January 15, 2018

Today's Hoax will be Tomorrow's Reality

If you are an accredited investor, please contact us for performance information.

2017 has been a remarkable year. I launched LRT Capital with the goal of compounding capital at a rate of 20% per year – approximately 10% more than the S&P 500 has returned historically. Given our performance-to-date we are well on our way, but patting ourselves on the back is never a productive exercise as markets can and have humbled the most skilled investment managers.

Extremely good outcomes are always a combination of skill and luck. The United States experienced a mini-recession in 2015/2016, with earnings for many companies stagnating and declining during that period. This set the markets up for an explosive performance in 2017, as earnings began to grow again and sentiment improved after the US Presidential election. Rising earnings, and rising valuations (justified by the prospect of lower corporate tax rates), propelled the US stock market to strong gains in 2017. The median stock in our portfolio gained 35% in 2017, with the best performer, Apollo Global Management up 94%, and the "worst", our US long-term Treasury position, up 8.5%. Combined with an average net exposure of 202% during the year, our portfolio gained dramatically.

After the excellent performance of 2017, suggestion of a repeat performance may be met with skepticism. However, I see no reason for this sentiment. Lower corporate taxes do make American corporations worth more – the rise in the stock market is therefore justified. Baring a dramatic rise in interest rates, the valuation of the stock market as a whole is not in bubble territory. Having said that, I only have modest expectations for global stocks in 2018. Why the modest expectations? Because, I believe that we are coming close to the end of the US economic expansion, which began in late 2009, and stock market participants will increasingly focus on this fact as 2018 progresses.

The US Term Structure

The biggest risk for stock markets in 2018 will be flattening of the US term structure of interest rates. Flat or inverted term structures have been a reliable forecaster of recessions in the United States since 1913 – the beginning of the Fed Era. I expect the US term structure to be completely flat by the end of 2018. This could spell trouble for all sectors of the US economy dependent on cheap credit, and presage a recession in 2019. I see this as the most likely macro-economic scenario over the next 24 months. I will first discuss the flattening US term structure of interest rates, followed by the implications for equity investors.

On December 14th, the US Federal Reserve raised short-term interest rates to 1.5% and released forecasts suggesting three to four more rate increases for 2018. Given that the US economy appears to be operating at full employment, the Fed's forecast makes sense – three or even more rate increases may be warranted in 2018. Should the 10 Year US Treasury bond remain at current levels, the US term structure could flatten completely by the end of 2018.

The Flattening of the US Term Structure and Recessions

Shaded areas indicate US recessions. Source: Federal Reserve Bank of St. Louis

As depicted in the chart above, historically, a flat or inverted yield curve has preceded a recession by 9-12 months. The exact transmission mechanism of a flat yield curve to the rest of the economy are complex and beyond the scope of this letter – as always I welcome your questions, with that said please reach out to me should you want to know more.

The alternative scenario involves a selloff in long dated US bonds and corresponding rise long term interest rates, which combined with a more modest rise in short term rates would keep the term structure positive. However, such a scenario would have a negative impact on US equity prices through at least two channels. First, it would raise the discount rates on corporate earnings, decreasing their present value. Secondly, it would make debt financing more expensive and crimp the ability of corporation to leverage their balance sheets to enhance equity returns (via dividend and buybacks). Either way, scenario one (recession in 2019), or scenario two (continued growth with higher interest rates) could lead to a turbulent 2018.

It is my contention that scenario one – low growth and recession by 2019, is the more likely outcome. Global interest rates are extremely low because of a lack of investment opportunities, an aging population and an abundance of capital. The United States is a younger nation than most, but it is aging and absent dramatic reforms. The US's economic future may be reflected by current conditions in other countries with older populations.

What would be a dramatic reform? Eight million new immigrants per year could reverse the long-term trend demographic trends the US is experiencing. However, it appears that at the moment, the US immigration system is going in the other direction – towards a more restrictive immigration policy. This will only exacerbate future demographic and welfare state sustainability problems.

The most likely future of the United States is therefore slower population growth, slower economic growth, higher debt and lower interest rates. A look around the world at other developed countries shows this template playing out. Despite the last few quarters of "rapid" economic growth around the world, the global stock of negative yielding debt is growing, pointing to a dearth of profitable investment opportunities.

Low global interest rates are not a result of central bankers with their hands on the scales, but rather a logical outcome of the structural economic policies pursued by most countries around the world. Almost every industrialized nation in the world is pursuing policies aimed at suppressing consumption (through taxation, import restriction or domestic wage suppression), increasing employment and promoting exports. Any policy that suppresses consumption automatically raises savings, since production must always equal consumption plus savings. This has led to a glut of savings around the world, with the United States acting as the consumer of last resort. These savings must go somewhere – they are going into consumer credit in the US, the US stock market, the US bond market, real estate in "global cities", Bitcoin, $400 million dollar paintings, expensive wines, etc. Despite all the complaints savers have about interest rates being low in the United States, they are high from a global perspective. As the table to the right clearly illustrates, the United States 10 Year bond yield is already higher than most developed economies in the world. I expect global investors, desperate for yield, to continue to pour into the US debt markets and keep long term rates low in 2018.

10-Year bond yields, select countries (%)

United States	**2.48**		
Australia	2.71	New Zealand	2.73
Canada	2.02	Norway	1.54
Finland	0.58	Portugal	1.44
France	0.73	South Korea	2.49
Germany	0.42	Spain	1.45
Italy	1.9	Sweden	0.75
Japan	0.04	Switzerland	-0.18
Netherlands	0.45	United Kingdom	1.24

Source: Bloomberg

Implications for equity investors

Since the economic expansion began in late 2009, different sectors have pushed growth forward. One by one the growth in each of these sectors has fallen. Industrial equipment, autos, the aerospace cycle, oil & gas, healthcare – none of these is likely to push the economy forward in 2018. Currently the only major sector contributing to growth in the US is housing. The growth in housing is highly dependent on the flow of credit and this will likely be choked off by the flattening yield curve. The implication for equity investors is that we are now closer to the top of the interest rate cycle than the bottom. We expect US short term interest rates to top out around 2.5% before another rate cutting cycle begins.

If we are right, rate cuts could come as early as late-2019. It is entirely plausible that the next rate cutting cycle takes US short term interest rates into negative territory and long-term rates to 1%. A few years ago, negative interest rates where unthinkable – today Japan, Switzerland, Sweden, Denmark and the Eurozone operate with negative short-term interest rates. There is over $11 trillion in negative yielding bonds around the world. Negative interest rates will be met with strong political opposition in the United States, and are likely to only be implemented after considerable handwringing, but I believe they will eventually be implemented. Investors need to seriously consider this scenario – the demographics and debt profile of the United States in ten years' time is likely to closely resemble that of continental Europe.

An environment of negative interest rates means that growth will be very difficult to find. We therefore expect companies with growth opportunities to command extremely high valuations. Or put another way, if the cash flows of a growth company are like an extremely long duration bond, the price of that bond should skyrocket as discount rates decline. One must only look at Europe and Japan today to realize that this is a plausible scenario. Most European stocks trade at low valuations, but companies that can grow earnings are trading at valuation of 60x, 70x and even 80x trailing earnings. For example, Temenos, a Swiss banking software company, growing at 20% per year, is currently trading at 120x trailing earnings. More importantly, there is an enormous gap in valuation between companies that are returning capital to shareholder and those will growth opportunities. Returning capital to shareholders in an environment of negative interest rates is unappealing. What are shareholders to do with this capital? Stick it in the bank for negative returns?

A global low growth environment, with low wage inflation and low interest rates is likely to lead to a huge <u>inflation</u> of financial assets with growth opportunities. Companies that can generate growth in such an environment will likely trade at nosebleed valuations. Even mid-single digit growth rates will look impressive in an environment of negative interest rates. Many US high quality companies with growth opportunities currently trade at 30x trailing earnings or more. If the scenario I am describing comes to fruition, these companies will likely trade at valuations of 50x earnings or more in a decade's time – they are therefore bargains today at 30x.

The current valuations in the US stock market appear high, but they are likely to be much higher given the scenario I just laid out. This scenario is not a fantasy – it already is a reality in many European markets. Constrained institutional investors have already pushed up valuations in many small European stock markets. I believe that in this environment our investment strategy will perform particularly well because it focuses exclusively on companies with competitive advantages (moats!) and growth opportunities. It is exactly these kinds of companies that are likely to reach dizzying valuation levels in a low yield/low growth climate.

If 2017 proved anything it is that great investment returns do not require "Hail Mary" passes, but can be achieved by simply putting one foot in front of the other each day. To summarize, a flattening yield curve and rate cutting cycle that will follow is the most likely outcome for 2018. With that said, the LRT portfolio is well-positioned to deliver on its mandate.

As the largest investor in our partnership, we share a common destiny and our fortunes are perfectly aligned as they should be. Investing has been a passion of mine for many years. With the launch of LRT, it is now my vocation. The trust you have instilled as a limited partner will always be rewarded with my complete commitment to disciplined and consistent execution of a rigorous quantitative and qualitative high conviction process designed to deliver sustained uncorrelated exceptional investment performance.

I thank you for your continued investment.

Housekeeping matters

We currently hold positions in two companies, Apollo Global Management (APO) and The Blackstone Group (BX), that provide K1-s to their shareholders. We need these documents before we can finalize the partnership's tax returns. We expect these to arrive around mid-February, and therefore expect our audit and tax preparation to be complete by late February and hope to send K1-s to you by March 1st. This will give you time to calculate your overall tax liabilities and make any withdrawals necessary to meet those obligations. I will be waiving the 30-day liquidity notice period for the month of March – any withdrawal requests made during March will be processed by April 2nd (April 1st is a Sunday) to allow all partners to meet their tax obligations by April 15th.

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