



Grisanti Capital Management

July 12, 2016

Dear Clients and Friends of Grisanti Capital Management:

For the second year in a row, a European referendum dumped cold water on the second quarter. At the end of June last year, the Greeks voted to reject an IMF bailout. This year, with a week left in the quarter, the British defied both the oddsmakers and the financial markets, casting their ballots to leave the European Union (Brexit), sending stocks down sharply. Still, the quarter was far from a washout. Your portfolio is conservatively positioned, and navigated Brexit well, barely down at all that week, and up about 2% for the quarter. We lagged the market slightly (about 0.5%) in the quarter due to our large cash position, the rationale for which is explained below.

Before we get to more pressing investment issues, first a few words on Brexit: We believe Brexit was an event similar to, say, the Soviets launching Sputnik: clearly consequential, negative on its face, but with long-term implications that are far from clear. (After all, because of Sputnik, a man walked on the moon.) Brexit does, however, have near-term consequences for U.S. financial markets in three ways, none of them good: First, as Britain's financial system is disentangled from the EU, it will slow the European economy by some small but material amount and put upward pressure on the U.S. dollar, hurting U.S. multinational businesses. Second, it will probably be negative for business and consumer confidence in Europe and perhaps elsewhere. Finally, it introduces the idea that an improbable, anti-establishment outcome can shock the governing elite in a national election, leading to uncertainty as November approaches.

While negative, we don't expect Brexit will be the main factor affecting market performance in the second half. That's because, even without the effects of Brexit, we are seeing evidence of a global slowdown, even as the market made new highs in the beginning of July. For this reason, we have taken gains in several long-term investments, and are holding the resulting cash in expectations of more volatile times ahead. This cash position allowed us to protect capital during the Brexit vote. For example, for the period from June 20 to June 28 (the Brexit vote was June 23), a week of great up-and-down turmoil, the market was down 1.66%, with your portfolio down 0.15%. We are not expecting Armageddon ahead, but we are looking forward to taking advantage of volatility like this to make strong, long-term investments at good prices. We do not think the current market, as it hits new highs, is discounting the risks we describe below.

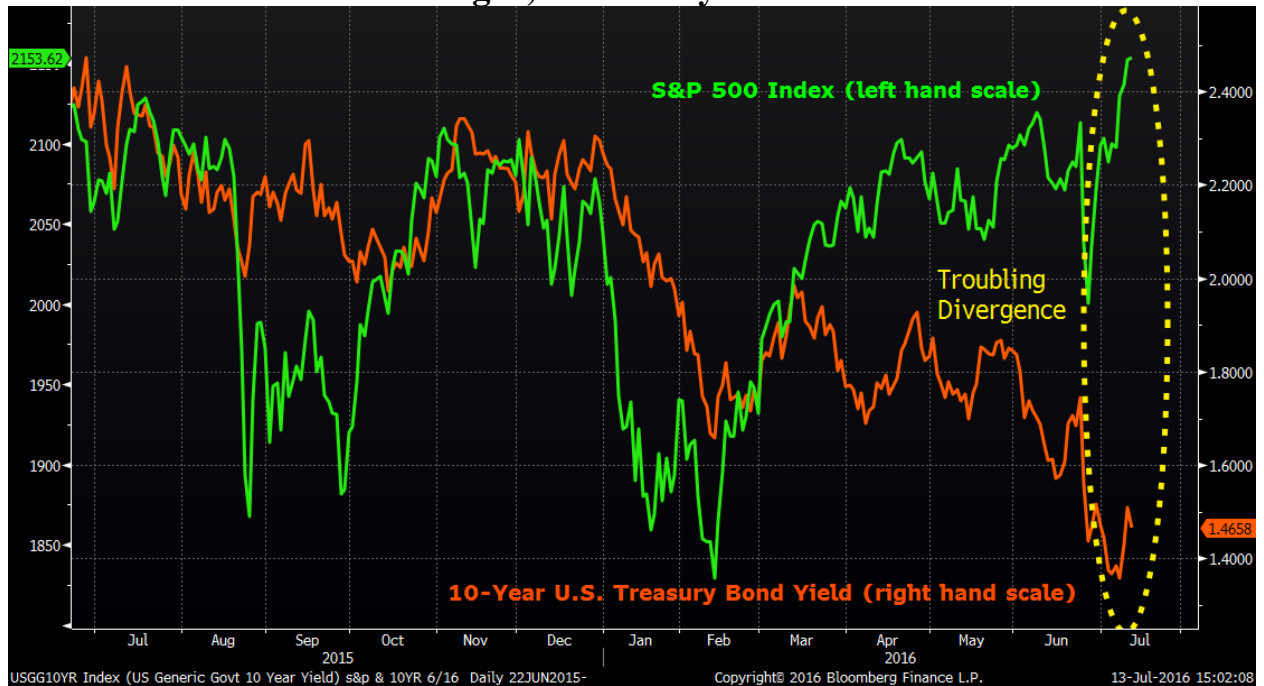


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There are a number of negative indicators right now: declining corporate earnings, slowing employment (while the June jobs report was good, May's was the worst in four years, and the six month average has clearly slowed), falling industrial production, not to mention Brexit. What has us most worried, though, is the market barometer that captures all these things: ever-lower interest rates. Usually higher interest rates are a bad thing for stocks. But now, when clients ask, in fear, whether the Fed will raise rates, I answer that I sure hope so. What I mean is I wish we were experiencing the conditions that would warrant higher rates – stronger economic growth, full employment, wage growth, even some inflation. If we had those things, slightly higher interest rates would be a small price to pay.

Instead, bond yields head ever lower. To us, this signals a worldwide fear of slowing growth and possible deflation, not a good backdrop for equities. Worse, there is a severe disconnect between the recently rising stock market and record-low bond yields. **The chart below shows the market (represented by the S&P 500 Index) and the 10-year U.S. Treasury yield.** As the market plunged in the fall, and then again in the winter, so did bond yields, as both seemed to predict a slowing economy. That's the normal correlation. As the market rebounded in March, so did bond yields. Again, as expected. But then something happened that we find troubling: Yields started to drop again, even as the market approached new highs. This week (early July), the 10-year yield fell to a *record low* of just 1.38%. Yields in Germany, Switzerland and Japan are all *negative* (i.e., bondholders in those countries pay the government to own their bonds).

Something's wrong with this Picture: Market nears record highs, but bond yield hit record lows





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The stock and the bond markets are sending two very different messages, one of strength, the other of weakness. Some people might say a higher market is a natural reaction to the economic stimulus that lower yields will provide in the future. The argument is that business and consumers can now borrow at (even) lower rates than six months ago, and this will spur economic growth. Maybe. But we think that seven years of low rates have fostered little in the way of growth, and that ever-lower bond yields are a sign of pushing on a string rather than green shoots of growth ahead. We don't doubt that higher rates would be worse, but the question is whether record low rates will bring about decent growth. With earnings and employment slowing, we think the answer is no.

Of course, at the end of the day, it's our job to make money in the equity markets. As the old saying goes, it's not a 'stock market,' but a 'market of [individual] stocks' and it is possible to find value, even in an otherwise vulnerable environment. To stress this point, it's illustrative to revisit stock market and GCM performance in the 2000-2001 period. During that time, the market rolled over sharply (down 28%), while our portfolios were able to climb 20%. Stock selection becomes crucial in a turbulent market. We are holding cash now, but we will use it to invest in sectors and specific companies that can appreciate in the uncertain times ahead.

One of these sectors is energy. There is a great deal of research underlying our new oil and gas investment, but it can be summed up by saying that energy has already had its bear market and we are picking among the ruins to find value. When we made our investment in February in **Devon Energy**, for example, the stock had already declined 75% from its highs of two years ago. Our investment decision depended on a reversal of the strong growth of oil production in the U.S., which was weighing on oil prices. Earlier this year, production finally started to decline, and we invested in three investment grade, well-managed oil companies. Since then oil production has continued to fall, and the weaker oil companies cannot afford to drill any more holes. The quickly depleted shale wells are drying up, and, as production falls further, prices are rising. It will not be a straight line, but oil prices have risen about 85% since their lows in February, and we have invested in **Devon, Chevron, and EOG Resources**. All have done well since purchase, with Devon leading the way, up 78%. In addition, we have sold all our investments in the refining sector, which we held for almost five years. It was a tremendously profitable sector for us, but now, with oil prices rising and refiners caught with extra gasoline and diesel, profit margins are suffering. The value proposition in energy has definitely shifted back to the producers.

Another sector we think can succeed in a turbulent market is healthcare, where earnings should be protected from an economic slowdown. Healthcare was the best performing sector in the portfolios during the quarter and also year-to-date. We are seeing strong returns from recent investments in Labcorp (up 22% since initial February purchase) and Pfizer (up 9% since initial May purchase), and also from a long term holding in Medtronic (up 16% year-to-date). We have tried to focus on those companies that are sheltered from government scrutiny on pricing, and in fact we believe some of our investments will benefit from the move towards increased health insurance coverage: more coverage means more prescriptions filled (**CVS, Allergan, Pfizer**), more pacemakers installed (**Medtronic**), and more blood tests completed (**Labcorp**). Allergan we find especially intriguing because it is poised to sell its generics business in the third quarter



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for \$40 billion, a transformative transaction that can serve as a catalyst for our investment, even in a difficult market.

In addition, individual ideas, like **Chubb** (up 7% since initial April purchase), an insurance company that just merged with ACE Limited, represents an attractive opportunity to enjoy merger synergies and strong management at an attractive price. This company is in the financial sector, which could suffer more than most in a downturn, but insurance is safer than banking, and we believe the merger story will provide a strong tailwind of earnings growth. **Time Warner** (up 19% year-to-date) is another company-specific story, with great content (e.g., HBO, Warner Brothers, CNN in an election year) that can buck the trend of a declining economy, especially at its current valuation of only 12 times next year's earnings (a 17% discount to the market, while earnings are growing at twice the market rate).

We find comfort in the fact that only two of our current portfolio holdings are down for the year (and those two stocks are long term financial holdings Morgan Stanley and Mastercard, which are up 97% and 30%, respectively, since initial purchase). The best way to outperform the market over time is to protect capital when there is market volatility. We believe we no longer have the tailwind of a growing economy. For the moment, we are in period where we need to be more patient in finding investments. We are confident we will find money-making ideas in the upcoming months, but we will also use your capital judiciously, mindful that there is a time to reap and a time to sow.

Very truly yours,

Christopher C. Grisanti