First Quarter 2016 Commentary and Outlook

The first six weeks of 2016 saw U.S. stocks post their worst start on record for a calendar year. Major indices fell to their lowest point in two years as investors reacted to a range of issues, including stagnant global growth, China's economic restructuring, currency volatility and depressed energy prices. A dramatic reversal occurred when the world's leading central banks signaled they would pursue monetary policies designed to stabilize currencies in order to protect and promote global growth. With fears pushed to the background the dollar eased, interest rates fell, oil prices rose and financial markets rallied globally.

Shift in Central Bank Policy

Recent Federal Reserve Board actions reflect a radical shift in policy to emphasize the importance of international factors in the central bank's decision making. This evolution in thinking recognizes the increased interdependence of global financial markets. The International Monetary Fund estimates that in 2015, a full 80% of the share of variation in individual countries' equity market returns was attributable to other countries' equity return variation. That measure has increased rapidly over the last two decades along with greater economic globalization. In 1995, this share of variation was estimated at only 50%.[1]

The Fed's policy shift acknowledges the current threat to global growth posed by divergence in the monetary policies of the world's leading central banks. With the Fed in a tightening mode and the European and Japanese central banks using monetary policy to stimulate economic activity the consequence has been to establish a linkage whereby U.S. interest rates rise, placing upward pressure on the dollar, and downward pressure on commodities. This undermines global growth because it weakens emerging and developing market economies, which tend to be tied to commodities. At the same time, a strong dollar increases the burden on foreign holders of U.S. dollar-denominated debt.

The shift in Fed policy seeks to mitigate the effects of this linkage, which puts U.S. policy initiatives at odds with broader global growth objectives. However, until global growth accelerates, divergence among central banks' policies will persist creating friction and challenges for policy makers.

Monetary Policy Challenges

With the economy approaching full employment and core inflation trending up, the Fed is faced with a policy conundrum as it seeks to strike a balance between fostering real economic growth domestically at a rate consistent with its 2% inflation target and acting responsively to the growth needs of the fragile global economy.

At a time when U.S. economic growth remains tepid, wage pressures are intensifying. Wage growth, as measured by the changes in average annual earnings and core services inflation, which is most closely correlated with wage growth, have been in rising trends. If the drop in the unemployment rate accelerates and inflation turns up, then the Fed may be compelled to raise interest rates more rapidly than the currently very low expectation implied by the federal funds

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[1] See International Monetary Fund, *World Economic and Financial Surveys: Global Stability Report – Potent Policies for a Successful Normalization*, April 2016.

market. Such an adjustment from current market expectations and Fed actions would likely be unsettling for financial markets.

The risk of the Fed making a costly mistake in raising interest rates is mitigated by a number of factors, including the current weakness in indicators of inflationary expectations, and, perhaps most important, the recent surge in labor force participation. If rising labor force participation is sustained, reflecting a much-improved labor market and better wages, then there would be substantial scope to grow employment without an excessive upside break-out in wages. This would mean less risk of inflation, particularly if the recent firming in core inflation moderates. Under such a scenario, pressure on the Fed to tighten monetary policy would abate. In addition, at a time when corporate earnings are challenged by lackluster revenue growth, declining margins and a slowdown in the pace of share repurchases, more modest wage pressures could lead to upside surprises in earnings.

Macro Forces Offer Positive Potential

The root causes of market instability remain and pose continuing risks to the economic outlook. Further, the uncertainties surrounding the UK's upcoming vote on whether to exit the European Union, the so called "Brexit," will intensify as we move closer to the June referendum. Nevertheless, there are grounds for optimism in key economic trends, among them: firming U.S. economic activity and labor market momentum following an expected soft first quarter, a moderation in dollar strength and stability in economic and financial conditions both in China and globally. If these conditions hold, then there is solid potential for financial assets to provide positive returns.

Portfolio Update

In the previous quarter, we discussed several large positions that, while continuing to accrete value, had suffered declines in share price. We emphasized at the time that, "in each case, the investment thesis remains fully intact and, by virtue of the decline in price, the return potential of these holdings is greater today than when the initial investment was made." In the first quarter of 2016, we began to see evidence of this value realization as stock-specific developments took place that confirmed our view. The juxtaposition between the last two quarters offers a reminder that in any given quarter or year, our portfolio returns can meaningfully diverge from those of the market. Because we hold a highly differentiated, concentrated portfolio of investments, performance will in large part be driven by stock-specific developments. However, over the long term, we believe this strategy will translate into superior long-term returns.

Firm Update

Growing families were a theme in the first quarter. Trader Sloane Krumland exchanged vows with his new bride Krisztina Mohacsi and Sandra Frederic-Gassant who works tirelessly on account reconciliation and administration gave birth to a beautiful baby boy, Samuel Noah. We hope you will join us in wishing them health, happiness and all the very best.

As always, if you have any questions please don't hesitate to reach out to us.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

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