Crossbow Partners
Experience & Discipline

New York Trip Report

In Search of High Quality Growth and Pricing Power

May 7 - 11, 2018

Executive Summary

The balance sheet reduction by the Treasury and the rate normalization process by the Fed have been well telegraphed and interest rate risk is more or less priced in today

Yet investors are underpricing the tax plan of the Trump administration which will lead to higher U.S. deficits and more Treasury issuance, adding a lot to the supply of bonds and creating a potential USD shortage in the world

Ironically, the opportunity set in the high yield bond space has changed for the better, as large amounts of capital are leaving the space – leading to wide single name dispersion, high spreads and much better shorting opportunities

The backdrop for M&A remains constructive and deal activity robust, as we see a bifurcation of the M&A space in "commoditized" deals with little risk and low spreads and deals with high regulatory risks and attractive spreads up to 20%

U.S. equity managers are increasingly favoring companies with pricing power and high quality growth rates in the tech and healthcare space over defensive and interest-rate sensitive "bond proxies" in low growth industries such a consumer staples, utilities, and REITs

Younger equity managers are increasingly relying on AI and on real time data analytics to underpin their investment theses, to verify trends between quarterly results and to risk manage quarterly earnings

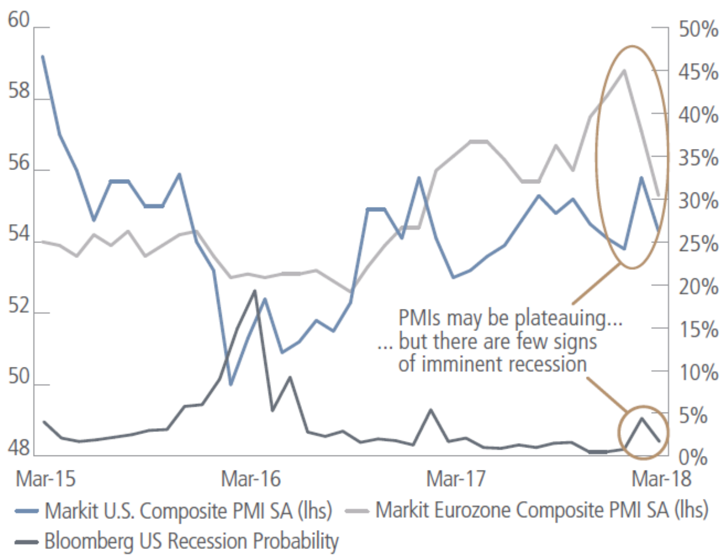
Biotech could be somewhat recession-proof, as the pace of innovation is high, valuations are largely reasonable, and M&A activity has heated up

Transitioning to Mixed and Bumpy Equity Markets

1. Market Conditions Are Changing Amid Rising Political Risks

In 2017, the S&P Index traded within a very narrow range and only moved by 1% or more on eight occasions. Investors lived in a “goldilocks” environment where risk assets steadily rose and complacency was rife. Since February 2018, we have already seen twice as many such spikes as last year, while the VIX hit its highest level since August 2015. There are many reasons why volatility should rear its head again: President Trump has taken a tougher stance on trade in 2018, alienating a great number of the American allies and stoking fears about potential trades wars with Europe, China, Canada and Mexico. The rise of the populists in Italy (and Spain) was also not helpful and has awakened concerns about systemic risks of the Italian banks. Data security issues – combined with fears about a potential regulatory backlash - haunt the biggest technology companies that have become the key growth engines of the US stock markets and a growing and important part of the U.S. economy. And, last but not least, investors are anxious to get more familiar with the leadership of Jerome Powell, the new chairman of the Fed.

LATE-CYCLE, NOT END-OF-CYCLE ECONOMIC DATA

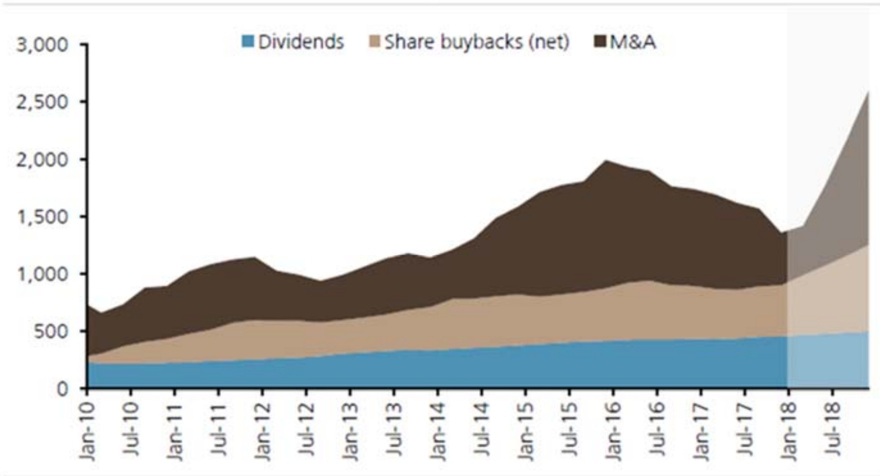


Source: Bloomberg. PMI data as of March 2018, Bloomberg Recession Probability Index data as of February 2018.
Source: Neuberger Berman, Asset Allocation Committee Outlook 2Q18

While geopolitics remains fragile and political risks are on the rise, global synchronised growth is still sound, even though we are late in the cycle and growth appears to be peaking outside of the US. Yet, there are few signs of a stall. Most hedge fund managers would concur that an imminent recession appears unlikely in the US and that the economic expansion might well last through 2018 or even into early 2019 - given the powerful stimulus provided by the tax reform and the expansive budget that have been approved. But, clearly, investors are worried that the status quo is as good as it gets and that the growth drivers might be plateauing from here.

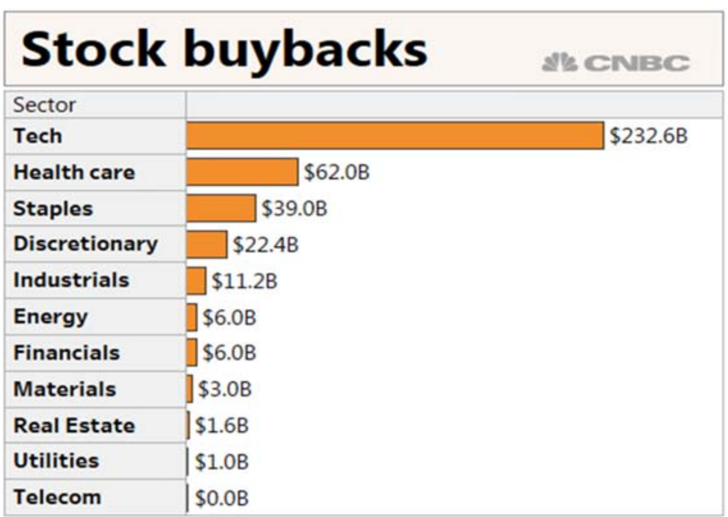
By contrast, money is pouring into the U.S. economy, providing support for the otherwise wobbly stock market. If current conditions persist, companies are likely to disburse more than $2.5 trillion this year through a combination of share buybacks, dividends, and M&A.

Companies are flush with cash and have parked domestically nearly USD 2.5 tn in cash – and probably another USD 3.5 tn overseas - after years of strong grains and thanks to the USD 1.5 bn windfall profits from President Trump's tax reform.



Source: CompuStat, FactSet, Bloomberg, Dealogic, UBS

In addition, analysts expect dividend issuance to top USD 500 bn, buybacks to reach USD 700 to USD 800 bn, and M&A to total about USD 1.3 trillion. Notably cash-rich large cap stocks from the tech and health care sectors announced the highest buybacks. If the numbers pan out, they would equate to about 10 percent of the S&P 500's market cap and 12.5 percent of GDP.



SOURCE: EPFR, CompuStat, FactSet, Bloomberg, UBS (stock buybacks by sector, year to date.)

Managers were also pondering whether regulation will hurt mega-cap tech stocks. Tech stocks were among the most volatile parts of the market in 1Q, as investors weighed the risk of privacy and anti-trust concerns. Questions about how Facebook has handled user data have triggered a political backlash - with speculation that tech companies may face more stringent regulations. The industry realizes that data ownership and leakage protection is a big issue and it is actively trying to self-police. Europe has already enacted new regulations to protect users' data (GDPR), but it is too early to say whether similar regulations will find their way to the U.S.

For now, most managers believe that the current debate about greater regulation will not be an immediate game-changer for internet companies in terms of users, the data they can gather and their ability to target advertisements – which is central to their growth and to their stock market value. Most users understand that giving access to data is the price they pay for having "free" access to these services. And as users value these platform enough, they tend to move on pretty quickly – even after a massive data leakage such as the data privacy violation by Facebook.

Amazon represents another interesting case, as its dominance seems to be hurting or even crushing "small business" in the U.S, leading to antitrust concerns. One manager believes that there is only a very low regulatory risk for Amazon in the US – despite the recent attacks from President Trump. Amazon's marketplace actually hosts millions of small business-sellers, offering them quality access to the online retail market place. Last year, merchandise sold by those third-party retailers exceeded sales by Amazon itself for the first time. And, online retail is hardly the first existential threat to the Main Street businesses, as consolidation in many areas (i.e. bookstores) has already set in long before Amazon became the dominant force in U.S. retail. The manager also believes that in a weaker economic environment the number of retailers being pushed into bankruptcy would go up fast – even without Amazon, as competition is intense and margins are razor-thin.

In sum, our managers focus on the long-term opportunities for internet companies, but are mindful of these risks. While regulatory risks for internet companies seem to be fairly contained in the US for now, managers weigh these near-term events within the context of their long-term investment theses and seek to tactically manage the risks within their strategy. The real – and bigger - issue, however, could be how these huge platforms can retain user trust and keep their users happy in the long-term.

2. High Quality Growth As Investment Theme

As we are in the late stage of the economic cycle, most managers believe that high quality growth is a rare commodity and will accordingly be valued highly by investors in an environment of rising interest rates and higher inflation. Thus, high quality growth sectors such as technology and healthcare are expected to trade at a premium, as the superior underlying fundamentals of these sectors outshine the rest of the market thanks to their stronger balance sheets and their higher growth rates. One of our manager claims that this is particularly true, or even more so, for technology stocks. There the secular growth outlook is meaningfully improving, as the sector is buoyed by a large-scale, broad-based, and highly disruptive wave of technological innovation.

Sector	ROIC LTM	Net Cash % Mkt Cap	P/E 2019	Cash Adj P/E 2019	FCF Yield 2019
Consumer Discretionary	11.2%	-22.4%	18.8x	28.6x	5.5%
Consumer Staples	13.3%	-18.9%	15.6x	18.1x	6.2%
Energy	5.8%	-19.1%	18.7x	21.1x	5.1%
Financials	4.5%	-67.5%	12.0x		
Health Care	8.7%	-12.3%	14.4x	16.7x	6.8%
Industrials	10.8%	-19.4%	15.7x	18.4x	6.1%
Information Technology	11.8%	3.2%	16.6x	16.9x	6.9%
Materials	8.6%	-17.7%	15.2x	17.9x	5.9%
Real Estate	3.7%	-39.5%	15.6x	33.5x	3.7%
Telecommunication Services	13.1%	-61.9%	10.3x	12.8x	10.0%
Utilities	4.8%	-79.1%	15.6x	21.6x	-0.8%
S&P 500	**7.9%**	**-23.4%**	**15.3x**	**19.8x**	**5.3%**

Valuation Metrics by Sector, April 2018, source Bloomberg and Alkeon Estimates.

By contrast, the darlings of the past which had dominated the ZIRP (zero interest rate policy) area as bond substitutes appear more and more overvalued and vulnerable to the downside. Defensive, low-growth and interest rate sensitive sectors such as utilities, consumer staples, and REITs exhibit elevated valuations with little to no earnings growth. And the downside risks are exacerbated by an inflationary environment of tax cuts, low unemployment and structurally induced labour shortages. What used to be a safe bet and a dividend proxy is increasingly emerging as quite shaky and risky.

Many of our managers therefore believe that this discrepancy of sector valuations and highly diverging growth fundamentals create a very fertile environment for long/short stock picking. And most of our managers expect to see a continuation of the sector rotation out of value and low growth stocks into high quality growth companies.

Tech stocks are propelled higher by technological innovation such as machine learning, artificial intelligence, the Internet of Things, and the advent of the fully connected economy (i.e. industry 4.0). These innovations will fundamentally transform the way we live, work, and interact – and, at the same time, disrupt businesses globally. Merrill Lynch predicts that 50% of the S&P companies could be replaced over the next 10 years.
Some managers suggest that the stock market has not yet priced in the disruptive, multi-year growth that tech stocks can deliver and that the tech sector therefore remains significantly undervalued on a relative value basis (i.e. notably vs. the defensive, low growth, interest-rate sensitive sectors). Information technology as a classic high quality growth story has been trading at the second highest forward free cash flow yield and at a significant P/E discount to the market, despite having one of the strongest revenue growth prospects and being the only sector in the S&P 500 with a net cash position.

Relative Forward P/E of Technology vs. S&P 500, 1975-02/2018, source Thomson Reuters and Credit Suisse.

One of our manager contends that this undervaluation of the tech sector is the most compelling risk/reward opportunity ahead of a large technological wave of innovation. But unlike the internet wave of the 1990s, the leading tech stocks of today are highly profitable and among the cheapest in the S&P 500 despite superior underlying fundamentals and an improving secular growth outlook.