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QUARTERLY INVESTMENT OUTLOOK

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SUMMARY

- The US recession indicators that we monitor show no imminent signs of danger, although domestic economic growth is likely to decelerate to 2.5% as we enter 2019. We believe that the selloff since September is a sharp and violent correction, not the beginning of a bear market.
- Fears of a yield curve inversion have been overhyped by the financial media, exacerbating Wall Street's sense of despair. Inversions since 1978 have been accurate forecasters of recessions, however economic contractions typically occur with a lag of almost two years. Moreover, since the late 1970s inversions have never marked a peak in the bull market, but instead signal the beginning of the final risk-on phase that has generated average equity returns of 25.2%.
- Investor sentiment is washed out. The current reading from the State Street Investor Confidence Index is at a low that has only been matched twice in the last decade. From a contrarian perspective this level of fear may indicate that the market's path of least resistance is higher.
- The Congressional Budget Office's (CBO) projection of deficit spending continues to deteriorate. Moreover, an analysis performed by Hoisington Management highlighted the CBO's estimates have significantly underestimated the rate at which the federal government's debt balance has grown. Our analysis indicates that a recession by yearend 2023 could increase the level of Federal debt to GDP from 107% currently to 129% by 2024.
- This issue marks the introduction of the Portfolio Additions section, which highlights the investment rationale behind Stuyvesant's recently added core holdings. In this issue we discuss Las Vegas Sands Corp., Paccar Inc., and The Chemours Company.

MACRO TRENDS

A REVIEW OF KEY MARKET INDICATORS

We believe the October-December decline in risk assets was a correction (roughly 12% in U.S. equities) and not the beginning of a bear market. We monitor several US indicators that have historically provided advanced warnings of pending bear markets. These include the yoy change in the U.S. Leading Economic Indicators, an inversion of the yield curve, an uptick in the unemployment rate of 0.3 within a three--month period, a 50-70% spike in oil prices within a six-month period, and a decline in capital goods orders. None of those indicators is signaling that a recession is likely to occur within the next year.

One closely monitored indicator is the relationship of the 5-year U.S. Treasury yield to the yoy change in nominal GDP. We view the 5-year Treasury yield as a proxy for the cost of capital and the change in nominal GDP as a measure of income growth. An increase in the 5-year yield above the yoy change in nominal GDP signals that incremental revenue is no longer profitable, which historically constrains business investment. This signal typically precedes a recession. At present the 5-year Treasury yield remains at a significant discount to the yoy change in nominal GDP (chart below).

source: FRED

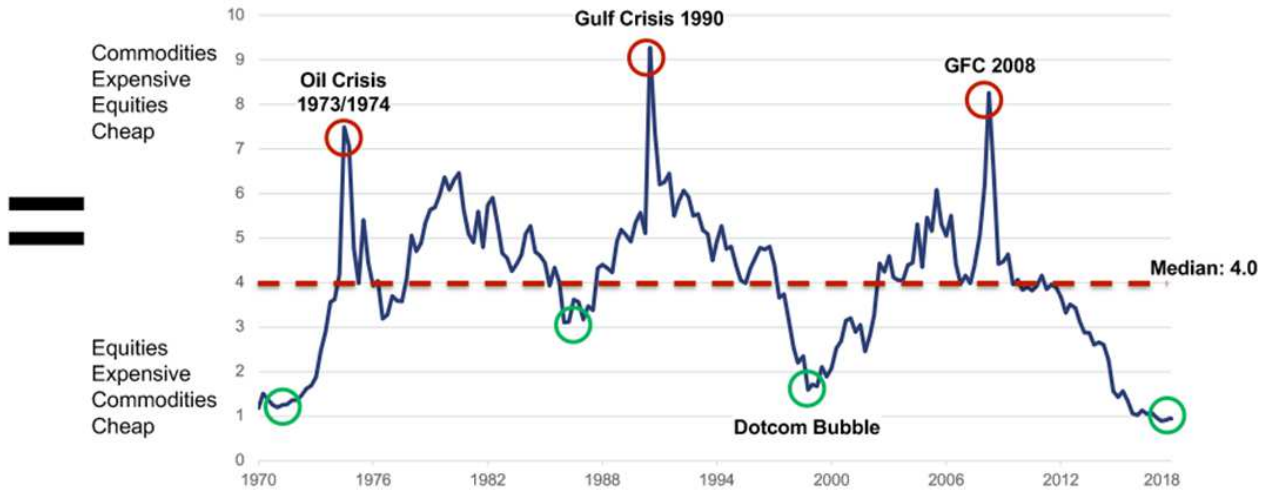
In fact, since none of the indicators mentioned above are "flashing yellow", we can say with reasonable certainty that the October-December selloff in risk assets was a correction and not the beginning of a bear market. Corrections are normally short but violent, characterized by a brief spike in volatility. We are encouraged that the VIX, a measure of volatility, traded at a high of 29 on October 13th. This level has not been exceeded in subsequent market selloffs, including the 800 point decline in the Dow30 on December 4th.

The chart below measures the percentage of stocks that are trading above their 200-day moving average, a measure of market breadth. There appears to be a bottom forming at the 25% mark (chart below).

source: stockcharts.com

We have also been impressed by the price action of copper throughout the risk-off phase, which is a proxy for global economic growth. It has trended sideways since September, which we believe

corroborates our assertion that there hasn't been a material deceleration in global economic activity. The chart below, courtesy of Incrementum, depicts the ratio of the Goldman Sachs commodity Index to the S&P500. Currently commodity prices are trading at a 48-year low relative to stock prices, which gives us confidence in maintaining exposure to commodity-sensitive equities.



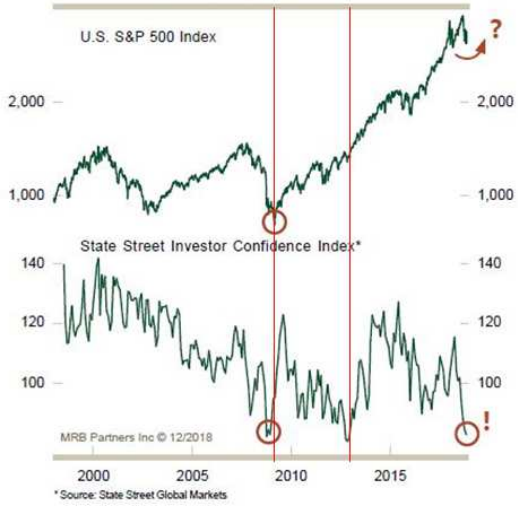
WHAT IS THE YIELD CURVE SIGNALING?

In our last communiqué we highlighted that Treasury spreads were narrowing across the entire yield curve. Historically an inverted curve, when short duration (maturing sooner) Treasuries yield more than long duration (maturing later) Treasuries, has signaled that monetary conditions have become overly restrictive. This eventually leads to a bear market in stocks and a recession. Recently the 2-10 spread traded at approximately 10 basis points, causing the financial world to panic.

We remain more sanguine on the yield curve. Firstly, an inverted curve does not signal an imminent recession. Since 1978 there have been five instances of the 2-10 spread inverting. On average it's taken 21 months ($1^3/_4$ years) from the month that the curve first inverts until a recession begins. Moreover, the average equity performance of the S&P500 from the month that the curve inverts until the market peaks has been 25.2% with an average duration of 15.8 months ($1^1/_3$ years). Within this sample the minimum subsequent return was 8.1% with a minimum duration of two months. However, excluding these outliers the average return for the S&P500 has been 29.4% with an average duration of 19.3 months ($1^3/_5$ years).

We believe fears that a 2-10 inversion will lead to an imminent bear market are misplaced. If anything, an inverted yield curve has signaled the arrival of the final stage of the equity bull market, which has been characterized as a period of investor over exuberance and outsized equity returns. The prevailing fear that has dominated the market since October 2018 may be setting the stage for this bull market's

final advance. This can be seen in the chart to follow, provided by MRB Partners, that contrasts the S&P500 against The State Street Investor Confidence Index.



Sentiment has only been this low twice in the last decade. The first reading occurred at the market's bottom following the Great Recession, while the second occurred in 2013 when the S&P500 broke out of a two-decade consolidation phase. In both instances the sentiment reading served as a contrary indicator, signaling that investors were overly bearish and underexposed to the equity markets. We expect that positive global economic surprises, coupled with a reduction in trade tensions and a dovish tilt from the Federal Reserve, will serve to re-rate equities higher.

We continue to expect that late-cycle stocks will outperform during this phase, which is why we have increased our exposure to the industrial, material, and consumer discretionary sectors during the most recent selloff. This is also why we continue to hold foreign securities and maintain exposure to the energy and material sectors. All of the aforementioned securities are classified as late-cycle holdings and tend to outperform in the final market advance. Moreover, they all represent an immense value opportunity while trading at significant discounts to the broader market.

It is interesting that while the 2-10 spread has flattened since our last missive, the 5-30 spread has increased by almost 50%, and the 10-30 spread has doubled (chart below).

Treasury Spreads (basis points)	12/29/2017	9/10/2018	12/6/2018
2-10 Spread	51	21	12
5-30 Spread	54	26	39
10-30 Spread	34	15	27

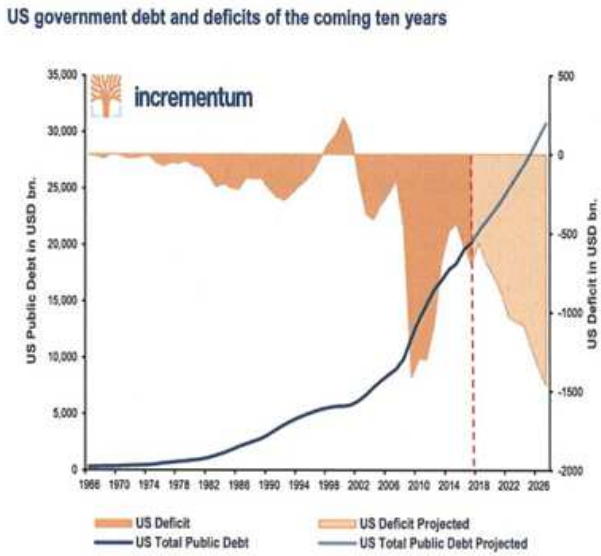
Source: generated internally

Treasury yields can be broken down into two main components: a growth component (real yield) and an inflation component. The growth component tends to dominate yield volatility towards the shorter-end of the curve as growth fluctuates from quarter-to-quarter and from year-to-year. However, over time the volatility in growth subsides as the economy trends towards its long-term potential growth rate. This tends to depress the volatility of real yields in at the long end. As a result, the further out you go on the curve the less influence that the real yield component has and the more influence attributable to the inflation component. Therefore, we believe that the that the steepening of the yield curve at the long end indicates that the incipient inflation that we have been forecasting is finally beginning to be priced into the bond market. We are confident in maintaining a significant exposure to Treasury Inflation Protection Securities, which benefit as the rate of inflation increases. We also intend to use any period of yield weakness to dispose of our investment grade credits.

THIS TIME IT IS DIFFERENT - WE ARE ENTERING A MAJOR INFLATION CYCLE

MRB Partners, a leading global macro research firm, believes that a multi-year up-shift in inflation will take place over the next several years. Moreover, they believe that this new era of inflation will come as a surprise to investors. The last inflation cycle began in the late 1960s and peaked in 1982. Hence investors today have had little experience managing money during a period of rising prices. Rising inflation normally fosters slower real growth. For example, between 1972-1982 M2 grew 141.5% and consumer prices rose 132.7%, while real GDP grew a tepid 27.2%.

Our inflation thesis is predicated on rising U.S. budget deficits fueling an acceleration in the level of federal debt, which has been projected for ten-years by the Congressional Budget Office projection (chart below).



source: Incrementum

However, the CBO appears to be drastically underestimating our current fiscal state and we believe that it is more than likely that their ten-year projection within five-years.

THE DETERIORATION IN THE US' FISCAL SITUATION IS MATERIALLY UNDERESTIMATED

"When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid." - Adam Smith

In their most recent Quarterly Review and Outlook, Van Hoisington and Dr. Lacy Hunt co-authored a section on "Fiscal Policy" that highlighted the unsustainable trend in the United States' fiscal profligacy. In it they noted that, "[i]n just the past 12 months, the amount of federal debt expanded by $1.271 trillion. This is not to be confused with the increase in the deficit which totaled only $804 billion. Over the past five years, the deficit is up by $2.977 trillion, whereas the total government debt has risen by $4.777 trillion." So what explains the 60% increase in Federal debt above the cumulative deficit spending? Hoisington and Dr. Hunt went on to elaborate that:

> "[e]lected representatives have decided that certain sums of money that are spent (therefore paid by borrowed funds) are in fact "investments" rather than "expenses". These items include certain transportation expenditures, federal loan programs, social security/military/civil service payments where benefits are in excess of tax collections, and a host of other items. It is material. Over the next five years, the Congressional Budget Office (CBO) projects the deficit will expand by $5.661 trillion. If federal debt continues to rise in excess of the deficit by the same amount as the past five years, then total debt outstanding will reach $28.9 trillion in 2023, compared with the CBO's projected GDP estimate for that year of $24.6 trillion. Debt therefore will reach 117% of a total year's income / output of the U.S. economy in just five short years."

The strategy employed by our legislators is akin to a firm capitalizing its employees' wages. While it might improve the income statement, it does nothing to alleviate the firm's debt burden nor does it bolster free cash flow. It is a deceptive practice that is exacerbating the nation's debt problem by ignoring it. Interestingly, neither Hoisington nor the CBO's scenarios account for a recession occurring by 2023. Therefore, we thought it would be interesting to examine what the total debt-to-GDP would be if we experience a run-of-the-mill recession at yearend 2023.

To do this we started with two items: Federal Government Current Receipts and Federal Government Current Expenditures. During an economic contraction Federal Government Current Receipts typically decline due to a deterioration in corporate profits and personal income (taxed), while Federal Government Current Expenditures typically expand in order to stimulate a contracting economy and to support individuals/families that lose their primary source of income. In order to see how these items might change in the next recession we looked at the six economic recessions that occurred from 1974 to

present day. From the peak of economic growth to the trough of the recession, Federal Government Receipts contracted by approximately 0.83% when compared to nominal GDP. The change in Federal Government Current Expenditures as a percent of nominal GDP was more significant over the six periods, expanding by 2.28%.

Putting it all together, we can get an idea as to what might happen to the level of federal government debt relative to nominal GDP in the next recession. Starting with the CBO's projected estimate of GDP at $24.6 trillion for 2023, we can calculate the change to be expected in the ensuing year's fiscal deficit:

Change in Deficit Due to Decreased Federal Government Current Receipts =
$24.6 trillion * 0.0083 = $0.204 trillion or $204 billion.

Change in Deficit Due to Increased Federal Government Current Expenditures =
$24.6 trillion * 0.028 = $0.688 trillion or $688 billion.

Total Change in Deficit =
$204 billion + $688 billion = $892 billion

Thus it is likely that the fiscal deficit will increase from approximately $2.0 trillion (assuming the differences between Hoisington and Dr. Hunt's deficit calculation relative to CBO's projections continue) to approximately $2.9 trillion. This would represent the deficit eclipsing 12% of GDP in the next recession if you were to assume that nominal growth remains flat (a 2% economic contraction is offset by the CBO's 2% average annual increase in inflation). This would result in the level of federal debt eclipsing 129% of GDP (federal debt reaching $31.8 trillion, while GDP remains at approximately $24.6 trillion) by the end of 2024.

Professors Reinhart and Rogoff previously demonstrated that countries that have total government debt at levels greater than 90% of their GDP experience subdued economic growth due to the crowding out of private investment. As a result we already find ourselves with a debt burden that we are unable to outgrow. Based on the projections we discussed this trend is set to deteriorate further.

With foreign investors reducing relative exposure to US Treasuries and institutional investors maintaining short duration bond exposure, the likelihood is that a significant portion of the debt will be financed via the Fed purchasing Treasuries directly from the U.S. Treasury. This is debt monetization, a euphemism for money printing. We continue to hold a core position in gold equities and TIPS to hedge against the ever-increasing risk of currency debasement. These hedges are vociferously promoted by investors like John Paulson, Ray Dalio, Jeffrey Gundlach, and Mario Gabelli.

Portfolio Additions:

From this issue forward we will include a brief synopsis of equity securities that have been added to our core holdings. We manage separately managed accounts so our clients have different risk tolerances, guidelines, and restrictions. As a result, not all portfolios are managed in the same manner and do not contain the same securities. We hope that you find the following investment rationales useful.

Las Vegas Sands Corp. (LVS):) is a leading global developer of destination properties that feature premium accommodations, world-class gaming, entertainment and retail, convention and exhibition facilities, celebrity chef restaurants and other amenities. It was founded by Sheldon Adelson, who maintains a 10.2% ownership stake in common stock (same voting power as the rest of us). This aligns management's wealth with that of the shareholders and has ensured that the business takes seriously its commitment to beating its hurdle rate of 20% ROIC for development projects.

Marina Bay Sands (Singapore)

The company corrected 40% this year due to fears that its resorts in Macau (60% of EBITDA) would be negatively impacted by a slowdown in Chinese growth and the Sino-US trade war. We took a position believing that the market's reaction was overly punitive as the security currently has a free cash flow yield of 9% and can comfortably maintain its dividend yield of 6% (management was confident enough to recently raise the dividend to $3.08 from $3.00).

We believe there exist multiple catalysts for the security. Game theory dictates a trade war detente is in President Trump's best interest since he lost the ability to pass meaningfully stimulative legislation to goose the economy prior to the 2020 election. Meanwhile, a 34-mile bridge was recently opened that connects Macau to the mainland city of Zhuhai and to Hong Kong. This will make it significantly easier for Chinese tourists to travel to Macau, where the company continues to invest. In fact only 2% of the Chinese populace visits the region every year and the annual rate of growth in visits is increasing at 14% for the trailing twelve months. The company is also in negotiations with the Japanese government to open one of three casino resorts that will have a city-wide monopoly. We believe that Las Vegas Sands is likely to receive the permit due to Mr. Adelson's past development success in Japan and the company's pristine balance sheet (1.4x net debt-to-EBITDA versus 6x for competitor MGM).

PACCAR Inc. (PCAR): manufactures light, medium, and heavy-duty commercial trucks and parts. It operates in the Unites States, Europe, and internationally. It operates domestically under the Peterbilt

and Kenworth brands and internationally through DAF Trucks. The company has been at the technological and quality forefront of the industry for the last couple of decades and has consistently generated higher operating margins and ROIC than its peers, which is indicative of superior product/management. This has recently been demonstrated by an increase in market share in Eastern Europe and Brazil.

The security has corrected more than 25% this year despite the fact that yoy revenues have increased by over 20% for the trailing twelve months. Moreover, management recently re-emphasized that the backlog for the business remains robust into 2019. Given that the free cash flow yield is approximately 9%, we felt it prudent to invest in this well-run business that trades at a significant discount to the industrial sector.

Management recently reinforced their commitment to generate shareholder value by declaring a $2.00 special dividend (special dividends are typically declared annually), increasing its regular dividend 14% (total forward dividend yield is greater than 5% including the special dividend), and by initiating a $500 million share repurchase program. These initiatives will be covered by the $11.00 of cash per share that is held on the businesses' balance sheet, which has no debt associated with the industrial business. The only debt held by the firm is held by its financial services division which is offset by finance accounts receivables.

DAF LF Electric, CF Electric and CF Hybrid Trucks

We anticipate that global growth will strengthen in the year ahead even as domestic growth slows, benefitting the DAF brand. Moreover, the company is set to grow its electric truck division through the immense investments that it has made in the Paccar Innovation Center in Silicon Valley where it showcased Electric Peterbilt Model 579 this past summer. The DAF electric and hybrid trucks are pictured above.

Chemours Corporation (CC): is a specialty chemicals company that was spun-off from DuPont in 2015. It is comprised of three separate divisions: Titanium Dioxide (TiO_2), Fluoroproducts, and Chemical Solutions. It has a market capitalization of $4.5 billion. The company has been in existence for over 100-years (operating within DuPont) and is responsible for many chemical inventions and innovations that are widely known and readily available like Teflon and Freon.

Over the past 13-months the stock has dropped from $60.00 to $25.00 due to fears that the Titanium Dioxide business was going to suffer a significant mean-reversion as the TiO_2 bull market ends. We

believe these fears are misplaced due to the pricing stability contracts that management is implementing with more than 50% of its TiO_2 customers. This should provide stability to a volatile division, which will serve as a cash flow foundation to finance the Fluoroproducts business.

Fluoroproducts accounts for 40% of the company's trailing twelve-month EBITDA ($777million) and is projected to grow at a CAGR of 15-20% through 2021 due to legislation requiring Fluorolefins like the firms' Opteon refrigerant to be installed in European automotive AC units due to their significantly lower global warming potential. Opteon is covered by hundreds of patents, which should provide the company with product exclusivity through approximately 2034 (management's estimates). Moreover, this division also creates polymers that will be used in insulation to reduce the risk of overheating/fires in cloud computing server farms and 5G modems.

This security is priced as a deep value stock despite the immense growth that is probable out of the Fluroproducts division. The Enterprise Value-to-EBITDA is currently 4.3x, which is a 67% valuation discount to the Dow30. The Free Cash Flow yield for the business is about 17% and the dividend yield is currently 3.8%. Moreover, at a recent industry event, management emphasized that their stock was significantly undervalued and noted that there is a $750 million share repurchase program that will purchase $250 million per year for the next three years. In conjunction with the dividend, this represents an 8.8% annual return to the shareholder for the next three years at today's price. In fact, we believe the current price of the security would represent a value opportunity even if the TiO_2 division made no contribution to EBITDA versus the $1.2 billion it contributed over the trailing twelve-months.

RISK FACTORS

- The Fed remains hawkish, tightening monetary conditions as the economy decelerates.
- Trade tensions flare between the United States and China or the United States and Europe.
- European growth is impacted by Brexit, the yellow vest movement in France, or Italian budget negotiations with the EU.

John Cooper, CFA
Jason Cooper, CFA
December 2018