June 6, 2018

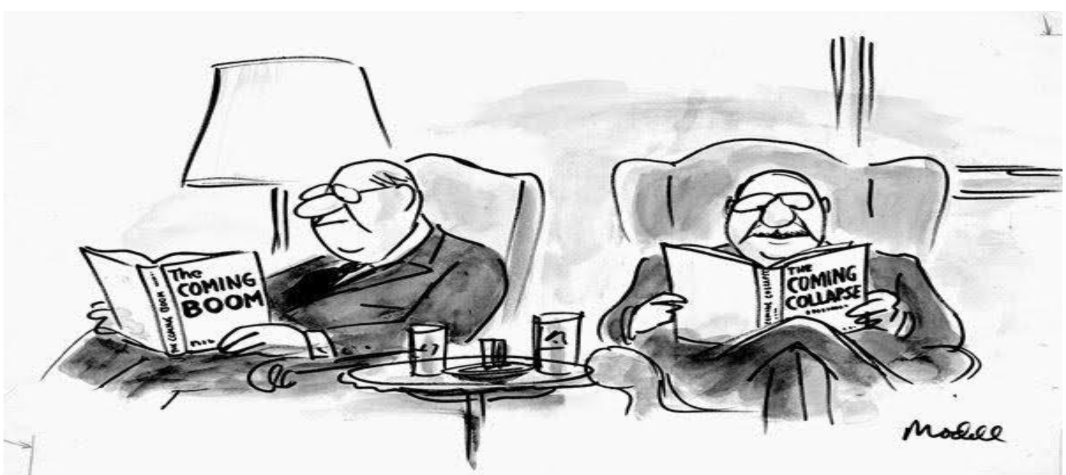
May 2018 - Performance Update

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

The LRT portfolio was performed strongly during May, with gains lead by companies such as Watsco, Visa, Moody's and North American railroad holdings. The Watsco position deserves extra attention as it is a picture-perfect example of what we look for: **Exceptional Undiscovered Opportunities**.

Watsco can be viewed as "hidden in plain sight". As a South Florida-based HVAC distributor, it is a wonderful "moaty" business, possessing an enormous growth runway and a management team with a good track record of capital allocation and execution. Also, Watsco has a compensation plan that is unique in Corporate America. Furthermore, the company looks "expensive" based on traditional valuation metrics – deterring most "value" investors. We have previously written a longer note about Watsco – please reach out if you would like a copy.

With respect to portfolio additions, during May we established a position in Comcast – another company with a great moat, a decent growth runway and management that's highly aligned with shareholders. Comcast has recently announced that it wants to acquire Sky TV, the UK pay TV company. Comcast's CEO, Brian Roberts, also expressed interest in purchasing assets from Fox – setting it up for a potential bidding war with Disney. The risk of overpaying and squandering capital has investors worried – to that end, wholesale selling promptly wiped out $53 billion, or more than 25%, of the company's value. At LRT, we see this as an opportunity. A more detailed discussion of our Comcast investment thesis will be provided in June's comment.



Cycle Indicators

In the year-end letter, I spoke of the ongoing flattening of the yield curve. LRT continues to expect the yield curve to flatten completely by the end of the year as the Fed hikes short term rates and long rates remain anchored by the relentless global hunt for yield. As of the end of May, the 10yr-2yr spread is 51 basis points and the 30yr-2yr spread 63 basis points. Should there be three (3) more quarter point rate hikes, the yield curve would be at flat/inverted. Three (3) rate hikes are exactly what the Fed has signaled to expect by the end of this year. So, with that: **Where is the economy heading**?

The Federal Reserve policy on short-term interest rates has changed meaningfully over the past year. Since the 2008 financial crisis, the Fed operated in a "*we will wait for the data to improve and then we will raise rates*" mode. Currently the Fed's approach appears to be "*we will continue to raise rates until the data worsens*." The Fed clearly sees the economy operating at full capacity and is determined to prevent an inflationary overheating. This is a classic hallmark of a late economic cycle.

The labor and housing markets are at historically tight levels. A top-down view shows an unemployment rate of 4.1% and 5.4 months of housing supply – historically very low levels. However, a bottom-up look reveals many companies reporting rising wages and difficulties in finding qualified workers.

To illustrate, AutoZone, the US auto parts retailer, during its most recent quarterly earnings call, mentioned "wages" fifteen times – the topic dominated the Q&A section of the call as well. Specifically, the CEO Bill Rhodes, said, *"On the cost front, I've highlighted the past few quarters the impacts we are experiencing from accelerated pressure on wages. Those pressures continue to exist and are much more than historical norms."* Similarly, Toll Brothers, the luxury US home builder mentioned "labor" 22 times during its recent quarterly conference call, and blamed labor shortages and rising lumber prices for the company's earnings miss.

Federal Government policies are accelerating inflationary pressures. Last year's tax cuts are providing a short-term boost to the economy just as it was operating close to full capacity. More importantly, the federal budget passed in March, represents another large fiscal stimulus as spending will increase along with budget deficits. In a perfect world, the Federal Government would be running surpluses and reducing the national debt this late in the economic cycle, but that's not the world we live in. Instead, the opposite policy is being pursued: Adding fuel to the economic fire, even though it is already burning brightly.

President Trump hates trade deficits. Unfortunately for him, the fiscal stimulus signed into law over the past twelve months is almost certain to increase it. By adding demand into the economy at a time when unemployment is already low, there is only one obvious way this extra demand can be met: Importing from abroad. What's more, the recent rise in the US dollar will only exacerbate the US trade deficit.

Late cycle indicators for the US economy are flashing brightly: Increasing commodity prices, a strengthening dollar, tight labor markets and rising short-term interest rates are all consistent late cycle actions. Additional data shows rising defaults on subprime auto loans and rising credit card delinquencies. None of this means a recession is imminent, just that the macro indicators are consistent with a late economic cycle. Strong corporate earnings are also consistent with a late cycle, as earnings will only roll over long after a recession has become blatantly obvious to everyone.

Yet, despite the proliferation of late cycle indicators, we see many cyclical businesses (CNH, Caterpillar, Deere) selling at very high valuations – presumably because investors believe we are in mid-cycle and corporate earnings will grow rapidly over the next year. At LRT, we are highly skeptical of that scenario. Predictive exercises are certainly not how we make money. However, our analysis suggests a strong probability an economic slowdown may be sooner than most expect. Consequently, cyclical and commoditized businesses should be avoided at all cost – especially at today's valuations.

Timing recessions requires a crystal ball which LRT does not possess – luckily, we don't have to. Instead as a process element, we never invest in highly cyclical businesses and rather focus on companies that we believe will be largely insulated from macro-economic slowdowns – just as they were in 2008. At LRT, we are focused on companies with wide moats, strong pricing power and below average cyclicality. We are not macro investors and we do not shift our portfolio in response to macroeconomic predictions, but if our analysis is correct and a slowdown does materialize, we believe we are ideally positioned to sustain performance through long-term corrective activity and a bear market.

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