STUYVESANT
Capital Management Corporation

EST. 1978

200 BUSINESS PARK DRIVE
SUITE 300
ARMONK, NY 10504
(914) 219-3010
WWW.STUYVESANTCAPITAL.COM

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QUARTERLY INVESTMENT OUTLOOK

JUNE 2019

SUMMARY

- Geopolitical risks have intensified since our last communiqué and will represent a material risk to the economic expansion should the trade war intensify. We still maintain that risks are likely to dissipate as President Trump is forced to focus on his reelection campaign.
- Over the last year-and-a-half the dollar was bought as a risk-averse investment, despite its deteriorating fundamentals. Two catalysts may cause the dollar to depreciate: converging global growth and interest rates.
- The yield curve has taken on a sinusoidal shape, indicating that growth is likely to slow over the next couple of years. We maintain that the steepening of the long-end may be forecasting a period of structural inflation. We believe that this inflation will be driven by a debasement of the dollar.
- The Fed will begin purchasing Treasuries by yearend. Shoddy forecasting and poor policy decisions have significantly impaired the institution's credibility. It is increasingly likely that their policy tools will be ineffective at stimulating the real economy during the next recession and may only serve to inflate asset prices further.
- The healthcare sector experienced a statistically significant selloff in 2Q19. We initiated a position in Allergan PLC(AGN) to take advantage of sector's weakness. The company is a restructuring play and represents a deep value investment.

GEOPOLITICAL RISKS INTENSIFY

Since our last missive the prospects of a trade war have intensified. Negotiations with the Chinese suffered a material setback, which could result in tariffs increasing from 10% to 25% by mid-June. President Trump threatened to implement tariffs on all goods imported from Mexico due to the migration crisis on America's southern border. A deal was recently announced between the US and Mexico, but there is still confusion with respect to its terms. Uncertainty also persists with regards to our trade relations with the European Union.

Tariffs result in a tax on consumption and increase business uncertainty, which results in reduced investment spending and slower growth. We are acutely aware that further escalations could pose a threat to the current economic expansion, though we believe that President Trump's erratic trade policies will be constrained by his popularity rating as we head into the 2020 election.

Flaring geopolitical tensions have occurred against a backdrop of decelerating domestic economic growth. The May Payroll Report indicated that only 75,000 jobs were added versus the average analyst estimate of 175,000. Jobs created over the previous two months were revised down by 75,000. This indicates that the economic expansion was decelerating prior to the deterioration in trade relations. Against this backdrop we have increased our client's cash position at the expense of cyclical equities and increased our allocation to the defensive healthcare sector. A constructive resolution to the trade war would lead us to redeploy idled capital.

A DOLLAR BREAKDOWN: TWO CATALYSTS EMERGE

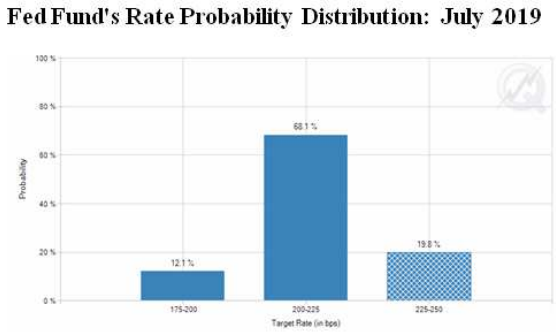
In his book *The Alchemy of Finance*, George Soros predicted that the 1980s carry trade in the dollar would break and that the currency would undergo a material depreciation. He highlighted that although Reagan's increased military fiscal expenditures and tax cuts were fundamentally dollar bearish, a combination of high US interest rates and strong domestic growth funneled speculative and non-speculative money flow into the dollar. This supported the currency despite its deteriorating fundamentals. There are many similarities between today's dollar and that of the mid-80s. Trump's tax cuts and fiscal stimulus would normally invite a depreciating currency, however a weak global backdrop has supported the currency.

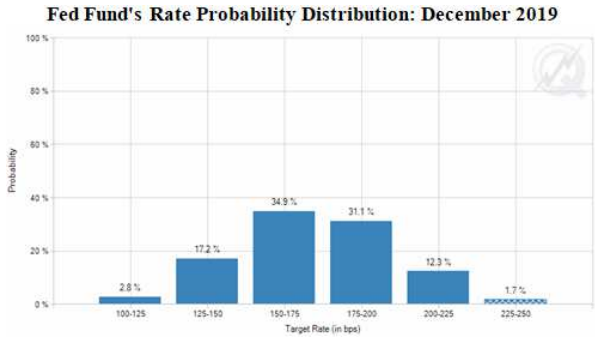
Soros successfully highlighted the two risks that ultimately catalyzed a 50% depreciation in the dollar from 1985-6. We believe that these same risks will reemerge and result in a material depreciation of the dollar within the next twelve to eighteen months.

1. A Convergence In Global Interest Rates:

Developed market central banks such as the BoJ and the ECB have pegged their short-term interest rates in negative territory. The Federal Reserve, on the other hand, has increased the Fed Funds Rate (FFR) nine times since the end of 2015. We believe that this divergence has fostered fund flows out of negative yielding developed international bonds into positive yielding US dollar-denominated bonds. The flow of funds has increased the demand for US dollars, causing it to appreciate. Foreign buyers of dollar-denominated assets have benefited from both price and currency appreciation. We believe that this carry trade is at risk of reversing if the spread between our short-term interest rates and developed market ex-US short-term interest rates narrows.

The market, represented by the Fed Funds futures contract prices, is beginning to discount that the Fed will need to lower the FFR by the end of the year. There is currently an 80.2% chance that the Fed will cut the FFR by 25bps in July, which is up from a paltry 17.4% chance just one-month ago. Moreover, there is now greater than a 50% probability that the Fed will lower interest rates by 75 bps by December (charts to follow). This would represent a material convergence in global monetary policy that could result in a weaker dollar.





source: CME Group

2. A Convergence In Global Growth:

Global ex-US growth was weak over the last year, while US growth remained resilient. This too has resulted in a carry trade of money flowing into US dollar-denominated assets, which were perceived as safe havens. The Fed's New York NOWCAST model and the Atlanta Fed GDP Now model are projecting an average 2Q19 growth rate of 1.2%, down from 3.1% in the first quarter of 2019.

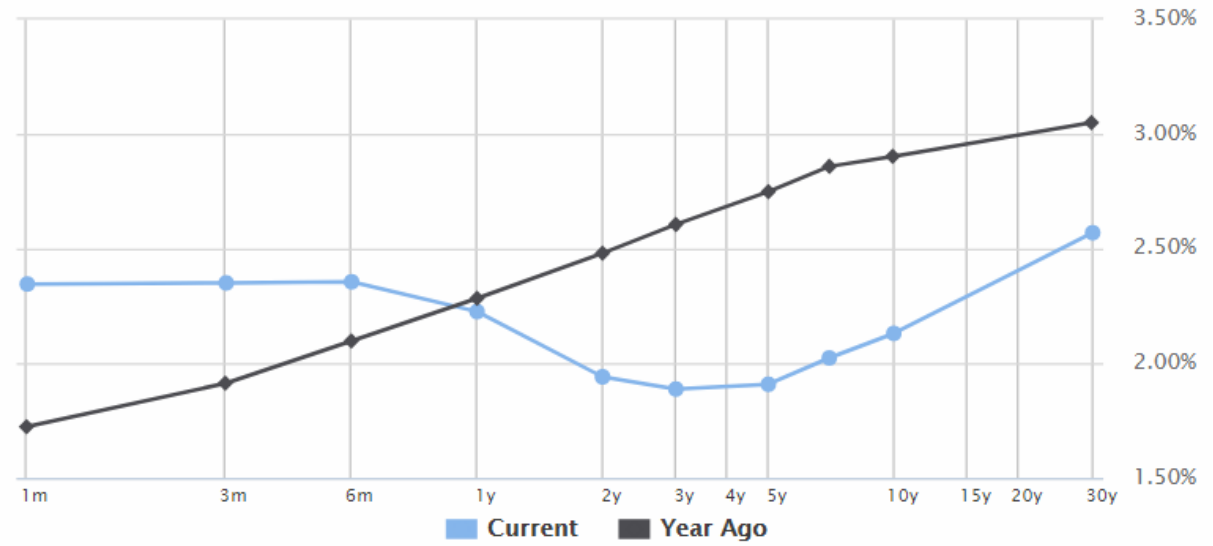
Our forecast is for global ex-US growth to stabilize at a low level and potentially accelerate into 2H19. We believe that the Baltic Dry Index (BDI) is a useful proxy in monitoring global trade and, by extension, the health of the global economy. It is calculated by surveying shipping brokers that book cargoes of raw materials over various routes. The supply of ships is highly inelastic and their products are the building blocks for the global economy. Small increases in demand for global shipments can lead to significantly higher BDI prices.

Since early February 2019, the BDI has increased by 89.5% and is trading at approximately the average level observed over the past two-and-a-half years (chart below). This advance occurred against a backdrop of escalating trade tensions between China and the United States. We believe that this divergence indicates that the global economic expansion has stabilized. Barring an escalation of trade wars, we expect that global growth metrics will continue to outperform relative to the United States, which could weaken the dollar.

source:www.stockcharts.com

THE YIELD CURVE COULD BE SIGNALING STAGFLATION

The current yield curve, shown in blue below, has taken on an unusual sinusoidal shape. The curve has decidedly inverted between the Fed Funds rate through the 3-year Treasury Note. In fact the spread between the 1-month T-Bill and the 3-year T-Note is -54.5 bps. From the 3-year T-Note out to the 30-year T-Bond the yield curve steepens. The 5/30 spread is +70 basis points and the 10/30 spread is +46 basis points, indicating that the majority of the steepness is occurring at the longer end of the curve.



source: WallStreetJournal

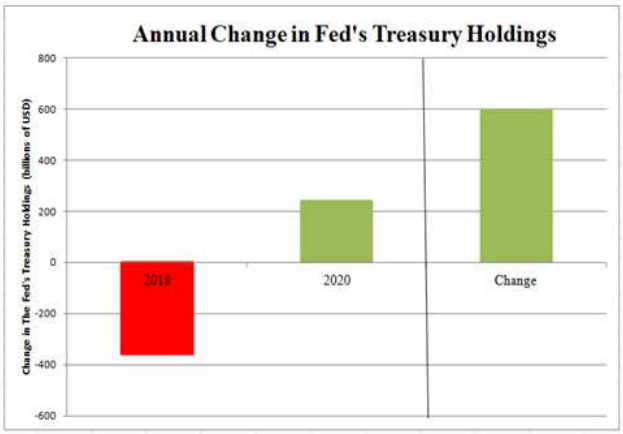
The steep yield curve inversion within 3-years reinforces the probability that growth is likely to remain below potential for the next couple of years. Moreover, a steepening in the curve at the 10/30 spread is likely signaling the potential for an acceleration in the rate of inflation. We believe that the aforementioned depreciation in the dollar could catalyze inflation to trend higher, despite currently subdued readings. Taken together we believe that the yield curve is forecasting a period of economic stagflation.

THE FED WILL BUY TREASURIES IN 2019:

The Fed's March 2019 Minutes highlighted a change in their balance sheet policy, indicating that they will once again become buyers of Treasuries:

"The Committee intends to continue to allow its holdings of agency debt and agency mortgage backed securities (MBS) to decline, consistent with the aim of holding primarily Treasury securities in the longer run. **Beginning in October 2019, principal payments received from agency debt and agency MBS will be reinvested in Treasury securities subject to a maximum amount of $20 billion per month**; any principal payments in excess of that maximum will continue to be reinvested in agency MBS."

The Federal Reserve will shift from selling approximately $360B of Treasuries per year in 2018 to purchasing approximately $240B per year in 2020. This delta of $600B represents more than 40% of our estimate of gross Federal debt issuance.



source: Stuyvesant Capital Management Corp. and Minutes of the FOMC Meeting

In December 2018 the Federal Reserve stated that the reduction in its balance sheet was on "autopilot" and would continue to be reduced by $50B per month ($30B Treasury and $20B agency MBS). We don't believe that there is a fundamental reason for the Federal Reserve to have altered its course. The change in its outlook occurred against a backdrop of accelerating issuance of Treasuries due to the continuously increasing US budget deficits. We had previously opined that the Fed would be forced to re-enter the Treasury market as the buyer of last resort. We believe that this change in policy is the Fed's opening salvo of debt monetization. This should benefit real assets that are denominated in dollars (commodities, real estate), businesses that have pricing power, earnings that are derived in foreign currencies, and Treasury Inflation Protection Securities.

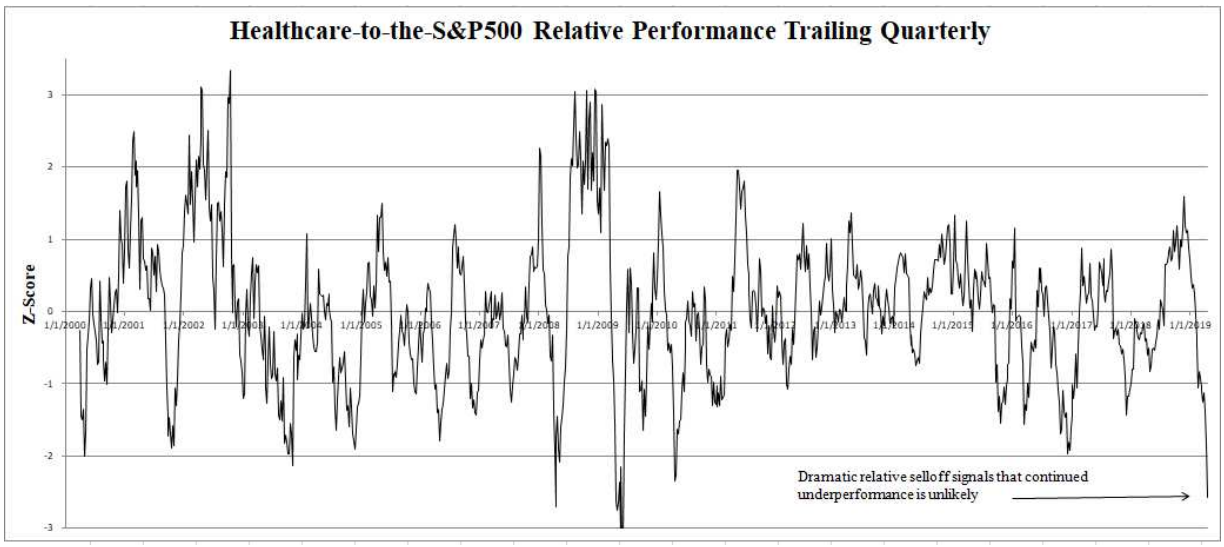
Moreover, Fed Governors Clarida and Brainard have discussed using yield curve targeting, which was last utilized by the Fed during WWII, as a policy tool to ease economic conditions. Yield curve targeting would result in the Fed buying and selling longer-dated maturities to manipulate the entirety of the yield curve. This would, in our opinion, ultimately result in deeply negative real interest rates. We are concerned that already unorthodox monetary policy will become increasingly extreme. For example, it is highly unusual that the Fed would be discussing easing monetary policy towards the end of an economic expansion with the stock market approaching all-time highs. Monetary policy may now only serve to drive higher asset prices, as it has been largely ineffective in stimulating the real economy over this subdued decade-long economic expansion.

PORTFOLIO ADDITIONS

We manage separately managed accounts due to our clients differing risk tolerances, guidelines, and restrictions. As a result, not all portfolios are managed in the same manner and may not contain the same securities. We hope that you find the following investment rationale insightful.

Allergan PLC (AGN): is in the pharmaceutical industry, which is part of the healthcare sector. We were provided with a timely opportunity to make this investment due to the severe selloff of the healthcare sector relative to the broader market, catalyzed by fears of Democratic Presidential front runners championing "Medicare For All" legislation. This was the most significant quarterly underperformance

for healthcare since 2010 and reached -2.6 standard deviations, which is only likely to occur 0.5% of the time.



source: Stuyvesant Capital Management Corp.

AGN currently trades at less than 10x EV/EBITDA and sports an adjusted free cash flow yield of 12%. This low valuation is nearly unheard of for a non-generic pharmaceutical business and represents a steep valuation discount to the broader market. The company's management has had a contentious relationship with some of its larger shareholders such as David Tepper's Appaloosa Management. Appaloosa has catalogued a series of value-destroying blunders made by management and pushed to split the roles of CEO and Chairman of the Board of Directors. The resolution failed to pass by a slim margin, but we believe succeeded in putting management on notice. On recent conference calls we were pleased to hear that the new members of the Board of Directors are reconsidering previously shelved plans to split the company into two separately traded businesses in order to spur value creation.

The Medical Aesthetics business (domestic and international) is the firm's most valuable asset and should command a premium valuation relative to the stock market. It currently represents 27% of sales and grew at 12.9% in 2018. Medical Aesthetics is also protected against changes to healthcare regulation due to the fact that it is paid for out of pocket. In fact, the combination of the Medical Aesthetics business and the International Business represents more than 40% of total sales. These segments should not be impacted by changes to domestic healthcare legislation.

There is a high moat around cosmetic Botox, which has a 70% market share of the anti-wrinkle injectable neurotoxin market. Last year AGN invested in training over 100,000 technicians to administer Botox injections. Differences in administration between brands prevents technicians from easily switching (high switching costs). Mistakes in administering the treatment could result in partial facial paralysis. The long-established brand has also engendered client loyalty, especially as demand grows in Asia. This has allowed cosmetic Botox to grow even though it's priced at a premium. As a

result, this off-patent medical aesthetics product had sales growth of 14% on a yoy basis in 2018, generating $1.55 billion in sales (10% of total). Allergan has also seen rapid growth in Juvederm (facial filling) and believes that the release of its CoolTone (muscle sculpting medical device) will lead to higher utilization of CoolSculpt (fat freezing medical device). Based on market valuations of its peers, we believe that a spinoff of the growing Medical Aesthetics business could command a premium market capitalization to that of AGN as an integrated entity, representing the most undervalued company in the healthcare sector.

RISK FACTORS

- An escalation in trade wars
- Fed policy error
- Further deceleration in global economic growth

John Cooper, CFA
Jason Cooper, CFA
June 2019