PROSPECTOR
PARTNERS

John D. Gillespie
Portfolio Manager

Kevin R. O'Brien
Portfolio Manager

Jason A. Kish
Portfolio Manager

Prospector Partners Quarterly Commentary

It's been a year since Jerome Powell led his first FOMC meeting as Chairman. Powell's outlook on the economy at the time was rosy. During the March, 2018 meeting the economic outlook strengthened and the 2019 GDP growth forecast rose from 2.1% to 2.4% with benign inflation expectations. Despite political pressure from the White House, the Fed's "dot plot" indicated three rate hikes in 2018, three in 2019, and two in 2020. Additionally, Powell stated the Fed's balance sheet would continue to run off barring a significant and unexpected weakening in the outlook.

Fast forward 12 months and the Fed outlook has changed entirely. The 2019 GDP growth outlook has slowed. The Fed is also expressing concern regarding current market sentiment and global growth. Internationally, 10-year government yields have once again gone negative in Germany and Japan. As a result, Fed officials are unlikely to raise rates and will halt the run off of the $4.0 trillion balance sheet at the end of September.

The market's prognosis on the economy is worse. The yield curve is partially inverted (which could be indicative of a looming recession) and the market is assigning a significant probability the Fed will cut rates this year. No doubt the White House will pressure the Fed to cut rates in front of the upcoming 2020 election. That said, numerous Fed officials are dismissing the possibility of a rate cut. Whether a cut comes to fruition or not, the yield curve should remain relatively flat this year. We also believe the fixed income markets will remain in a "holding pattern" until further economic data is released and as we wait for developments on trade talks and Brexit.

In past commentaries we have asserted that there are no immediate signs of a U.S. recession, despite what the curve is indicating. To summarize, credit quality is excellent, GDP growth is robust (albeit slower), most investment-grade corporate balance sheets are in good shape, the consumer remains healthy, and there aren't obvious financial excesses. The only recession indicators we can point to is a widening of credit spreads off the early 2018 low levels and

inversions in the yield curve (which can be a false flag as we discussed last year). That said, recessions are often sourced from exogenous events which arrive with little warning.

If a recession occurs in the near term, it will likely be a mild one and unlike the 2008 recession. It has been some time since we experienced a garden variety recession (the last one occurring in 2001 when the U.S. economy realized a mere 0.6% contraction). We also do not see asset bubbles that could result in a disastrous implosion. However, one area of concern is in the private equity and leveraged lending markets. Given this extended period of low rates, investors have "chased" returns by flocking to illiquid assets. The private credit market alone has nearly quadrupled in size since 2007. There has also been a dramatic rise in "dry powder" and deal valuations. The average private equity deal through the cycle has risen from 7x Enterprise Value / EBITDA to 13x, coupled with an increase in leverage. Our interpretation is too much capital is chasing too few deals. This results in private investment firms paying higher prices and/or accepting a lower return. In the event of a "normal" recession, lower-quality leveraged loans and portfolio companies will likely come under pressure. While not a large systemic risk to the economy, pressure on private markets could create a negative wealth effect, freeze up the alternative credit market, and leave many portfolio companies "broken" which could exacerbate an economic contraction.

Another area of concern is the national debt level of the U.S. which now stands at $22 trillion. This figure represents a $2 trillion increase since President Trump took office. Today, national Debt / GDP stands at 104%, far above the 63% level in 2007. A higher debt level constrains future growth and makes it harder to engage in discretionary fiscal spending to limit the impact of an economic contraction. Additionally, the recent tax cut will further exacerbate the fiscal deficit, effectively removing a fiscal tool that could have been used in the next downturn.

As for the international markets, China is worrisome. The U.S. / China trade talks are a wildcard with an uncertain outcome. However, our greatest concern is the Chinese leveraging cycle of the past decade. Total debt / GDP is estimated to be over 300% which has almost doubled in size since 2007. With growth in China modestly slowing (if you trust the official numbers) and a surge in known defaults ($120B yuan defaults in 2018, four times the 2017 rate), China looks increasingly due for a deleveraging cycle. While we are not experts on China and hold no direct exposure in our portfolios, any economic contraction will inevitably spill over to the global economy.

If a recession or economic shock is around the corner, we believe our focus on first questioning the downside of every potential investment will act as a buffer. Prospector strives to invest in companies with conservatively stated balance sheets, substantial franchise values, significant cash flow generating capabilities, trading at reasonable valuations, and avoiding excessive risk taking. Importantly, we target companies for our short book that exhibit the opposite characteristics. That said, if an economic contraction does not occur, our strategy should be positioned with the ability to produce acceptable risk adjusted returns.

WWW.PROSPECTORPARTNERS.COM
370 Church Street, Guilford, CT 06438
203-458-1500

The views described herein do not constitute investment advice, are not a guarantee of future performance, and are not intended as an offer or solicitation with respect to the purchase or sale of any security. Investing involves risk, including loss of principal. Investors should consider the investment objective, risks, charges and expenses of a Fund carefully before investing. Please review the offering memorandum or prospectus of a Fund for a complete discussion of the Fund's risks which include, but are not limited to: possible loss of principal amount invested; stock market risk; value risk; interest rate risk; income risk; credit risk; foreign securities risk; currency risk and derivatives risk.

Nothing contained in this document constitutes investment, legal, tax, or other advice nor should be relied upon in making an investment or other decision. Any projections, outlooks or estimates contained herein are forward looking statements based upon specific assumptions and should not be construed as indicative of any actual events that have occurred or may occur.