Fourth Quarter 2017 Commentary and Outlook

Benefitting from expectations that lower taxes would boost corporate profits, U.S. equities wrapped up 2017 with strong gains in the year's final quarter. For the full year the combination of rising corporate earnings, and inflation and interest rates that remained near historic lows provided the favorable conditions that enabled equity markets to continue their unprecedented advance. As we move through 2018 and into 2019, however, this favorable set of fundamentals may begin to shift in a manner which could weigh on the economic and investment outlook in the years ahead.

Inflation Likely to Awaken in the Second Half of 2018

The current low inflation rate has given the Fed the luxury of moving cautiously, which has kept markets buoyant. Therefore, an unanticipated acceleration in inflation is probably the biggest risk for financial markets this year.

For now, inflationary pressures remain benign even as the economy demonstrates solid growth before any additional lift is generated from the recently enacted tax cuts. The core Consumer Price Index, which strips out energy and food, is estimated to have risen at a pace below the Fed's 2% target rate in 2017. Over the same period the nation's jobless rate held close to 4%, a level generally considered to represent full employment.

This high level of price stability has been consistent for the last decade. In that time, members of the economic establishment have repeatedly raised the specter of inflation as a threat to our economic and financial well-being only to be disproved time and again. Many factors have contributed to inflation's long slumber. Employee bargaining power has been undermined by globalization, technological advances, the impact of the 2007 – 2009 economic downturn and more recently a demographic shift that favors lower-skilled and less-highly paid younger members of the work force. While these forces explain a weakened relationship between the unemployment rate and wage growth they do not negate a foundation of economic theory, which holds and has demonstrated, that inflationary pressures build as an economy's productive capacity moves toward full employment. While inflationary pressure has been largely absent from the economy's eight-year recovery from the financial crisis, the increasingly tight labor market stands poised to produce inflationary wage pressures in 2018.

High Capacity Utilization Consistent with Price Pressures

U.S. manufacturing capacity utilization is hovering near its effective maximum rate, a level that may be breached if the pace of economic activity quickens due to the tax cuts and possible infrastructure spending. This could be felt in the latter half of 2018 and 2019. The good news is that the Trump tax bill provides businesses with strong incentives for capital investment, which could lead to productivity gains and a bolstering of the economy's productive capacity. The new tax law allows companies to expense 100% of their capital spending over the next five years (up from 50% today). Thereafter, this benefit expires. Therefore, if capital spending, with its associated productivity gains, is pulled forward, it could help produce a long-term, low-inflation economic boom. While we do not dismiss this favorable outcome out-of-hand, if it does occur it is unlikely to deliver productivity improvements with sufficient speed to avoid an inflationary episode.

A final, though less desirable, scenario would see inflation held at bay due to a slowing in the pace of economic growth to a level below 2%. This would serve to reduce the immediate threat to our financial markets. In this case, however, corporate earnings would likely disappoint.

Powerful Economic Forces Converge

With the economy operating near peak levels, the jobless rate signaling a fully employed labor force, and fiscal policy set to turn noticeably stimulative, 2018 seems likely to be the year in which price inflation begins to rise at a more sustained pace. With both investors' and policy maker's expectations anchored comfortably to the status quo (i.e. 2%+ real GDP growth and 4%+ unemployment), it wouldn't require much of a change in these variables to force policy makers and investors to react to a new reality. If the Fed were to face an overheating economy, it would be forced to tighten monetary policy at a faster pace than generally anticipated. This would lead to a slowing in the pace of economic activity, reduced corporate profits and downward pressure on asset prices. Pressure on stock prices would be aggravated because multiples (price-earnings ratios), which are currently in the bounds of historical norms for an economy with inflation in a range of 0-2%, would begin to compress as the pace of inflation started to pick up and investors began including a higher inflation component in their analysis of equity valuations.

Increased Government Borrowing Could Drive Interest Rates Up

Even before President Trump signed the tax bill into law, the Treasury Department was expected to significantly boost the sale of new government securities in 2018 by about $1 trillion, around twice the amount sold in 2017. All else being equal, more supply should mean lower Treasury prices and higher yields, which could increase the competitive pressure on equities. While it is possible that investors could step up demand to meet this incremental supply, keeping government bond prices high and yields low, it is far from clear this will occur.

On balance, as we move through 2018 and into 2019 the combination of a still gradual but more rapid rate of inflation, a tighter monetary policy and a less favorable supply-demand balance for U.S. Treasury securities points to higher interest rates that could create a headwind for financial markets.

A Coming Shift in the Economic and Investing Landscape

Today we may be on the cusp of significant changes: The end of an era of subdued inflation and historically low interest rates. A move away from fiscal conservatism. Policy pushbacks against globalization. A rise in labor's share of income at the expense of corporate profit margins and therefore earnings. As this plays out, investors can expect anemic returns in the coming decade, certainly when compared to the above average returns enjoyed in the aftermath of the financial crisis when monetary policy was ultra-easy. However, as the new investment environment emerges we are confident that investors who are focused on identifying attractive fundamentals of individual securities will perform well.

Investment capital held in index-like funds, in their many and varied forms, will likely receive disappointing long-term returns both on an absolute basis and relative to the returns that skilled fundamental investors produce. We believe the securities that comprise your portfolio have exceptional risk-reward characteristics, and are positioned to deliver outstanding returns.

Discrete Investments Offer Opportunity

While there are risks to the global economy and markets are not inexpensive, we continue to identify discrete opportunities to make investments that meet our return objectives.

One investment we believe presents a particularly attractive risk-reward opportunity is a for-profit hospital operator in the United States. Our investment is predicated on management's continued ability to deploy the company's substantial free cash flow in a shareholder-friendly way (share repurchases, accretive acquisitions and other high-return projects). The company's long track-record of industry-leading operations and disciplined use of the cash generated from those operations gives us confidence in its ability to generate excellent returns. In addition, the company's management team members are large shareholders, with interests well aligned with shareholders.

Hospitals exhibit high fixed costs, are subject to a high regulatory burden, and their pricing is dictated by or heavily influenced by the government. As a consequence we do not regard them generally as high-quality businesses. However, this business is the exception to the rule. It exhibits excellent returns on capital and better margins than peers. It has achieved this performance by strategically building dominant positions in fast growing geographies. This targeted approach supports increases in patient visits over time, as populations grow. More importantly, it gives their business leverage in price negotiations with commercial insurers who need to provide their policy holders with access to the dominant health care provider in a given region or risk losing them. In addition, its size enables significant economies of scale leading to lower costs by capitalizing on centralized purchases of medical supplies and equipment, for example. While there are structural advantages that have been built into its model over time, it is also true that management have shown themselves consistently to be best-in-class operators.

The business operations generate large amounts of free cash, representing a meaningful portion of its current market cap. Management has assiduously deployed this free cash for the benefit of shareholders through accretive acquisitions and share repurchases. As part of its effort to build scale in targeted geographies management has been an acquirer of underperforming hospitals, executing turnarounds that have brought the performance of these assets in line with that of the overall company, thereby creating substantial value. Given the large opportunity that acquisitions present, it is worth noting that the current acquisition environment is particularly favorable for this business.

In addition to acquisitions, we believe that management will continue to generate value for shareholders by using free cash flow to repurchase shares. If management was so inclined (and they very well may be, should the share price not appreciate meaningfully) they could repurchase around 30% of the company's shares over the next three years. In an alternative scenario they may simply choose to take the company private.

While government cuts to reimbursements for health care services are always a risk, we believe this risk is mitigated by two factors. First, a significant portion of revenues and earnings come from commercial insurers. Secondly, a significant percentage of hospitals in the U.S. are just barely break-even or losing money. If government reimbursement rates were to decline over a sustained period many of these hospitals would be forced to close. Given that hospitals provide a critical public service and are one of the largest employers in many communities, prolonged cuts in reimbursement rates have not been and are unlikely to be politically palatable. That said management has a demonstrated record of successfully navigating the ever-changing health care environment and maintaining attractive returns.

Based on this year's earnings, shares trade at an attractive valuation. We believe that earnings per share will rise by more than 50% by the end of the decade. At today's P/E multiple, which we believe is reasonable based on its business characteristics and earnings growth profile, this would suggest the stock price could roughly double by 2020.

The company's large free cash flow, coupled with management's demonstrated ability to deploy capital in a manner which meaningfully enhances shareholder value, and the reasonable share price, we believe creates an investment opportunity with an excellent risk-reward profile.

Firm update

We are pleased to let you know that we have begun managing concentrated portfolios for clients who choose to invest in a single stock. We believe this is a natural extension of our business and builds upon our fundamental, bottom-up research process. If you would like to learn more, additional information is available in our ADV Part 2A.

We hope that you enjoyed your holiday season, and wish you and your family health and happiness in the New Year. As always, please do not hesitate to reach out to us with any thoughts, comments or questions.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

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