SAYBROOK CAPITAL

INVESTMENT UPDATE

June 30, 2013

U.S. stocks pulled back somewhat in June, posting their first monthly decline since last fall, but the sharp sell-off in bonds, gold, and emerging market investments was the real story of the second quarter. While the S&P 500 finished June 4% below its all-time closing high, the normally stable Barclays Municipal Long Bond Index has fallen over 5%, and more dramatically, gold prices and the MSCI Emerging Market stock index have both tumbled (down 29% and 17% respectively) from their highs this year.

The recent sell-off was triggered, to a large degree, by Fed Chairman Bernanke's recent statements that expansive monetary policy may begin to "taper" later this year. The prospect of the Fed unwinding its extraordinary efforts at monetary stimulus, known as quantitative easing, sent interest rates higher, with the yield on the 10-year U.S. Treasury bond rising from a low of 1.6% on May 2nd to 2.5% at June 30th. The good news implied in Bernanke's comments is that the Fed sees the economy getting stronger, and importantly, they will only begin to reduce monetary stimulus if economic growth and employment continue to improve. Furthermore, Bernanke said that longer-term inflation expectations remain stable.

The combination of this benign inflation outlook and improving economic growth is positive for stocks in the long run. The bad news, however, is that rising interest rates often lead to financial market dislocations, especially among financial institutions that have assumed greater degrees of portfolio risk (e.g., chasing yield by owning lower-quality and longer-duration bonds, including those in emerging markets). As we have experienced in recent years, disruptions can spread when traders are forced to sell higher quality assets to cover losses from more speculative investments.

Money is now being pulled out of funds that concentrate on developing economies, after years of large capital in-flows. As noted above, emerging markets have been *submerging* this year. China faces slowing economic growth and a credit squeeze as the country's central bank attempts to curb its glut of domestic lending. Shanghai's stock market is now at its lowest level since 2009, down 13% this year. In Brazil, demonstrators have taken to the streets in anger over deteriorating economic conditions, as the country faces pressures from both rising domestic inflation and lower exports from falling global commodity prices. Brazil's stock market is down

24% year-to-date. Economic and political instability is also occurring in countries such as India, Turkey, and now Egypt. In our last letter we cited 1994 when rising interest rates in the U.S. caused significant declines in bond prices and a temporary pull-back in stocks. Likewise, the impact of rising interest rates on emerging market countries could be reminiscent of Mexico's debt crisis in 1994 and the Asian financial crisis of 1997.

Today, investors face a myriad of challenges as interest rates rise. But we continue to believe – as we have stated in past letters – that the U.S. stock market is the "best house in a bad neighborhood." Our multinational companies will likely see a slowdown in the non-U.S. portion of their earnings, hurt by a strengthening dollar and ongoing economic weakness in Europe and emerging markets. Nevertheless, we are optimistic about the U.S. economy, which we believe is strengthening, slowly but surely. For instance, the U.S. private-sector is advancing at a solid rate, masked by reductions in federal and local government spending. Although overall gross domestic product has been growing at a sub-par rate around 2%, the private-sector portion of the economy was up 4% in early 2013. This suggests that the underlying economy has been able to withstand fiscal austerity and may be stronger than many realize.

In short, a measured unwinding of the Fed's extraordinary monetary stimulus, in conjunction with an improving domestic economy, would be extremely positive for equity investors with long time horizons. However, the dislocations caused by rising interest rates are likely to cause volatility throughout financial markets, including stocks. Our goal is to further position the portfolio for a gradually improving economy, even while enduring likely periods of heightened turbulence. We will seek to take advantage of near-term dislocations to add new quality holdings and increase positions in our core portfolio companies.