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Inside this issue:

Walking the Wire: The Long & Short on Current Markets 1 - 4
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The Essex Exchange Newsletter

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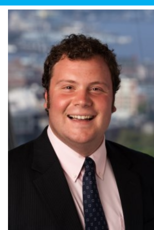


Walking the Wire: The Long & Short on Current Markets

By: Alex Forse & Joseph C. McNay

While equities continue to be the best performing asset class over time, our current market view is balanced with an emphasis on stock selection and downside protection. We are still in the 2nd longest bull market since World War II but the market has shown some renewed volatility. February marked the end of a 15-month streak of positive S&P 500 returns, which is a record. More importantly, February also highlighted the end of quantitative easing ("QE") with most central banks now firmly in tightening mode with the notable exception of Japan. This is certainly a new paradigm for markets and we believe has a variety of implications.

First, the best outcome of the end of QE is that active management and particularly hedge funds will have a chance to outperform again. As we move from an environment where the overriding theme has been 'low rates/risk on' to one with so many variables, the result will be a market with lower correlation and higher volatility - both characteristics increase the opportunity for active managers to create alpha. We may continue to have sector biases influenced by economic and geopolitical views, but more important, within each sector we expect to see greater disparity in individual stock performance.

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Second, the unwind of QE comes at a very delicate time for the Fed as they are set to sell the most debt in eight years. It will be critical for other entities to absorb these new issuances as the Fed sells. Unfortunately, Trump's tax cuts have added even more leverage to the system with Goldman Sachs estimating that U.S. Federal debt will be well over 100% of GDP with interest expenses that jump to 3.5% "putting the U.S. in a worse fiscal position than the experiences of the 1940's or 1990's." This would suggest that barring a significant uptick in growth the US will likely enter the next downturn with the highest cyclical deficits ever for peacetime and structurally rising deficits thereafter. These deficit levels are disappointing in light of any lack of real tangible improvements or investments, especially in infrastructure, where according to Vanderbilt University the US ranks 60th in the world for road safety & quality.

Third, cheap money and low interest rates have caused a significant increase in debt across companies and individuals. US Households have taken on a record $13.5t of debt and importantly half of the increase in private consumption over the past two years has been financed by households drawing down their savings ratio to about 2.5% of income. Corporations have also taken on loads of debt and are using their tax savings on buybacks and not paying back debt, bringing buybacks to an all-time high this year at $800 billion - that's significantly higher than last year's $530 billion! Companies do have a lot to feel good about post tax cuts and deregulation. Earnings revisions have rocketed up with tax cuts and sales have also come in nicely, growing faster this quarter than any period since 2011.

Of course, the elephant in the room with all this debt are interest rates, which look to be headed higher. Bond flows this year are indictive of a market preparing for higher rates as inflation protected bonds have seen the most inflows, whereas high-yield and junk bonds have been punished.

Turning to stocks and market sectors, the leading tech companies have come under scrutiny and newfound pressure. Most Americans are now worried that the government won't do enough to regulate them with a recent survey showing concern about government inaction up significantly the past three months. Putting our law school antitrust hats on has us looking at market share to see what, if anything, the justice department can do with 50%+ market share generally being the bogie. To that end the closest we can come up with is 43.5% of all e-commerce sales in 2017. However, that argument could be muted by the fact that e-commerce sales only account for 9% of overall retail sales. Larger internet publishers do have a combined market share above 50% but they do not collude, in fact, there have been noticeable share shifts recently.

Meanwhile, internet companies' shift into traditional media has been powerful with some of their services yielding a very high share of users - tracking especially well among millennials. Compare that to old media which is struggling to stay relevant, even sports, cable's crown jewel is showing its age with demographics trending precariously old. It is important to note that tech's motivations towards media can be different. For instance, "The Man in the High Castle" cost $72m to make, but brought in 1.15m new Prime subscribers at $63 each showing that subscription economics can change Hollywood.

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Continuing in technology, cyber security has never seen more demand. Driven by new areas such as cloud and the internet-of-things, global cyber spending is projected to reach $96 billion in 2018 that's up from 8% in 2017. While 80% of experts say a 'catastrophic' data breach is inevitable by 2021, 68% of IT professionals said their boards of directors aren't briefed on preventing or mitigating cyberattacks and 77% of businesses lack proper incident response plans according to a new study. Most recently, a large pharmaceutical company said that a cyber breach cost them $270 million in just one quarter. All this is to say, we continue to be bullish on cyber security firms who innovate with the latest area in need of spending being satellite infrastructure. Due to telecom and government investment our global satellite constellations are critical infrastructure crucial to everything from air travel to basic telecommunications and are in dire need of cyber spending.

Healthcare maintains a balanced but constructive outlook in our book. On one hand we have never had more innovation in the space for e.g. scientists have used the gene-editing tool CRISPR to restore hearing in animals with a genetic form of deafness. On the other hand, our system has never been more inefficient and has caused some real problems for people for e.g. nearly 50% of the $2B raised on GoFundMe in 2016-2017 was for medical expenses and according to a 2015 study, 23.8 percent of Americans find themselves in medical debt. This is mostly because the real cost of healthcare for American families has soared 180% in just 15 years. But there is hope, aside from technological innovation which we believe is ripe to drive efficiencies into the system, a continued push toward healthy living should help as half of healthy Americans are responsible for only 3 percent of health care costs. Thus, healthcare remains the perfect sector for a long/short approach: short the inefficient companies causing systemic problems and go long the innovative companies that are improving outcomes and saving lives.

Turning to financials we see also see a balanced view with a positive skew. While rising rates should help the sector from an earnings point of view, continued threats from technological innovation does drive some room for caution. US and UK consumers ranked leading internet companies nearly as high as banks for trust with their money in Bain's new survey. That said, savvy managements could use technology to their advantage as software can sift through 12,000 commercial-loan contracts in seconds whereas human teams need 360,000 hours.

On to energy where we remain contrarian bulls. There have been some dramatic changes in the energy landscape with US oil imports hitting lows and domestic production hitting highs. The LNG market is the most dramatic where the US was projected to import 4tn cubic feet of LNG by 2025 and is now on track to export that much by 2025! Demand also seems to be steady as SUV and light truck sales hit new highs, and while electric cars and ride sharing are absolutely a long-term risk to oil demand, nearly 60% of people who ride-share say they otherwise would have taken public transit, biked, walked or just not taken the trip. In other words, they are adding to congestion, gas consumption and greenhouse gases. Further, car OEMs are still losing money making electric cars and there are significant constraints on some inputs like cobalt.

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Moving to the consumer sector, as potential new tariffs and trade tensions come into play, the outlook for domestic facing consumer companies seem more insulated. For example, certain areas in the housing market look strong with Americans relocating for retirement driving population in some southern and western counties up 2% last year - almost 3x the rate of national population growth. We are bullish on new technologies for finding and buying homes, especially when you consider 58% of millennials find their home using a smartphone. However, some areas of the consumer landscape look challenged such as brick and mortar retail where vacancy rates have rocketed up for e.g. in Manhattan they have gone from 5% in 2014 to 18% in 2017 - almost entirely due to e-commerce. Herein lies another example of a good opportunity for long/short strategies - while buying an e-commerce winner is great - shorting a loser like a department store at the same time is even better.

Finally, gold continues to consolidate and we remain constructive on the metal as a market hedge. While bitcoin may have taken the short-term action, it has also experienced some nauseating fluctuations of late. We'd rather own a gold miner than a bitcoin any day of the week.

Since 1926 the average bull market has lasted 8.9 years with an average cumulative return of 490% while the average bear market has lasted 1.3 years with an average cumulative return of negative 41%. The current bull market is long by historical standards and there are signs that the market dynamics are shifting with increased volatility and a potential broadening out beyond the sharp outperformance of large cap tech. There's no great mystery here: tariffs, taxes, interest rates, deficits, global tensions, infrastructure spending, productivity, inflation, technology etc. are all issues that appear to be at inflection points, and the impact they will have on individual securities should differ greatly. We no longer are in an environment where everyone participates. These trends can be a positive backdrop for active investment managers, particularly those managers focused on quality growth stocks in the mid and small-cap arenas. Indeed, the relative performance for many of our strategies in the later weeks of the first quarter is supportive of this. However, as a reminder, for those that are more comfortable with a little less volatility, Essex manages several hedge strategies that aim to take advantage of market inefficiencies and short fundamentally disadvantaged stocks and sectors.