October 24, 2016

Dear Fellow Investor:

The third quarter of 2016 was about as placid a quarter in the financial markets as I can recall. This outcome was entirely predictable as I had been warning you for considerable time that markets are much thinner now than, say, ten years ago, and so bouts of high volatility have become the norm, not the exception. How did my prediction turn out? The least volatile quarter in memory; and another reminder of why it is a good thing we do not invest your money based on any particular view of what near- or intermediate-term market trends might be (the long term is almost always up), but rather on the selection of quality securities built to survive and thrive in any beehive environment.

The prelude to the quarter was the surprise vote in late June by those obdurate British to leave the European Union, the so-called Brexit. The markets spent all of two days in considerable turmoil and then launched rocket ship style (more than ten percent) to reach all-time highs in short order. Things subsequently calmed down and have been pretty quiet ever since.

At the end of September, the Standard & Poor's 500 Index was up a little more than 6% since the end of 2015 (7.8% with reinvested dividends), a perfectly respectable showing. The accounts for which we are responsible have been tracking ahead of the market throughout 2016 and I am pleased to report that we widened our advantage in the third quarter. Nearly all of our accounts are up double-digit percentages year-to-date through September 30. (The exceptions, as always, are brand new accounts just in the process of getting going.)

So markets are orderly and turning in decent results, and we are ahead of the markets—should we just relax and focus on our golf games? You should relax, but we won't. That's because, recent experience aside, I stand by my contention that markets are indeed volatile and vulnerable to exogenous shock. What kinds of exogenous shock? Three come to mind, Donald Rumsfeld's "known unknowns" (his "unknown unknowns" by definition defy detailed delineation): 1) The general election in the U.S, which will be upon us in about three weeks; 2) the possibility—nay, the probability—that the Federal Reserve will raise interest rates in December; and 3) the trajectory of corporate earnings.

1) Many have expressed concern about the outcome of the presidential election and its impact on financial markets. No surprise here, as this has been the ugliest campaign season in living memory, not, in my opinion, worthy of the dignity of a free and self-governing people. (Nevertheless the 2016 presidential election looks like it wears kid gloves compared to the presidential election of 1800, which ultimately gave us President Thomas Jefferson and set the stage for nearly two hundred years of rising prosperity and growth.) I have no dog in this fight (full disclosure: I plan to vote for Gary Johnson), but some observations can be ventured. It is well known, for instance, that markets hate uncertainty, that they prefer the devil they know to the devil they don't know. In this sense there is hardly a better known political entity on the planet, one more familiar, than one whose last name is Clinton. Thus a Clinton victory, which the polls increasingly indicate will take place, would be well-received. A Trump victory, not so much. (Again, I am not indicating personal preference, simply what I think market reaction is likely to be.)

The make-up of the Congress after November is less clear. Divided government has tended to favor the U.S. economy and financial markets—politicians too busy fighting each other to bother the rest of us are usually good for the rest of us—so if Republicans hold on to at least one house of Congress, such an outcome would likely be regarded favorably.

2) The Fed has been going to great lengths to set the stage for a rise in short-term interest rates in December. This can, and should, I believe, be regarded as a vote of confidence in the U.S. economy. In 2016 and beyond we no longer need the extraordinary monetary policy of 2008-9. Interest rates should be set in the private economy as lenders and borrowers come together to figure out the true time value of money. It is hard to believe an extra quarter point or so in the short-term market will have much effect on that process.

Still there are always unintended consequences. A possible result of higher U.S. rates could very well be a higher U.S. dollar relative to foreign currencies. Trillions are invested in debt instruments bearing NO interest rate or, more incredibly, NEGATIVE interest rates—the government of Japan, for instance, charges you to hold your money (!!!). Clearly, trillions would LOVE to migrate to a home in which the owners are actually paid, however modestly, for the use of their funds. If the new home is also very large, liquid, and of high credit quality, as is the U.S., so much the better. Along the way, though, yen, euros, even yuan, must be converted to dollars, putting upward pressure on the price of our currency. This is what happened a year ago when the Fed raised rates, and could well happen again.

A stronger dollar would be good for U.S. tourists—can you imagine being able to afford Switzerland?—but bad for the competitiveness of goods manufactured in the U.S. And most global commodities, from soybeans to oil to orange juice, are denominated in dollars. A stronger dollar could mean large price increases for vital commodities in a world economy already growing weakly if at all.

3) The last half of 2015 and the first quarter or so of 2016 witnessed a deceleration and then decline in the level of corporate profits. Not surprisingly, the stock market turned distinctly hairy about the same time. A host of reasons have been proffered: the collapse of commodity prices on a global basis, the not-unrelated slowdown in economic activity in China and emerging markets, and the effect of a strong dollar on reported U.S. profits. Manufacturing was hit particularly hard. As 2016 has progressed, however, the rate of decline has decelerated, and may have turned positive. As I write we have finished the first week of the third quarter earnings reporting season, and so far so good: Strategas Research Partners reports that profits overall are up 2% versus a year ago—that's not a lot, but certainly a welcome step in the right direction.

Here at Weybosset Research we are less concerned about the direction or level of corporate profits precisely because we seek companies whose profits are not particularly hard to forecast. That's because our companies' goods or services are necessary—natural gas to heat homes in winter, insurance, healthcare or a place to bury departed loved ones—and our investees enjoy significant competitive advantages in their respective markets.

So it has been a quiet quarter, though that could quickly change. We don't intend to become complacent. At some point the pendulum will swing and stocks will become wildly popular. Valuations will go to extremes and strangers at cocktail parties will want to tell you of killings they have made with XYZ Corp. or some whizz-bang disrupter recently arrived on the scene. About that time you will start receiving sell confirms in your mailbox as we dial back our exposure. But that day has not yet come. Likewise, at some point interest rates will cease to be an insult and we will gladly wade back into the fixed income market—but only if we are adequately compensated for any risk we incur. Again, that day has not yet come.

In the meantime, things are progressing satisfactorily in my opinion, and we hope you agree. Please do not hesitate to give us a call, shoot us an email or make yourself available to get together. We would love to hear from you and are profoundly grateful for the confidence you have placed in us.

Yours very truly,

Fla Lewis III
Principal