Knightsbridge Asset Management, LLC

October 18th, 2018

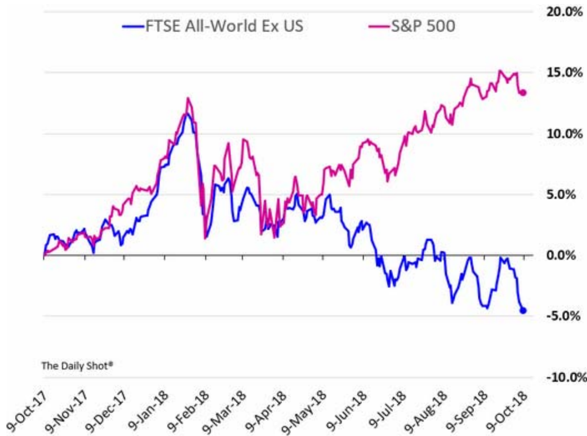
Fall Quarterly Commentary

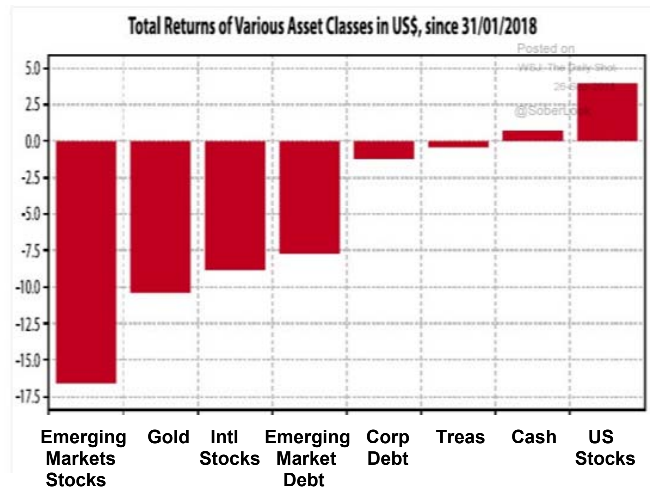
"I would have written a shorter letter, but I did not have the time."

Blaise Pascal (1623 – 1662)
French polymath, physicist and theologian
Inventor of the mechanical calculator
Co-father of probability theory

Following some early-year jitters, in the third quarter U.S. equities steadily marched their way to record highs, leaving other markets in the dust. Foreign stocks lagged the U.S. by more than 15% this year while most asset classes delivered losses. The domestic equity market willingly ignored valuation concerns, plunging emerging market currencies, steadily rising oil prices and trade war worries... that is until the quarter ended and we began penning you a letter about the dangerous complacency in the stock market. But risk happens fast! (Apparently faster than we can write the letter.) In the early weeks of October the S&P 500 Index fell 7%, erasing its entire third quarter gain. So far, the move appears not to be based on any new troubling information. Instead, the market is simply waking up to risks that were already there but had previously been shrugged off. This letter outlines some of those risks.

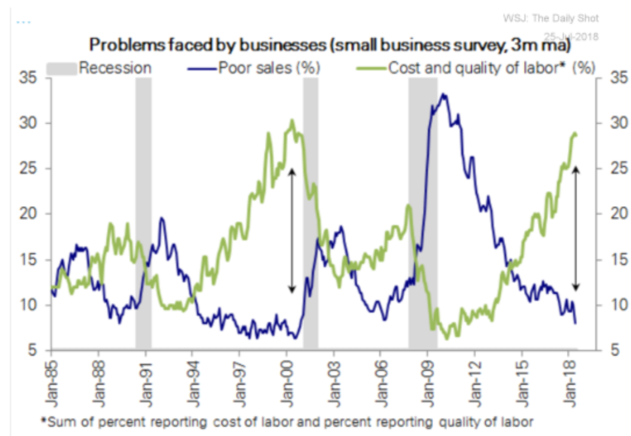
500 Newport Center Drive • Suite 680 • Newport Beach • California 92660
(949) 644-4444 • Fax (949) 717-5030





SOURCE: GAVEKAL DATA/MACROBOND

The main thing driving stocks higher during the quarter (and which has not changed) is the strong economy. The number of Americans receiving unemployment benefits just hit 3.7%, the lowest level since 1969. In surveys, near record numbers of small businesses are reporting that their biggest problem is "cost and quality of labor" as opposed to "poor sales".



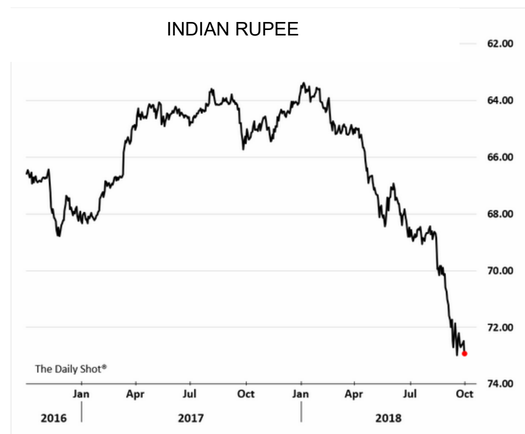
SOURCE: DEUTSCHE BANK RESEARCH

Initial Jobless Claims

Though uncommon ten years into an expansion, the roaring, even accelerating economy shouldn't really be a surprise. There has been a giant fiscal stimulus unleashed on the economy: the Tax Cut and Jobs Act of 2017. A fiscal stimulus is when the government puts money into the hands of the people, by either cutting taxes without cutting spending, or increasing spending without cutting taxes. The stimulus of today is of the tax-cutting variety, and boy is it a doozy. One rough measure

of the size of a stimulus is how much it adds to the government debt. The Congressional Budget Office (CBO) estimates that the current tax cutting program will add $1.891 trillion to the national debt[1] over ten years. Compare this figure with the $831 billion CBO estimate for the additional debt resulting from the crisis-era stimulus[2]. The current stimulus is more than twice the size as the one passed to fight "The Great Recession"! In addition to the stimulus supplied by the Republican-only tax cut, this February both parties joined together to increase spending by passing the Bipartisan Budget Act, throwing more coal in the economic furnace[3]. The result is the largest stimulus outside a recession since World War II. No wonder the U.S. has a booming economy. The stimulus has other implications (for the budget deficit, inflation, and interest rates) but for now the big one is an economic jolt.

It has been a very different story in emerging-market-land, which is in complete financial (if not yet economic) turmoil. Broadly, emerging market currencies are off over 10% since this spring, an enormous move when it comes to currencies. The following charts give a feeling of the synchronized nature of this move.

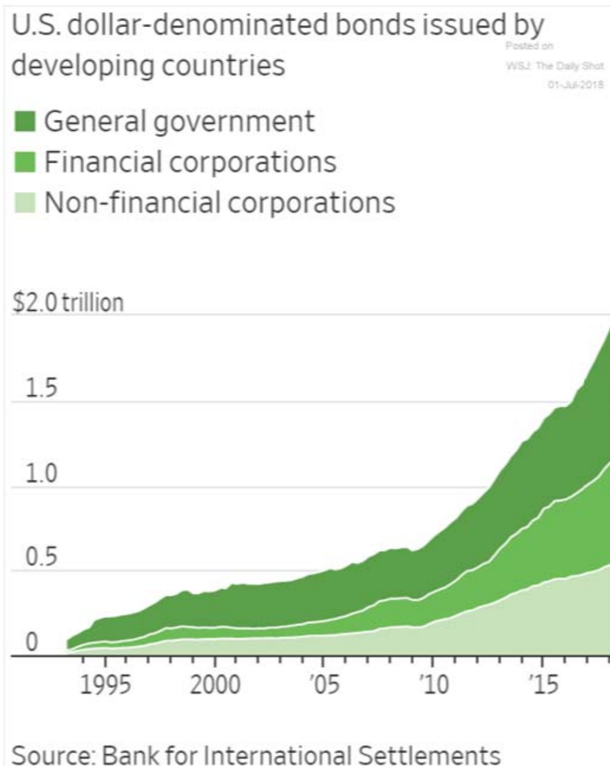


---

[1] For those curious, the national debt currently stands at $9.8 trillion.
[2] This comparison actually *understates* the differential, because the CBO considered macroeconomic effects (of faster growth due to stimulus) in its report on the impact of the tax cut, but not for the report on the crisis-era stimulus.
[3] We like this awkward metaphor as we imagine an old locomotive furnace could overheat, as might the U.S. economy.

A handful of countries including Turkey and Argentina have seen their currencies depreciate even more; the Lira and the Peso have been sawed in half relative to the dollar. Were we to chart the above countries' stock markets instead of their currencies, you would see similar downward trajectories, with most in bear market territory. This includes the stock market of China (now the world's second largest economy), which has dropped about 30% since its January peak, hitting a four-year low.

For some countries, what began as a currency problem will turn into a debt problem, largely because they have a lot of U.S. dollar denominated debt. In these countries, a 10% currency decline means their (dollar) debt pile just got 10% larger[4]. It's a big issue. As the chart at right shows, emerging markets have $2 trillion in dollar denominated debt outstanding. Debt problems can turn into bank problems, and as we remember from 2008, bank problems can quickly become everyone's problems. Fortunately, it is not our banks that are in trouble (yet?).



Furthermore, many of these countries face the additional burden of skyrocketing energy costs. The global oil benchmark price is up some 20% year to date... but that's the price in USD. If your currency has declined, the rise is even steeper. Since February, oil prices are up 47% in China, 58% in Brazil and 55% in India. In Turkey, it's doubled. The world still runs on oil and we are going to see a lot of countries struggling to keep chugging.

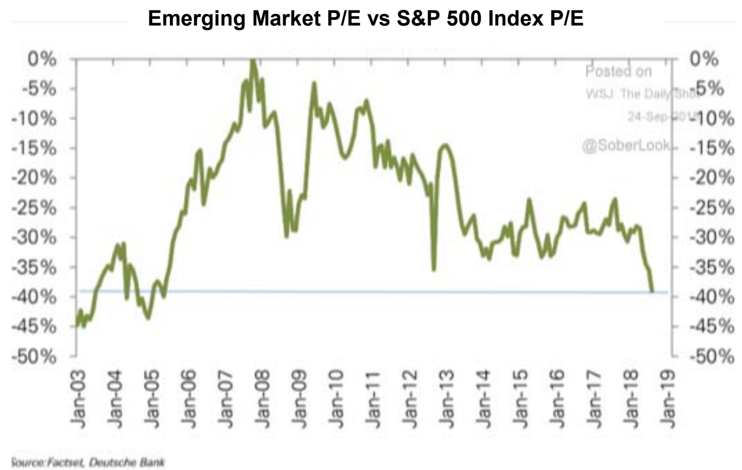
---

[4] Oh, and it just so happens that your debt is exploding when rates are rising. Thanks for playing.

There are even fresh bubbles of panic in Europe, with Italy's new ruling coalition embracing fiscal profligacy. Italian bond yields have moved sharply higher as a result, alongside a 28% decline in Italy's financial sector since the election.

The overarching point is that, while the U.S. is doing great, the remainder of the world is, to a certain extent, sucking wind. Can this divergence last? Probably for a while, given the aforementioned stimulus, but it is ominous nonetheless.

Conditions in emerging markets may sound terrible and indeed this is a painful cycle for the people of these countries. At the same time, sometimes good investment opportunities are born out of tough times. This could be the case today with emerging markets, which now trade at a 40% valuation discount to the U.S. We are beginning to explore some of these foreign markets, as they offer investment opportunity where conditions have *already* been bad (and have the potential to get better) as opposed to the U.S., where we know conditions have been very good but won't always be this way.

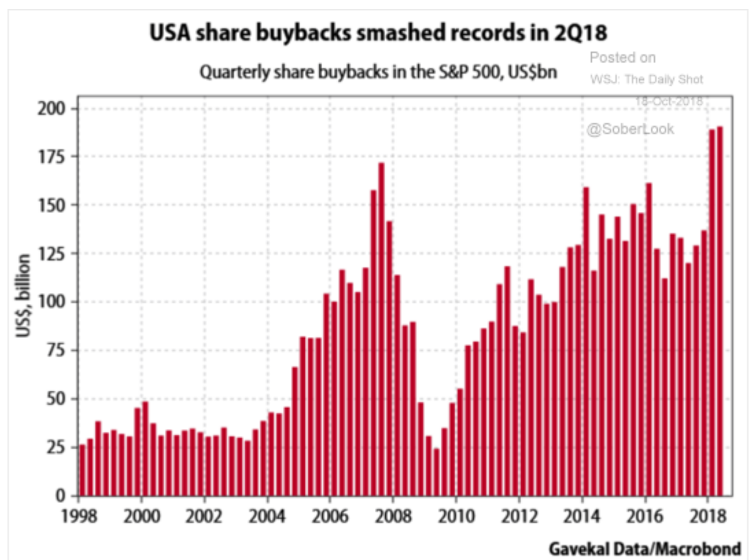


Today's investment environment is in some ways reminiscent of the late 1990s, when Asian currencies and the Russian ruble were being devalued. The economies and equity markets of those countries became very depressed and we found some real bargains, which enabled us to invest away from the dotcom speculative mania that had taken hold of U.S. equities. The U.S. stock market is not in a mania this time, but, even after the recent pullback, some areas look a little frothy.

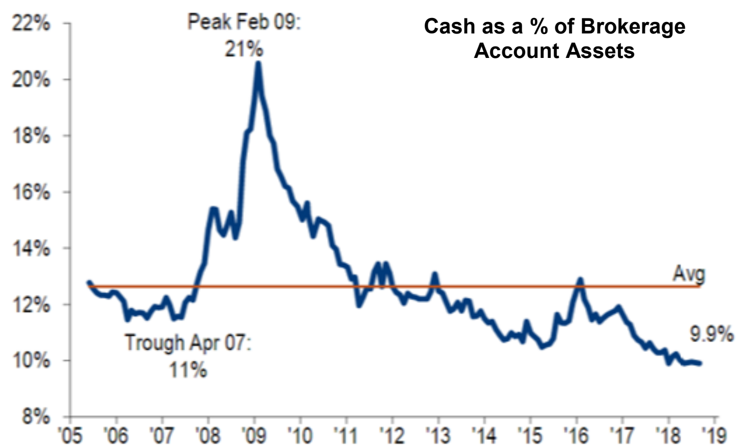
So what are the signs of frothiness in the U.S. market?

1. The Conference Board's Consumer Confidence Index stands at its highest level since 2000. When consumers are confident it is good for the economy, but when investors are confident it can be bad for the market (well, the market's future returns that is).

2. Fueled by the big corporate tax cut, the amount of stock buybacks by S&P 500 companies is set to exceed the previous record set in 2007. Companies tend to buy back more stock near market peaks, and 2007 was the final year of the last market cycle.



3. Investment funds are not holding much cash. With the markets "all in", there's less firepower out there to "buy the dips". These low cash readings are not a surprise knowing cash literally has paid zero for years, but as we will discuss, this too changed.



SOURCE: MERRILL LYNCH

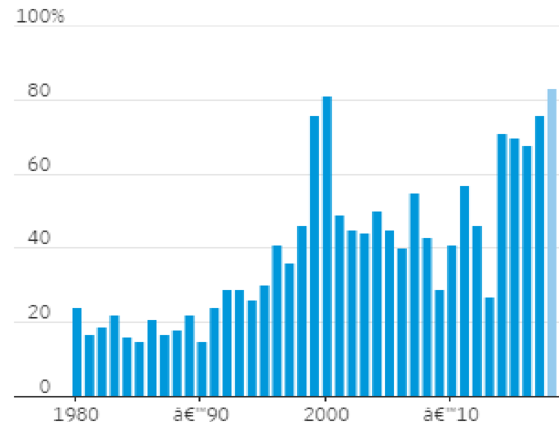
4. A near record high number of companies in the Russell 3000 Index (which covers most of the U.S. equity market) are valued at a staggering price to sales ratio of more than 10. This is nearing the all-time high portion reached during the dotcom mania. Be assured, none of our investments possess such a heady valuation and the weighted average price to revenue multiple across our portfolio is 1.8.

5. In a period of historically low interest rates, companies have shown their confidence by increasing their net borrowing. The number of companies with net cash on their balance sheets has declined by half while those with net debt equal to two or more times their annual EBITDA has nearly doubled.

Source: FactSet, Goldman Sachs Global Investment Research

6. 83% of this years' IPOs lacked profitability in the year prior to going public. Such exuberance exceeds that found during the speculative frenzy of 1999-2000 and is the highest reading since at least 1980.

The percentage of U.S.-listed IPOs that lost money in the 12 months leading up to their offerings in 2018 is on track to top the 2000 high.

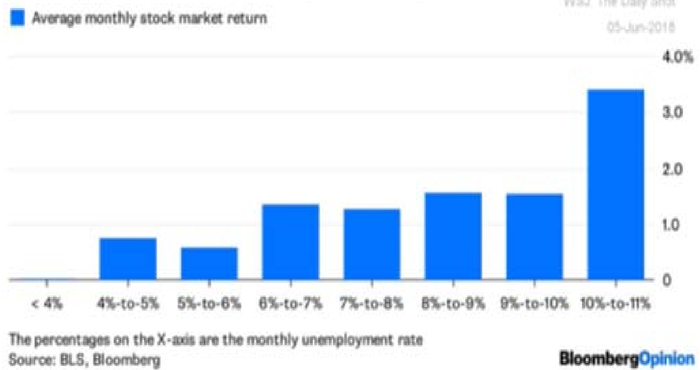


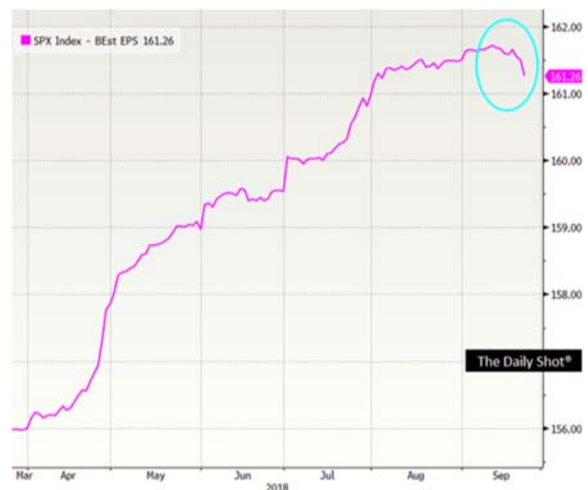
SOURCE: WALL STREET JOURNAL

The six preceding charts measure different things but all point to corporations and investors being confident and perhaps complacent, which again is perhaps not surprising given the improving economy. However, when it comes to the stock market, sometimes what seems good is actually bad. Take the incredibly low 3.7% unemployment level we mentioned earlier, the best since 1969. Historically, really low unemployment has been associated with a low forward rate of stock market return. The current unemployment rate falls into the < 4% bar on the left side of the below chart. That bar is not missing; it just shows 0% appreciation. There is a similar phenomenon when it comes to consumer confidence (the first of our five points above). In the past, the S&P 500 index has *lost* an average 3.7% in the year following the highest 5% of confidence readings[5]. Where are we today? The 98th percentile.

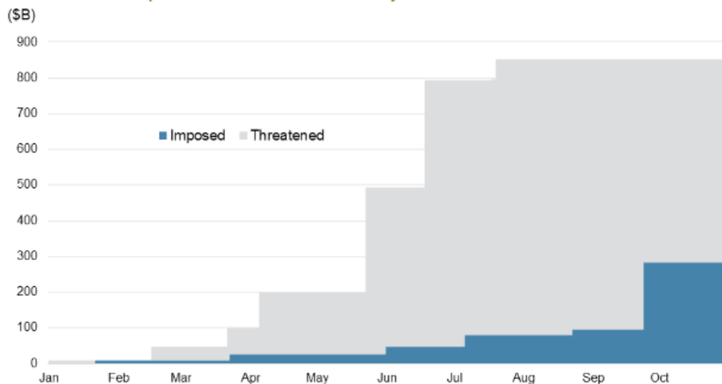
[5]Thanks to Mark Hulbert of the WSJ for these statistics

These examples demonstrate that sometimes when things are great, they are about to get worse. Perhaps this is already happening. Firms are starting to issue a lot more negative earnings guidance for the coming quarter, and analyst earnings estimates are coming down as well. The economy is booming, but perhaps corporate profits (which aren't exactly the same thing) match the heady expectations.



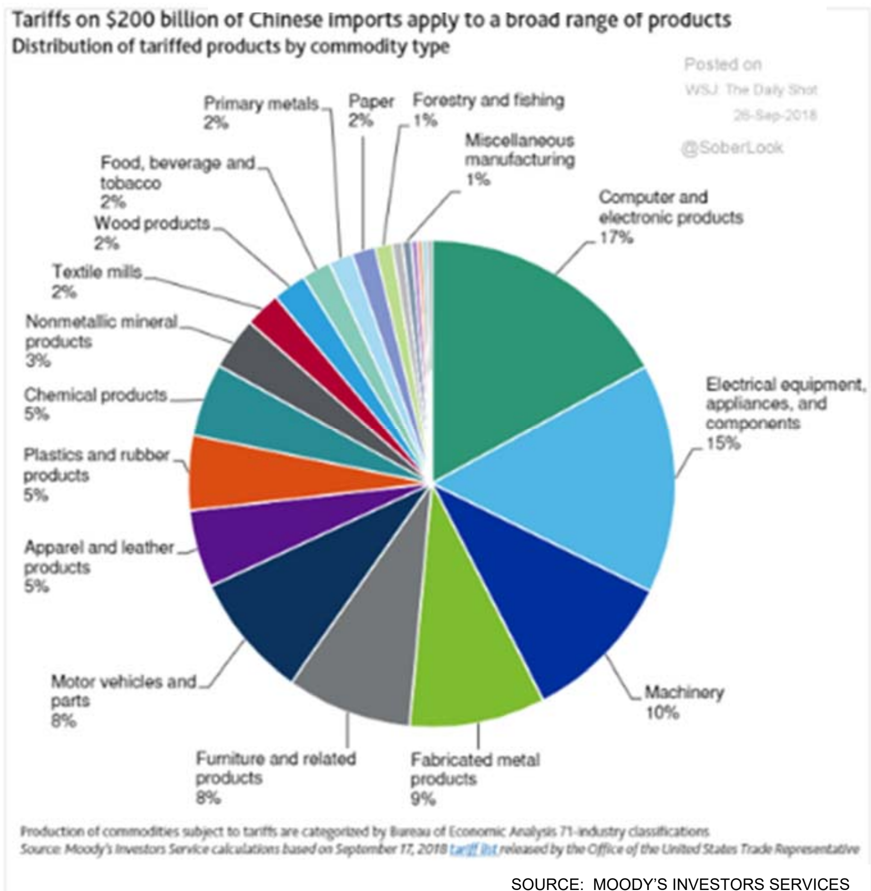


Our main suspect for what might be threatening corporate margins and profits is the newly implemented Chinese tariffs. Until recently, there had been a lot of headlines, a lot of bluster, but (relatively) little action on this front. This all changed September 24th when tariffs on $200 billion of Chinese goods (on top of the previously announced $50 billion) went into effect. The rate starts at 10% and goes to 25% January 1st. The chart on the right shows that the magnitude of



tariffs *actually implemented* just made a very big jump. This will also be the first round of tariffs that include consumer goods, and thus the all-important U.S. consumer will be taking a direct hit for the first time[6].

There are several reasons we think the stock market might not be ready for this. First, we find markets tend to *under*-react to big changes, something we refer to as mental inertia. Second, many market participants (us included) were unsure how seriously to take Trump's threats of tariffs. Even now, after implementation, investors and businesses might not be taking them seriously, thinking that soon a deal will be reached, the tariffs will be lifted, and it will turn out to all have been bluster... as it now appears to have been with NAFTA. We ourselves opined in our first quarter letter that the unfolding trade war was just a lot of negotiating noise which would not ultimately interfere with commerce. We now think that things might be different with China and we were wrong to be so dismissive. Trump has laid out two goals for trade with China: close the trade gap and stop the theft of U.S. intellectual property. We question what steps could possibly accomplish the first goal and what assurances from China could possibly be good enough to secure the second? Consider the recent blockbuster Bloomberg article which claims the Chinese army hid tiny microchips on server boards manufactured in China that enabled backdoor access to the largest U.S. tech companies and potentially the U.S. government. How is any trade deal going to assuage concerns like this? The goal of tariffs might very well not be "fairer trade with China". The goal might simply be "less trade with China", which would be accomplished by simply leaving the tariffs in place.

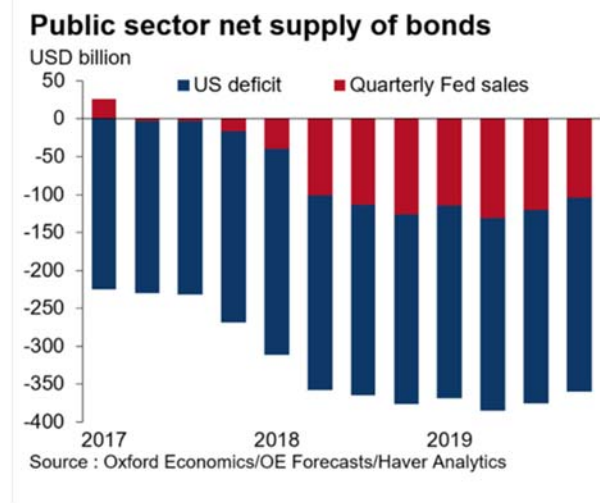


SOURCE: MOODY'S INVESTORS SERVICES

[6] We admit this will be somewhat offset by the Chinese currency having already dropped 10%; equal to the first round tariff 10% rate.

We take no view about whether these moves may be good for the country in the long term, but in the short term they will probably not be good for the stock market. J.P Morgan estimates that when the 25% tariffs are levied in January, it will reduce S&P 500 earnings by about 4.5%. We calculated in our last letter the new tax bill would boost earnings by 10% to 12%; next year's tariffs potentially are set to erase half that earnings boost.

Meanwhile, we believe we will continue to be in an environment of rising rates[7], driven by more federal debt hitting the market from three sources: increased deficits from the tax cut, increased debt held by the public due to the liquidation of the Social Security trust fund[8], and the shrinking of the Fed's balance sheet[9]. This increase in the supply of debt will be accompanied by a decrease in price (in bond-world, lower prices are just another way to say higher rates). We think of interest rates like turbulence. When turbulence increases, fragile things break. At some point, we're going to find out what is financially fragile.



Source: Oxford Economics

Aside from things breaking, higher rates have implications for stocks because they are the competition. A few years back, we wrote that while stocks looked very expensive relative to their own history (still true today), they looked very cheap compared to bonds (increasingly less true). A couple of perhaps mentally important thresholds have been reached. The Fed's rate hikes have just now reached the point that short-term interest rates exceed the rate of inflation, meaning that in

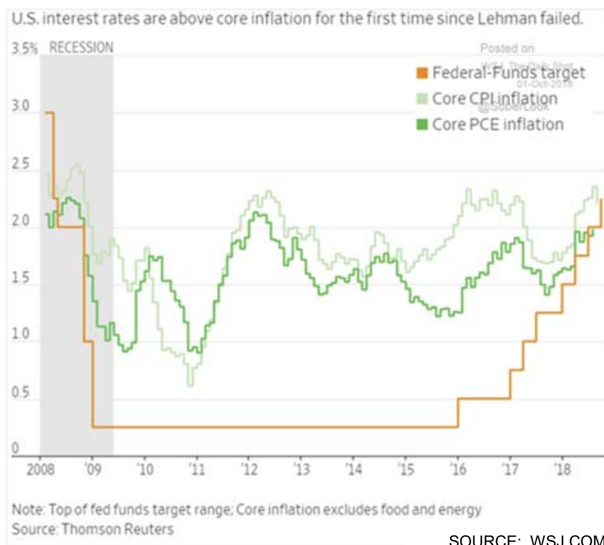
---

[7] That is until there is another recession, which will happen eventually and when it does, the Fed will respond by lowering rates again, potentially taking them lower than ever before. This is why we feel comfortable holding a utility, despite our view that rates are heading higher in the interim.

[8] This gets a little complicated. Until recently, Social Security had been taking in more money than it paid out. The surplus was "saved" and "invested" in government debt. That is to say, the government wanted to spend some money, so instead of getting money by selling the debt to the public, it sold the debt to the Social Security trust fund, which handed back the extra dollars it had collected. In this way, the Social Security program made it so a lot of U.S. government debt was held by an arm of the U.S. government. Now that the Social Security program is giving out more money than it takes in, it will be taking the government bonds it holds and selling them to the public to plug the gap. Thus, the supply of government debt held by the public will be increased.

[9] Happy 1st birthday to Quantitative Tightening! The Fed is now shrinking its balance sheet by selling $50 billion of bonds every month, up from $10 billion a year ago.

real terms one's purchasing power doesn't diminish when one holds cash[10]. Also, Treasury Bills now yield more than the S&P 500 Index, meaning that for income-oriented investors, they can get more current income from their cash deposits than they can from S&P 500 dividends[11].



SOURCE: WSJ.COM

Fortunately, before we were writing about all these risks in this letter, we were reacting to them in the portfolio. So far, this has enabled us to outperform somewhat during the market's recent downturn. Earlier this year we sold our emerging market stock position when U.S. interest rates started rising, but before those higher rates produced what are now crisis conditions. Around the same time, we sold our bank preferred stock given its high sensitivity to rising rates[12]. In July, we sold some of our financial stocks, even though they directly benefit from rising rates because down the road they can become hurt by the fragility that a rising rate environment often brings. We also sold our two most highly valued stocks this summer, when they hit our sell targets; our assessment of the general investment environment contributed to our decision not to hold out for higher gains. While these two terrific businesses which should continue to grow, we believe higher rates put their elevated valuations at risk. The sale of all these stocks required us to harvest more long-term capital gains than we would prefer, but we still felt it prudent. This has so far been the correct course, as in most cases we sold above current prices.

---

[10] Well, actual cash, like a bill in a drawer, doesn't earn any interest, and bank deposits don't really earn much interest either. When we say "cash" here, we mean the extra money in your brokerage account, which we invest in one of a few money market funds we compare periodically. These now yield about or just over 2%, which happens to be the rate of inflation.

[11] This being said, focusing on current income alone is a huge mistake because it ignores the main mechanism of enrichment in stocks which is price appreciation.

[12] Even though we felt it would continue to outperform other bank preferred issues.

As we wrote in the opening, we do not believe the market's recent downturn is in reaction to new news, but rather it is in recognition of concerns which were already appreciated by ourselves and others, and already reflected in other global markets. Therefore, with a new lower price against the same fundamental outlook, U.S. market risk is lower than it was before. Already we have attempted to take advantage of the downturn by increasing one of our position sizes.

As always, we appreciate the trust you place in us as we attempt to navigate, respond to, and take advantage of the ever-changing investment environment.

Sincerely,

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

Past performance is not indicative of future results. The above information is based on internal research derived from various sources and does not purport to be a statement of all material facts relating to the information and markets mentioned. It should not be construed that the information in this commentary is a recommendation to purchase or sell any securities. Opinions expressed herein are subject to change without notice.