October 28, 2015

Dear Client:

The quarter just ended was the most turbulent for U.S. equities in more than four years. Two principal factors caused the recent correction, and they form the subject of this letter: 1) the slowdown in China and its actual and potential spillover effects on both emerging and developed economies, and 2) the actions and commentary of the Federal Reserve. Let us treat them in order.

August 11 was the sort of day investors don't like to see, as it brought news that was both potentially ominous and totally unexpected. After keeping its currency in a very narrow band against the dollar for many years, out of nowhere the Chinese authorities stunned the world financial markets by allowing the renminbi to float downward by 2% in a single trading session. They then repeated this action the very next day. Although that proved as far as the Chinese government wanted to go for the moment, no one else knew that at the time. And although an adjustment totaling 4% is far from a major devaluation, markets all of a sudden began questioning their assumptions about China.

The devaluation was not the first time the Chinese had unsettled the financial markets in the past year. The regime's promotion of the Chinese stock market bubble that began inflating late last year was short-sighted in conception and ham-handed in execution, its efforts to prop up the market once it began to falter even more so. But while the stock market episode did cause many to question whether the Chinese authorities really knew what they were doing as, despite their clumsy attempts to halt it, the crash gained momentum over the summer, for the most part investors fell back on the Chinese Communist Party's record, amassed over the previous several decades, of spectacular economic growth combined with remarkable stability. The government's actions surrounding the stock market added to worries over the slowing of the underlying Chinese economy, but by and large China remained a point of concern rather than alarm.

The August 11-12 devaluation was a clear tipping point. The confusing, surprise manner in which the regime announced the move called into question its competence and credibility in economic matters in a whole new way, and worry over China instantly moved from the background to front and center. What was the true purpose of the devaluation – to liberalize their currency and gain "special drawing rights" with the IMF, as the Chinese claimed, or to goose exports? What surprises would the regime have in store next for the global economy and financial markets? And – most ominously – just how bad was the Chinese economy to warrant such a seemingly panicky series of actions by a government desperate to spur growth? To be clear, it was not these actions in and of themselves that spooked the markets. As we've explained previously, the Chinese stock market is a casino, Chinese investors know it's a casino, and it is nowhere near as central to the broader economy as are the U.S., European, and Japanese markets. And a roughly 4% currency devaluation is more or less inconsequential, provided it's not the precursor to truly substantial depreciation. What was alarming, rather, was what markets feared these developments might be signaling – that the Chinese economy was in far worse shape than investors had appreciated, and that the government could not be counted on to forestall the sort of "hard landing" they have long been worried about as China undergoes the inevitable transition from an industrial, export-driven to a consumer, services-driven economy.

That was the fear throughout global markets, anyhow. Two weeks after the surprise August 11 announcement, the S&P 500 had fallen nearly 13% from its record high in May. The market bounced some, then retested its lows in late September. And while the market has since recouped most of its losses and is, as of this writing, narrowly up on the year, nervousness and volatility persist. In assessing our positioning in the current market, we are faced with two critical questions: 1) What is the likelihood we are currently witnessing the dreaded Chinese hard landing, and 2) what would be the consequences for U.S. stocks if the Chinese economy were indeed in a state of something approaching free fall?

Let us dispense with the second question first: If the market's worst fears concerning China are realized in the near term, we would almost certainly see a full-fledged bear market. Those who argue that the U.S. doesn't trade all that much with China and is therefore reasonably insulated from the direct effects of a Chinese economic meltdown do not appreciate the

interconnectedness of the modern global economy. A severe downturn in China would cripple Europe, as well as developing economies, with which we do share critical touchpoints – indeed, the latter are already suffering heavily from low commodity prices and rising debt service payments denominated in a U.S. dollar that has appreciated sharply over the past year – and the weakness would undoubtedly be transmitted to the U.S. through any number of mechanisms: trade, currency, defaults, loss of basic confidence, you name it. A hard landing in China could easily tip the still relatively anemic U.S. economy into recession.

Now for the first question, which is far trickier. Given, among other things, the massive debt overhang China has accumulated since the 2008 financial crisis – some out of necessity to escape the worst effects of the crisis and some from imprudent and inefficient allocation of resources (think vast swaths of empty high rise apartments in many cities) – the transition from an investment-heavy, industrial-led paradigm to sustainable consumption-driven growth was always going to be delicate. But through decades of masterfully directing the Chinese economy along its path of modernization, the Chinese Communist Party had built up a great store of capital with financial market participants, ourselves included. The events of the past year, culminating on August 11, however, have eroded that capital. While, again, a 2% or 4% devaluation does little to change economic reality, the way in which it was handled changed perception a great deal.

All of that said, it is indeed the underlying economic reality, as it is revealed in time, that will prevail over the long term. While it doesn't help that the Chinese economy remains opaque and that official growth figures must be taken with a healthy grain of salt, based on the available evidence we suspect the situation is not as dire as markets had feared. Chinese manufacturing and exports have indeed dropped off sharply and the industrial northeast is almost certainly in out-and-out recession, but consumer spending in general and the services sector in particular continue to grow nicely. (Although as a general rule we do not discuss individual holdings in our letters, it seems appropriate to note here that Apple's just-reported September quarter betrays no evidence, to say the least, of any impact the slowdown may be having on Chinese consumption.) If one is going to paint a bleak picture of towering debt and overinvestment leading to the collapse of the old industrial engine of Chinese growth, then one must also note evidence that the Chinese consumer is in fact picking up the slack – just as the government has planned all along. Moreover, in the event that the Chinese economy is actually slowing more sharply than the official figures indicate, the regime still has a full array of monetary and fiscal policy tools at its disposal. Last week the Chinese cut interest rates for the sixth time since last November and also lowered reserve requirements, but the latter are still rather high at 17.5% and the former remain at a reasonable 4.35%. There is ample room for further easing if necessary. Overall, we are far from sanguine on China, but we also are not convinced the sky is falling. We tend to think the intense pessimism that gripped markets in August and September was for the time being overblown.

Of course, events in China have played out not in a vacuum but rather against the backdrop of the will-they-or-won't melodrama surrounding when (if?) the Federal Reserve will move to raise interest rates above zero for the first time in nearly seven years. The U.S. economy is still far from hale: The labor market remains sickly when one looks beyond the headline figure to broader measures of unemployment (as we've talked about ad nauseam in recent letters), inflation is nowhere in sight, and strong headwinds continue to buffet the U.S. from abroad. But none of that has stopped members of the Federal Open Market Committee – mainly certain regional Fed presidents but also Vice Chairman Stanley Fischer as well as Chairman Yellen herself – from making considerable noise the last several months about beginning interest-rate liftoff. To open with the punch line, we have come to think that such a move would be folly in the near term, and more important we do not see the Fed pulling the trigger anytime soon. If you've been reading our recent letters closely, you'll notice this view represents a change of opinion on the Fed and interest rates. To paraphrase John Maynard Keynes, the father of modern economic theory, when the facts change we must change with them. (Note: This letter is being written before, but will arrive after, the FOMC's October 27-28 meeting. While there's virtually no chance the Fed will actually raise rates at that meeting, it is possible it could insert into its statement more hawkish language that would serve to change our assessment as to the likelihood, if not the wisdom, of a December increase.)

The underlying condition of the U.S. economy has been the subject of numerous prior letters so we will not undertake yet another full exploration of it here. Instead we will examine the interest rate question through the lens of the "secular stagnation" thesis developed by Larry Summers, a highly respected economist and former Treasury Secretary, which we

find compelling. In brief, Summers holds that the Fed follows rather than leads real interest rates, which have actually been gradually falling for decades due to weak domestic and global demand. There are many ways to think about interest rates, but the most basic and often most useful is simply as the price of money. And if one thinks about money just like any other good or service, then it is subject to the same fundamental laws of supply and demand. Summers speaks of "saving" as the supply of money to lend and "investing" as the demand for money to borrow. Over the past couple of decades, there has been a "chronic excess" of savings over investment. In other words, demand for money has fallen way behind supply. And according to the most elemental of economic principles, the outcome of this process can only be for the price of money to fall.

As for what has caused such secular stagnation, very simply, both businesses and consumers will, either explicitly or implicitly, only borrow money at a given interest rate if they believe that they will be able a) to repay the money when due and b) to invest the money, in one form or another, to earn a return greater than the interest rate at which they borrowed it. Put another way, if individuals or companies believe their prospective returns may be lower than given interest rates, they will not borrow money at those rates, and the price of money must then come down to bring borrowers into the game. As Summers argues, this process will play out whether the Fed leads the way or simply recognizes the reality. But if the Fed chooses to *fight* this reality by attempting to raise rates, it will only make matters worse. That is precisely what the Fed did in the 1930's.

In the present environment, the threshold above which both consumers and companies will no longer borrow the quantity of funds available to lend – i.e., the equilibrium rate of interest – is historically low by modern standards. In real-world terms, workers cannot afford to borrow at rates higher than something like their expected rate of wage growth – and, despite steadily falling nominal unemployment, wages remain stagnant. Similarly, businesses will not borrow to fund investment at rates higher than the profits they expect such investment to return based on demand for their products – and overall demand remains sluggish (they may still borrow to buy back their own stock, as we've seen in spades in recent years, but such buybacks ultimately do little for the economy.) The point is that the Fed is not suppressing rates so much as still-feeble economic growth simply has not allowed for real interest rates to go higher in the first place.

Atop this underlying secular environment, we now have to contend with cold, deflationary winds blowing from China, Europe, Japan, and emerging markets. As we wrote about in our last letter, low commodity prices, a strong dollar, large debt overhangs and currency outflows in developing economies, and generally weak global demand paint a picture far more deflationary than inflationary. A rate increase would only reinforce these phenomena, in particular the strong dollar and its impact on U.S. exports. (This is the point at which we would delve into an unrelated and largely positive secular trend that we've been meaning to address – namely, the disinflationary character of many emerging technologies – but we will save that topic for a future letter following a less turbulent quarter.) Add it all up and you have a much greater risk to the downside (recession and deflation) than the upside (overheating and inflation). Inflation hawks at the Fed and elsewhere are busy worrying about the 1970's when really they should be thinking about the 1930's. Extraordinarily accommodative monetary policy helped stave off abject catastrophe in the wake of the 2008 financial crisis, but premature tightening could strangle the still-fragile recovery, just as happened early on in the Great Depression. Furthermore, we agree with those who claim that the strong dollar and the mere expectation of a rate increase have already had a meaningful tightening effect on the U.S. economy. Proponents of getting on with interest-rate liftoff argue that raising rates a quarter of a percent one time and then waiting would do little to alter what would still be extremely accommodative conditions. But, as Summers has demanded, if a 25-basis-point increase wouldn't do much, why do it at all? Even such a "one-and-done" move would risk sending a strong signal as to the Fed's intention to proceed with tightening notwithstanding what many see as a still-precarious economy. Far better, in our view as well as Summers', to be patient.

That is what we think the Fed *should* do, at any rate. What do we think the Fed *will* do? Yellen and company have attempted to have it both ways in the past year by purporting to be "data-dependent" while at the same time providing quasi calendar-based guidance in repeatedly stating they believe it will be appropriate to begin raising rates before the end of 2015. It would appear Yellen has thus painted herself into something of a corner, as the data in our view clearly do not warrant even a minimal rate increase before year-end. It has not helped the Fed's communication problem that seemingly

every day in late August and September a different Federal Reserve branch president went public with a different, often hawkish, view on the economy and interest rates. That said, we cannot imagine Yellen pulling the trigger in December unless she is utterly convinced that it's the correct move, and her prior record speaks to both dovishness and caution.

Moreover, as muddled as the Fed's messaging has been recently, we believe some clarity has lately emerged. The unexpectedly weak September jobs report and other soft economic data the past couple of months have most likely tied the central bank's hands through at least the rest of the year if not beyond, we suspect, barring some very strong numbers between now and then, which we don't anticipate. In addition, in the past few weeks two Federal Reserve Board governors, Lael Brainard and Daniel Tarullo, have openly taken issue with not just the hawks but also the centrists, including Fischer and Yellen themselves. While it is not terribly uncommon for regional Fed bank presidents to engage in open disagreement with the Fed Chair, it is far less typical for other members of the Board of Governors in Washington to do so. So when not one but two such governors speak out regarding their disinclination to raise rates any time soon without real evidence of inflation approaching the Fed's 2% target, it's best to pay attention to what they have to say. Despite strong headwinds from abroad the U.S. economy continues to grow modestly, but it is not yet strong enough to begin raising interest rates.

And thus we arrive at essentially the same conclusion we've reached in each of our recent letters: We remain in more or less the same mode of slow to moderate growth accompanied by very low inflation and interest rates – historically, a quintessentially bullish environment for stocks. Are we somewhat less bullish than we've been, due to the increased risk of a downward shock emanating from China? Yes. But the market has withstood a serious wave of negative sentiment over the last two months and is still standing, having recovered most of its losses suffered in the ongoing growth scare. Ultimately, we do not currently believe the odds of a recession and accompanying bear market are substantial enough to warrant a meaningful move into cash. We suspect the six-and-a-half-year-old bull market may well have life left in it yet. Sometimes one must take the familiar saying and invert it: Don't just do something – stand there.

If there have been any changes in your investment objectives or in your personal or financial circumstances, or if you have any questions or comments, please give us a call.

Sincerely,

Michael G. Hofkin

Benjamin J. Hofkin

(A copy of our disclosure brochure is available upon request.)