Knightsbridge Asset Management, LLC

April 17th, 2018

Spring Quarterly Commentary

There is a time for everything,
and a season for every activity under the heavens:
a time to be born and a time to die,
a time to plant and a time to uproot,
a time to kill and a time to heal,
a time to tear down and a time to build,
a time to weep and a time to laugh,
a time to mourn and a time to dance,
a time to scatter stones and a time to gather them,
a time to embrace and a time to refrain from embracing,
a time to search and a time to give up,
a time to keep and a time to throw away,
a time to tear and a time to mend,
a time to be silent and a time to speak,
a time to love and a time to hate,
a time for war and a time for peace.

Ecclesiastes 3, New International Version

New Year, new market; a lot has changed. Last year's red hot market continued into most of January, when it violently reversed and began thrashing about. When the dust settled, the quarter closed the books with a negative return for the first time since 2015. Volatility has come roaring back, with market indexes routinely moving more than one percentage point per day in all directions, whereas they had previously trended quietly upward. Not being active day-traders, the increased volatility doesn't affect our day to day operations, but cognizant of the conventional wisdom that "volatility increases at market tops and bottoms", it does make us wonder... and not if we are at a bottom.

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One result of the heightened volatility is that a number of volatility-driven funds spectacularly blew up, with one losing more than 90% of its value on a single day - *$2 billion in fifteen minutes* – on its way to being shut down[1]. These blowups aren't in and of themselves worrying, but could they be a warning sign of dangers to come? Recall that the financial crisis of '08 was preceded by two Bear Stearns hedge funds going belly-up in mid '07, long before the bank itself ran into trouble. Being fragile, derivatives can cause disasters that prove to be the canary in the coal mine.

So what is roiling the markets? Some point to "broken leadership", as the extraordinary gains produced by FANG stocks (Facebook, Amazon, Netflix and Google) have begun to reverse in the face of President Trump bashing Amazon on Twitter and Congress dressing down Mark Zuckerberg and Facebook. The world seems to have just woken up to the notion that Facebook and Google know nearly everything about you. Between the two of them, there is a good chance they know who all your friends are (your "real", not Facebook friends, via your smartphone's contact information), where you've been at all times (if you took your smartphone), and what web pages you've visited (including your reading habits). This is *in addition to* all of the information you've explicitly and voluntarily shared on Facebook. This has been the state of affairs for some time, but until now, with the Cambridge Analytica scandal, there was no central event that got everyone together talking about it. Will the market's tech leaders be vanquished by regulation? We do expect to see regulation coming down the pipeline. These companies have too much power not to be regulated. But how bad will it really be for their businesses (and stock prices)? We doubt the government will want to kill the golden goose. Given the market decline has been fairly broad based, we also doubt whether it is really these company-specific issues that have been pulling everything else down. If anything "broke", it was general investor sentiment once the "Promoter in Chief" seemed to stop caring if his words and actions sent the market into a tailspin. In any event, this environment of falling FANG stocks has been generally good to us.

[1] It took quite a while, but our 2011 warnings against exchange traded notes finally appear warranted.

Then there are the rumblings of a trade war which have roiled the markets. While the market does seem to gyrate on each verbal salvo, we think the prospects for further plunges on this count are limited. The President's negotiating strategy often unfolds from a wildly extreme opening position in effort to create leverage. He might even make good on some of his threats, but China and the U.S. both have too much to gain from trade to let this get too out of control. Following the day-to-day news here will drive you insane and it will not leave you with a better understanding of where all this will end up. Regarding the potential trade showdown, we think the scorecard looks something like this:

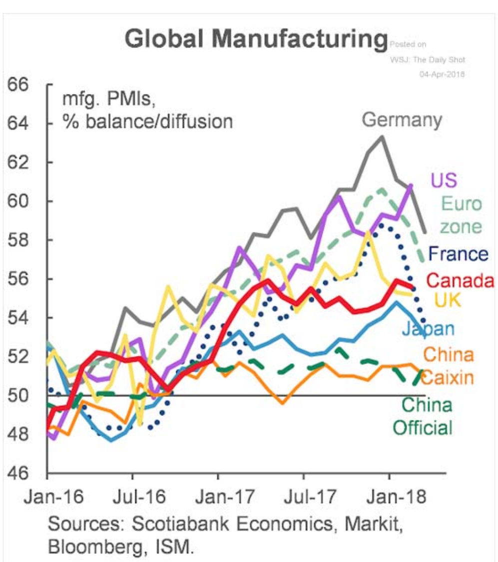
- Who has more incoming trade they can tax? Advantage: U.S. When Trump proposed tariffs on $50 billion of Chinese imports, the Chinese shot back with a proposal for tariffs on $50 billion of American imports. Not to be outdone, Trump fired back that he was ordering his subordinates to consider tariffs on an additional $100 billion of Chinese imports. This put the Chinese tit-for-tatters in a bit of a bind, considering that the U.S. only exported a total of $115.6 billion of goods to China in 2016. (It should be noted that China has other forms of leverage, for example potential expropriation of American stakes in the numerous mainland China joint ventures.)

- Who has more capacity to suffer while resisting political pressure? Advantage: China. China is smart to be intentionally targeting Trump's political base with its retaliatory tariffs. The President may at some point have to worry about getting voted out of office. That prospect is not something that Chinese President Xi Jinping, who just cleared his way to being named President for Life, has to worry about.

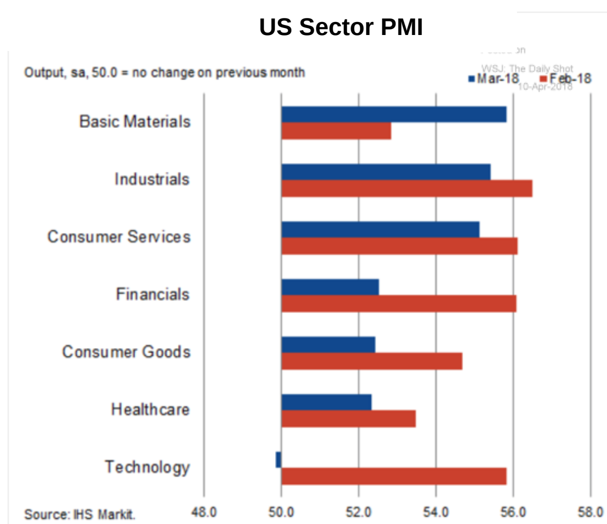
- Who has the more stable financial situation? Advantage: U.S. We have written in previous letters that we believe there are large risks lurking in the Chinese economy and financial system. Recent (non-trade) policy action seem to indicate that the Chinese believe this as well. Our biggest worry in all this is that posturing causes some economic disruption which ends up popping the Chinese bubble. When possible, we have sought to limit our exposure to the Chinese economy, but we doubt that we would be completely insulated from any economic catastrophe.

Could the market, backing away from its January high, be pointing toward future economic weakness? Wait, what? Isn't the economy extremely strong? Yes, for the moment. In fact a giant leap is expected in upcoming corporate profits (due in large part to the new tax bill).

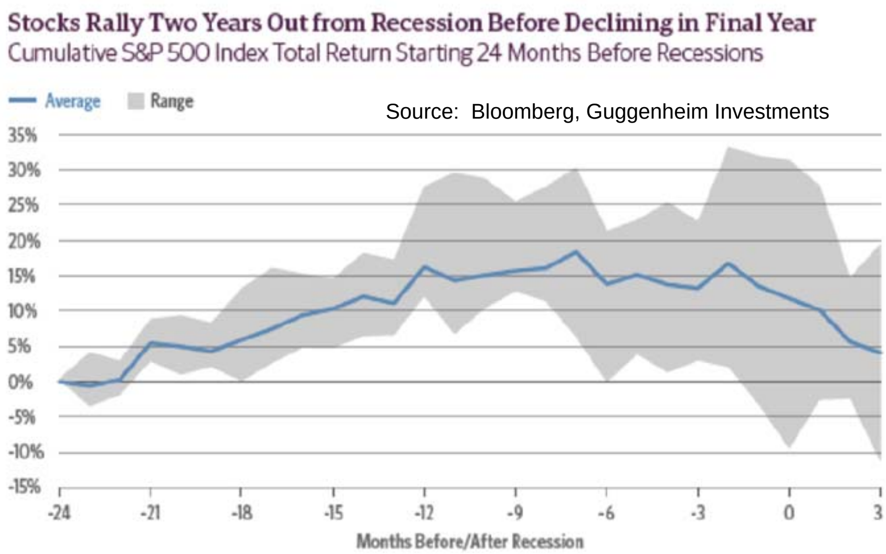
So what is going on then? Well, the stock market prices what's "next", not what's "now". We submit that part of the explanation is that the market is sniffing out slowing growth. The Purchasing Managers' Index (PMI) is a survey of companies regarding new orders from customers, the speed of supplier deliveries, inventory levels, order backlogs, and the employment level; the aggregate final number just happens to be one of the best and most leading of economic indicators. These numbers have been coming in weaker as of late. The first chart shows how internationally, many PMI indexes look as if they rolled over, but it has not been updated for the latest U.S. numbers, which appear in the second chart.



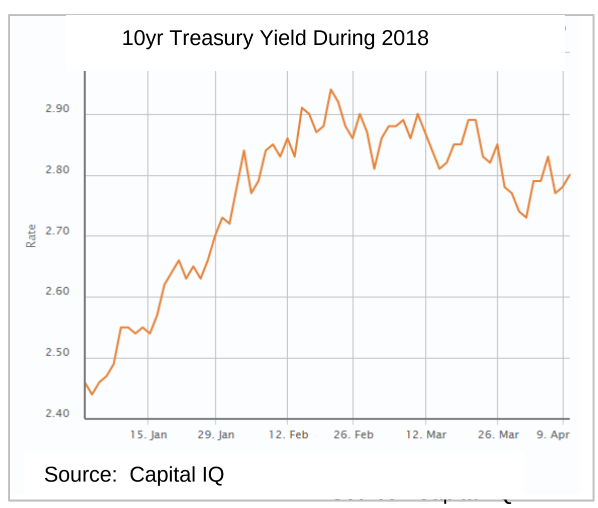
Source: Scotiabank Economics



To be clear, these indicators still signal growth, just slowing or decelerating growth (with markets only just now pricing in the "slowing" part). The obvious concern is that you have to slow down before you can stop. While we are definitely stopping far short of calling out the next recession, we present the next chart showing how the market typically peaks six to twelve months *before* a recession starts in order to illustrate how the market often sees down the hall and around corners. It seems plausible that the market is sniffing out a chink in the "synchronized global growth" story.

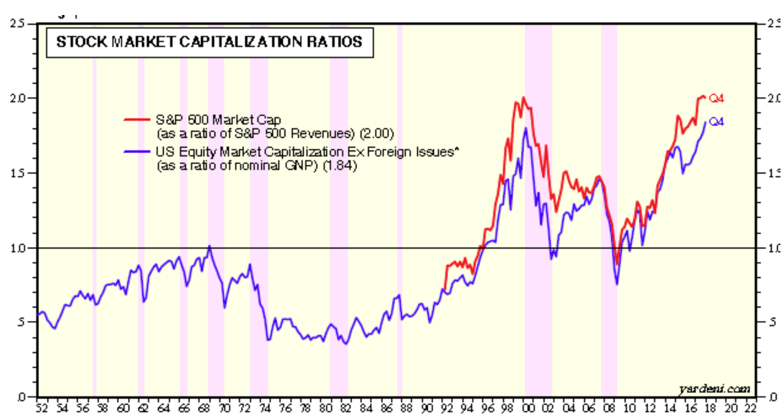


So there are a number of potential reasons to be worried, but in our opinion, the biggest threat to the market is inflation, because of the higher interest rates it would surely bring. This, in our opinion, is the real reason that markets originally took a dive in late January. Inflation expectations shot up after a report was released that showed rising wage pressures. Long-term interest rates soon followed suit, with the benchmark U.S. Ten-Year Treasury rising 50 basis points (half a percent) from the start of year through late February – a huge move in fixed income world. These developments are less in the headlines

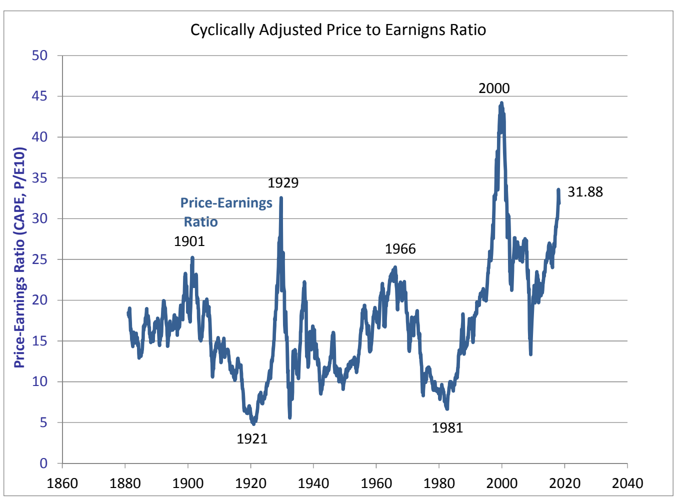


than are the day-to-day developments in the brewing Trans-Pacific Trade War, but they matter more in our estimation. (In the above chart, the "U.S. 5yr, 5yr Forward Breakeven Rate" represents a market-based measure of inflation expectations.)

The reason that rising interest rates present such a threat to the market is that valuation is already very high and the economy is already so good. Often, rising rates are a sign that the economy is improving, but many are skeptical that the economic situation can improve further given unemployment is already at record lows. (This story is seemingly corroborated by the weakening PMI readings, as described above). This means that if rates were to continue to rise tomorrow, they could have their detrimental effect on today's high valuations without the offsetting beneficial effect of signaling an improving economy. And a detrimental effect they would have. Interest rates act on valuations the way gravity acts on matter – the higher the rate, the stronger the downward pull. If this "gravity" were to heat up, it would seem we could have a long way to fall as the two following charts illustrate.



* Total excluding market value of holdings by US residents of foreign corporate equities, investment fund shares, and ADRs.
Note: Shaded red areas denote S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: Federal Reserve Board, Bureau of Economic Analysis, and Standard & Poor's.

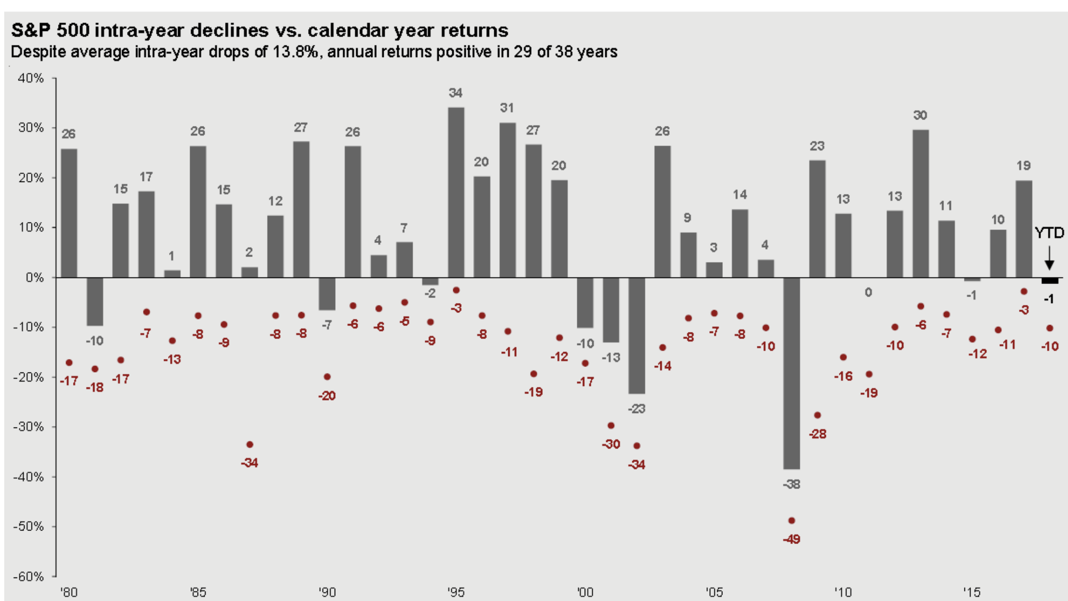


Source: http://www.econ.yale.edu/~shiller/data.htm

While we think there are some potential issues with the above Cyclically Adjusted Price to Earnings Ratio[2] (CAPE), most (but not all!) measures show the market is rather expensive. The fear is then that rising rates could both take some air out of valuations at the same time as they throw a wrench in the gears of the real economy.

For now, inflation expectations have backed off from their highs, though they remain elevated. Inflation itself hasn't yet emerged, but appears just about ready to rear its ugly head... precisely as it has for a number of years now. Perhaps the "Mysterious Force" that has been keeping inflation in check until now will continue to do so. There have been many false alarms.

If the Mysterious Force does continue to triumph, it might also mean that this year's ten percent correction could already be behind us. Such a magnitude of decline would represent a *less than normal* annual correction. If this doesn't "feel" normal, perhaps it should. The red dots on the below chart denote the maximum drawdown experienced during each year; the full calendar year return is represented by the grey bars. The average intra-year decline is fourteen percent, yet the market managed to rise in 29 of 38 calendar years. Short-term pain and long-term gain. Last year's feat of only a three percent maximum drawdown in stock market value was an aberration, matching the smallest drawdown in the past 38 years.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

2 We hope to explore these issues in the next letter.

In a nutshell, the above chart explains why, while we always worry, we rarely panic. More likely than being a disaster which requires evasive action, 2018 could turn out to be a year of a solid economy, with a lackluster market. The rub is, even if we are right and forward market returns are modest, this knowledge doesn't do us investment managers a lot of good. Unless things get really extreme, there usually is no better alternative to staying the course and remaining invested in stocks. We do however feel these warnings of likely muted forward returns can be useful for your own financial planning and how you think about spending in what may be some relatively leaner years to come.

We thank you for the trust you place in us.

Sincerely,

JOHN PRICHARD   Miles E Yourman

John G. Prichard   **Miles E. Yourman**

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