Third Quarter 2017 Commentary and Outlook

Major stock market indices finished the quarter at record highs, marking their eighth quarterly advance in a row and moving this bull market into the record books as the second longest in history. A combination of factors – moderate economic growth, rising earnings, low inflation and interest rates near historic lows – continued to drive equities higher. More recently, investor expectations have been buoyed further by the prospects of an overhaul of federal tax laws that holds the potential to accelerate economic growth and corporate profits.

Changing Investment Landscape

The Federal Reserve Board has signaled that it soon will begin rolling back the policy elements that comprised its historic level of support of financial markets. Begun nearly a decade ago in response to the worst financial crisis since 1929, the Fed's combination of traditional monetary accommodation and quantitative easing (QE) has served investors well. The resulting ultra-low interest rate environment nurtured steady advances in economic activity and corporate earnings while also supporting higher stock-price multiples that contributed significantly to market returns. As the Fed begins unwinding these policies, the tailwinds that pushed equity markets higher can be expected to subside.

As this era of easy monetary policy concludes, important questions arise for investors, including whether the Fed will manage the transition to normalization in a manner that avoids dislocating the economy and financial markets. The answer to this question is clouded by uncertainty surrounding inflation and all the unknowns that come with the first-ever unwinding of a $4.5 trillion Fed balance sheet.

Uncertainty Tied to The Fed

Inflation has been rising at a rate below the Fed's target for an extended period and the monetary authorities have not been able to explain exactly why this is happening. Have the forces of technology, demographics, and globalization conspired to create a structural change that will keep a lid on inflation? Or are there, as the Fed chair postulates, transitory forces at work that will soon dissipate?

The answer is important because if interest rates rise noticeably above inflation, then economic activity could suffer as the higher real cost of money causes the demand for credit to fall. The Fed's announced gradualist approach to raising interest rates would appear to be the soundest way to address this conundrum. Of all policy options, it is the one least likely to get too far ahead of or behind inflation. It permits more modest adjustments to monetary policy to be made and is best suited to modulating swings in investor expectations and sentiment. It does not, however, eliminate the risk attached to an unexpected surge or acceleration in the rate of inflation that could force the Fed to abandon its gradualist approach.

The uncertainties surrounding the Fed's move away from a policy of ultra-easy money are compounded by difficulties in predicting what effects the unwinding of the Fed's multi-trillion-dollar balance sheet will have on interest rates since this has never been done before. Again, a gradualist approach is best suited for avoiding a major policy error.

Increased Volatility Likely

The developing shift in monetary policy is likely to create challenges for investors that will be reflected in greater volatility than has been experienced since the onset of the financial crisis. The unknowns surrounding inflation and the unwinding of the Fed's balance sheet are likely to require policy adjustments along the path to normalization and those may not always be consistent with investor expectations. To be sure, there are factors beyond Fed policy that could unsettle investors and create periods of market volatility. These include developments surrounding a resolution of tensions between the U.S. and North Korea, the upcoming appointment of Chairman of the Federal Reserve Board, political developments in Washington, or the changes in the market's structure toward programmatic trading and away from fundamental investing that we discussed in last quarter's letter. These all hold the potential to create sharp moves in the market at any time, particularly since equity markets are trading at elevated levels. However, ultimately it will be the ability of the Fed to successfully navigate the path to normalization that most heavily informs investors' long-term returns.

Positioned for the Long Term

With inflation and interest rates likely trending higher in the longer-term, the effects will be widespread: investors will no longer benefit from the tailwind of rising price-earnings ratios, U.S.-based multinational businesses will likely face headwinds caused by a strengthening dollar as higher U.S. interest rates attract foreign capital, and fixed income investments will suffer from rising interest rates that cause the value of bonds to decline. The challenges that such an environment may present to equities could be offset by investors shifting the weight of their portfolios more towards stocks and away from bonds. This would be particularly beneficial for portfolios built around businesses where the return profiles are tied to discrete developments and/or business characteristics that can drive an inflection in earnings growth. Since our inception as a firm, this has represented a core element of our investment strategy, and this is an important reason why we believe your portfolio is and will be well positioned.

Portfolio Update

As you'll recall, we seek investments in businesses believed to have an extraordinary risk-reward profile and whose performance is driven by a company's ability to capitalize on discrete events as a function of its competitive position.

It is estimated that 40% of the world's natural gas reserves sit in what are known as stranded gas fields. These fields, often located offshore, can be difficult to access and as a consequence are costly to develop. A long-held investment, through its development of a solution to this problem, and in partnership with a leading oil services company is, in our view, singularly positioned to capitalize on this very large market and will do so as the low-cost producer. Along with its partner, the business expects to develop a stream of projects in the coming few years which would dramatically increase the equity value of our investment. Based upon our research, under conservative assumptions, we would expect shares to trade significantly higher than the current share price.

We believe a recent development will serve as a significant catalyst for the business and the stock as investors and participants in the LNG market (from financiers to resource developers) will have clear proof of what we have believed for some time: that their solution will have a dominant market position in developing stranded gas fields and that it can generate exceptional returns in *any* reasonable energy price environment, where peers cannot.

The road to value creation in this investment has been long and uneven to say the least. However, with "first gas", from the first project anticipated in the coming months, an enthusiastic, deep pocketed and highly sophisticated partner on board, and a number of additional projects in the pipeline at various stages of development we believe our conviction and optimism are well-founded.

Firm Update

There were no noteworthy business developments at the firm during the quarter. However, we would like to send our warmest wishes and congratulations to trader Nicholas Daniello and his wife Jolene who welcomed son Nicholas. We could not be happier for them.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

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