some combination of higher capital investment (e.g. water infrastructure company Xylem and truck maker Navistar) or defense spending (e.g. Aerojet Rocketdyne and Honeywell). Other areas were challenged by changing consumer preferences, including consumer staples and media (although the announced acquisition of Fox, discussed below, was an early Christmas gift). We think those companies could be poised to rebound in 2018, especially in the event of consolidation.

In any given year certain areas are more in favor than others. This year saw the third highest concentration in market movers (after 1999 and 2004) in over two decades. The five stocks of the FAANG – Facebook, Apple, Amazon, Netflix and Google (now Alphabet) – comprised an

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average S&P 500 weighting of 10% and drove nearly five points (25%) of performance. The current period strikes us more akin to the "one decision" stocks of the Nifty Fifty of the late 1960's than the Internet Bubble of 1999 in that the FAANG as a whole are generating large and accelerating amounts of cash flow and possess deep moats. Apple, Google and Facebook are merely expensive with no "absurdly" or "outrageously" attached. In our view the biggest threats to those businesses are the law of large numbers (Google and Facebook already account for 40% of US advertising spend) and regulatory/antitrust pressure. Google and Facebook are under investigation in Europe and facing scrutiny over their roles in the Presidential election in the US; we imagine that Amazon may be on the radar as well. Just as we look for bargains, there are pockets of exuberance in this market that we normally avoid.

A Bit on Bitcoin

Speaking of exuberance, it may be worth mentioning Bitcoin, which over the last year has risen 2,200%. All the bitcoin mined to date would be worth $295 billion, a large number to be sure, but a mere shade of the $8 trillion value of all gold mined to date. Bitcoin and other cryptocurrencies are based on the "blockchain," a secure, distributed method of storing information that could be valuable across many functions. Bitcoin itself may have a place in the future as a store of value in an environment of eroding faith in central banks. Like gold, Bitcoin is in limited supply and is no one else's liability; it is cheaper to store, transport and handle than gold though it lacks a few thousand years of gold's history. For the moment, however, its usefulness as a currency or asset class is limited by its extreme volatility and lack of wide acceptance. Bitcoin's explosion in value seems based on a greater fool being willing to pay more for it – almost the very definition of a bubble. Much like the Tulip Mania of 1637 or the Mississippi Bubble of 1720, this bubble will also pop. Unlike those classic bubbles of yore, Bitcoin is a global phenomenon, as accessible as a touch of one's cellphone, which gives it the potential to get much bigger, but perhaps limits the collateral damage to any one economy.

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Bitcoin and blockchain will be with us in some shape or form for a very long time and are certainly worth monitoring.

Deals, Deals, Deals

US deal activity has slowed slightly to $1.1 trillion. Nevertheless, as we look into 2018, the underpinnings of "merger mania" – low interest rates, scarce organic growth and rising corporate confidence – are even more powerful. Uncertainty around tax structures (now resolved) and a challenge to the AT&T/Time Warner merger may have given some pause. Historically the Department of Justice has been loath to challenge vertical combinations like distributor AT&T buying supplier Time Warner. The transaction was cruising for approval until Makan Delrahim, President Trump's nominee as Assistant Attorney General for Antitrust who took office in September, rejected proposed behavioral remedies and is suing to block the merger. If the cynics are right and this is motivated by Time Warner-owned CNN's negative coverage of the President, then this may not be worrisome for future mergers (albeit a blow to the rule of law); if the attempted block is a broader populist backlash against big corporations, it may be a problem. Nevertheless, the controversy did not dissuade Disney from attempting a purchase of Fox's assets, a security we own on your behalf. With Disney and AT&T's potentially broader reach and the entry into the entertainment arena by tech companies including Amazon and Facebook, the need for scale becomes an even stronger impetus for consolidation in media. These same forces are being felt in other industries undergoing change, in particular consumer products. We are well represented in those sectors and expect to see more deals in the new year.

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Conclusion

Surmounting a Wall of Worry

Our process tends to be very respectful of risk – we look down before we look up. A list of things that could go wrong in the larger economy is easy to compose, but short of a hot war, major terrorist attack or social unrest, the two biggest risks to the US economy would seem to be an inflationary spike and a Federal Reserve that raises rates too fast because it finds itself behind the curve and/or a 1930's style trade war. A little inflation might be good for the economy and (y)our portfolios as we tend to own companies with pricing power. The impact of a collapse of NAFTA or an escalation of trade tensions with China and Europe (who are not happy with the new tax plan) is difficult to gauge and the fallout for most companies would be hard to avoid. One would hope that good sense prevails on the topic.

A different kind of risk is underestimating what could go right. What if deregulation and changes to the tax code really do spur renewed investment while inflation is kept at bay by technology and globalization (basically the goldilocks scenario of the last year)? Ultimately the health of the US economy is not reliant on who occupies the White House; the stock market is not the President's report card. Growth and markets are driven by the collective efforts of entrepreneurs and hardworking individuals and we remain as bullish as ever on those factors. We also remain confident that our time-tested investment process and methodology will ensure you share in this prosperity.

Thank you for entrusting your assets with us. Please accept our sincere wishes for a happy and healthy New Year.