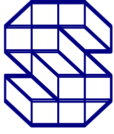

Steinberg Asset Management, LLC

Second Quarter 2017 Commentary and Outlook

Boosted by healthy corporate earnings and investor expectations for improving economic growth, most major stock market indices advanced around 3% for the second quarter, contributing to the strongest first half year for stocks since 2013. The steadiness of the advance was particularly noteworthy. The maximum drawdown (decline from peak to trough) for the S&P 500 never exceeded 2.8% in the first half of the year, the second smallest first-half drawdown level in 89 years.

Heightened Awareness of Potential for Increased Volatility

This exceptionally low level of volatility is unlikely to reflect a new norm. A structural change in our equity markets has occurred in recent years. Where stock trading once reflected the value of individual companies based on business fundamentals, the majority of trading volume today is program generated and designed to capitalize on or mimic short term movements of markets, sectors or securities. Formulaic trading of this magnitude, coupled with reduced liquidity due to such factors as Dodd-Frank trading regulations and today's historically high levels of margin debt, holds potential to significantly amplify market movements.

Such an increase in volatility can act as a double edged sword. It can produce mispricings in individual equities, creating exceptional investment opportunities for investors who are focused on fundamentals. However, it can also cause economic headwinds, especially if the resulting price swings cause consumers to suffer erosion of net worth and loss of confidence. This aspect of the market's changed structure and the instability it may create has drawn the attention of the Federal Reserve. Several board members, including Stanley Fisher, the Fed's highly regarded vice chairman, have highlighted the rise of financial stability risks. These concerns should not be ignored. For now, the Fed has few choices beyond monitoring the situation and raising awareness. Absent policy error, it is unlikely this issue will cause the Fed to shift to a monetary policy that would derail the current economic expansion.

Gauging the Inflationary Threat

Although inflation has been benign during the recovery from the global economic crisis and stubbornly below the Fed's 2% target in recent years, there are sufficient inflationary forces in place today to warrant attention. Facing a rising capacity utilization rate and a low and still-falling unemployment rate, the Fed has sent signals that it will continue a sustained, gradual reversal of the aggressively accommodative policies it has followed since the financial crisis.

The Fed's hawkish tilt is understandable. Only three times in the last 50 years has the jobless rate fallen this low and each of these periods was associated with boiling excesses that led to economic trouble: Overheating in the late 1960s preceded an inflationary spiral in the 1970s. The late 1990s coincided with extremely low unemployment during the incubation of the dot-com bubble. In the middle of the last decade unemployment fell sharply in the buildup of the U.S. housing bubble. For now, many of the signs of excess that would be suggestive of another period of vicious inflation are missing. Capacity utilization, at around 77%, remains well below

more normal levels reached in prior periods and wage growth is less than 3% annually, well short of the 4%-6% levels of earlier periods.

Structural Changes May Mitigate Against Inflationary Pressures

Since 2012, U.S. businesses have been able to raise prices for goods and services by a modest 1.4%. In the same time span, worker productivity has nudged up 0.6%. The sum of these figures serves as a proxy for sustainable wage growth. At just 2%, it's at its lowest level in more than 60 years and unlikely to improve any time soon. Baby boomers, who comprise the most experienced, skilled and compensated segment of the workforce, are retiring. As they move off workplace rolls, they are being replaced by workers who are less experienced, less skilled and lower paid. This dynamic will challenge labor quality and limit productivity improvement and wage growth. While there is no telling how long this low unemployment cycle will last, it will end eventually. Until then, with limited pressure on wages, a low unemployment rate should not pose a serious threat to inflation and the Fed should not feel pressed to raise rates aggressively.

Finally, the economy is very different from 20 years ago. The combination of technology, intense competition and globalization make it difficult for inflation to gain traction. Consider the case of Amazon, which now threatens to disrupt the grocery and prescription drug businesses in the same way it is remaking the retail landscape. Through technology and scale, Amazon may be singlehandedly responsible for killing inflation.

Extending the Equity Cycle

Inflation normally brings an end to bull markets. It forces central banks to raise interest rates, restricting the availability of capital in order to slow economic growth and tame inflationary forces. In the current environment, the core rate of inflation (i.e. consumer prices ex. food and energy) is likely to remain subdued for an extended period. As this is the central bank's primary focus in managing inflation, it is unlikely the Fed will be pushed to shift its tightening stance from gradual to aggressive. As a result, the monetary environment should support economic growth and continued earnings improvement against the backdrop of gradually higher interest rates. While this could create unfavorable conditions for credit markets, it is unlikely to undermine equities.

Equities: A Store of Long Term Value

Cycles will come and go but the case for equities as an effective long-term store of value remains compelling. This is readily illustrated by comparing advances from 1940 to present. Over that time span, the U.S. economy grew about 200x, with GDP rising from $100 billion in 1940 to nearly $20 trillion today. In the same period, U.S. home prices increased around 100x, or about half as much as the domestic economy. In contrast, U.S. stocks, as represented by the S&P 500, rose about 200x, mirroring the advance of the economy for the 70+ year period.

We are confident our long-term fundamentally disciplined focus on equity investing will continue to protect and enhance the capital you have entrusted us to manage on your behalf.

Portfolio Update

As our clients of longstanding are well aware, we seek to find discrete opportunities that exhibit what we regard as excellent risk/reward profiles. As value oriented investors we have sought to find businesses which are beneficiaries of the changing world, described above, by capitalizing on trends towards lower costs and more flexible services while maintaining our valuation

discipline. One such business that we have owned for several years is a leading provider of manufacturing, design and supply chain related services. The business is in the process of transforming itself from a low value add, contract manufacturer to a high value add, high IP content manufacturing partner for clients across various industries. This transformation has and will continue to lead to an acceleration of revenue growth and more importantly an expansion of operating margins as the mix of business improves, becoming less commoditized. The company provides the design and supply chain speed and flexibility that consumers in an e-commerce world demand. However, shares are trading at a reasonable earnings multiple, despite healthy earnings growth.

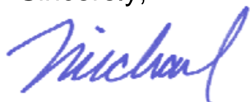
The business recently entered into a new strategic partnership, whereby it will help its new strategic partner increase the speed and responsiveness of its production and supply chain so it can respond quickly to the changing demands of consumers in a cost effective manner. It has already developed a number of design innovations with its new partner and is collaborating on additional projects.

Over the next several years, pre-tax operating earnings from higher margin, higher value-add offerings should approximately double. Margins have already expanded in the most recent quarter, and we believe this trajectory should continue with margins expanding further in the coming few years. Earnings convert at a high rate to free cash flow and management has and, we believe, will continue to return free cash to shareholders through share repurchases. As a consequence, the company is poised to grow EPS at mid-teens rates per annum in the coming years. Use of the incremental free cash for acquisitions, where the company has a recent record of success, could meaningfully enhance earnings further, and support additional share price appreciation.

Firm Update

We have no new news to report this quarter. We hope that you and your families are enjoying the summer and please know that we are spending our summer continuing to work to identify new investment opportunities and delve more deeply into existing portfolio positions for the benefit of your portfolio. As always please do not hesitate to reach out to us with your thoughts, comments or questions.

Sincerely,



Michael A. Steinberg
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