THORNMARK ASSET MANAGEMENT INC.
PERSPECTIVE
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ECONOMIC EXPANSIONS, EVEN LONG ONES, DO NOT HAVE PAST DUE DATES

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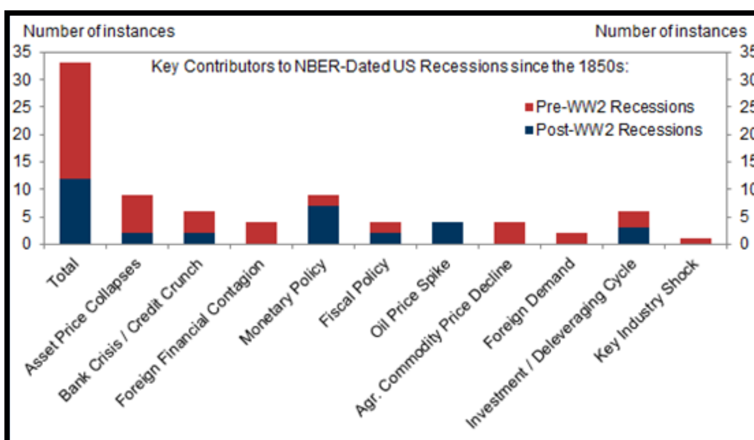
The current U.S. economic expansion has been long, very long, but not strong. The expansion which began in 2009, is now the longest on record (Source: National Bureau of Economic Research). Given the duration, some people speculate the expansion has lasted too long and expect it to hit some unexplained wall. In other words, they wonder if the expansion has a past due date? The answer is emphatically, no.

Time alone is no reason for an economic expansion to end. Like all other expansions, time will not end the current expansion. If not time, then why do cycles grind to a halt? Surprisingly, virtually every recession was caused by the Fed. It's not just heresy. Goldman Sachs shows that after World War II, recessions result from two contributing factors:

1. Monetary policy tightening by the Fed, and
2. Oil price shocks.

Interestingly, at least to me, the former is usually in response to inflation that gained momentum from the latter. Hence, the Fed becomes the proverbial straw that breaks the economic camel's back. In fairness to Goldman's research, before WW2, there are two other contributing factors (see chart above):



3. Sentiment-driven swings between over-borrowing and heavy investment followed by deleveraging and investment cutbacks contributed to the two most recent recessions and also played a role in the early 1900s, especially during boom-and-bust cycles of railroad investment.
4. Fiscal policy shocks have sparked U.S. recessions, but only in the context of demobilizations from major wars.

However, the current cycle's cumulative real GDP growth per capita, a measure of the cycle's strength, has grown by less than all but the previous expansion (Source: CIBC World Markets). From another lens, the current cycle has the lowest average growth rate since 1949 at 2.0%, compared to 4.6% for other expansoins (Source: Deutsche Bank, 2017). In other words, the longest expansion in U.S. history has been abnormally weak. Therefore, given the depth of the Credit Crisis (the worst recession since the Great Depression) and subsequent weak recovery, it makes sense that the current recovery should be long - very long. Paradoxically, this is good for our current outlook of continued growth and the Fed's current tightening cycle.

After the Credit Crisis, the U.S. Federal Open Market Committee held its target fed funds rate at 0.25% from December '08 until September '15. The fed funds rate is the interest rate at which banks lend money to each other. A lower fed funds rate provides fuel to the economic engine by making capital more accessible. Lower interest rates were part of a multipronged assault to overcome the severe recession – and it worked! Then, in 2015, the Fed commenced eight interest rate hikes to 2.25% (the last on September 26th) designed to normalize monetary policy, moderate growth and avoid runaway inflation. The goal is to preserve the current expansion. However, given the Fed's history of cataclysmic tightening cycles, we must be vigilant.

Every economic cycle is unique within a similar pattern. Therefore, Thornmark's vigilance includes understanding what differentiates this cycle from past cycles. A consequence of a slow growth cycle is spending on capital equipment has been weak, never approaching pre-recession levels (Source: Yardeni Research, Inc.). Also unique is the late-cycle fiscal stimulus. The Trump administration's massive and indiscriminate deregulation, 2018 tax cuts, rumoured 2019 tax and pending infrastructure spending programs when growth is already above 3% is, well, unusual. Therefore, the 3rd and 4th of Goldman's recession risks are unlikely to materialize. Deleveraging and investment cutbacks are unlikely without excessive corporate borrowing, which has not occurred this cycle. At the same time, government spending and stimulus are ramping up, not down. Consequently, Goldman assesses the **probability of a recession before 2020 at around 20%**. We agree that the chance of a recession within our 1-year investment outlook horizon remains remote.

Given global trade tensions, the IMF recently reduced global GDP output for '18 and '19 by 0.2 percentage points to 3.7%, the same as in 2017. We expect geopoliti-

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cal tensions to moderate. However, the risk to the outlook is more balanced than at the beginning of this year when the risks were skewed to the upside. The North American economy will moderate but should remain above 2017's 2.3% growth. While valuation remains reasonable, equity markets in the late expansionary phase typically become more volatile with +/-10% corrections. During corrections, it is critical to remain grounded to capitalize on buying opportunities.

COMPANY COMMENTARY

Defensive Cigna Corp. is the fifth largest US healthcare provider with stable earnings, positioning it well for the early deceleration phase in the economic cycle. Cigna negotiates rates with hospitals, physicians, and drug providers on behalf of its patients and over the past seven years has been the industry leader capping medical cost inflation at 4% vs peers at 6%. Well-positioned to accelerate growth, Cigna's patient growth should accelerate as it expands into new market segments like commercial risk, which represents more than 50% of the market. Recent results show accelerating market share gains, and we expect revenue growth to accelerate to 8-10% from a historical range of 5-8%. Analysts will need to revise estimates higher, a catalyst to push the stock price to new highs. Cigna recently announced the acquisition of Express Scripts. While we believe it will be a valuable combination, some investors were concerned about the purchase price, and Cigna stock price tumbled 15%. The sell-off provided a good entry point as we believe the strategic benefit of controlling pharma prices, cross-selling synergies and the 20% accretion to EPS more than justify the acquisition price. Sentiment should improve as the deal closes around year-end. Investor attention will then refocus on improving fundamentals from synergies, cost-cutting, higher growth rates and improving free cash flow. Dividend increases, buybacks and additional accretive transactions will also boost sentiment. Free cash flow yield of 9% and P/E of 14x on a proforma basis is an attractive valuation. Despite 200bp of faster EPS growth of 15% by Cigna, peers trade at a 3-point premium of 17x P/E. Our target of $260 is 17x 2019 EPS as we expect the valuation discount to close in 2019 as Cigna delivers on operational efficiencies.

Northrop Grumman is one of the world's largest defence contractors. Large, long-term contracts with the US government, which in some cases exceed a decade, mean profits are less economically sensitive than other industrial companies. Growth should exceed its peers given its R&D and recent contract wins in space, cybersecurity and new defense technologies aligning it well to strategic initiatives of the US military. NOC stock was attractive following a selloff on concerns that a Democratic mid-term win would mean lower government spending on defense. While Democrats will likely want to make Republican priorities more difficult to pass, Congress will need to find a compromise since the military needs to be modernized after a downcycle in spending with inventories of missiles, ammunition and other consumables at very low levels. There is also a bipartisan focus on new space technologies and new programs including GBSD, ABMS, GPS III and T-X Trainer. Additionally, geopolitical risks remain elevated under the unpredictable Trump administration. Geopolitical tensions are escalating again with Saudi Arabia/Turkey (Khashoggi murder), Iran (US nuclear treaty withdrawal), Russia (violating arms treaties), and North Korea (denuclearization uncertainty). Our target of $360 is based on a P/E of 18x in line with its peers and is based on known contracts being awarded in the future, therefore embedding little value for a large geopolitical conflict that would provide further upside.

U.S. financial services company, State Street Corp., is a leader in clearing, settlement and execution of securities transactions servicing 80 of the top 100 firms in the industry. It is less economically sensitive than its financial peers due to its sticky relationship with clients from high switching costs, and from the stable fees it generates from its SPDR brand of ETFs. It incrementally benefits from higher interest rates and volatility in the markets, both of which should persist going forward. An attractive entry point occurred after a weak quarter and its acquisition of Charles River (CR) in July which lead to a 20% underperformance. Sentiment and expectations are now low which provides a lot of upside should the quarter prove to be a temporary impact that management is arguing or if it can come close to the synergies it projects from the deal. Recently Morgan Stanley did a deep dive into the acquisition that showed it should at least meet its synergy targets since its existing clients can save $10-15mn using CR. Estimates should also be raised higher from the recent announced restructuring which should close the operating margin gap to its peers from the current 28.5% level to 30-33%. Our target of $105 is based on a P/E of 12.5x which assumes the premium valuation it typically trades at relative to peers is restored and that analysts will revise estimates higher with signs that the integration is going well.

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