Grisanti Capital Management

July 8, 2013

Dear Clients and Friends of Grisanti Capital Management:

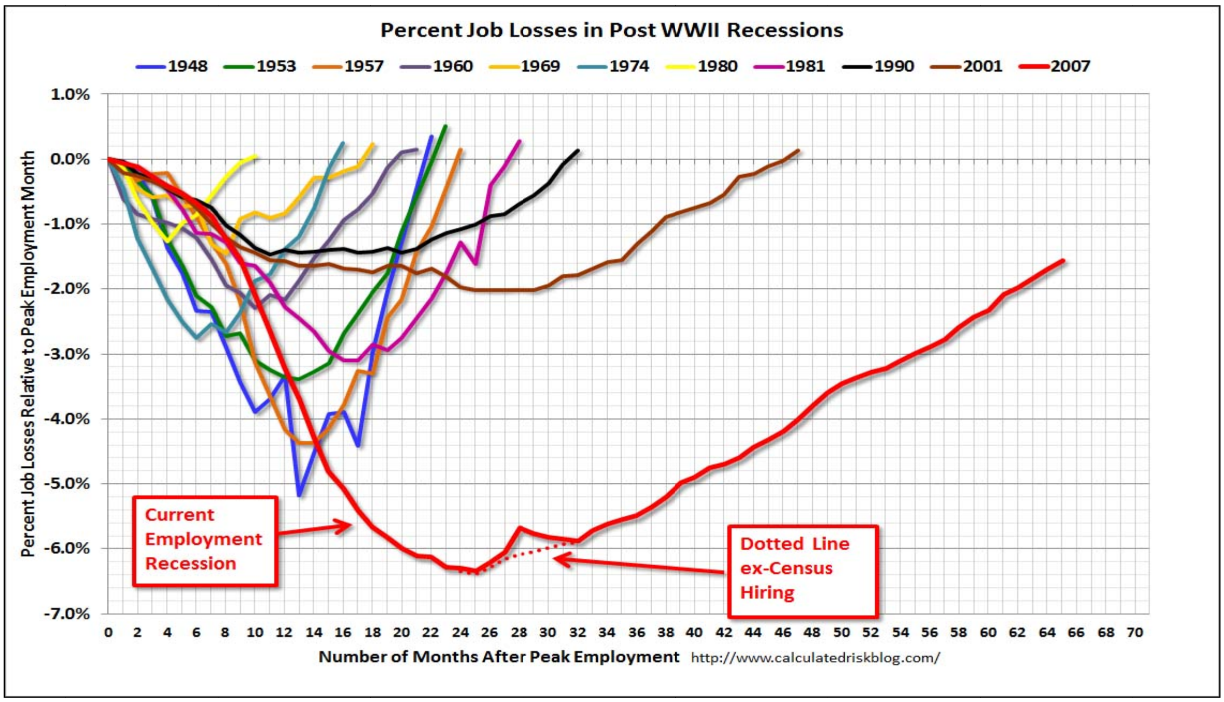
The second quarter of 2013 was the most consequential since the financial crisis. It was also exceptionally perilous, as investments labeled "safe", like government bonds and certain high dividend stocks, sustained significant losses. Alternatively, those investments seen as "risky" since 2008, like financial and auto stocks, flourished. The proximate cause of all this apocalyptic behavior is that interest rates are finally rising, and they did so with a vengeance in the second quarter, spelling bad news to all segments of the fixed income market. The yield on the 10-year US Treasury bond rose from 1.61% to 2.66%, an astounding 65% increase. Mortgage rates fared even worse than government bonds, and the Barclay's aggregate bond index (a widely followed benchmark of corporate, mortgage and government bonds) suffered its worst loss in more than a decade. All this occurred on speculation that the Federal Reserve may begin to taper its aggressive monetary stimulus, a rumor that the Fed did nothing to dispel. We believe this "taper tantrum" is the first salvo in what will be a multi-year evolution to a higher interest rate environment. Years from now, we believe the second quarter of 2013 will be remembered for the death knell of the 31-year bull market in bonds.

This turning point is of great consequence not just for bond investors, but for equity investors as well. We believe that the end of the bond bull market means the start of a multi-year preference for equities that we haven't seen since 1999. This letter sets forth our short-term frustrations with the quarter, but more importantly it spells out the various opportunities this new paradigm presents going forward.

It is one of Wall Street's recurring mysteries that no matter how many pundits are making investment forecasts, higher interest rates still come like a thief in the night, taking everyone by surprise. Rates rise without warning and the effect is dramatic. The recent move has temporarily stopped the equity market's rally, with June being the first down month of the year. **But we believe that the interest rate fears that caused the recent pullback have actually created a buying opportunity in equities.** We have three reasons for this optimism.

First, while the market is alarmed that the Federal Reserve may slow its stimulus, the entire reason for the curtailment is that we may not need it anymore. The U.S. economy is finally getting over the shock of the massive financial crisis and is producing the best economic growth in five years. **That is exceptionally good news for equities.** The biggest positive change is in housing, where prices are finally starting to rise and inventory is dropping sharply, but unemployment, manufacturing and consumer spending are improving as well. The **second** reason that equities need not fear the Fed is that a slowing of stimulus (which we think may happen in the Fall) is not the same as the Federal Reserve hiking short term rates, which we believe is significantly further off. It is simply slowing down the unprecedented amount of monetary accommodation, not putting on the brakes**. Finally,** we can all argue whether Chairman Bernanke's dovish stance towards accommodation (e.g., creating QE1 and 2 and 3 in order to spur economic growth) was the right approach, but everyone agrees that *dovish* is the right adjective. He has said time and again that unemployment must come down, that massive accommodation is necessary, and that inflation is under control. That leads us to conclude that if there is the slightest signal that the slowing of stimulus is hurting the economy, the accommodation will resume (QE4?), as it has in the past.

We believe the path forward is one of further economic recovery. The following chart shows that the current recovery lags all other post-war comebacks by a wide margin, at least by one important statistic: regaining the jobs lost since the previous recession. In many ways, this chart is like a Rorschach ink-blot test: some see a broken system, not healing as well as it used to; others see



downside ahead because enough time has passed for another recession to start; but we see (at long last) the growth and opportunity that comes with financial healing after a disruption so severe it took five years to get back on track. We've already lived through the five long years of sub-par employment and paid the price in slow earnings growth and a stock market that has only just returned to highs set in both 2000 and 2007. (In our last letter we wrote about the 13-year dry spell.) Finally, the recovery seems to be gathering steam. The unemployment report released on July 5th, as we were writing this letter, showed continued strength. Your portfolio is poised to take advantage of continued recovery.

Of course, if QE3 is the last dose of this unique (and rather frightening) stimulus medicine, that begs the question of where we go from here, and what effect rising rates will have on our investments. Historically, the end of interest rate declines has been a *good* time to be an equity investor. In the last four interest rate cycles (1988, 1994, 1999 and 2004), the Fed stopped lowering rates and the equity markets performed strongly in the following six months. This is not rocket science: As mentioned above, rates stop dropping because the economy is improving and that's a favorable environment for owning shares of a profit making enterprise (as opposed to owning a fixed income security). What makes 2013 different is the magnitude of the changes. Interest rates were driven so slow by artificial means (count your QEs), that a reversion to market interest rates will require a large increase (especially on a percentage basis). Further, it will take time and cause a great deal of pain for fixed income investors. There are millions of investors waking up to the fact that the bonds they relied upon for both income and security are losing value fast and will probably decline a great deal more as rates continue to rise. The trickle of funds switching from bonds to stocks has become a stream, and, we think, will soon be a wide river. ($30 billion moved out of bond funds in the last *week.)* For the first time in thirteen years, investors are favoring equities by a wide margin, and those trends tend to last for multi-year periods. With the resurgence of economic growth, value investing – buying companies that have been hurt by the financial crisis – should be in a particularly advantageous position.

Portfolio Review

As you know, we manage a concentrated portfolio, and our results will differ from the markets from quarter to quarter, often by a wide margin. That divergence is what has allowed us to significantly outperform the market since 2000 (Grisanti Capital up 89.7% net of fees; S&P 500 up 40.4%). But in the second quarter, we were down about 3% with the market up about 3%[1]. **The primary reason for this frustrating performance was the decline of our refining investments.** In an up market, that portion of the portfolio was down 12% for the quarter. **While this is frustrating, in light of our research on the American Oil Renaissance, we continue to believe strongly in the investments.** Last year they were terrific performers, and we believe they are suffering a short term slump brought about by the narrowing of the spread of the price of domestic oil to European and Arabian oil. (Since February the spread has declined from $21 to $4.) We believe this trend has run its course, and will start to reverse as we head towards 2014. **But this is complex analysis, and rather than set forth the detailed case here, we have included a separate memo outlining the case for the refining stocks. We urge you to read it so that you will feel, as we do, that our energy investment is not only sound, but offers great potential, especially in light of this quarter's setback.**

Our investments remain up for the year, due to the non-energy companies that make up the bulk of the portfolio. Our largest single investment, **Ford**, was also our best performer for the quarter (up 18%) and is now up 51% since purchase last September. We think even better days are ahead for Ford, as European losses are masking enormous earnings power at the moment, just as the US division achieves record gains. If Europe simply losses *less* money, Ford should perform well. In addition, the financial sector continues to lead the market forward. Our large holdings of **JP Morgan** and **Morgan Stanley** are up 9% and 8% respectively for the quarter and about 15% for

[1] In spite of this divergence, we remain in positive territory for the year, and since the market low in October 2011, we are up 53.7%, slightly ahead of the S&P 500 Index (up 51.8%). These figures represent the performance of the Grisanti Capital Management Large Cap Value composite. Your portfolio's specific performance is included with this letter.

the year. We believe that the healing of the financial markets will continue. In addition, the recent rise in long-term rates is actually good for the banks, provided that short term rates remain low. The steeper yield curve (low short term rates, higher long term) allows them to borrow (via deposits) at almost nothing, and lend at higher rates (think higher 30-year mortgages). For the first time since 2007, lending money can be a good business again.

For that reason, in June's pullback, we added **Citigroup** to our financial investments. Its new CEO (Michael Corbat) is a banker in the John Reed/Walter Wriston tradition at Citi, and we believe will focus the company on its core businesses, which include an exceptional international presence. This is a departure from the recent leaders like Sandy Weill or Vikram Pandit, whose background was not banking and who led the company in a myriad of different directions. Like Morgan Stanley, we purchased Citi below book value, and think it should trade at a small premium to book. Further, book value ought to grow over the next few years, leading to an expected return of over 50%.

In closing, after the recent interest rate scare and the market's decline in June, we have found attractive investments and are now fully invested. That is not a "market call", at least not in the short term, but it is consistent with our belief that the US economy is finally getting stronger and has created long term opportunities. With this backdrop, we believe the two most important ingredients for profitable equity investing – earnings growth and reasonable valuations – are present in our portfolio companies. We are excited about the second half of this year, and are confident we are positioned to take advantage of the market ahead.

Very truly yours,

Christopher C. Grisanti