Fourth Quarter 2016 Commentary and Outlook

Election Rally Sends Stocks to Record Highs

Investors were unenthusiastic heading into election day: The prospects of continued anemic economic growth and rising interest rates, along with uncertainties surrounding the upcoming federal elections combined to pressure stocks lower for nine consecutive days — the longest such stretch since 1980. Post the election, equities have surged as investors embraced the view that the Trump administration's pro-growth agenda — tax cuts, infrastructure spending and regulatory reform — would usher in an acceleration of economic growth and rising corporate profits. As a consequence stocks reached record highs and major indices demonstrated strong gains for the quarter and the year.

Opportunities and Challenges

While many aspects of the Trump agenda bode well for stocks, some of the policy initiatives proposed during the campaign could prove inflationary. The president's promises for fiscal stimulus, tighter immigration controls and higher tariffs could add inflationary pressure and prompt the Fed to raise interest rates higher and more quickly than it otherwise might. Capacity utilization is already rising and the economy is approaching full employment. Other long-term inflation risks are gaining strength globally: The world's central banks are looking to boost inflation, populist movements are forcing governments to abandon austerity measures and nationalist policies are beating back the inherently deflationary force of globalism.

The bond market has been quick to recognize the long-term threats of rising inflation and higher interest rates. For equities the impacts of the developing inflation and interest rate cycle are not as well defined. Those impacts will largely be determined by the degree that increases in economic activity and rising earnings serve to offset the impact of higher interest rates, and by the ability of the Fed to avoid dislocations that could occur as a consequence of a rising dollar.

The Dark Side of the Dollar

The trade-weighted dollar has surged about five percent against major world currencies to a 14-year high since the election. This rise reflects investors' views that the U.S. economy is poised to hit a higher gear thanks to policy measures President Trump has promised to enact immediately. These include tax cuts (corporate and personal), government spending (infrastructure and defense) and regulatory relief.

The dollar's surge suggests the economy may be poised to emerge from its recent period of deflationary sloth. This would clearly be a positive development. However, with fundamentals (accelerating growth and rising interest rates) stacked in favor of continued dollar strength, it will be important for policy makers to be sensitive to the potential threats a sustained rise in the dollar poses to global growth and financial stability. These threats include tightening global liquidity and protectionist policies.

In an increasingly interdependent world the lesson of the dollar is that everything is connected. The Fed needs to protect against the dollar increasing too much. Apart from creating a headwind for our exports and domestic economic growth, a sustained surge in the dollar can create other undesirable consequences including:

- A global shortage of dollars, presenting liquidity problems for the global financial system;
- Elevated debt payments and spikes in costs for emerging market countries and corporations that have been accessing cheap dollar-denominated debt;
- Lower revenues from dollar-denominated commodities for emerging and frontier economies; and
- Making U.S. exports less cost competitive and making imports into the U.S. cheaper.

The last point poses a particularly nettlesome problem for the new administration. Trump's pledges to tackle the trade deficit were a central feature of his campaign and were instrumental in delivering votes from disaffected blue collar workers in the industrial Midwest. However, a sustained strengthening of the dollar will work at cross purposes to this goal by making U.S. manufacturing less competitive and making imported goods cheaper and more attractive for American consumers and businesses. If the trade deficit widens over time, this could cause the Trump administration to pursue aggressively protectionist policies which would not be good for global growth.

If the Economy is Accelerating Rising Rates Won't Matter

While the prospects of increased spending and reduced taxes have been good for stocks, it has caused bonds to decline sharply. The yield on the 10-year Treasury bond has risen to the area of 2.50% compared to a low of just 1.36% last summer. With unit labor costs starting to accelerate and the labor force approaching full employment there is potential for inflation to accelerate with bond yields rising further. Higher interest rates are unlikely to derail the economy or the stock market if businesses, consumers and investors remain confident that the economy is entering a sustained period of stronger growth. In this scenario stocks could likely absorb higher interest rates without major adjustment because the equity risk premium (the return that investors demand from holding stocks relative to the returns available on treasuries), which has been unusually high, would fall as investor concerns that the economy is mired in slow growth and disinflation dissipate.

Implementing Policy May Create Volatility

In the macro setting that is now developing, the interplay between fiscal policy, economic growth, inflation and interest rates will largely determine the shape of our financial markets. Investors have already discounted a large measure of the near-term benefits likely to be derived from Trumponomics, and have seemingly not discounted the challenges to implementing policies so broad and deep in scope. Since President Trump is unlikely to abandon those Rust Belt voters who awarded him the presidency, investors may be underestimating the likelihood of disruptive trade measures. As a consequence, there would appear to be room for disappointment to develop, from time to time, and this could unsettle markets. This volatility could present investors with exceptional long-term investment opportunities.

Favorable Supply-Demand for Equities

There is a reasonable case to be made that equities will benefit from an improved supply-demand balance in the years ahead if investor concerns about the long-term impact of rising inflation and interest rates lead to a shift in the weight of their portfolios towards stocks and away from bonds. For example, in the international arena, Norway’s sovereign wealth fund, the largest in the world, recently announced that it is shifting about 10% of its nearly $1 trillion fund to equity-type investments and away from fixed income. On the domestic front, a 10% shift to stocks from bonds would translate into around a 15% increase in the demand for equities. In addition, rising corporate cash flows and possible repatriation of cash to the U. S. could result in increased share repurchases, also improving the supply-demand balance.

A Well Positioned Portfolio

An investment world shaped by Trumponomics will be characterized by accelerating unit growth, rising inflation and interest rates, lower taxes and a rising dollar. Companies that generally will be most well positioned in this emerging landscape will be those characterized by:

- Pricing power to offset inflationary cost pressures
- A capital structure that insulates from rising interest rates and is not highly dependent on debt to finance growth
- A domestic orientation that protects from the headwinds of a rising dollar
- Tax exposure that enables the company to benefit fully from lower federal tax rates
- A customer base that benefits fully from reduced personal income taxes
- A large unfunded pension liability that will be reduced as long-term interest rates rise
- A large deferred tax liability that will be reduced with lower tax rates
- Operations that have been encumbered by federal regulation

The more of these boxes a company checks the more it is likely to be in a preferred position to benefit from the policies of the new administration.

Portfolio

During the course of 2016, with few exceptions, the businesses in our portfolio developed in line with or ahead of our expectations. We believe the portfolios are well positioned for the post-election world we are entering.

One position we increased was our holding in a global leader in high throughput satellites which enable high speed broadband for communication and data applications. The company exhibits several of the characteristics outlined above and over the next several years is poised to demonstrate several step function increases in cash flow and earnings growth that will drive what we expect to be exceptional returns.

The company provides satellite based communication services, systems and equipment to the U.S. government, commercial customers, and U.S. consumers through its satellite based residential broadband. The total global residential market for the company's broadband service is enormous, consisting of an estimated 2 billion homes and, according to the company, represents a $350bn-$600bn revenue opportunity. There is no satellite competitor we are aware of that can provide this market with comparable broadband speed, capacity and economics. In the future, the company plans to launch additional satellites that will have around ten times the capacity of current satellites and together will provide global coverage at unprecedented satellite broadband speeds.

Moreover we expect many of the potential drivers of share price appreciation to begin to materialize. These include increased government use of satellites, and continued growth in the in-flight Wi-Fi market.

Firm Developments

While there were no new developments of note this quarter, as we reflect back on the year we are pleased with the progress we made as a firm. Among other developments, we launched our new fund and most importantly initiated an advisory board comprised of individuals who have a wealth of experience in the investment industry and are held in high regard. They have already made meaningful contributions to the firm, and we are deeply appreciative.

We would like to wish you all a happy, healthy and prosperous New Year. 2017 marks the 35th anniversary of Steinberg Asset Management. This anniversary serves as a reminder of how fortunate we have been over these many years to have partners, like you, who share our long-term investment approach and philosophy. We are excited to see what the next 35 years will bring.

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

This letter is confidential and is not for further distribution.

This letter is for informational purposes only and should not be deemed as investment advice or as a recommendation to purchase and/or sell any individual securities discussed in this report. Past performance is no guarantee of future returns. All investing involves risk including the possible loss of principal.

The opinions, forecasts, assumptions, estimates, and commentary contained in this report are based on information provided to Steinberg on both a formal and informal basis which Steinberg believes to be reliable. However, Steinberg cannot represent or warrant their accuracy. The impact on Steinberg's opinions, forecasts, assumptions, estimates, and commentary due to inaccurate information, incomplete information or information taken out of context may be substantial. Further, all opinions, forecasts, assumptions, estimates, and commentary in this report are made only as of the date indicated and are subject to change at any time without prior notice.

Discussions and calculations regarding potential future events and their potential impact are based solely on historic information and Steinberg's estimates and/or opinions, and are provided for illustrative purposes only. No guarantee can be made of the occurrence of such events or the actual impact such events would have on the performance of the companies described in this report.

The securities discussed in this letter are current holdings of Steinberg clients. The reader should not assume that investments in the securities identified were or will be profitable and it should not be assumed that recommendations made in the future will be profitable. There can be no assurance that Steinberg will continue to hold the same position, or any position, in the companies described in this letter in the future. Positions reflected in this letter do not represent all the positions held, purchased, or sold, and in the aggregate, the information may represent a small percentage of activity or holdings in client portfolios. The information presented is intended to provide insight into Steinberg's investment process and certain noteworthy events, in the sole opinion of Steinberg, affecting client portfolios.