Third Quarter 2015 Commentary and Outlook

Major stock indices registered their first quarterly loss in four years as uncertainty over the timing of the Federal Reserve's plan to raise interest rates, along with concerns over slowing growth in the world's emerging economies, weighed heavily on markets in the quarter.

With China and the world's other developing economies accounting for nearly 50% of global GDP, a downturn in their collective economic health holds the potential to trigger recessions in the world's developed economies. The Fed's Open Market Committee cited softening U.S. exports and weak price inflation among other factors in its decision not to raise interest rates in September, a move that had been widely expected prior to the market weakness.

In our last quarterly letter we noted that equity valuations were extended and that corporate profits remained highly dependent on global growth. Any significant global slowing could cause profits to fall short of expectations. At the time of that writing, critical indicators such as inflation, monetary policy, interest rates, corporate margins and profits had not yet begun to flash signs of possible recession. Therefore, we concluded that any earnings-related market correction was likely to be modest in depth and duration. Since then, slower growth in emerging markets, particularly China, coupled with increased currency instability, widening credit spreads and a number of corporate earnings shortfalls combined to create a high level of investor uncertainty and anxiety that translated into the short-but-vicious market correction that amounted to more than a 10% decline in the major averages from peak to trough.

Financial markets subsequently regained their footings and some of the leading indices are now back within shouting distance of recent highs. This recovery appears to be based largely on expectations that policy actions will be taken here and in China to effectively reverse the threats to global economic growth and financial stability. However, unless or until such concrete actions actually occur, risks and volatility may remain elevated.

A Challenging Global Environment

Problematic international conditions, well beyond the control of the Fed, have been surfacing since early summer. First, there have been unmistakable signs of weaker global growth with recession conditions in force in Brazil, Canada, Japan, Russia and South Africa. Europe remains weak and China is clearly slowing.

China’s economic difficulties weigh heavily on both emerging market economies and select developed markets, including South Korea, Taiwan and Japan. This significance cannot be overstated. The developed Asian economies serve as important U.S. trading partners. All of these economies will find it difficult to rebound while China struggles.

As exports from emerging market countries slow, their GDP growth will also decelerate, causing consumer incomes and corporate profits to decline. With businesses in many of these economies now highly leveraged, bankruptcies can be expected to rise as debt service becomes difficult and deflationary forces depress asset values.

The deterioration of near-term growth and diminished financial prospects may reasonably be expected to trigger an outflow of capital from these countries. This would further aggravate the situation because it would likely lead to quantitative tightening as monetary authorities in these countries seek to support their currencies. Emerging market countries that engage in programs to support their currencies may affect our financial markets because when these countries sell dollars and buy domestic currencies they often fund these purchases with the sale of U.S. debt instruments. This may help to explain why foreign official net purchases of U.S. Treasury notes and bonds have been declining at the fastest pace on record.

It is worth noting that foreign central bank purchases of U.S. Treasury securities over the past decade are widely perceived to have helped depress long-term bond yields. If foreign central banks now divest significant portions of their U.S. Treasury portfolios, it could pave the way for higher bond yields unless the slack in demand is picked up by U.S. and foreign entities.

An economic turnaround in China, which is essential to spur overall emerging market growth, may not come soon. Growth in China's fixed asset investments, which has been the biggest driver in the country's economic rise over the past ten years, is likely to remain soft as China's excess industrial capacity, believed to be large relative to demand, is absorbed. At the same time, the shift to a consumer-led economy is not far enough along to be able to drive the economy forward at a rate of growth that the world has come to rely on.

A Cautious Domestic Outlook

With quantitative easing coming to an end, the U.S. economy needs to transition to a self-propelled rate of growth sufficient to advance corporate profits at a pace that will support current equity valuations. Unfortunately, economic data has not been supportive thus far and a further down-grading of earnings expectations remains probable in the face of slowing global growth.

The deterioration in emerging market economies may serve to underscore that the U.S. economy is not an island unto itself. Each 5% decline in U.S. exports to emerging market countries reduces our GDP by about 20 basis points. While that may not sound like much, it is meaningful for an economy that is struggling to grow at a real rate of 2%. At the same time, sluggish domestic consumer spending and an anemic industrial sector further cloud the outlook. However, improvement could materialize as we move through 2016 if lower commodity prices, particularly oil, buoys consumer spending. In the meantime, slowing global growth suggests a more cautious outlook.

Policy Imperatives

In order for financial markets to advance it will be important for monetary authorities around the globe to ensure sufficient liquidity. Additionally, it is incumbent on Chinese policy makers to advance a package of fiscal and monetary measures that will lead to a sustained rebound in China's economic activity to restore confidence in emerging markets and to take off the table the threat of global instability due to a rundown of China's reserves. Finally, the U.S. Federal Reserve Board needs to convey, with one voice, a policy message that will instill confidence in financial markets here and abroad, that U.S. monetary policy will be supportive of global growth.

Portfolio Positioning

As we have consistently noted, our focus is on identifying businesses that we believe will be successful in creating large and enduring value relative to the price we pay for a share of the business. We have chosen this approach because we believe it will lead to superior long-term returns. In the most recent quarter, investors' concerns over the macro environment overshadowed progress toward the creation of value in businesses that comprise a significant portion of your portfolio. For example, shares in a large retail holding, with substantial real estate assets underpinning the value, declined in part because a third of the business is in Canada, a commodity-driven economy. This occurred despite the fact that the management has called out its Canadian business as performing better than expected and that the company closed on a transformational acquisition at the end of the quarter. Similarly, shares in a liquefied petroleum gas (LPG) carrier company with a dominant position in its market, saw significant declines in its share price despite exceptional earnings growth and fleet utilization of nearly 100%. The company’s association with the energy sector contributed to the drop despite the fact that the rapid decline in oil prices has had no discernible impact on its business.

In contrast, in another investment we estimate the time table for the development of a business that has extremely attractive financial and operating characteristics has been set back by around one year. A single business unit of the company bears responsibility for the firm's poor performance. The management team of the business unit is being strengthened and we expect the company should resume the trajectory we initially anticipated. In addition, we made an ill-timed purchase of a commodity-like business at a price that we thought would have support given the company’s asset backing. While this constitutes a relatively small portion of your portfolio’s assets, we continue to hold this position because the value and earnings power of this business are large relative to the purchase price of the security.

In the current unsettled global market environment we continue to focus on identifying businesses that are uniquely positioned to demonstrate accelerated earnings and free cash flow growth with an emphasis on those that have predominately domestic exposure. For example, in the quarter we began to build a position in a leader in consumer and defense satellite technology. The business operates in a monopoly or duopoly in virtually all of its markets. The business has compounded EBTIDA at an average rate of 20% per year for the last decade and is poised to continue its record of exceptional growth as it increases its capacity through the launch of new satellites that are meaningfully superior in design and capacity to those of its peers. Further, the cash flows of the business are particularly attractive as they come from subscription revenue in the consumer business and from long-term defense contracts. Finally, the management team is thoughtful, and like us takes a long view to building shareholder value. Most importantly, they are significant shareholders themselves.

Firm Update

We congratulate Justin Steinberg, a senior member of our investment team, and his wife Shirley, on the arrival of their first child, Eli. We wish them all the 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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