THE
LONDON
COMPANY

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To clients and friends of The London Company:

> *"The supreme art of war is to subdue the enemy without fighting.*
>
> - Sun Tzu*, The Art of War*

With the rekindling of political tensions and threats of a full-fledged trade war with China dominating the headlines, we thought it appropriate for this quarter's letter to look to the writings of the great Chinese military strategist Sun Tzu for our inspiration. Tzu, who is believed to have lived during the Chou dynasty in the latter half of the 5th Century BC, was credited with authoring *The Art of War*, widely heralded as one of the seminal works about the strategies and tactics of psychological warfare. Largely unknown in the West prior to the 20th Century, *The Art of War* has been cited by such disparate modern day sources as military tactician General David Petraeus, former director of the CIA, and pro football tactician Bill Belichick, head coach of the New England Patriots. From across the far corners of military, government, business, and sports, the Sun never sets on the wisdom imparted by Tzu……

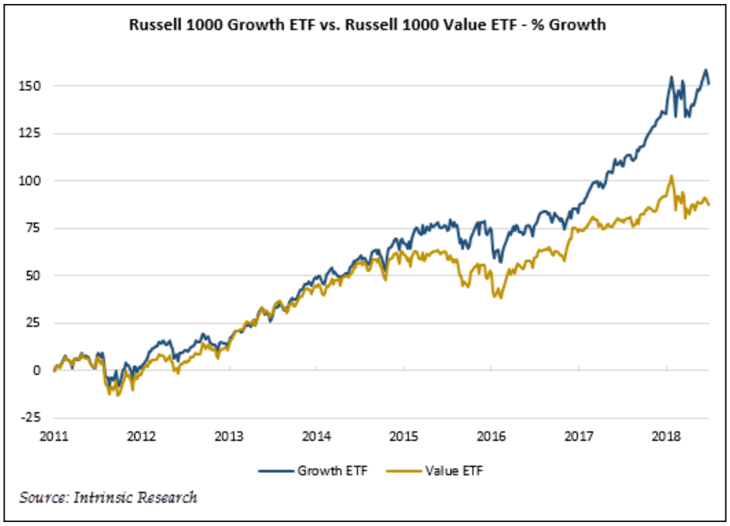
The rancorous policy chess game with China is the latest salvo in US relations with the rest of the world. From the outset, President Trump and the leaders of his administration have adopted a bellicose demeanor of engagement. It has encompassed a series of wide-ranging skirmishes and political wars with perceived adversaries within its own Republican Party, opposing parties, individuals, companies, industries, professional sports, countries and even ally coalitions such as the European Union, the G-7 and G-20, and our neighboring North American trading partners operating under NAFTA. There is an undeniable fighting spirit charting the current course of the United States, which has created controversy and outcomes that can be seen both for the better and for the worse. Thus far, the various wars that have been waged have been advanced as much by words as actions, perhaps a nod to Tzu's artful approach to battle. Certainly this approach has yielded no shortage of anxious moments, evidenced by last fall's provocative exchange between the US and North Korea, which held the potential of escalating into true nuclear warfare. While prevailing wisdom at the time braced for the worst, threatened military action ultimately was not unleashed. Instead, the resulting "truce" led to this June's face to face meeting between President Trump and Kim Jong Un and an announced framework for a possible cooling of hostilities between the two longstanding arch-enemies. This was an inconceivable outcome a mere nine months ago.

The wars of words have created all kinds of responses- contentious disputes, standoffs, settlements, non-actions, and détente- the sum of which have been supportive of the indefatigable bull market in equities while keeping the market bears subdued. The growing trade flap with the EU and NAFTA have caused ripples but little palpable concern. Whether or not the unfolding donnybrook with China will adhere to President Trump's preferred negotiating script, or erupt into something messy and disruptive to the economy and the capital markets remains to be seen. In rapid succession, so far announced tariffs have ballooned from $25 billion worth of Chinese goods to $200 billion to the imposition of restrictions on Chinese investment in the US and the export of US technology to China. Each announcement has been met by quid pro quo Chinese retaliation, a spiraling situation of unquantifiable economic magnitude if these proclamations convert into actions. While $200 billion in tariffs has been estimated to represent about only a 0.2% hit to US GDP, the collateral damage from retaliation and across global supply chains could be far worse, considering the fact that the US and China together account for approximately 30% of global GDP. For US investors, the market impact could be even more pronounced. The epicenter of a trade war would be US manufacturers, which comprise over 40% of the earnings and capitalization of the S&P 500 and almost 12% of US GDP (source: Empirical Research Partners).

As the second quarter came to a close, these lengthening shadows began to eclipse what otherwise had been a sunny first half for the domestic economy and growth-oriented equities. There is no question that the combination of tax cuts, reform, and repatriation enacted during the first quarter had a salutary impact upon the trajectory of domestic growth. After years of steady but lumbering expansion, the US upshifted into a higher gear powered by government stimulus and public optimism. A strong and tight labor market propelled consumer confidence ever higher, despite the headwinds of disruptive weather and rising energy prices. For the first time since the data started being captured in 2000, there now are more available jobs than reported unemployed workers to fill them. At the corporate level, business confidence has surged in tandem, reflected by a material boost to capital spending, record share repurchases, and in mergers and acquisitions, with the later increasingly funded by debt. S&P 500 reported profits jumped over 20% in the first quarter, with a reprise expected in the second quarter. Finally, investor confidence has followed along, though less evident in the bifurcated and selective performance of equities during Q2 and the first half of 2018. While applauding today's strength and good news, market investors tend to focus on the predictive assessment of tomorrow's news, and how the change in the rate of change will manifest in the future.

In that light, strong economic conditions and strong profit growth, confirmed by ascending confidence often do not translate into the most favorable broad-based equity results. Moving to the quarter and first half just ended, this inconsistency readily can be seen. Riding the back of rebounding US dollar strength, coupled with predominate domestic exposure, small cap stocks fared the best, with the Russell 2000 gaining 7.7%, thereby erasing a modest Q1 loss. The large cap Russell 1000 index, heavily populated with multi-nationals, thus negatively impacted by dollar strength and trade protectionism rhetoric, captured less than half the gain of small caps, rising 3.6%, good enough to get six month results back into positive territory. Common to stocks both large and small was the enduring allure of growth; first half results built upon the huge divergence in performance between growth and value stocks witnessed in 2017. So far in 2018, the Russell

2000 Growth Index has run away from its value counterpart by over 400 basis points, +9.7% vs +5.4%. The differential widens even more moving up the capitalization spectrum, with the Russell 1000 Growth Index outperforming Value by over 900 basis points year to date, +7.3% vs (1.7%), with half of that occurring during the latest quarter. One of the anomalous features of this long bull market that we have cited in these quarterly letters is the clear and seemingly insatiable investor preference for growth, even when economic conditions have improved. The visual, on the right, underscores this accelerating divergence in style, wherein paying up for growth has become more loosely tethered to valuation.

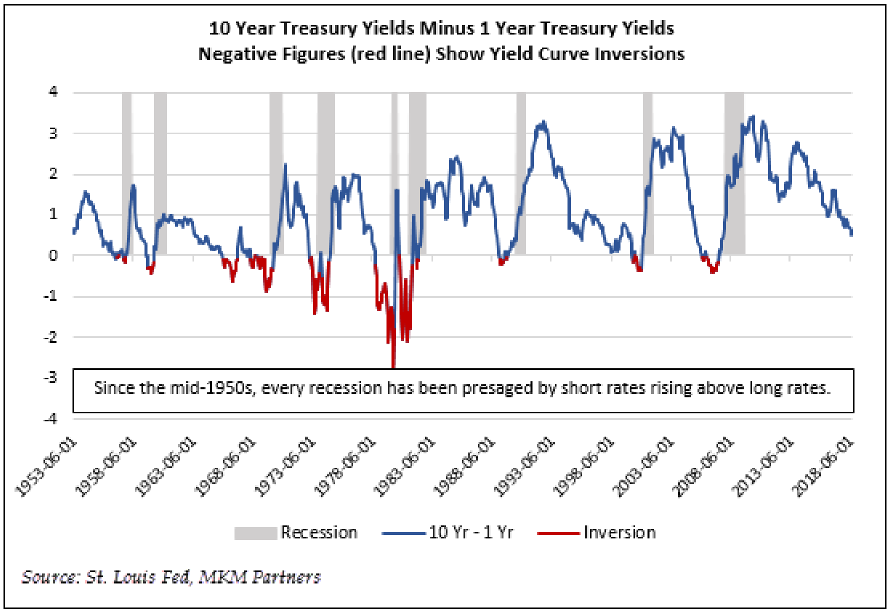


Source: Intrinsic Research

Against this backdrop and with our more value-grounded orientation, it should be unsurprising that our strategies generally lagged the strong performance of core benchmarks during the second quarter. Five of our seven strategies trailed, with MidCap outperforming and Income Equity exceeding the Russell 1000 Value gross of fees though unable to keep pace with the juggernaut core Russell 1000. Year to date, both our Small/MidCap (SMID) and MidCap strategies are ahead, while Income Equity similarly is ahead of value gross of fees but behind core benchmarks. Stock selection always is a key driver to relative performance, but quarterly reporting periods also have factors specific to the different benchmarks. The growth influence in the Russell 1000 has been driven primarily by technology and consumer discretionary, which together have generated most of this year's return. Along with energy, which had a huge snapback in the second quarter, these three sectors are the only ones ahead of the Russell 1000 benchmark this year. Bifurcation across and within sectors has further muddied the waters. As observed by Cornerstone Macro Research, over 75% of technology stocks outperformed the benchmark in 2018 while less than half of the winning discretionary sector constituents outperformed and virtually all of the sector contribution there can be attributed to Amazon and Netflix. Beyond energy and healthcare, which had roughly a 50/50 distribution between outperformers and underperformers, the rest of the lagging market sectors had only a third or less of constituents that delivered above benchmark returns. This combination has proven to be a formidable recent hurdle for the portfolios we run.

At the other end of the market in smaller capitalization, the multiyear impediment we have been struggling to overcome has been the dominance of technology, healthcare, and other unprofitable growth businesses, all of which have been supercharged by the huge amounts of capital that have flowed into passive investment vehicles. We have addressed this topic in our prior commentaries, that small cap indexing tends to disadvantage strategies like ours that focus on the quality and profitability of the businesses in which we invest. In the second quarter, the indexing effect was powerful, with a reported $9 billion of inflows into small cap ETFs. We have been battling this headwind for the past several years, and recognize and share in the frustration it has caused our investors. In 2018, our stock selection has been additive to relative performance, and we have participated in the M&A wave through a pair of our holdings. We have and will continue to make adjustments to the portfolio that buttress downside protection, but are unwilling to compromise our investment philosophy to get in better sync with the glaring fundamental flaws of investing in the benchmark. A basic tenet of The London Company has been to adhere to its principles of long-term investing, which have been rewarding over full market cycles albeit not at various points within the cycle. Today, our portfolios command far above benchmark profitability, as measured by return on capital, and balance sheet strength, as measured by net debt to EBITDA. While these attributes have gone unrewarded over the past few years, we are confident they remain relevant and central to providing the full market cycle downside protection that we seek.

Looking ahead, we do not expect an outbreak of peace from the turbulent war of words. We do anticipate that political tensions will overhang the global landscape, and that some economic actions likely will be triggered as threatened. The US and China could continue down this dangerous path or could pivot abruptly towards a summit that averts a trade war. If there has been one hallmark of the current Administration, it has been the fluid approach to its engagement with the rest of the world. Of course the Chinese are well versed in *The Art of War* and strategizing for victory. With its market already down over 20% and its weakening currency exerting upward pressure on the US dollar, China has leverage through the dynamics of global trade, demonstrated by the stresses already becoming evident across several emerging market economies and capital markets. With the US stock and bond markets on balance resilient to these negative prospects, there is mounting concern how much longer we can remain insulated from trade repercussions, a strong dollar, an uptick in inflationary pressures, and a Federal Reserve continuing toward policy normalization. The methodical rise in short term interest rates has not been matched by a concurrent rise in the long end, resulting in a noteworthy flattening in the yield curve. The durable economic recovery in an era of historically low rates, low inflation, and low growth has removed yield curve discussions from the market narrative for almost a decade. The recent flattening has reinserted yield curve analysis into the macro narrative, as the potential for inversion historically has served as an early warning about a future cyclical downturn into recession. As the chart below indicates, every US recession post-World War II has been preceded by an inversion of the yield curve:


10 Year Treasury Yields Minus 1 Year Treasury Yields
Negative Figures (red line) Show Yield Curve Inversions

Since the mid-1950s, every recession has been presaged by short rates rising above long rates.

Source: St. Louis Fed, MKM Partners

Between trade uncertainties, economic cycle uncertainties, and the upcoming mid-term elections in November adding yet another layer of uncertainty, the market's phenomenal resiliency should continue to be tested. The timeframe in which the invincible bull market finally succumbs to these elements, a topic of hot debate among prognosticators, is not something we feel within our sphere of expertise. While we monitor and are keenly aware both what is happening today and what is being discounted about tomorrow, we continue to narrow our focus to the companies we own and the companies we might want to own. Our portfolios continue to evolve, and we believe that evolution strengthens the downside protection that we expect. As we assess the portfolio metrics that we believe are integral to delivering favorable upside/downside capture over full market cycles, we like where we stand vis-à-vis our benchmarks today.

Thank you again for your trust and support, and please feel free to contact us with any questions or concerns.

Best regards,

The London Company

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