Riverstone Advisors First Quarter 2018 Letter

April 1, 2018

Although this is April Fool's Day, volatility is anything but a joke. This quarter, we witnessed the resurgence of volatility in the market. While it can feel like we are driving over thousands of speed humps and the car is falling apart, volatility is actually a healthy part of a well-functioning market. In this letter, we will first discuss investment returns followed by a discussion of the three factors that ushered in this higher volatility.

Market Returns

The market rallied strongly in January and then experienced a series of small step backs in February and into March. In the last two weeks in March, the big technology stocks lost their momentum and headed down. Small stocks outperformed large stocks in March but lagged large stocks for the quarter overall. Growth stocks outperformed value for the entire quarter. Most of our portfolios are currently growth focused. The S&P 500 was down -0.8% in the first quarter.

Meanwhile, economic reports and corporate earnings remained firm. Consumer confidence is at a 17-year high.

Only two of the ten industry sectors ended the quarter with positive returns. The two positives were Technology with a 3.2% return and Consumer Discretionary at 2.8%. The return in Consumer Discretionary was driven by Amazon with a 22.5% first quarter return. Almost all Riverstone stock portfolios own Amazon.

Telecom, Energy and Consumer Staples all had the worse quarterly returns down by 6% to 8%.

Global equity returns were similar to U.S. equity returns. Latin America was the only outlier with a return of a little over 8% in equities. Bonds were similar to the stock markets with a return of -1%.

Event Trifecta

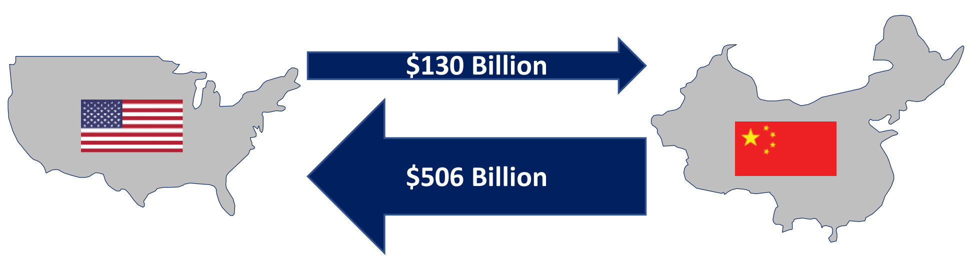
The event trifecta of (1) Trump returning to his election promise to tackle trade issues, (2) the Federal Reserve coming out strongly in favor of higher interest rates, and (3) Facebook users coming out of a deep sleep and grasping that their personal data is being sold and used for marketing have all combined to give the market a volatility induced anxiety attack over the past month. Volatility gauges jumped from 13 on February 1st to 37 on February 5th as measured by the VIX. To put this in perspective, in 2017, which was an unusually calm year, the VIX averaged 11.1. In 2016, the average reading was 15.8. Higher numbers indicate more volatility.

Let's look at these factors in more detail.

Factor 1 - The Art of Trade

This simple graphic below sums up most of what you as an investor need to understand regarding international trade. Are you familiar with the expression "follow the money"? The key to international trade is to follow the money.

U.S. - China Relative Exports in 2017



What do we see when we look at the above chart? The most striking fact is that China's exports to us are almost four times our exports to them. China's top exports to us are electrical machinery, furniture, toys & sporting equipment and footwear. The U.S.'s top exports to China are soybeans, corn, pork, aircraft, electric machinery and vehicles.

23% of China's exports come to the U.S. while only 8% of U.S. exports go to China. The 2017 U.S. trade deficit with China was $376 billion.

Let's start a pretend trade war with China on paper. We slap tariffs on their exports to us. They slap tariffs on our exports to them. Looking at the graphic, which country could feel the most pain? If you answered China, you are right. The U.S. clearly has the most ammunition and, hence, a strong advantage over China in this who-does-what-to-whom situation.

Fortune cookie says, "He who exports more loses a trade war."

Our trade with China creates 65% of our U.S. trade deficit. Our other large deficit partners are also our other largest trading partners. They are Canada, Mexico, Japan and Germany in order by diminishing size of deficit. It follows that the risks from an escalating trade war would be substantially greater on all these partners than they would be on the United States. Each countermove costs the United States less than it does its counterpart. The percentage of GDP at risk in a trade war for U.S. trading partners is much greater than for the United States, which means, on the surface, that the United States will win such a war. More to the point, it makes it unlikely that our trading partners will risk a trade war.

Underneath the U.S. posturing and chest thumping, are the seeds of an effort to safe guard U.S. intellectual property. While it may seem reasonable that U.S. technology companies selling into China are required by China to enter into a joint venture with a Chinese company, some believe these joint ventures are a ruse for accessing and pocketing U.S. technology expertise.

So what would a trade war mean for the market? There is a good possibility that on a net-net basis the impact on the U.S. economy would be to minimally slow the economy. The impact on the stock market would be to add to volatility, as it has already. A trade war would slow the economy as tariffs would make our goods more expensive overseas as well as make incoming goods more expensive. This would be negative for U.S. exporters' profits and negative for U.S. consumers due to higher prices for imported goods. If countries do go forward with new tariffs and/or higher tariffs, the impact on the stock market is likely to be negative but not sustained. At this point, it is still mostly talk.

Factor 2 – The Federal Reserve Contributed to Recent Volatility

Jerome Powell took over for Janet Yellen as the Chairman of the Federal Reserve on February 5th. Although he is expected to continue the data dependent path that Yellen followed as Fed chair, Powell thinks inflation will rise to a normal level above 2% following more rapid GDP growth. As a result, he has "suggested" four interest rate increases this year compared to three previously. His announcement came at a time when it seemed the economy was slowing a bit.

When the market receives news that isn't already priced in, there may be a sell-off. New interest rate assumptions moved the market. Higher interest rates bring inflation fears to the fore. This is not the case, however, as inflation is weak, and the economy still has room to run.

Factor 3 – Facebook Data Issues Contributed to Recent Volatility

Facebook has egg on its face for not maintaining stronger privacy protections on user data. In 2014, Cambridge Analytica, a political consulting firm, was given Facebook user data by a Cambridge University professor for approximately 50 million user profiles. While accessing the data for academic purposes, the professor did not break Facebook's privacy policies, but his subsequent transferring of the data to third parties (Cambridge Analytica) for monetization did. Cambridge Analytica used and/or sold the data for political analysis and voter targeting.

What does this mean for Facebook? Facebook in the last few weeks has begun tightening control over users' data and is informing users how they can be proactive in keeping their data safe. From a user standpoint, this is great. From a profit standpoint, this will weigh on the advertising contracts that they already have in place.

The tech sector was the best performing sector going into March and Facebook has been one of the best performing companies in the sector. When the news of this scandal broke, it led a broader tech sell-off and the market followed suit.

The impact of all three of these factors will be short lived. As we have seen in the case of the trade wars, the initial news is always the gloomiest. As days and weeks go on, the impact and practicality of each news report is hashed out and put into perspective by the markets. We do not view these three factors as systemic risks to the economy.

Conclusion

While the market is happy one day and sad the next, the demand for stocks continues to show strength.

If you watch the market and see that it opens down, check to see where the Asia/Pacific markets closed earlier that morning. Just Google "Asian stock markets today". The global markets are like a dog chasing its tail. The U.S. market and the Asia/Pacific markets tend to copy each other until there is news or an event that breaks their chain reaction.

Fortunately, we have a very strong jobs market, low interest rates, and expect strong corporate earnings this quarter. General conditions are good, but the speed of change from the factors discussed above has given the market indigestion. This is akin to when you eat too quickly.

The action in small capitalization stocks indicates that investors should wait out the market indigestion. In mid-March small caps started a rally and have outperformed large stocks through quarter end. Generally, when the market is anxious, small cap stocks are a harbinger of the near-term market. The strength in small caps likely indicates the bull market has room to run. We call this a digesting market. It is digesting, and rationalizing prices based on recent events and news. Reach for the Tums, this is only temporary.

Sincerely,

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Enclosures

[1] Sources: *Bretton Woods Research, Morningstar, Economy.com, Barron's, Standard and Poor's, Lowry Research*