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Dear Fellow Investors,

A number of things are making the markets jittery right now, including the presidential election and the possibility of higher interest rates. However, these were fairly minor factors during the past three months and we did have an exceptionally good quarter for our investments.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q3 2016	6.21%	3.85%	+2.36
2016 Year to Date	7.10%	7.84%	-0.74
Annualized Return Since Inception	9.06%	8.95%	+0.11
Total Return Since Inception	104.55%	102.81%	+1.74

Data reflect total returns (including dividends) net of fees as of 9/30/2016. 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.

We like to think of this as a "stock picker's market," meaning that high quality and undervalued companies performed well. One thing to note is that the markets seem to have shrugged off the Brexit vote. You'll remember that last quarter we mentioned one holding with exposure to British real estate that took it on the chin. Britain has stabilized and our investment in JLL made a speedy recovery. Emerging markets finally rallied as investors seem to realize how inexpensive these companies are compared to the US market. The recovery in oil prices helped our energy investments outperform. But mostly we saw investors buying companies we view as deeply undervalued, including Apple (AAPL), Dolby Laboratories (DLB), Sotheby's (BID), and Portfolio Recovery (PRAA).

Election-Proof Your Portfolio??

As we mentioned above, the markets are keeping a close ear on the presidential campaign rhetoric for possible economic policy changes. Among the big worries are trade barriers, tariffs, and tax hikes. We have

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been listening closely too, because as investors, we benefit from free markets and policies that encourage economic growth, as well as favorable tax rates on investments. That said, there are really so many variables in this election that we would be uncomfortable making any investment choices based on probable outcomes. We agree with behavioral economist Dan Ariely that this kind of financial decision-making just leads to "bad bets and deep regrets."[1] However, we have been disturbed by the public's lack of understanding about the issues of manufacturing jobs and trade barriers. So we thought we'd try to set the record straight about what is – and isn't – happening to American jobs.

What Happened to US Manufacturing?

In Roald Dahl's delightful novel *Charlie and the Chocolate Factory*, Charlie Bucket's family is one of the poorest in town. Charlie's father, the family's sole breadwinner, supports his family via his job screwing the tops on tubes of toothpaste. Shortly after we're introduced to Mr. Bucket, he loses his job at the toothpaste factory, and moves on to shoveling snow in the street. Mr. Bucket's unemployment is certainly a tragedy for the family. However, twisting the tops on toothpaste tubes was clearly a job whose days were numbered. Would the Bucket family have been better off if Britain had enacted high toothpaste tariffs?

Both presidential candidates have talked tough about protecting American jobs. Both candidates seem to think that free trade is bad for jobs and Trump in particular is a fan of high tariffs as the answer to all our employment problems. The main reason the polls are affecting the stock market now, as the election nears, is that trade barriers hurt economic growth. High enough trade barriers could push us into a recession. There is not much clarity on exactly what policies each candidate would implement -- and how much of this is just election year rhetoric. But suffice it to say that the market has taken Trump seriously and the president does, in fact, have unique powers over trade agreements. This is making the stock market very jittery.

As usual, these issues are much more complex than what we hear in a sound bite. The most tangible reality is a loss of American jobs, particularly in manufacturing. Unfortunately tariffs are not a golden ticket. Trade barriers cannot change the fact that the US is not the same country it was 100 years ago. Our own success has brought us to a place where we can't pay people good wages to cap toothpaste. Going back to that world really is like trying to put the toothpaste back in the tube. We see outsourcing as an inevitable part of the changing global economy.

Let's think some more about Mr. Bucket's job at the toothpaste factory. Say his job is outsourced to China where workers are paid $2 per hour instead of the $10 per hour Mr. Bucket demands. If both workers put in 2,000 hours per year, that amounts to $16,000 in annual savings ($4,000 vs. $20,000). But there's more to the equation than just labor. Now the toothpaste is in China and it must be shipped back to its consumers in England, where the story is set. Now the factory workers in China need to take direction from their English managers, which will present linguistic and cultural barriers to effective communication. Now the toothpaste factory has to source its materials from Chinese vendors. Now the English managers need to ensure that the quality of the raw materials is on par with British suppliers. (Maybe they import British materials to China instead and then send the finished product back to England. That's a lot of shipping…) Suffice it to say, lower labor costs abroad don't drop dollar-for-dollar to the bottom line.

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[1] http://www.forbes.com/sites/elizabethharris/2016/06/15/behavioral-economics-guru-dan-ariely-suggests-the-smartest-way-to-play-the-2016-election/#74816b245b8b

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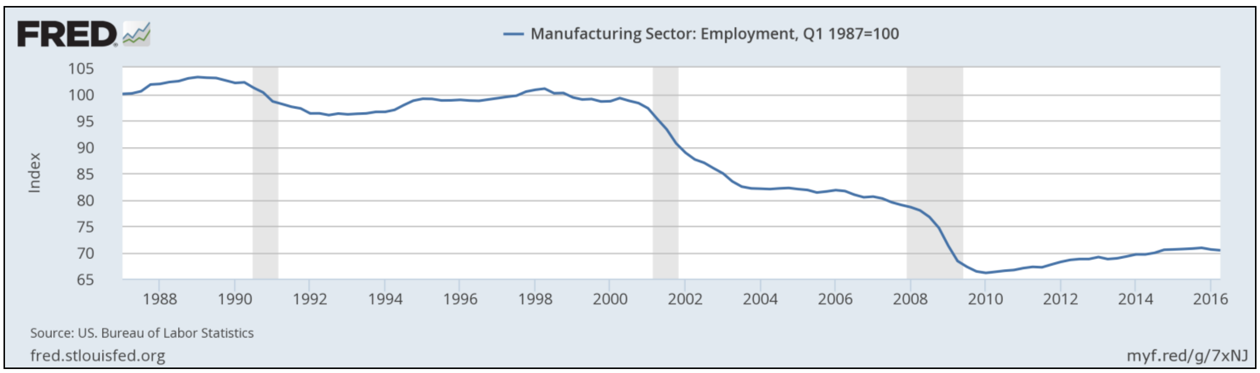
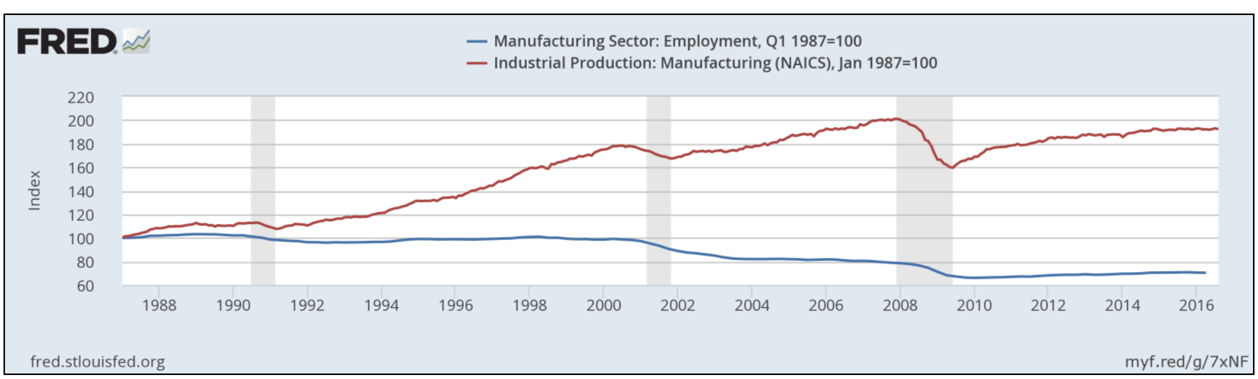
In our example, let's say $6,000 of the savings in labor are eaten by shipping costs and other headaches. It still makes perfect sense for the job to be sent to China, as it will yield $10,000 in annual savings. But let's reexamine Mr. Bucket's job through another lens: screwing the top on a tube of toothpaste is a job a machine could perform. What if this machine could be bought – in England – for $100,000? Moving the job to China will cost $4,000 in labor and $6,000 in headaches per year. Replacing the job with a robot will cost $100,000 up front, but will only cost a token sum in electricity and maintenance. And, this robot can be based in England near the company's consumers and suppliers. That $100,000 outlay will save $10,000 per year – a 10% annualized return on investment! Chinese workers should be deeply concerned that their jobs will be outsourced back to England, where they'll be performed by a robot. This robot, along with a few highly paid robotic maintenance workers, will replace scores of foreign workers and scores of Mr. Buckets.

This scenario is *exactly* what we've seen in the U.S. / China trade relationship over the past decade. Consider the following graph showing employment in the U.S. Manufacturing sector:



For every 100 manufacturing jobs in 1987, there were only about 70 by 2016. But look carefully at the last few years. There's a notable uptick between 2010 and present. This is the "manufacturing renaissance" you may have heard about. Note that it coincides with the massive expansion in the Chinese economy, when Chinese workers could start to demand higher wages.

These data might make you think that the manufacturing sector has been gutted, supporting politicians' notion that we don't make anything anymore. Well, actually the opposite is true. Below is the same graph with industrial production overlaid in red:



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We’re actually manufacturing almost *twice* as much as we did in 1987! Part of this is due to efficiency, and part of it is due to America producing more high-value goods. (That is, tube socks are made in China, while business suits have stayed stateside.) It’s disingenuous for politicians to say we’ve shipped our manufacturing overseas. The data contradict that. It’s even hard to say whether we’ve shipped our jobs overseas, or whether we’ve replaced our low-value jobs with automation.

In either case, that toothpaste isn’t going back in the tube. The world has moved on and left us with the hulks of closed factories that used to provide living wages for many American families and sometimes entire communities. We see them as tangible reminders of the “good old days” but these old factories are really more like the worn-out clothes of a child growing to maturity. Overall America really is much wealthier, at every level, than ever before. Going back to the good old days means giving up our iPhones, SUVs, and restaurant meals in favor of a single TV in the living room, prohibitively expensive air travel, and cars that (in hindsight) were death traps – when they were ran, which they often didn’t.

Where does that leave Charlie’s father, then? Should he advocate free trade even though all his fellow workers are at the Brexit rally? What’s in it for him? That’s not a trivial question since Mr. Bucket represents a whole swath of people who are the victims of economic changes like the buggy whip manufacturers before them. But the answer does not lie in reviving the buggy industry. The challenge for a country like ours, and soon for countries like China as well, will be retraining workers with skills to meet the needs of a new economy. We’d like to see Mr. Bucket learn more in-demand skills, like machine repair, welding, and computer coding. It makes a better sound bite to say that outsourcing is an issue of corporate greed, currency manipulation, or a broken tax system. It’s really an education issue. We do have serious problems with under-investment in job training and unaffordable college education. These will come back to bite us if we don’t fix them.

What our politicians propose – and what we at Midway vehemently disagree with – is imposing tariffs on foreign goods in order to create jobs in the United States. Tariffs on foreign goods will make them more expensive in America. It’s remotely possible this will create some American jobs, but far more likely, it will create a strong motivation to adopt automation. Jobs that have been sent abroad are usually low-skill, low value-added jobs. Even worse, it will probably lead to retaliation by other trading partners, making our American goods more expensive in foreign markets. This is a scenario that has very few winners and many losers. It could indeed spark a global recession. Don’t be fooled by all the rhetoric surrounding manufacturing. Manufacturing is thriving in the US, including companies we own such as Lincoln Electric (LECO). It’s just that these firms employ fewer, more highly skilled workers – a trend that’s likely here to stay.

Your partners in investing,

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

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