December 4, 2017

November 2017 - Performance Update

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

As investors continue to fuel one of the longest bull markets in US history, risk appetites remain extremely high. Nothing sedates sound judgment and rational thinking more than an extended period of effortless profits – such as the markets have experienced the past 18 months. Foolish behavior and risk taking is on the rise. A few recent examples illustrate the current *psychosis*:

- European "high-yield" bonds trade at a yield of under 2.5% - lower than US Treasuries.
- Argentina, the world record holder in debt defaults, has sold a 100-year bond.
- Bitcoin, which has no intrinsic value, soared from $952 to over $11,000.
- A Leonardo da Vinci painting, whose authenticity is in question, sold for $450 million.
- The New York Times profiles former Target employees who become multi-millionaires through day trading volatility.

At LRT we are not macro investors. However, understanding the prevailing climate enables us to vigilantly detect threats to performance as we actively research investment ideas for compelling opportunities and exceptional companies that can become additions to the portfolio. Most investors and commentators are current bullish. Markets around the world are at record highs, earnings are strong and valuations rising. Markets participants are optimistic about the future – making investment bargains hard to find. We are in an environment where optimism predominates and the influenza of FOMO (fear of missing out) and TINA (there is no alternative to stocks) have driven feverish investors to take on more and more risk. This environment requires the conviction to diverge from the crowd and think long-term – something that only an active manager with a rigorous process and disciplined execution can accomplish.

We continue to be bullish on the long-term future of American business, but are turning more cautious on the outlook for the US stock market, because so much good news is already priced in. A market priced for perfection is dangerous. The passage of tax reform appears to be fully priced into the value of securities today, and should tax reform fail it will likely be a catalyst for a major move down in the market. Even if tax reform passes, we are skeptical it will result in a rally, because it is already anticipated. Over the next 12 months, we expect market sentiment to worsen, as growth in corporate earnings slows again. Market participants have become sedated by low volatility and are highly leveraged. Optimism and borrowed money is a recipe for a market correction when sentiment worsens as we expect it will next year.

The US economy is operating at close to maximum capacity. Labor shortages are emerging throughout the US economy, as many companies report rising employment costs on their quarterly conference calls. Anecdotally, we see for "hire posters" on the doors of most business. Domino's Pizza has even begun gluing employment applications to the outside of their pizza boxes. As we move into 2018, rising interest rates and rising employment costs may begin to squeeze corporate profitability. The impact of rising interest rates may be felt more harshly than in past hiking cycles as corporations have gorged on record cheap debt over the past several years. We expect the market to recognize this reality by mid next year.

Finally, there is a high probability that political gridlock in Washington will continue. We see little improvement and actually a few factors that can make things worse. By the spring of next year, Donald Trump could be a lame duck president, with Congress only interested in their re-election campaigns. It appears an almost certainty that Republican majorities in the House and Senate will be in *jeopardy* after the 2018 midterms, leaving the President less able to “drain the swamp” and get things done. Should the Republicans lose control of the House of Representatives, there is a distinct possibility Congress would move swiftly on Articles of Impeachment, even if the Senate remains in Republican control. Finally, while the economy is currently strong, there is no telling when it will get worse – if the polls show POTUS is unpopular now, wait to see what happens when unemployment goes to 8%.

The investment returns we have achieved over the past year are a result of consistent execution of a disciplined investment process along with improving market sentiment. If market sentiment worsens in 2018, as we expect it will, it is unlikely that we will repeat the returns we had this year. However, don’t mistake pragmatism for gloominess. We expect 2018 to a profitable year – not because we have a crystal ball, but because we have a clear and disciplined investment process that enables high-conviction investing.

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Your individual account statements will be distributed in approximately two weeks. As always, your questions are welcomed.

Sincerely,

Lukasz Tomicki

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