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# Quarterly Letter July 2018

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*"We cannot solve our problems with the same thinking we used when we created them."*
*Albert Einstein*

The first half of the year has proven to be volatile and generally modest in performance. Most asset classes and equity sectors have experienced roller-coaster moves that ultimately produced flat, or close to it, performances. The exception was, once again, technology which posted high single digit gains and which now sports expensive valuation metrics.

This state of play is unsurprising as risky assets had to digest the outsized earnings of 2017 and withstand many domestic and international policy cross-currents. What is currently unnerving investors the most, is the escalation of the so called "trade war." A day of reckoning of global trade imbalances was long overdue but the timing, and the seemingly random and antagonizing strategy so far implemented, certainly raise the caution level. Admittedly, with a mid-term election around the corner, it would seem unlikely that all the recent threats may indeed be executed but stranger things have happened.

From an economic perspective, what seems more dangerous is the possible simultaneity of global trade frictions and an oil shock. The energy market has been the victim of incredible volatility in the last three years and such dynamics have significantly impacted the long-term supply/demand balance. While shale supply (mostly domestic) has greatly increased and shows more short-term potential, the long-term supply picture is much less positive. A crunch is possible in 2019 and that could result in significant pressure on the economic cycle.

Speaking of the economic cycle, while recession odds are rising (now set at 16% in the next 12 months by Spanish bank BBVA), it is important to recognize that global economies are still firing on all cylinders and earnings are growing at double digit clips. Eventually, this cycle will end but the resulting correction should be much milder than the last two. In the 2000-2002 and 2007-2009 recessions, the convergence of valuation excesses and massive leverage (especially in 2007) caused major dislocations. This time around, valuations are at long-time averages and in a few sectors (i.e. energy, pharma, REITs) they are actually quite attractive. Balance sheets are also generally healthy and while there is a lot of debt on the books, thanks to the low interest rates, there is also a counter-balancing large amount of cash as well. Corporate cash as a percentage of current assets currently stands at over 30%, one of the highest levels in the last 20 years.

We mentioned three undervalued sectors, energy, pharma and REITs. Energy is a classic late cycle outperformer. As the economy overheats, energy prices rise and benefit sector's earnings. Currently, the dislocations suffered by the sector in the last three years might have created an even better set-up. Not only integrated energy companies look potentially attractive but also the much-beleaguered midstream sector. For midstream companies, the combination of historically low valuations, rising domestic production of gas, crude and petrol-chemical products along with many distribution bottle-necks (especially out of the Permian) provides a great lay-up for the sector. Midstream companies need to still mend relationships with investors who were repeatedly mistreated during the difficult last three years, but as better governance surfaces and simplification processes occur at the corporate level, more institutional interest should arise and valuation gaps should eventually close. It is important to note that in the private markets, midstream assets are being purchased at valuations that are 20% to 30% higher than in the public markets.

Pharmaceutical companies and many biotech outfits are also attractive from a fundamental valuation perspective. Conflicting policy discussion and a few R&D disappointments have kept investors generally uninterested in the sector. However, the long-term thesis for these companies remain positive thanks to a convergence of demographics and revolutionary research methodology.

And last but not least, the REIT sector. The sector has generally underperformed lately as interest rates have increased and put the brakes on REITs. In 2017, we found pockets of outperformance by expanding our exposure to global commercial real estate and profiting from a lowering US Dollar. However, the first half of 2018 did not provide many chances to find valuation anomalies. As a result, the set-up for domestic REITs is now much more favorable. Many outfits are trading at a significant discount to their Net Asset Value, a situation that in the past has led to index outperformance. Fundamentally, the current strong job market provides a solid foundation for commercial real estate. It produces broad-based demand, positive rental rate increases and occupancy stability. The analysts' community also points out how the current pace of supply is about to slow down significantly in the next couple of years.

From an earnings perspective, while the fantastic growth rate of the S&P500 is expected to decelerate from the current 22% to just 10% in 2019, the picture is inverted in the REIT universe. REITs' earnings are expected to accelerate to 4.9% in 2019, up from 2.9% in 2018 (source: JP Morgan). Rising interest rates remain a headwind for the sector but less so as growth accelerates.

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On the subject of interest rates, we should also point out what the expectations are.  Currently, FOMC's estimates are for an end of 2019 Fed Funds rate at 3.38% while market expectations are set at 2.76%.  If the FOMC does not change its estimates, there is room for a market disappointment and possible negative reactions.  However, the FOMC long run projection is for Fed Funds at only 2.88%, a rate that is not too distant from what the market sees.

In other words, it is reasonable to expect the FOMC to continue to raise rates another four to six times (25 basis points each) before turning neutral.  Naturally, all these projections are linked to inflation and inflation expectations; should inflationary pressures start building up faster than the current pace, we can expect the FOMC's reaction to be correspondingly so.

Ultimately, at such juncture, we reiterate our advice to be diversified in asset classes and strategies while tilting the allocation toward value areas and trimming expensive exposures.

As always, we would like to thank you for the renewed confidence in our work,

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