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Dear Fellow Investors,

This quarter was another good one for our investments, continuing the trend we've seen in the past three quarters. We have the favorable tailwind of a return greater than 20% on our investment in the past twelve months. While we are pleased with the results, we are also growing more cautious. Bull markets don't last forever and the high prices investors demand for their shares dampens our enthusiasm for buying. However, most investors feel more confident buying when prices are high. It's easier to follow the crowd. So this environment of optimism brings out the deal makers. Several of our holdings have been bought by other companies, most recently Linear Technology. This long-time holding was acquired by Analog Devices (ADI) in a deal that was mostly paid for in cash. Two more of our smaller companies have recently sold themselves to bigger firms so we find ourselves in the position of holding more cash than usual in a market that has few bargains. That's a high-class problem, to be sure, but it means we'll be tracking down the elusive value in a market high on its own success.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q1 2017	5.52%	6.07%	-0.55
Annualized Return Since Inception	9.91%	9.62%	+0.29
Total Return Since Inception	128.61%	123.34%	+5.27

Data reflect total returns (including dividends) net of fees as of 3/31/2017. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

The Trump Trade Revisited

In our last letter from early January, we noted that a stock market rally was underway. Investors were buying stocks that could benefit from President Trump's stated agenda. Specifically, there were four main things investors were banking on: deregulation, lower taxes, higher infrastructure spending, and paradoxically, the lack of a trade war. Trump has now been in office for eleven action-packed weeks and he has been aggressively pursuing his agenda. But the bloom is off the rose already. The so-called "Trump trade" – buying

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companies that would benefit from the four factors we mentioned above – is waning. Investors are no longer certain that Trump can push through his agenda, let alone do it on his terms.

There have been some steps toward deregulation, particularly the rollback of environmental regulations, but little on the banking front. Nothing is happening with tax reform. Trump promised to dismantle Obamacare and reform the tax code in his first 100 days. On the heels of his failure to replace the Affordable Care Act, many investors are wondering whether tax reform will end up the same morass of competing agendas and unclear vision. The tax code is nothing if not complex and many of its beneficiaries have a vested interest in preserving loopholes and deductions. As for infrastructure, U.S. Transportation Secretary Elaine Chao has said that the President will announce a $1 trillion plan later in 2017. So far, a trade war seems a little less likely than we had originally thought. Trump has seemed to soften his rhetoric on NAFTA.[1] The most recent draft letter to Congress, giving notice of his intent to renegotiate NAFTA, contains little of the fiery rhetoric about trade that we saw on the campaign trail.

We said previously that we were cautious on the Trump trade because it seemed like a speculative rally. Wall Street appears to have come to the same conclusion relatively quickly. The momentum now driving stock prices is around economic expansion and consumer confidence. We can get on board with some of that optimism. Looking at the economy through the lens of Janet Yellen's dashboard (a series of metrics the Fed Chair keeps a close watch on) we see improvement in job openings, low unemployment, and some upward pressure on hourly wages. Inflation is picking up and U.S. manufacturing is expanding. Both the index of small-business optimism and consumer confidence are at their highest levels in 17 years.[2] However, consumer and business sentiment seem to be outpacing the actual hard data, which are still pointing to slow growth. We feel that much of this premature optimism has spilled over into the stock market, making investments relatively expensive. If there are some hiccups or bumps in the road, prices could easily fall to more reasonable levels. We're currently leaving some of our cash on the sidelines so we can take advantage of such circumstances.

Prisoner's Dilemma Oil

If God wanted humans to fly, He would have made airlines profitable. – Old Wall Street joke

The Prisoner's Dilemma is a cornerstone study in game theory. Two prisoners posses information sought by the police, who present a choice: either cooperate with the authorities or remain silent. There are consequences for each choice. If the prisoner cooperates and betrays his compatriot who remains silent, he'll go free immediately while the other prisoner serves a three-year prison sentence. If both prisoners remain silent, both will serve a one-year sentence, and if both betray each other to the authorities, both prisoners serve a two-year sentence.

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[1] Davis, Julie Hirschfeld and Alan Rappeport. After Calling Nafta 'Worst Trade Deal,' Trump Appears to Soften Stance. *The New York Times*. March 30, 2017. https://www.nytimes.com/2017/03/30/business/nafta-trade-deal-trump.html

[2] Driebusch, Corrie. Stock Surge in First Quarter of 2017 Rides the Tech Wave. The Wall Street Journal. March 31, 2017. https://www.wsj.com/articles/stock-surge-rides-the-tech-wave-1490999580

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Looking at this dilemma completely rationally, the best combined outcome is mutual silence: each prisoner serves a one-year sentence for a combined two years. Betrayal always makes things worse, yielding either a three-year or four-year combined sentence. However, a self-interested prisoner would betray his compatriot at the earliest opportunity. The outcomes for betrayal are either a zero-year sentence or a two-year sentence – an average of one year. A silent prisoner will receive either a one-year or a three year sentence – an average of two years. So does the prisoner trust his compatriot will remain silent in hopes of obtaining a one-year sentence? Or does he act to protect his own best interest? Even though the rational thing to do is for both prisoners to remain silent, self-interested prisoners betray each other at the first opportunity. Now, expand this scenario out among dozens and hundreds of prisoners: the first to cooperate receives a disproportionate share of the benefits. Each additional prisoner increases the chance someone will choose betrayal, which drives up the incentive to act preemptively and cooperate with the authorities.

This game is a cornerstone of modern economic theory because it explains certain situations perfectly. Presently, we're looking at the energy sector, which has become a fascinating study in the confluence of global finance and geopolitics. Saudi Arabia remains the lowest cost producer of crude oil. Even though the Saudis are sitting on oodles of oil, they have kept their own production levels low in hopes of driving up the price of crude. Historically, OPEC quotas have kept other nations' production levels low enough make this work, and to prop up the global price of oil. However, if one party pumps a disproportionate share of oil under this scenario they'll be rewarded with a disproportionate share of the profits.

Two years ago, Saudi Arabia switched course. They *increased* production in the face of falling demand. The consequences are still reverberating through the energy sector. American shale firms stopped drilling new wells and took massive write-offs. An estimated $70 billion of energy debt fell into default. Now though, American companies have developed improved drilling technologies and lowered their overall cost structure to be more competitive. American firms can make money at lower oil prices. Russia, Iran, and Iraq have all improved their oil operations as well. In betraying its fellow oil producers, the Saudis opened the door to a cycle of vicious competition and price undercutting.

We believe the outcome of all this back-stabbing will be decades of cheap energy. To be clear: no energy producer wants this, but the only way to achieve the desired outcome – high energy prices – requires unwavering cooperation among all producers, that is, Texas, Iraq, Iran, and Russia all come to an agreement. It won't happen.

Enter renewable energy and green tech. For a long time, alternative energy was much more expensive than fossil fuels. Only the most eco-conscious consumers were interested in battery operated vehicles. Now though, electric cars are *cool*. They're a status symbol generating billions of dollars in annual sales, which allows for billions of dollars of further research. The current lineup of electric cars is reasonably competitive with a gas lineup, though the sacred summer road trip has kept internal combustion engines on top. As batteries improve, however, and charging stations become more ubiquitous, the playing field will ultimately level out. This means that oil prices alone won't determine the price of fuel for our cars. (It's important to point out that electric cars aren't green by themselves. Electricity is just a way to deliver energy from some other source. In some places, that electric-powered Tesla is really a coal-powered Tesla.) Electricity from a variety of sources – wind, solar, natural gas, coal, nuclear – is competing directly with oil.

Meanwhile, electrical engineers not busy with batteries have been making equally dramatic advancements in other fields. Future nuclear plants – if they can pass regulatory muster – have the potential to be hundreds or

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even thousands of times more efficient (and safer) than our current 60s and 70s-era facilities. Solar and wind energy have made rapid advancements in cost and efficiency, though without tax credits, they still aren't quite competitive with fossil fuels. Given the recent rate of technological advancement, it isn't a foregone conclusion that fossil fuels will always be the cheapest source of energy.

All this is to say, there's an upper limit on the price of oil and gas, and it isn't very high. If prices increase, drillers will start producing more, resulting in a glut. Even if prices don't jump dramatically, drillers are so starved for profit that we're seeing signs of a glut any time oil gets near $50 per barrel. Oil producers aren't cooperating with each other to boost prices. In fact, they seem to be bending over backwards to undercut one another.

This all brings up an interesting scenario. For decades, any number of industries had to survive the whims of energy producers. Recall the devastating shortages caused by the Arab oil embargo of 1973. And how many times have you seen a "fuel surcharge" on a plane ticket or shipping receipt? For most businesses, utilities are the second-biggest overhead expense after personnel costs. Could the balance of power be shifting away from energy producers towards energy users? We believe this is now the case.

Who stands to benefit under such a scenario? Really, anyone who's a consumer of petroleum or natural gas has a leg up. This would include refiners and chemical producers (hence, our decision to invest in ExxonMobil vis-à-vis the other big oil firms, or "supermajors.") We also think large, well-capitalized energy companies will have a good opportunity to pick through the scrap yard of bankrupt competitors. Curiously though, airlines – the butt of countless jokes – stand to be potential winners if they can keep from undercutting one another. Consider the old joke that begins this section. Well, last year all four major U.S. airlines showed strong profits while half of the oil supermajors showed a loss. Perhaps in twenty years, the new joke will be, "If God wanted dinosaurs above ground, He would have made oil companies profitable."

Your partners in investing,

Rachel Barnard, PhD, Todd Schrade, CPA, and the Midway Capital team

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