February 7, 2019

January 2019 – Performance Update

Dear Friends & Partners:

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

January was a highly profitable month for our Partnership, as asset prices rebounded across the board and across the globe. You should not extrapolate these results to the entire year nor judge an investment manager on one month's results – whether they are good or bad. At LRT, we are focused on our investment process – not the outcome. If an investment process is sound and executed with discipline and patience, good results will follow. Our investment strategy bares repeating: 1) identify companies with sustainable competitive advantages, above average growth opportunities, and management teams with excellent capital allocation skills; 2) acquire shares in said companies without overpaying; 3) sit patiently. While short term results are unpredictable, we are confident that the disciplined and consistent execution of our strategy stacks the odds in our favor when it comes to long-term success.

In last year's January letter, we identified the flattening term structure of US interested rates as a likely precursor to a US recession and warned about the diminutive prospects for most US consumer staple companies. With respect to the term structure: it is now flat as we forecasted (it is flat overall but inverted between the 1- and 7-year terms as of this writing). As for consumer staple companies, with a few notable exceptions these have fared poorly over the past year. We free admit that we have avoided both the winners and the losers in this sector and, given the current valuations, don't foresee buying shares in any consumer staple company in the months ahead. We believe that the short hand of "defensive company" = "consumer staples company" should be struck from the lexicon, as many consumer staple businesses face declining end markets, diminishing barriers to entry and operate under staggering debt loads. They will not provide investor much "defense" in the next recession.

The flat term structure deserves further discussion. Since WWII there have been fourteen rate tightening cycles. Thirteen have ended in recession, so the track record of the Federal Reserve getting monetary policy "just right" is poor. While at the moment the economy appears strong, we have reason to believe that history will repeat itself once again and that the Fed will drive the US economy into recession sometime in 2020. Not only are short term interest rates rising, but the reduction in the Fed's balance sheet is pressuring borrowing costs for the least creditworthy borrowers. Interest rate sensitive sectors such as autos and housing have already weakened and could deteriorate further if rates continue to rise. Finally, the impact of corporate tax cuts and fiscal stimulus will likely fade by the end of 2019, further depressing US economic growth.

Many Are Getting Arrested

Robert Mueller's investigation has produced several new indictments over the past month. The arrests are growing increasingly closer to the President. Would an arrest of one of the President's children spook markets? We can't be certain, but we believe there will be **ample volatility and ample opportunity** in 2019. Do not be deceived by the relative calm and bullishness of January – volatility could be lurking just around the corner. There are several issues that we wish to highlight that could return to the forefront and spook markets in the months ahead.

First, The US Federal Reserve. Per Chairman Jerome Powell's comments, it is on pause, but for how long? The Fed has never actually "paused" its interest rate increase cycle. A "pause" has historically meant an end of the tightening cycle, soon to be followed by rate cuts, and that is what the markets are pricing in today. If the economy continues to be strong and inflation rises again, there will be renewed pressure on the Fed to move rates higher. However, any rumbles about a resumption of the march towards higher interest rates could spook markets as it would be at odds with current market expectations.

Secondly, the trade negotiations. The ongoing trade dispute with China has taken a backseat during the month but will return to haunt markets soon. President Trump has stated that he will meet with the Chinese leader, Xi Jinping, before the final deal is announced. This has been taken by commentators to mean that a deal is imminent, as no President would want to call for such a high-level meeting unless the deal was certain. If the occupant of the White House was a more traditional President, we believe this logic would be sound, but given the current administration, no conventional wisdom can be taken for granted. We believe there is a real possibility that no deal is reached with China by the end of February, and higher tariffs on Chinese goods kick in on March 1st. The list of companies whose products would be affected by these new and/or higher tariffs is long. The Trump administration is particularly focused on technology and China's plans to modernize its economy – the telecom giant Huawei is therefore a prime target: a modern, globally competitive company with cutting edge technology. While the market appears to be optimistic that a deal can be reached, the recent criminal charges brought against Huawei signal that the administration intends to take a harder line on China. These actions make a trade deal compromise less likely.

We are reminded of the great war movie, "Bridge over the River Kwai" by David Lean, in which British prisoners of war build a bridge over a river in Thailand – something that their captors, the Japanese, have failed to do. The movie has many great qualities but incorrectly leads the viewer to believe that Japanese engineers are incompetent and cannot accomplish anything without the help of the West. Of course, during this time, the "incompetent" Japanese Imperial army is steamrolling across Asia, dealing blow after blow to the British army (the failures of the British army are precisely why the Brits are prisoners of war in the movie after all). Similarly, there is a ting of racism in the Trump's administration ideology which contends that any advanced technology that the Chinese possess must have been somehow purloined from the United States and not invented by one of the 100,000+ engineers who graduate from Chinese universities each year. It easy to forget that for centuries China was in fact the center of global technical progress and invented many of the things we take for granted today including: paper money, gunpowder, the wheel barrel. If we are correct, in that the Trump administration's goal is to slow China's rise as a global superpower and not address actual trade imbalances, then the odds of a trade deal are indeed low.

Finally, the ongoing US Government disfunction can negatively affect sentiment. The longest government shutdown in US history is now over but could return in a matter of weeks. The US government is likely to remain gridlocked over the next two years, with both sides playing to their political bases and eyeing the 2020 presidential elections. The United States is running fiscal deficits of nightmare proportions. The US deficit this fiscal year will exceed a trillion dollars for the second year running with no end in sight. These deficits are occurring in the context of a booming economy and record low unemployment – they are clearly unsustainable in the long term and will have to be brought down by a combination of tax increases and spending cuts. US Corporate tax reform is the signature accomplishment of the Trump administration but makes any compromise on the budget harder, because many Democrats view it as having moved the goal posts for any future negotiations. Absent a fiscal debt crisis in the United States, there is little hope for any budget reforms coming out of Congress in the next two years. This atmosphere of hyper partisanship will make it much more difficult for Congress to act in the event of a genuine economic slowdown. In the event of a recession, US deficits could easily exceed $2 trillion on an annual basis. Such a scenario could result in a further downgrade of the US sovereign debt rating and bring with it increased market volatility.

Volatility is Opportunity

As the saying goes: what the wise man does at first, the fool does in the end. Similarly, on Wall Street many bubbles begin as a good idea but are taken to an extreme in the end. The long bull market that began in 2009 has created many overvalued companies. We believe that a recession in 2020 is likely and it will result in a liquidity crunch for the least creditworthy borrowers. Reduced liquidity can quickly turn into panic and drive down stock prices – even for companies largely unaffected by a slowdown and trading at "fair" valuations. As markets are always forward looking, we expect this turbulence to occur sometime in 2019, and while some "air" has been let out of the stock market in 2018, we believe there is much more to come. Many companies, especially fast-growing ones remain overvalued, or rather are priced to perfection with little room for error. To name just a few examples: most SaaS businesses are currently trading at revenue multiples of 6-7x, several prominent roll-ups have used cheap debt to hyper charge growth, and even an "innovative" pet insurer with a promotional CEO has become the new darling of Wall Street. All these types of companies have massive downside potential if economic growth slows and market liquidity becomes scares. In times of economic slowdowns, investors focus on the here and now, and heavily discount any future growth. Any slowdown in economic growth and a tightening of financial conditions will hit the aforementioned types of stocks particularly hard. Indeed, in times of panic, the baby is often thrown out with the proverbial bathwater, creating opportunities for discerning buyers.

After the strong rally in January, markets are relatively close to their all-time highs, yet the prospects of a recession, tighter monetary policy, intensifying trade wars and political disfunction in Washington DC loom large. This is not a time to stretch for risk or seek out complex investment ideas. Rather, we believe that all investors should evaluate their portfolios and concentrate on the companies with the most resilient business models that can survive and even thrive in an environment of slower economic growth. We are confident that we have constructed such a portfolio and are well positioned for the year ahead. Furthermore, we are always on the lookout for new investment ideas and expect volatility in the year ahead to bring with it the opportunity to invest at favorable prices.

We expect that 2019 will bring several opportunities to acquire shares in the kind of companies we are looking for: wide moat businesses, with grow opportunities and excellent management teams. If fear grips Wall Street in the coming months, we will take it as a sign of opportunity and stand ready to buy. Our investment strategy is focused on companies that can survive and even thrive in times of economic slowdown and dislocation, as they can take share from weaker competitors. We expect the companies we are invested in to perform well, relative to the broader market if we experience heightened volatility in the months ahead, and we look forward to the chance to add to our positions at attractive prices if they were to materialize.

As always, I look forward to answering your questions.

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