MOON CAPITAL MANAGEMENT

July 2017

Dear clients and fellow shareholders:

World equities	2017 Q2 return
S&P 500	2.41%
DJIA	3.02%
Nasdaq Composite	3.87%
UK: FTSE 100	-0.14%
France: CAC 40	-0.04%
Germany: DAX	0.10%
China: Shanghai Composite	-0.93%
Sovereign debt rates	**Yield**
US: 90-day US	1.04%
US: 10-year	2.34%
US: 30-year	2.86%
Germany: 10-year	0.48%
Japan: 10-year	0.08%
UK: 10-year	1.27%

The U.S. equity market continued its 2017 rally in the second quarter, as the S&P 500's 2.4 percent return was easily the best performance among broad-based indices of the world's developed economies. The Federal Reserve's quarter-point increase in the Fed Funds rate on June 14 had no negative effect on stock prices or even most market interest rates. Both ten and thirty-year U.S. Treasury rates are lower than they were three months ago; 90-day rates have increased since March 31, but this occurred in anticipation of the Fed hike, not in reaction to it. Overall stock valuations continue to be excessive, a topic addressed later in this letter.

Proving the folly of trying to predict the political winds, Congress surprised us (and most observers) by not even voting on a single type of tax reform – not corporate, individual or estate taxes. Our April 2017 letter addressed investors' collective expectation of a corporate tax cut – a factor that is, in our opinion, already embedded in the prices of stocks. Like most investors, we assumed that if a single political party controlled Congress and the White House, corporate tax reform – an issue for which there is at least the appearance of bipartisan support – would quickly and easily be approved. However, this assumption proved incorrect, further reinforcing our view that it is far easier to correctly assess the value of a specific asset than make a top-down bet on what a group of politicians might do to the economy. Thinking about the investment implications of potential Congressional action is akin to watching professional wrestling: there is some curious entertainment value in the exercise, but one should never base a decision on the projected winner of a match.

Concentration and valuation

While short-term performance is as much a matter of luck as almost anything else, we do find some significance in the sources of the returns of both the overall U.S. market and our stock portfolio this year. Valuations continue creeping away from both mathematical reason and historic norms, with much of the S&P 500's return resulting from a small number of outsized, overpriced members of the index. Indeed, five stocks produced a third of the S&P 500's return in the first

	2017 YTD return	P/E ratio
Apple	24.3%	16.7
Amazon	27.4%	180.8
Facebook	29.8%	37.3
Microsoft	12.2%	30.3
Oracle	28.4%	22.1

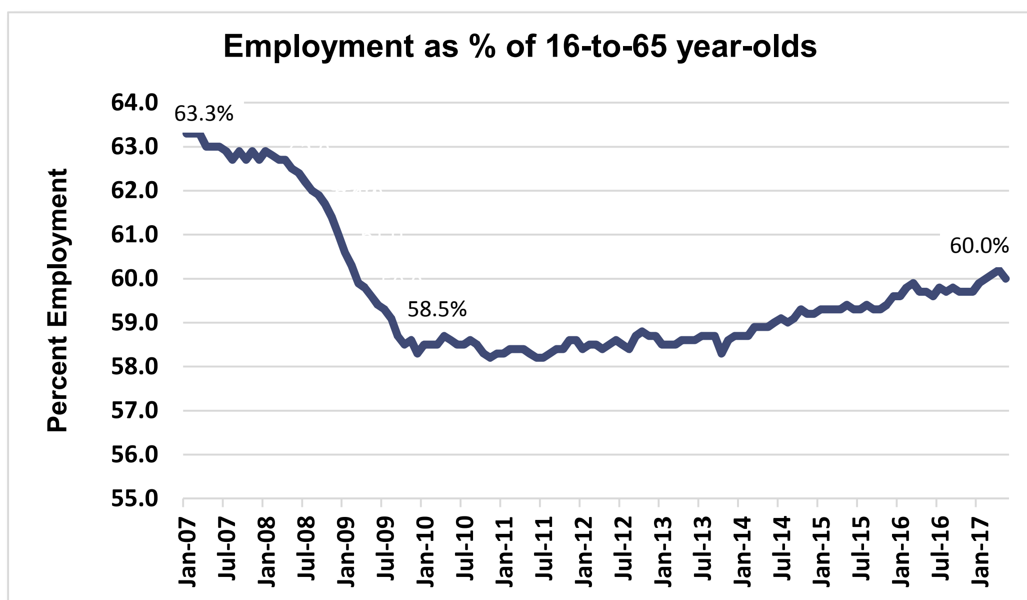
S&P 500 return concentrated in only a handful of overpriced stocks

half of the year: Apple, Amazon, Facebook, Microsoft and Oracle. These five stocks, up an average of 24.9 percent from January to June, hardly fit most definitions of "bargain."

A quiet anniversary

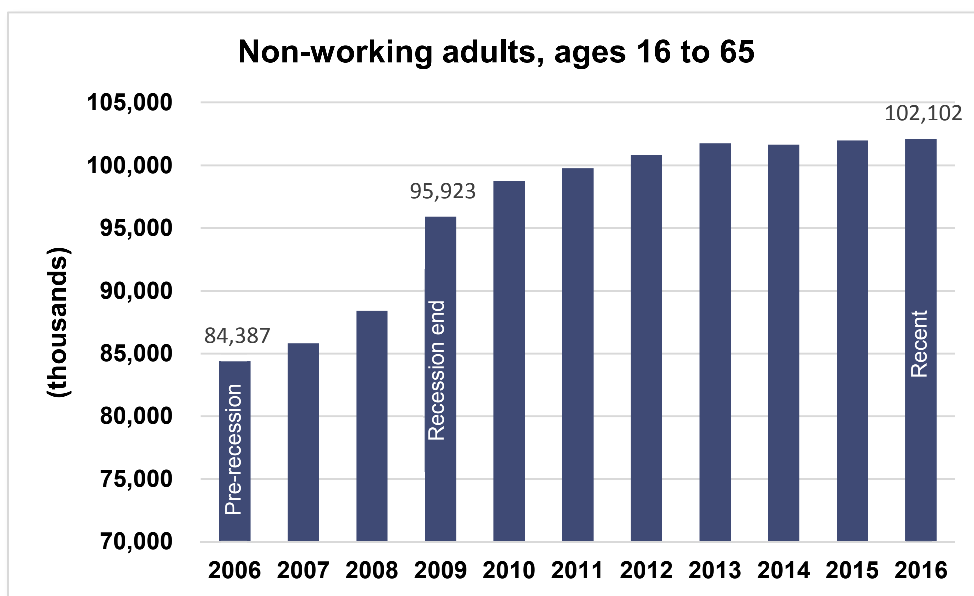
This month marks the eighth anniversary of the end of the Great Recession, a 19-month economic contraction that was our country's most severe since the 1930s. The recovery has been unique in a number of ways. Its lack of strength (as measured by the GDP growth rate) has produced the weakest recovery in U.S. history. After two consecutive calendar years of decline in which our economy shrank a total of 4.3 percent, our eight-year recovery has averaged annual real GDP growth of only 2.1 percent and has not included a single year of three percent economic growth. However, while growth has been anemic-to-modest, the recovery's length has been impressive: 96 months and counting, now the third longest in U.S. history.

The nature of this economic recovery has also differed from most, in that growth has been driven by capital investment, not employment expansion. Although the number of employed persons in the U.S. has fully recovered to its pre-recession levels, when adjusted for the number of working-age people, employment is actually weaker today than the recession lows posted during the Clinton presidency.



In January 2007, prior to the beginning of the recession, 63.3 percent of the adult population was employed, a figure that would fall to 58.5 percent by the end of the recession. Despite 96 consecutive months of economic growth, the percentage of working-age, employed Americans has remained stalled at 60 percent – barely 1.5 points above the recession low and more than three percentage points *below* pre-recession levels.

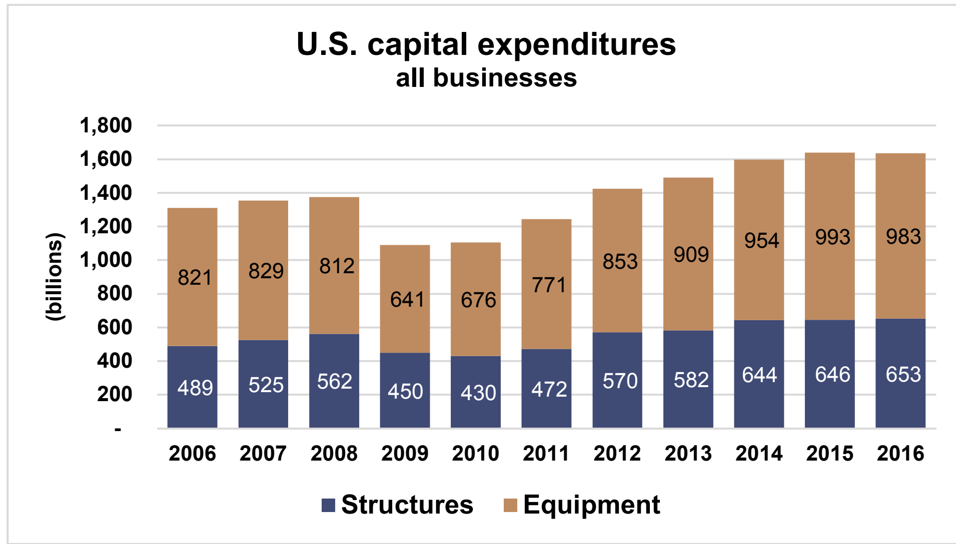
In the three years following the commencement of the recession, the number of non-working individuals increased by 11.5 million. This figure includes all non-incarcerated people between the ages of 16 and 65 who do not have full or part-time jobs *for any reason.* Despite a decline in the headline unemployment rate, the number of non-working adults has continued to increase during this economic recovery. Since the end of the recession, the number of jobless adults has increased by another 6.2 million people.



Rather than add employees, U.S. companies have added to their physical plant. Since the recession's end in 2009, annual corporate capital expenditures have increased from $1.09 trillion to $1.64 trillion. (See chart on next page.)

Not coincidentally, credit has also made a rather robust recovery. Since the start of the economic recovery eight years ago, total domestic non-financial debt has grown by 32 percent, to $47 trillion. At 252 percent of GDP, the current figure exceeds the third quarter 2009 high of 250 percent. Total consumer debt has also increased roughly six percent, to $14 trillion. The modest decline of mortgage debt (from $11.9 trillion to $11.5 trillion) has been more than offset by an increase in auto and student loan debt. From June 2009 through March of this year, auto and student loan balances expanded by 53 percent and 90 percent, to a total of $1.1 trillion and $1.4 trillion, respectively. And the much-discussed $2 trillion increase in the Federal Reserve's balance sheet resulted from a 123 percent growth in indebtedness.

Stock prices have recovered much more than either employment or capital expenditures. Despite the stock price increases, bond yields remain artificially low, still constrained by a Fed bond portfolio that, only two weeks ago, did Fed officials seriously signal they were considering beginning to unwind.

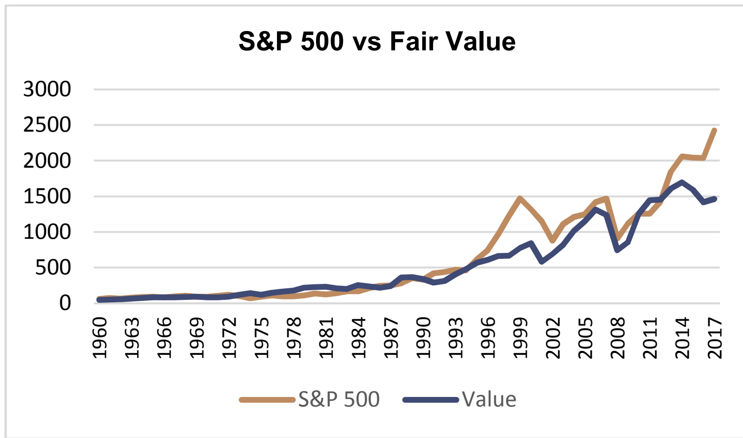


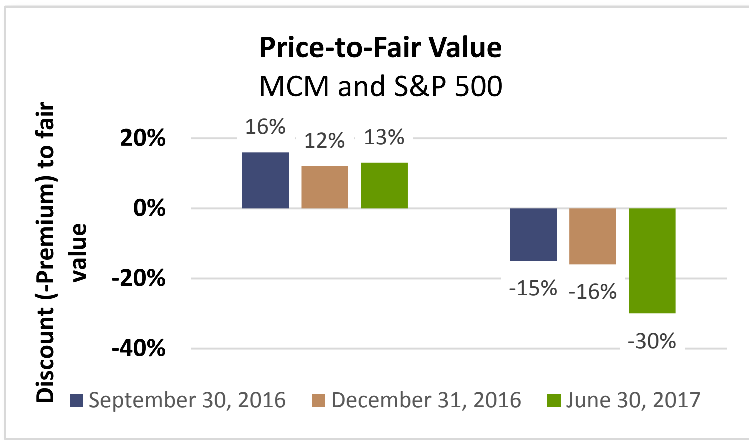
Measuring vs. musical chairs
We aren't in the prediction business; we measure things. We measure values and compare them to available prices. We enjoy higher stock prices at least as much as anyone who has significant assets in the market, but the exercise of comparing values to prices becomes more frustrating as price increases continue to outpace improvements in the values of underlying businesses. Although the U.S. markets suffered extraordinary declines prior to and during the 2008-09 recession, the price recovery of the broad market indices has far exceeded improvements in the values of underlying businesses.

We closely track the relationship between the price and value of all sorts of assets, including baskets of stocks such as the S&P 500. The first chart on the following page is a historical look at both the value and price level of the S&P 500. It likely looks familiar, as we have shared it previously.

The data series most correlated with stock prices is corporate earnings. There is both a statistically significant correlation and a logic to that relationship. On a daily, monthly and even sometimes annual basis, the prices of businesses bounce around in reaction to numerous factors, many of them unknown or unknowable. But over the long term, stock prices ultimately reflect the underlying values of those businesses – and values are a function of the owner earnings those businesses generate.

Based on our estimate of the value of the S&P 500, the index is overpriced somewhere between 25 and 30 percent. Do not misinterpret that observation as a timing prediction of any type. It is a

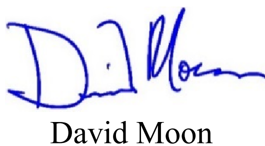




statement of fact – a measurement. We do know, however, that Herb Stein was correct: something that cannot go on forever will eventually end. Since the beginning of recorded stock market history, the central tendency of stock prices is to cluster around corporate earnings, regardless of the interest rate environment, tax rates, geopolitical strife or Presidential tweets. An overpriced market seduces some investors into playing a financial game of Russian roulette, naively believing they will know when to safely withdraw from the game. We prefer to take more prudent approach; attempting to outguess the short-term direction of a market trend is a flawed and dangerous strategy.

Relative value – buying an overpriced stock because it is less overpriced than some other stock – seems a little like a convict celebrating his prison sentence being reduced from 300 years to 200 years. Therefore, it is a bit difficult for us to be excited about a portfolio of stocks trading at only a 13 percent discount from their underlying business value simply because the S&P 500 is 30 percent overpriced. Nonetheless, our portfolio does trade at a discount, and we own businesses with attractive balance sheet and cash flow characteristics. We aren't concerned about higher interest rates, as the interest rate sensitive investments in our portfolio should enjoy higher operating earnings and net interest margins if interest rates ever reprice to fully reflect realistic inflation expectations.

While the 13 percent discount to intrinsic value offered by our portfolio does not provide a massive margin of safety, little in today's environment does, including all other asset classes, not just stocks.


David Moon

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