A New Paradigm: REVISITED

At the start of 2018, the Biltmore Investment Team met to summarize the state of the markets and to assess the potential impact on Biltmore families. In the process, we reviewed last year's letter, published in March 2017, and were struck at how relevant those conclusions are one year later. A few segments from that letter:

- "With the election of Donald Trump, we see a new paradigm. We have spent the last few months analyzing the various "Trump Trades" prevalent since November 8th [2016] and believe the dots are increasingly converging around an environment of higher interest rates, rising inflation, and increased volatility. As a result, the new path of safety lies in active versus passive management.

- President Trump will attempt to deliver on his campaign promises. What does this mean for our investments? Below is a chart that breaks down his major policy proposals and how they would likely effect the economy:

Policy Proposal	Inflation/Deflation	Economic Growth/Drag
Immigration Reform	Labor supply will tighten: Inflation	A shrinking population: Drag
Comprehensive Tax Reform	Simpler, lower rates: Inflation	Incentive for reinvestment: Growth
Corporate Deregulation	Freeing of capital: Inflation	Profit incentive: Growth
New Trade Policy	Higher cost of goods: Inflation	Less consumption: Drag
Infrastructure Spending	Multiplier effect: Inflation	Capital spending: Growth
Repatriation of Capital	Increased hiring: Inflation	Domestic capital spending: Growth

- All of what President Trump proposes is potentially inflationary. Everything. Even if he only accomplishes a small part of his agenda, the results of those accomplishments will be inflationary. While we are not predicting rapid inflation will occur, we do see a systematic shift of risk from deflation to inflation.

- The last time the United States experienced inflation over 3% was 1993. Interest rates have been in a state of secular decline for over 35 years. This has resulted in the largest bull market in bonds in 500 years and the third largest bull market in 800 years.

Source: 1, 2: Bloomberg; 3:"Venetians, Volcker and Value-at Risk: 8 centuries of bond market reversals," Paul Schmelzing, Harvard University, 1/4/2017

- While the Trump-policy fueled growth spurt in the U.S. economy would be welcome to many Americans, the resulting increase in interest rates could be disruptive… With the Trump policy changes, there will be winners and losers. As a result, we expect to see a significant pick up in market volatility… It's a scary and uncertain future. So, how best to protect our capital? How would we take advantage of the new fiscal and monetary policies? We are shifting portfolios away from passive market investment and towards active managers. Fixed income portfolios will shift away from the risk posed by higher interest rates and towards specific company credit risk…"

The recently passed Trump tax reform offers a few clues towards investment opportunity. In addition to lowering the corporate tax rate from 35% to 21%, the law eliminates the corporate Alternative Minimum Tax rate, thereby removing any floor on corporate taxes. Digging in further, one large benefit to business is the change in depreciation for capital expenditures. Under the new law, businesses can depreciate 100% of capital expenditures made over the next five years in the year that the capital project is put into service. This incents owners to further reduce their tax rates by investing into their businesses. When one analyzes a business decision between stock buy backs and capital expenditures, the new tax law incents companies toward capital expenditures.

	Year 1 Current	*Year 2 Use of Year 1 Cash Flow?	
		Buybacks	CapEx
Revenue	$1,000	$1,000	$1,050
Operating Margin	$350	$350	$368
D&A	$(50)	$(50)	$(295)
Pre-tax Profit	$300	$300	$73
Taxes	$(105)	$(63)	$(15)
Income	$195	$237	$57
Cash Flow	**$245**	**$287**	**$352**
Shares	50	47.5	50
Cash Flow / Share	$4.90	$6.04	$7.05
Growth		**23.30%**	**43.80%**

* Assumes company invests all of Year 1 cash flow into share buybacks at a market multiple (20x) or into a capital project with identical margins and return on capital as the existing business (i.e. Year 1)

Source: BlackRock, Inc.

Over the past year, we have shifted portfolio allocations in advance of volatility and interest rate risk. During this time, we saw the markets shrug off interest rate risk on their way to record low volatility. On February 2nd, fear of rising inflation stemming from higher wages sparked a wave of selling. This came just a month after the President signed the largest piece of tax reform legislation in more than three decades. Given this backdrop, what should we expect for the rest of 2018?

For the first time since the global financial crisis, U.S. corporate earnings are at record levels and we have concerted global growth in Europe, Japan, and China. Additionally, unemployment is back to historically low levels (even after accounting for a skewed reporting methodology). Despite some modest increases, interest rates are still at historically low levels. Arguably, the global economy is as fundamentally strong as it has been in decades. Add in the effects of extraordinarily favorable tax reform, and we could move from solid growth to supersonic growth.

Equity market commentators cite two concerns: 1) that inflation will eat into earnings, and 2) that the resulting interest rate increases will stamp out growth and lead to a recession. Ostensibly, these concerns have led to the recent market volatility. That said, we are not certain if inflation will appear. Even if it does, we are not confident that the Federal Reserve will respond with rapid interest rate hikes. As we detailed in the excerpt above, inflation has not crossed 3% since 1993, despite the fact that the Fed has actively attempted to increase inflation during this period of time.

During the equity market sell off, the S&P 500 fell to a forward PE of 16.5, the lowest level in two years. We see more opportunity than risk at those levels. Despite the shift from deflation risk to inflation risk, it is not certain that inflation will occur. Given the structural changes to the U.S. economy towards services, and the growth of inherently deflationary technology-driven businesses, it may be much harder to produce inflation than history would imply. Furthermore, we believe that the Federal Reserve will be much more tolerant of inflation than market fears would indicate. Should inflation remain relatively low (~3%), we see potential for tremendous growth in many developed market economies and businesses.

One might assume that large corporate reinvestment will be inflationary. We see a more nuanced picture, where large businesses invest capital in automation and modernization of existing facilities. While this is likely to increase GDP and corporate earnings, it may not result in wage increases or additional hiring. More directly for Biltmore families, we have begun to build an "automation" theme into our equity portfolios. Tax reform will incent further advances in industrial robotics and automation, medical and surgical robots, and transformational technologies such as autonomous cars.

We'll conclude as we did in March of 2017: "…We believe that volatility will come. In advance, we are asking for your patience and bravery. We see the impending volatility as opportunity. Paraphrasing Warren Buffet, at times of fear, we must be greedy. At those times, we will seek to pick up assets at valuations below their inherent value. Thank you for entrusting us to protect your wealth. We all look forward to speaking with each of you over the coming months."

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