April 23, 2010

Dear Fellow Investor:

I'd like to touch base with you on how we at Weybosset Research & Management LLC view the current investment situation, where we see opportunities and where we see dangers. As usual, this quarterly letter is summary in nature, designed to give a broad overview of our outlook. If you want more in the way of specifics, or would like to discuss how issues discussed herein relate to you and your situation, please do not hesitate to get in touch with Karin, Jeannine, Tom, or me via your favored medium—e-mail, telephone, in person, message in a bottle, carrier pigeon—and we will be happy to provide more detail.

First of all, to state the obvious: the powerful rally in the financial markets that began a little more than a year ago continues, albeit at a statelier pace. At roughly 11,000 on the Dow or 1200 on the S&P 500, the stock market is back at levels last seen in late 2008, but far below the peaks first reached in 2000 and again in late 2007. I am pleased to report that the vast majority of accounts for which we are responsible have fully participated in the recovery, and in many cases, more than fully participated. (I contend that we achieved full participation without having incurred full risk, though, fortunately, that contention has not been put to the test.)

And the outlook for the near future remains favorable. This is for a number of reasons, some of which may appear at odds with economic conditions as reported in the press. The first is that non-financial U.S. corporations, that is, those that are not big banks or other financial institutions, came into the crisis of 2008-9 in good financial condition. To some extent that is because corporate America had its own financial crisis early in the last decade when the tech bubble burst. (The bankruptcies of Enron and World Comm were emblematic of that sorry chapter in U.S. business history.) As a result, most companies spent the period 2002-2008 rebuilding liquidity and balance sheet strength. When disaster struck in late 2008, many non-financial companies serendipitously found themselves in good shape to weather the storm.

Secondly, corporate America responded to the crisis with speed and decisiveness, cutting back inventories, capital projects, and, yes, employment, in a rush to circle the wagons. The result, on the negative side, is high unemployment; but on the positive side, profitability, and especially cash flow, has held up well.

Thirdly, big U.S. companies, such as those in the Dow Jones Industrial Average or Standard & Poor's 500, do a large amount of business outside the United States, much of it in developing markets such as China, India, or Brazil, where economic growth proceeds at a brisker clip than in the U.S., Europe or Japan.

Thus the apparent incongruity between a rising stock market and a domestic economy in many ways still mired in deep doldrums. Remember that profits are the *raison d'être* for share ownership, and profits have been quite good of late. (This is particularly true for the companies we own.)

Every indication is that the trend will continue--good news for us! All the way around the world, people eat more hamburgers, drink more soft drinks, bottles of water and juice, use more industrial commodities and energy, buy more insurance, and buy more airplanes or fix up the ones they already have. Add to this the fact that, due to the collapse in the market in 2008-9, share prices remain for the most part quite reasonable, and it is reasonable to imagine a favorable stock market for the foreseeable future.

The fly in the ointment is the absolutely deplorable condition of government finances in the U.S. and abroad and at the state and local level here at home. Governments have committed to levels of spending that will prove very difficult, maybe impossible, to finance. And much of that commitment is structural in nature, that is, expenditures are mandated without regard to the level of revenue. So when President Obama, in his State of the Union message, in grand fashion pledged a freeze on all non-defense discretionary spending, cognoscenti were unimpressed, as he was referring to only about one sixth of the budget. The rest goes to fund our wars, entitlement programs such as Medicare, Medicaid, or Social Security, and interest on the national debt. It is the latter that is set to explode as debt piles upon debt, meaningfully compounding when interest rates begin to climb from their current historically and artificially low levels.

The nightmare scenario is that at some point the United States winds up looking like Greece looks today. It is not at all implausible that one day the world will decide that it holds enough U.S. Government debt and will require substantially higher interest rates as inducement to take on more. The result would be an acceleration of the debt spiral as government interest costs increase, and a flight from the dollar, the currency in which all this unhappy debt is denominated. The effect on the financial markets could be severe.

Will this happen? Not necessarily by any means, but averting a Greece-style debacle will require entirely uncharacteristic fiscal restraint by U.S. lawmakers. I take a degree of solace on this front when I contemplate the situation in the early 1990s, immediately after Bill Clinton was elected President. Ross Perot, running solely on a platform of fiscal responsibility, won a whopping 19% of the popular vote in the 1992 presidential election, catching the undivided attention of politicians. Federal spending did not decline subsequently, but its rate of increase diminished substantially at the same time that a growing economy produced progressively higher tax revenues. The result was a good-sized budget *surplus* by 2000. History therefore shows that it is not impossible to successfully address large structural fiscal deficits when politicians have the proper incentive; providing that incentive is the difficulty.

What steps are we taking to defend your net worth from the possibility of a Greece-style debacle here in the U.S.? In a word (actually, two words), *hard assets.* In past letters I referred to our "commodity basket", the companies in which we are invested that own

and produce everything from industrial commodities to oil and gas to gravel for use in building roads, bridges and runways at airports. Recently we doubled our investment in gold, the "anti-currency." When the time is right, that is, when the present atrocious financial circumstances are to some extent straightened out, we will be interested in real estate. We are looking for sensible ways to get involved with agriculture. And it may be that investing in the sovereign debt of countries *not* up to their eyeballs in debt—Australia, New Zealand or Canada, for instance—offers a degree of protection from the depredations of the crowd in Washington.

So that is my message to you today. The outlook for the financial markets remains positive, especially for the companies in which we are invested. Fortunately the benign market environment gives us the luxury of some time in which to assemble defenses against the *possibility*—again, not the certainty—of a riot by markets in response to irresponsible stewardship of the finances of the government of the United States.

As ever, we thank you for your business and would welcome the opportunity to speak with you in more depth about these or any other matters you care to discuss.

Yours very truly,

Fla Lewis III
Principal