

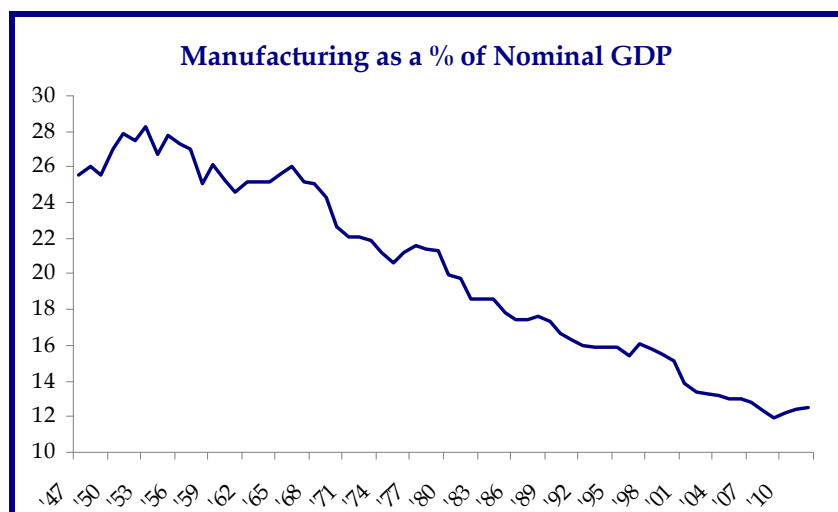
SAYBROOK CAPITAL

INVESTMENT OUTLOOK

First Quarter 2014

We wrote an expansive essay in the spring of 2012 addressing changes in North American energy production and the potentially positive impacts on the economy. We described how advanced technologies were reversing long domestic declines, and the U.S. was growing less reliant on petroleum imports and even experiencing a glut of natural gas. At the time, we felt the long-term trends were favorable, not just for energy companies, but also for broader U.S. industry that benefits from stable supplies and for the overall U.S. economy needing new economic drivers on the heels of the Great Recession. Two years later, these ideas have become reality, symbolized dramatically in late 2013, when domestic petroleum production exceeded imports for the first time in two decades. Today we are “doubling-down” and predicting that America is on the cusp of an industrial revitalization driven by a unique combination of forces, including energy supply, technological innovation, productivity efficiencies, and other competitive advantages. In this letter, we step back from analysis of the stock market and Saybrook’s portfolio companies to take a look at changes to the U.S. manufacturing sector and the accompanying benefits and consequences for the economy as a whole.

Our peers in the financial and energy businesses were skeptical of our bullish views on natural gas two years ago, when energy companies were abandoning gas projects in the face of \$2 per million British thermal units (mmBtu) prices and gas producers’ stocks stood at 52-week lows. Now, following the coldest winter in memory and heightened talks of LNG (liquefied natural gas) exports as a foil to Russian threats in Europe, prices have more than doubled to \$4.75/mmBtu and gas shares have surged (Southwestern Energy, our pure-play gas producer, has enjoyed a 75% stock price increase in the last two years). We cited potential changes in domestic consumption – most notably conversion of coal power plants to natural gas. We also highlighted U.S. gas’s potential impact on the global economy – both as LNG is *exported* to foreign markets, such as Japan where prices are \$16/mmBtu, and as industry is *imported* to the U.S., attracted by our growing supply of natural resources among other important attributes. It is that increase in domestic manufacturing that has us most excited for the U.S. economy and has caused us to look closer at this growing phenomenon.



Strategas Research Partners

Comparative Advantages for U.S. Manufacturing

In the halcyon days of the post-war U.S. industrial boom, manufacturing peaked at 28% of GDP and 38% of employment. We are under no delusions that those days have returned. Manufacturing, while still growing in absolute dollars to a current record \$2.3 trillion in annual output, has declined in its contribution to overall economic growth and employment. The relative drop in domestic manufacturing has been influenced by overseas competition (first Japan, then China), the growth of the non-manufacturing sector (services such as healthcare, finance, retail, and education), and (on the jobs side) automation. Only in the last two years have we seen signs that this trend may be reversing. We believe this is the beginning of a new renaissance in American manufacturing, driven by several significant comparative advantages:

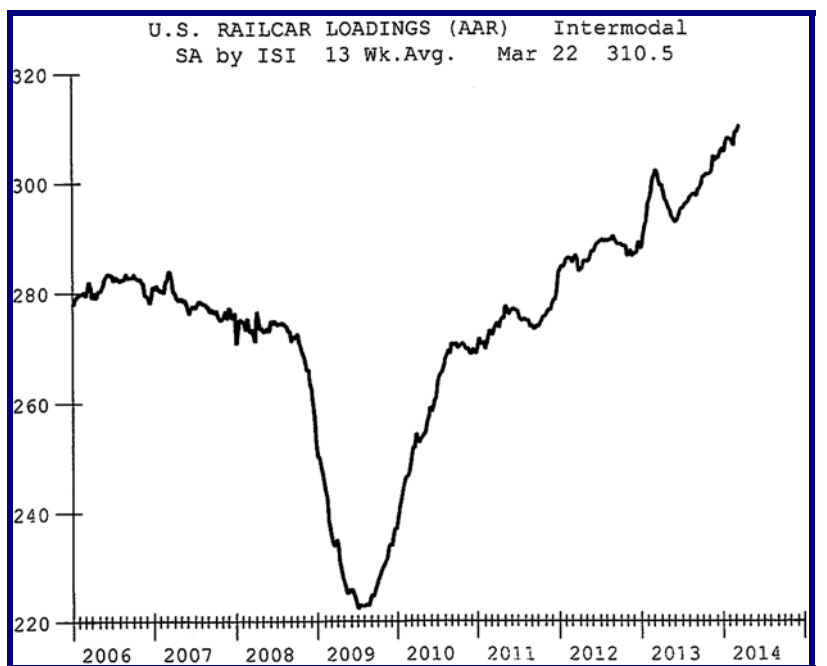
- The aforementioned surge in North American energy supply is driving companies to locate plants near plentiful raw material feedstocks, transportation links, and lower-priced power utilities.
- U.S. research and development and technological innovation are the envy of the world. New products are being developed around 3-D printing, material sciences, robotics, drones, renewable energy, medical devices, mobile connectivity, and nanotechnology, etc.
- Design-production flexibility and proximity to end markets are increasingly important when manufacturing high-value goods. Given the precedence of design, engineering, and marketing, Apple's iMac and Google's Glass are now designed and *assembled* in the U.S.
- As manufacturing has become more automated, many physical and repetitive tasks have become obsolete. Assembly line labor as a percent of total costs has declined, reducing the prime reason for outsourcing.
- The U.S. remains the world's largest consumer of finished goods. And, helped by 20 years of integration with Canada and Mexico via the North American Free Trade Agreement (NAFTA), American-made products are well-positioned for many end markets.
- Productivity and labor flexibility make U.S. a more attractive market for hiring than Europe. Unit labor costs in the U.S. are 25% lower than industrial juggernaut, Germany.
- China and other emerging markets face serious challenges. Escalating labor costs, poor infrastructure, low productivity, slow and expensive supply chains, currency volatility, and weak intellectual property rights all lessen the benefits of moving production of high-value goods to China.

Early Signs of Domestic Industrial Strength

This sea-change is in its nascent stage, as illustrated on the chart on the previous page. Traditional macro-economic measures, such as the Institute of Supply Management's Manufacturing PMI Index and the Labor Department's monthly job figures, show continued moderate expansion, hardly the dawn of a new industrial era. However, we do see promise in some regional data. Certain industries, such as chemicals and engineering, are rapidly "reshoring" to areas such as the Gulf Coast, taking advantage of access to natural resources, skilled labor, refineries, and transportation and pipeline hubs. According to the Philadelphia Federal Reserve, nine of the ten

fastest growing states are in the energy/manufacturing belt; they include oil and gas stalwarts like Texas, but also rebounding rust-belt states like Ohio and Michigan. Economist Nancy Lazar has recently called “Middle America” her favorite “emerging market,” citing a swath of counties stretching from the Dakotas to Louisiana and as far as Pennsylvania, which have experienced above-average growth in family median income since 2007.

Railroads serve as a broad and timely economic indicator that is not limited to certain high growth regions. The below chart shows accelerating intermodal railcar loadings (+10% from last year), reflecting broad manufacturing, energy, housing, and agricultural activity. This is a positive sign for U.S. industry as a whole and specifically for our rail holdings, including Norfolk Southern and BNSF, a subsidiary of Berkshire Hathaway.



International Strategy and Investment Group

Anecdotally, we see evidence of a manufacturing resurgence in companies big and small. In 2013 we flew out to Ohio to visit management of Emerson Electric and tour their plant that assembles and services back-up power systems for data centers throughout the Western Hemisphere. In a time of high-profile power failures on cruise ships and the Super Bowl, Emerson’s products are essential to an increasing number of industrial customers. Technicians at this location also remotely monitor and diagnose the company’s installed systems world-wide. Management cited a skilled workforce, engineering R&D, and proximity to end customers as reasons why this plant is domestically located. GE head Jeff Immelt shares this view, calling outsourcing “yesterday’s model,” citing GE’s return of appliance production to Kentucky from China and the company’s new engineering center in Michigan. We were disappointed not to don hardhats for Emerson’s factory tour, but perhaps the eye-protection, tight security, and impeccably clean factory floor are emblematic of a more sophisticated industrial age.

On the small business side, we recently met with Justin Lukach, President of Micromold Products, a Yonkers, NY maker of industrial pipes, valves, and filters. His customers, primarily U.S. chemical companies, are expanding rapidly to take advantage of cheap and plentiful natural gas. Mr. Lukach cited the over 100 U.S. factories currently under construction that will employ over 500,000 workers. His company benefits on the top-line from increased orders and on the bottom-line as their products, constructed out of plastic and other resins, cost less to

manufacture. They employ 25 workers today and look forward to expanding as demand increases. What these thriving businesses, from Fortune 500 to privately-held, have in common is a requirement of skilled workers to fabricate their sophisticated products, a hunger for a steady supply of raw materials, and the importance of a short supply-chain to their customers. Not every manufacturer fits these criteria, nor do we anticipate garment-producers reshoring their operations from Asia back to the Carolinas; however, we expect these examples to represent the type of high-value manufacturing that can thrive domestically.

Risks and Unintended Consequences

As with any major economic inflection point, there lie challenges, entrenched interests, and potentially negative outcomes. First, in the near term, it is likely that further industrial growth could contribute to a “growth scare” prompting a surge in interest rates and fears of inflation. We do not expect a smooth transition from our stimulus-driven sluggish recovery to a more vibrant expansion. As seen most vividly in 1994, a spike in interest rates can severely disrupt the bond market and also lead to a correction in stocks. While it would not be without inevitable fear and panic, ultimately a 10-20% stock market correction and return to a more normal growth and interest rate environment would represent a buying opportunity and eventually be positive for investors.

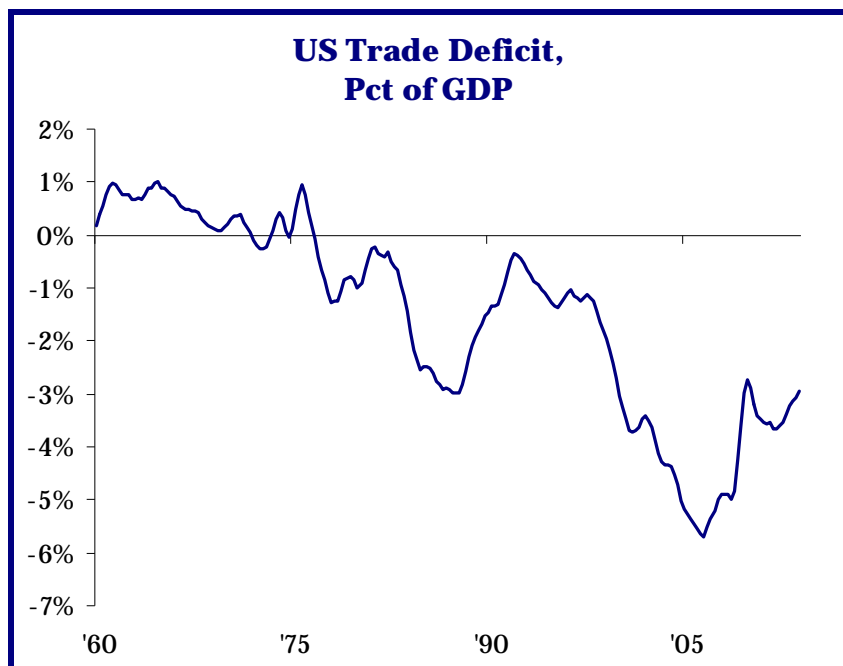
This manufacturing resurgence could falter; its success is no foregone conclusion. Unexpected changes in commodity prices or geopolitical crises that reduce the appetite for free trade are two potential stumbling blocks. Failing urban schools, a lack of emphasis on STEM disciplines (science, technology, engineering, and math), and restrictions on visas for skilled workers limit the supply of labor to meet this manufacturing demand. Governments and lobbyists protect existing industries and companies with subsidies at the expense of new, potentially disruptive, innovators. U.S. tax law disincentivizes hiring and domestic profits, effectively favoring automation and encouraging corporate cash to remain overseas. Finally, in a country where we revere manufacturing *in the abstract*, hardly anyone welcomes the idea of a chemical plant, fracking well, or export terminal in their proverbial backyard. If this manufacturing transformation is to expand beyond a regional phenomenon, our elected officials must rise to meet this growth opportunity with sensible regulation and cost-benefit analysis, as well as ambitious immigration, tax, and education reform.

The greatest concern is that any jobs saved or gained in the revival of domestic manufacturing will be lost as factories become more automated and whole industries are replaced by new technologies. Recent *Economist* article, “Rise of the Robots,” and insightful book, *The Second Machine Age*, discuss the understandable fear of workers being left behind as machines replace not only physical labor but also cognitive decisions. When asked how he would prepare for a chess match against IBM’s Deep Blue, Dutch grandmaster Jan Hein Donner replied that he would bring a hammer, echoing the frustration many harbor in a world of technology. Indeed many argue that automation and innovation have already created long-term underemployment and stagnant real wages. The same pessimism reigned in the 1930s when John Maynard Keynes urged that “temporary phases of maladjustment” often occur before society eventually realizes the benefits of productivity. The history of the last three hundred years from the steam engine, the automobile, and the mechanized tractor to the word processor and the internet shows periods of technological upheaval, societal resistance, job dislocation, and eventual economic realignment, as economies have progressed from subsistence farming to industry to information technology. In fact, nearly all human advancement in life expectancy, democracy, and scientific achievement has paralleled this

path of productivity. And, while it has not been without individual losers (e.g., the horse-and-buggy driver who does not evolve to a new career), mankind has inarguably benefited as productivity has generated wealth, which has created demand for new products and services, which, in turn, leads to new jobs. This time *could* be different, but that argument refutes all evidence of past centuries of progress and improvement for humanity. New jobs will certainly look different from the last generation, and certainly those, like engineers, whose talents *complement* computers, are better positioned than those whose skills are *replaced* by computers, such as travel agents. This debate is far from over, and Keynes' optimistic theory is surely being tested, but we continue to foresee a more prosperous and thriving economy ahead.

Broad Benefits of Manufacturing Growth

If this new era of energy and manufacturing continues to take hold, it promises positive geopolitical consequences. Increased export manufacturing is already beginning to improve the long moribund trade deficit, which stabilizes the dollar and stimulates overall economic growth. With an abundant product mix of natural resources and manufactured goods available for export, the U.S. becomes an attractive trading partner, opening up heretofore protected markets to bilateral trade, which benefits the economy and international relations. Japan, for example, has long been resistant to free trade, but the thirst for U.S. LNG has the potential to loosen Japan's protectionist grip on agriculture and the auto industry. Furthermore, domestic energy and manufacturing could reduce the West's dependency on current, less savory foreign sources that are marred by corruption, revanchism, sponsorship of terrorism, and inhumane working conditions.



Strategas Research Partners

While recognizing the difficult adjustment for some trades, we are still optimistic that growth in the energy and manufacturing sectors is a net *benefit* to the beleaguered American middle class. Expanding the domestic economy beyond financial services and residential construction, industries which have dominated recent decades,

will strengthen the sluggish recovery. While “new economy” pursuits such as writing software code and investing venture capital have created wealth among the most educated, growth in the more industrial sectors promises a broader expansion. According to the National Association of Colleges and Employers’ annual survey of recent graduates, the bachelor’s degree currently collecting the highest starting salary is petroleum engineering, with the remainder of the top-ten filled with other engineering and logistics majors.

The benefits reach beyond management levels as demand increases for technicians, line supervisors, and machinists. Manufacturing today is less the “smoke-stack” industry of yore, and a higher range of skills is required with less demand for repetitive tasks. A decade ago, for instance, metal-working was seen as a dead-end job, victimized by outsourcing. Today, demand for trained welders has surged with employers such as Caterpillar and GE scrambling to find workers who can fabricate metal and alloys to assemble heavy machinery and jet engines. Now we are starting to see evidence of growing interest in training and vocational programs in high schools and community colleges in order to meet this new demand. Economists cite the high multiplier effect on the manufacturing side of the economy, i.e., industrial activity demands raw materials and transportation, and each of these tasks also require labor which leads to consumer spending and housing which then leads to more manufactured goods. While still in the early innings, we are optimistic that this manufacturing boom has the potential to expand the breadth of economic growth and prosperity in America.

We are excited about this burgeoning development in American manufacturing and believe that opportunity exists across the U.S. equity landscape, beyond just core industrial companies. Saybrook’s portfolio is exposed to nearly all elements of this promising trend, including capital goods, technology, infrastructure, aerospace, railroads, oil and natural gas, payroll processing, and packaged goods. A strengthening American economy is, of course, bullish for U.S. stocks as a whole, especially as domestic growth rates begin to look favorable compared to emerging markets which have attracted so much investment capital in the last decade.

Others are starting to share this constructive view, as we learned last month when we were fortunate to have an audience with General David Petraeus, former Director of the CIA and Commander of U.S. forces in Iraq and Afghanistan. After frightening us with his sobering remarks about the dangerous and destabilized world in which we live and invest, he pivoted and cited North America’s remarkable advantages. Echoing our thesis, he highlighted population growth, an openness to legal immigration, world-class higher education, sophisticated infrastructure, NAFTA integration, bountiful energy and agricultural resources, a healthy distance from the world’s security hotspots, labor flexibility, the rule of law and property rights, and, of course, manufacturing and information technology prowess. He closed by assuring us that these positive forces far outweigh our challenges and that the “Chinese Century” may not be here after all.