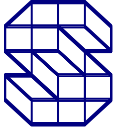
Steinberg Asset Management, LLC

First Quarter 2018 Commentary and Outlook

Broad market indices were little changed during the quarter with the S&P 500 Index declining 0.8%. However, after a period of historically benign market conditions and robust stock gains, the market traced a volatile path over the quarter. To wit, 2018 was one of only 13 years since 1950 with a January return greater than 5%. That stands in contrast to the week of March 19th, the worst week for stocks since January 2016. These swings represent a bracing change from the past several years, particularly 2017, when implied volatility hit a 30-year low.

The increased volatility in markets may reflect investor uncertainty moving forward as the post financial crisis period concludes and new economic realities and market dynamics take hold.

A New Chapter in Equity Markets

The almost decade-long period following the financial crisis has been marked by exceptionally accommodative monetary policy, generally constrained fiscal policy, tepid economic growth, subdued inflation and low and declining interest rates.

Now the conditions that led to, or at the very least coincided with, this historic market environment are in the process of reversing. Perhaps most significantly, the Federal Reserve has made it known that in addition to continuing to raise the short-term interest rates from which other rates take their cue, it plans to unwind its $4 trillion balance sheet. The consequences of this exercise are unknown since there is no precedent. However, there is some logic to the notion that such quantitative tightening will dampen returns of equities and other “risk” assets since quantitative easing appeared to inflate those values over the last many years.

Fiscal policy has also sustained a dramatic reversal. Where the post-crisis period had seen shrinking budget deficits due to constrained government spending and an improved economy, the new $1.5 trillion tax bill and $1.3 trillion omnibus spending bill are expected by some to lead to $1 trillion deficits as early as 2019/2020. Large deficit spending will require financing through Treasury borrowings. In 2018 the U.S. Treasury is expected to double its new issuance of debt – the largest new issuance since 2010. All things being equal, a large increase in the supply of Treasury bonds from both the Fed and new Treasury issuance, absent meaningful new demand, will lead to lower prices, which for bonds means higher yields or interest rates. Higher rates are further supported by expansionary fiscal policy, which may spur already accelerating inflationary trends. This is to say nothing of the effects of proposed tariffs and sanctions which are similarly inflationary since they limit the supply and free flow of goods around the world.

Consequences for Investors

The reversal of the financial conditions that characterized the post-crisis period has near-term and long-term consequences.

First, in the near term, as interest rates rise, the discount rate that investors use to value the cash flows of a company will also rise. This should serve to reduce the prices that investors are willing to pay for stocks. Said another way, higher rates may lead to a contraction of stock valuation multiples such as the price-to-earnings ratio.

As we have noted in the past, ever increasing multiples have been largely responsible for equity gains over the last several years. If multiples are at risk that means earnings growth will be needed to support equity valuations. Currently, the combined earnings of the companies that comprise the S&P 500 Index are expected to increase around 20% in 2018 over 2017. An increase in earnings of this magnitude or greater has happened only four times since 1992 and in most cases coincided with an acceleration of growth following a recession, which is clearly not the case today. Admittedly, S&P earnings will enjoy the benefit of lower tax rates as a consequence of the new tax law; nonetheless, the bar for earnings growth is very high, which increases the likelihood that earnings will disappoint.

Longer term, the change in the economic backdrop may be more profound. We believe it will accrue to the benefit of value oriented active investors. The post-crisis economic conditions led to equity markets that exhibited very low levels of dispersion (i.e. stocks moved in unison), subdued market volatility (culminating in 2017 when implied volatility reached a 30-year low), and historic increases in equity gains, with the S&P recording its second largest and second longest bull market in history. All of these conditions presented significant headwinds for active managers who tend to thrive when there is dispersion among stocks, at least modest volatility and flat-to-declining markets. They presented the greatest challenges to value oriented managers.

According to Goldman Sachs, since 2008 there has not been a single rolling three-year window where the S&P 500 Value Index has outperformed the S&P 500 Growth Index. This marks the longest growth cycle since at least 1975 when the S&P 500 Growth and Value indices were initiated. This should not come as a surprise for two primary reasons. First, growth equities can be thought of as "long duration." Investors are paying for cash flows that are many years away, so these stocks are more sensitive to changes in interest rates. An increase in rates should have a more negative impact on growth equities than value equities, whose cash flows exist today. Second, in an environment of tepid economic growth investors were prepared to pay a premium for faster growing businesses. Should economic growth prove stable or accelerate, growth stocks would be less desirable relative to value stocks.

Portfolio Opportunities

Our investment approach has a clear value orientation that should stand us in good stead should the profile of the market change along with the evolving economic backdrop. Regardless, what remains most important to us is identifying businesses that can exhibit step function increases in earnings growth due to identifiable events or company-specific developments *and* which represent excellent risk/reward profiles due to attractive existing valuations, coupled with opportunities to substantially increase intrinsic value. We hope the following example highlights one such opportunity.

One of our holdings is a global leader in the design, construction and operation of high-throughput satellites. The company provides satellite-based communication services, systems and equipment to the U.S. government, commercial customers and U.S. consumers. Our investment is based on the company's ability to use its position as a low cost provider of bandwidth to capitalize on the very large unserved and underserved global market for broadband enabled communications and services. It is estimated that the addressable market

for residential satellite broadband alone is two billion homes and represents a $350Bn-$600Bn revenue opportunity; in addition to the consumer opportunity, the business operates in both the government and commercial markets. We believe the current value of the stock is largely underpinned by the franchise quality defense business and its in-flight Wi-Fi business which exhibits exceptional economics and long duration contracts. Their Wi-Fi service is now on planes operated by several leading carriers and is consistently recognized as a more compelling service than its competitors.

The company is in the advanced stages of developing and building its next generation satellite solution – an initiative to provide global coverage. These new satellites are expected to be launched into service in the next few years. Each new satellite will have significantly more capacity than the company's current solution. As a consequence, the capacity to serve the company's primary end markets – government, in-flight Wi-Fi, and residential – will expand dramatically. It seems reasonable that each satellite could generate something in the area of $1 billion of revenue at an approximate 50% EBITDA margin. On this basis the company could over the next several years be on a path to generate an incremental $1.5 billion of EBITDA which if valued at 10x would be worth significantly more than the current share price.

In summary, we believe we are paying a discount to the company's value today and have the opportunity to make multiples on our invested capital over a multi-year investment horizon.

Firm Update

We hope you will join us in extending our warmest congratulations to Wayne Davis and his wife Amie who welcomed daughter Abigail (Abbey) in January. Wayne is a colleague on our investment team and has shown no signs of fatigue…yet. We wish them all the very best. We hope that you are enjoying the belated Spring weather (for those on the East coast). As always should you have any thoughts or questions please don't hesitate to reach out to us.

Sincerely,

Michael A. Steinberg
Managing Partner

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