April 19, 2016

<u>Do I repeat myself? Do I repeat myself?</u>

Dear Fellow Investor:

This letter marks at least the third time I have written to you in the past year to report that the period under review—a prior quarter, a prior year—was characterized by extraordinary volatility in the stock market, only to end, with respect to the broad averages, right about where it began. The first quarter of 2016 was no different. 2016 began with the worst January since record-keeping launched in the 1920s, with the S&P 500 down nearly 12% at its low point (more than 15% below its 2015 high). A rally commenced in mid-February and by the end of March the S&P 500 closed a whopping 0.77% above its December 31, 2015 close (1.35% with reinvested dividends).

I am pleased to report that virtually all the accounts for which we are responsible fared better than the averages in the first quarter of 2016, the exceptions being new accounts which we have only begun to invest. Our typical account was *up* low-single digits in the first quarter. I am also pleased to report that, as the rally has persisted so far in April, our advantage over the averages has widened.

Two main concerns disquieted investors in the second half of 2015 and the first quarter of 2016: Federal Reserve policy here in the United States and developments in China; neither proved to be the calamity feared by those devoted to fearing calamities.

The Fed long ago signaled its intention to end the aggressively accommodative monetary policy in place since 2008, and, true to its word, raised rates for the first time in more than nine years (!) by all of a quarter of one percent on Beethoven's birthday, December 16. (Imagine the hammering of the opening four notes of the Fifth Symphony). This could and should be read as a vote of confidence in the health of the U.S. economy, but, as ever, unintended consequences ensued.

The main problem was that as the Fed looked to be less accommodative, around the world more and more central banks were becoming *more* accommodative. The phenomenon of negative interest rates, which I described to you a year ago as about the craziest thing I'd ever heard of, is now nearly normal. Almost 25% of global GDP now originates in countries in which you are charged to park your cash in a bank. (Sales of safes in Japan are booming because if money is in a safe rather than a bank, at least there is no charge!). So if you are, say, Swiss, and your bank wants 0.80% to hold your cash, and you notice that in the U.S. you can get a positive return along with the probability of higher returns in the future, wouldn't you consider converting at least some of your francs to dollars and maybe buying a Treasury note?

Thus Fed policy resulted in a stronger dollar relative to other currencies and a stronger dollar has proven disruptive. For one thing, many foreign entities—corporations, governments—have dollar-denominated debt. That debt just became more expensive, in some cases much more expensive. Likewise most global commodities, oil for instance, are denominated in dollars; what should have been a significant economic tailwind, lower commodity prices, was offset to varying degrees by the strength of the dollar.

And we live in a truly global economy. What is bad for our neighbors is bad for us. Roughly 40% of S&P 500 companies' earnings come from abroad; so if a strong dollar is bad for foreign economies, it is also bad for business at multi-national U.S. companies. Business problems are then further compounded when foreign profits are translated back into (greatly appreciated) dollars, diminishing reported profits.

Just as the Fed long ago indicated it intended to end its highly accommodative monetary stance, so China, the world's second largest economy, long ago indicated a dramatic change in economic policy. China would no longer seek to be the international manufacturing hub but would look instead to stimulate domestic consumption and demand to better resemble the economies of developed countries such as Japan, the U.S. and Europe. This meant fewer additional beautiful airports, highways and apartment buildings. The unintended consequence was a collapse in global commodity prices as what had been heretofore voracious demand waned --a real blow to commodity-exporting developing economies.

In addition, Chinese economic statistics are maddeningly opaque. The government targets GDP growth of 7.5% (way down from the 10%+ of the last decade) and *voilà*—the numbers come in right at 7%. *How* they came in at that level and *whether* 7% really is accurate is left entirely to the imagination (or gullibility) of the consumer of this information. China has also attempted to liberalize its financial markets, but accompanying attempts to regulate these markets, especially the stock market, have at times been ham-fisted. The result has been volatility of mind-boggling magnitude.

The combination of collapsing commodity prices, slowing GDP growth, *meshugana* market action and questionable economic reporting has wreaked havoc with confidence in all things Chinese. The loss of confidence reverberated around the world, contributing significantly to the weakness seen in our markets since early last summer.

But markets have a way of adjusting to change, though the process can be jarring. This appears to be the case now. The Fed, in response to rioting markets, has backed off its relatively aggressive stance. Whereas the market had been allowed to expect four interest rate hikes this year, expectations are currently down to only two—if any at all. A people that endured what the Chinese endured in the last century—the Japanese invasion, the Civil War, the Great Leap Forward and the Cultural Revolution are only the first national miseries that come to mind—can surely handle a change from working in steel mills to standing behind the counter at a retail outlet. China is an epic economic miracle story and there is no reason to believe the story has ended. Its course has only been altered somewhat.

With the Fed and China ameliorating, the stock market has resumed its natural course, which is up. (The "natural" direction of the stock market is up because its fortunes ultimately depend on the fortunes of its underlying businesses, which in turn depend on the prosperity of their customers. Prosperity, with notable interruptions, has generally been on the rise since the end of the Middle Ages).

I find myself, then, in the pleasant position of reporting to you a satisfactory start to 2016. (I hope you agree!). The volatility evinced by financial markets late last year and early this year sank neither the stock market nor our portfolios. Indeed winter's turbulence allowed us to put spare cash to work at prices we may never see again. We could face the storm with confidence because of our confidence in the innate resilience of the businesses in which we have invested.

Other storms lie ahead; we just don't know what they are yet. In past epistles I have noted that for various reasons (unintended consequences) markets are thinner now than in the past, so moves up or down can be alarmingly violent. And the last half of 2015 and the first quarter of 2016 have reminded us (in case we needed reminding) of the interconnectedness of global markets and global economies. The combination of thin markets and interconnectedness means that (metaphorically speaking) a butterfly flapping its wings in a Brazilian forest can indeed trigger a chain of events leading to a hurricane in the Caribbean. We need to be ready for hurricanes, and I believe we are. Again, our best line of defense—and our best weapon of offense—is the resiliency of the businesses in which we invest. That and a little patience put the odds on our side.

I thank you for the confidence you have placed in us and pledge our very best efforts on your behalf.

Yours very truly,

Fla Lewis III
Principal