July 15, 2016 Second Quarter 2016

To: Customers & Friends
From: Christopher Weil & Company, Inc.

We recently received a letter from a CWC client of longstanding in which he set out his concerns about some of the serious challenges facing our economy. Because I believe his concerns are shared by millions of our fellow citizens I thought it worthwhile to publish his letter (edited) and my response.

I am also reproducing a letter we recently sent to clients setting out the 'official' CWC response to Brexit as well as some personal comments as to what <u>should</u> happen as a consequence.

Dear Chris:

I have a hunch that we are actually in the midst of a profound economic transformation — to a yet to be formulated economic order. And yet, our current economy (and markets) are acting as if it's all still the same, and as things continue to get better we'll go back to the good old days. What are the factors that make me uneasy?

• China is resetting itself, and we don't yet know how it's all going to shake out. There were some warning signs (enough for a whole bunch of people to jump out of buildings), but at the moment they are still able to "fake it" enough to settle us down again, and go on our merry ways. I know this is a pretty big deal, because we have a huge migration of "refugees" from China (folks with money) to our neck of the woods. They buy everything they can. Some move here, others just want to secure their assets. They are genuinely scared about what they see coming in China.

• Internet of Things, robots, IA, Uber-fication: the idea of industrial era jobs and job creation is over. While the employment numbers are looking more positive, too many people are underemployed or have given up looking. And that's never going to change. 35% of people are freelancers, and that number is going to about 50% by 2020.

• The middle class (consuming class) is shrinking. I don't see that changing.

• Global economic turmoil is significant (Brazil, Argentina, China, Europe).

• Add to that terror, environmental degradation, etc. and the conditions of the moment look rather ready for some kind of black-swan scenario.

I am feeling a bit queasy. There are just a lot of things that point in the direction of a massive disruption coming our way. And if I am right, if we are really heading to such a massive rule change, then I wonder: what's the best way to keep what we all have?

Signed "Longstanding Client"

Dear "Longstanding Client":

I am not very good at translating super macro secular changes, the kinds you identify, into specific short-term micro impacts. In fact, I don't think anyone is. I suspect that there is a direct correlation between certainty in these matters and charlatanism.

But, with due regard to the risk of charlatanism, I will give it a try.

You say we are in the midst of a profound economic transformation, which I think is true. But let me remind you that it has always been the case (or at least during the last three or four hundred years) that we (that is, the global economy) have been involved in profound economic transformations. Each has brought huge dislocations (which is econo-speak for huge job losses, huge capital losses and huge shifts in power relationships, national and international). There have been countless profound transformations with which we are all familiar, at least in outline: transportation, energy, exploration (including space exploration), agriculture, infrastructure, housing, medicine/pharmacology, communications, labor relations, etc., etc. We are living today in the midst of transformations, the geneses of which are years or decades or, in some cases, centuries old. What is new is not transformation itself but the pace at which at least some transformations are occurring. (As an aside, the pace of innovation is not the same as the pace of adoption. I will come back to this below.)

And I don't agree with you that our current economy and markets are acting as if it's all the same old thing. Or rather, they are acting as if it <u>is</u> the same old thing if you mean that the process of creative destruction continues unabated. Consider the decline of the coal industry as a paradigm case for the disruption of industries, technologies, products and careers with which current economic life is littered and for the ruthless "adjustments" which have accompanied each. No one in the coal industry is saying "these are the good old days."

Your concerns about China in bullet point one are sensible. China is clearly transitioning from a third or second to a first world country. The "dislocations" are and will continue to be massive. And you're right: no one knows how it is all going to shake out, particularly as the disruptive transition from domestic over-investment and export dependency to (hoped for) enhanced internal consumption plays out. From an investment perspective, we are beyond cautious when it comes to investing in Chinese companies. With that said, however, we are comfortable that the risks and uncertainties of this transition are already priced, however roughly, into the shares of effected enterprises. Our caution is not so much based on price as it is on our ignorance of the cultural, political and economic infrastructure within which Chinese companies operate.

And what's wrong with rich Chinese coming to the U.S. (and Canada and Australia, among other countries)? The fact that they are frightened about "what's coming" in China sounds sensible to me. Most people are not pioneers. Most people prefer stability to instability. And most rich people would rather live in a country characterized by the rule of law than in one where the government might take it into its head at some point to challenge the legitimacy of the process by which personal assets were acquired … and expropriate them.

As to your bullet point two, forgive my being blunt but this consists of large, abstract, sweeping "conclusions" dear to the hearts of economic journalists and commentators that look and sound coherent but from which no specific actions, strategies or decisions can be derived, at least ones that have any resemblance to a cause/effect relationship. One of the reasons for this is that the "conclusions" fail to include whatever "credits" accompany the "debits." We live in a double entry world. There is no such thing as an action without a reaction, a debit without a credit. An example from among your concerns: Uber-fication. One of the consequences (credit) of the Uber phenomenon (debit) is that there are hundreds of thousands of people, generally heretofore underemployed, making additional money as Uber drivers. There are 4,000 such drivers, I just learned, in Portland, Oregon - some full time, most part time. They may not have the same compensation or working conditions as the cab and limo drivers they have displaced – all of that is still a work in progress – but what I suspect this illustrates is that as investors, we should be concerned about net effects and not let ourselves be carried away by contemplating debits only. Of course it is easier to talk about net effects than it is to calculate them with any hope of accuracy, for it may take years, even decades, before such debit/credit impacts can be assessed.

I don't think that going to 35% freelance is the right number but even if it is anything like this there is a corresponding credit. The loss of job security (debit) translates, I think, into what may well prove to be a new and dynamic wave of entrepreneurial activity. Yes, this comes at a cost (what doesn't?) but certainly, in principle at least, employer or self-employed autonomy and self-sufficiency is better for many people than employee dependency. After all, the hope for "being in business for oneself" is very much a part of this nation's DNA. We will see.

Fortunately, we live in an advanced capitalist age. As our economy has matured it has birthed an unbelievable variety of niches that "big business" is unsuited to fill. Ask around among people you know. You will be surprised at the variety of jobs with which they are involved, jobs that didn't exist ten or twenty years ago. For whatever it's worth, I don't think the direct challenge to full employment or under employment is arising or will arise from the Internet of Things, robots, AI, immigrants (legal or otherwise) or the rise of freelancing. In terms of decent compensation, there are plenty of opportunities for the educated (broadly defined) and much less for the undereducated. Income inequality, if you take out the top and bottom 10% or so, correlates pretty nicely with levels of education. So the challenge is "adequacy" of educational preparation (academic, technical, craft and trade).

From all this I hope you do not conclude I am some kind of Pollyanna. I do not deny the pain, the messed up lives, the failed companies, the social upheavals that are and will be endemic. I am arguing that these kinds of transitions are nothing new. It is the task of investment management to pick its way as carefully as possible through the confusion, seeking to identify those companies and sectors that will survive and prosper.

I would say, in response to your bullet point three, that if a goodly percentage of the "35%" you mention in bullet point two manage to make a decent living then, voila, the purchasing power of your "consuming class" will be more or less (and possibly more) restored. And if some percentage of the 35% manage to be sufficiently successful as to actually create additional jobs, then there is even more hope for the restoration of some part of an otherwise diminished middle class. And for whatever it's worth…walk through any city in any country in the developing world and you will be surrounded by evidence (billboards, signs, cars, posters, technology, clothes) of a U.S. commercial and industrial presence. Virtually all of these countries are in the process, some very slowly, others more rapidly, of growing their middle classes. So we should stop focusing exclusively on the U.S. middle class (which may, if the stars align, "heal" itself anyway) and think globally. Whatever long-term losses there may be in domestic purchasing power (and the jury is still out on this) will be dwarfed by the growth of purchasing power worldwide to which U.S. companies will be significant suppliers.

I have written about your bullet point four before and, while I agree, I ask you to compare and contrast (as they used to say on college exams) your examples of turmoil with other "turmoils" of the last hundred or so years. Time passes and memories dim. Nevertheless, compare and contrast your concerns with, let us say, World War I, World War II, the Russian Revolution, the world wide depression of the 1930's, the Atomic Bomb(s), the Cold War, the "Great Recession" and the millions of lives disrupted and damaged thereby. This is not meant to minimize your concerns, just to remind you, me and everyone else who cares to listen that turmoil and trauma are constants in human life. Given a choice between participating in the First World War or participating in the mess that is Brazil's current political and economic condition, the typical Brazilian might well opt for the mess.

Finally, as to your bullet point five, I would include global warming as a component of environmental degradation and say that this is a true existential threat, where "existential threat" means a takedown threat to everything. I suppose, in keeping with the spirit of what I have written herein, I should seek the corresponding credit but, while I know there is one, it seems slow in showing its face. True, there is growing worldwide awareness of the danger but we (people, nations, the world) are still at the front end of policies, regulations and mechanisms that will mitigate or even reverse the danger. But let me give you one tangible sign/symbol/metaphor suggesting that not only are we headed in the right direction but that Divine support is being provided. One of the last CEO/climate change deniers left standing (Donald Blankenship of Massey Energy) has been sentenced to a year in prison. True, the reason for his incarceration is (in human terms) unrelated to his denial, but God works in mysterious ways and it is no bad thing that climate denial and prison are now (however unfairly) associated in the public consciousness.

Well, there is one (economic) "credit" in connection with the plight of the environment that seems obvious but has yet to emerge. To some as yet undetermined degree, much of the planet's infrastructure – its energy economy, its agricultural base and its talent – is going to have to be "re-engineered" to deal with the whole issue of environmental degradation and associated miseries. God knows how long this process will take, and God knows what it's going to take to "master plan" the undertaking. But one certain component of the process, assuming that, globally, sane heads prevail and are successful in getting it kick started, will be job creation on an unprecedented scale. Think Marshall Plan and then scale it by many orders of magnitude.

By way of closing, let me refer to what I said above about the pace of innovation (something that sometimes feels a lot like sweeping change) and the pace of adoption. Most of your concerns relate to "long wave" phenomenon and, if history is any guide, these transformations/changes will play out over years and even decades, giving people, governments, markets and companies the time and opportunity to adjust. Remember, as well, that innovations are not <u>automatically</u> adopted. People, institutions, nations are often slow to adopt/adapt – for reasons of cost, institutional inertia, fear of the new, inadequate investment in any supporting physical/intellectual infrastructure, and so on and on. It likely took thousands of years for dinosaurs to die out even after creatures nimbler, brainier, and generally better adapted to survival showed up.

What all this comes down to is that there are any number of examples where the pace of innovation has bought time to adjust to transformation/change and bought time for generations of the earth's denizens to live out their lives, persisting in their "old ways," even while these old ways of life are in the process (slowly but persistently) of coming to an end.

You seem to bring out the old pedagogue in me so forgive the length of this response. Thanks for bearing with me.

Chris Weil

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Supplement
Brexit Observation

The consequences of the Brexit vote will be worked out over many years, and no one yet can confidently profess a clear understanding of all of its impacts on the international economy. In a way though, for us as *investor-manager-advisors*, responding to Brexit is just "business as usual": we are always in the business of considering how developments in the economy (regional, national, international) are likely to impact our collective fortunes in the near, medium and long term.

As advisors and asset allocators for client accounts, our focus is typically on the medium- to long-term horizon. We are prepared to act more immediately, in view of extraordinary circumstances, but we are very mindful of the risk that emotions rather than facts drive short-term market fluctuations. (That certainly seems to be the case with the precipitous drop and partial rebound following the Brexit vote.) Wearing our client advisory and account manager hats, therefore, the questions we are asking ourselves in the wake of Brexit (and consider afresh on a daily basis) revolve around whether this vote is likely to lead to long-term, secular changes in the global economy that challenge our bedrock assumptions about the advantages of broad diversification in client portfolios, and our belief that, over any reasonable period of time, the value of a diversified portfolio of equities will trend upward as the economy expands (and/or as inflation kicks in).

As for the various funds into which much of our and our clients' wealth has been allocated, it is safe to assume more immediate steps are being taken to respond to Brexit. If we are considering the appropriateness of our overall asset allocations on a daily basis, "business as usual" for fund managers means managing through this volatility on an hourly basis. And while information about the specific buys and sells of the fund managers to whom we allocate (ourselves among them) is confidential until it is reported publicly (usually quarterly), our history and that of our various active managers shows that we can be nimble and opportunistic, working to take advantage of the openings offered by market turbulence (and to side-step the more obvious risks).

While we are not yet convinced that the Brexit vote justifies fundamental course corrections, we can draw some conclusions that will inform our investment decisions going forward. For one thing, world GDP projections are almost certainly going to be adjusted downward in the weeks to come. For another thing, it is already clear that the Brexit vote has accelerated the long-term trend (evident for a couple of years now) of a "flight to safety." Steady income-generating securities (for example, government bonds, dividend-generating equities like utilities and telecoms) were looking expensive before the Brexit vote. Now these "safe havens" are looking positively frothy, with prices (in the case of the utilities and telecoms) generally well beyond what their low or negative earnings growth should reasonably support. To the extent the debt markets were developing something of a "bubble," the reaction to Brexit has made things worse. At the same time, assets that have been cheap (i.e., down) in recent months (international equities and some value stocks) are looking cheaper still and may offer even more attractive buying opportunities as a result of Brexit.

So "business as usual" means watching these developments and weighing appropriate actions carefully and having some degree of confidence that markets, over time, tend to work through shocks like this and revert to long-term means.

All of that having been said, there has certainly been no end of lively debate here concerning the broader economic and political implications of the Brexit vote. So I will share with you my personal - perhaps idiosyncratic - take on Brexit. Enjoy.

Any "authoritative pronunciamentos" (including, perhaps, Prime Minister Cameron's recent declaration that there will be no second U.K. referendum on E.U. membership) are bound to be misleading at best and partisan cant at worst. While I cannot speak authoritatively about what will happen in the coming months in the U.K., I feel reasonably comfortable speaking about what I think should happen. What should happen is that there should be a second referendum and that the "Remain" side should prevail.

Consider the following:

1. In the first week following the vote, some of the most ardent supporters of "Leave" have pulled back from their more extreme campaign promises/arguments. This is symptomatic, it seems to me, of a dawning realization on the part of many Leavers that, in their enthusiasm for a "Leave" vote, they (or those speaking for them) discounted and/or misrepresented the costs of "Leave." My view is that the costs of Brexit are and will be huge and painful to the U.K. And I remind you that the perceived "benefits" ("recovery of national sovereignty" and "immigration control" chief among them) are highly emotional issues which lend themselves to short-term sloganeering, while the "costs" have not been all that easy to quantify and communicate clearly and are, in any event, much longer term in their impacts.

2. It became immediately clear after the votes were counted that an inter-generational conflict has arisen over this issue. 75% of voters between 18 and 24 said "Remain." These folks are not inclined to Leave quietly. There is a developing movement among the Anti-Brexit young, the sense of which might be paraphrased as follows: "We are not inclined to allow a bunch of old fogies to dictate to us how we are to live our lives, particularly when what the fogies are supporting is so clearly against the national interest as well as our own."

3. Scotland has strong economic ties to the E.U. This was evidenced by 62% of Scotland voters who said "no" to Brexit. When the issue of Scottish independence was recently argued (and settled), one of the assurances the Scots relied on was that Britain would stay in the E.U. No doubt the promise was made in good faith, but it is now null and void. The Scots are a strong-minded people. A majority of them feel that they have been twice betrayed. So expect a resurgence of nationalist activism (will Wales and Northern Ireland be far behind?) and expect some deep soul-searching within the English electorate as they contemplate the possible breakup of the U.K. as a Brexit consequence.

4. The complexities associated with the execution of Brexit are mind numbing (the "good" news: thousands of lawyers and bureaucrats will be kept busy and well paid for a decade). As a new non-E.U. member, the U.K. will, among a multitude of other tasks, be faced with negotiating trade deals with more than fifty other nations including the U.S. and China. And it seems unlikely that these deals will be as favorable as those negotiated by the E.U. Why should they be? General Electric can buy furniture cheaper than CWC can. E.U. members can buy cheaper (and sell dearer) by virtue of scale than would be the case of any stand-alone country. (Well, maybe not the U.S. but certainly Albania and a non-E.U. England.)

5. There is no question that E.U. governance can be, to put it mildly, clunky. But the Brexit movement bypassed obvious avenues of reform and proceeded to amputate the foot to cure an ingrown toenail. The vote will, I believe, refocus all parties (even some of the Leavers) on serious reform opportunities (particularly in the areas of immigration and over-regulation) as an alternative to a concluded Brexit.

I could go on but you get the point. In a rational world (a world characterized by prudence, common sense, economic reality, competent governance), a second referendum would be a no-brainer. (Of course, in a rational world, Brexit would never have arisen.) I think there is a strong and obvious case for a second referendum and, while I have no knowledge of what will happen, I am comfortable, as I noted above, with my claim of what should happen.

Brexit is one of many crises that impact the markets through which CWC and other investment managers must navigate. There will certainly be volatility for some time, presenting some risk analysis challenges and investment opportunities. But we continue to believe that quality equity securities - domestic, international and global - are a vital component for total return in an investment portfolio over the long term.

Chris Weil