MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
150 N. MICHIGAN AVENUE, SUITE 800, CHICAGO, ILLINOIS 60601

January 17, 2017

Dear Fellow Investors,

It has been a memorable year. We're very pleased to report that our returns outpaced the S&P 500 index for the year and the quarter. There were several things that worked well and certainly some unexpected happenings. However, if we have to boil the successful year down to one thing, that one thing is patience. All of our best performing stocks, the ones that returned the most in 2016, are things we've held for a number of years. These include the banks and semi-conductor firms which dominated our best performers. The banks were companies we started buying just after the financial crisis when pessimism around banks was high and investors were pulling money out of bank stocks. Similarly, we've been buying semi-conductor equipment maker Applied Materials and analog chip maker Linear Technology every time there was a downturn in the microchip industry. Our investments seldom pay off right away because we are buying companies and industries that are out of favor for one reason or another. Waiting is not easy, but buying high-quality stocks at a discount and hanging onto them is one of the few investing strategies that has been proven to work over time. The good years make it all worthwhile.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q4 2016	5.92%	3.82%	+2.10
2016 Year to Date	13.45%	11.96%	+1.49
Annualized Return Since Inception	9.52%	9.15%	+0.37
Total Return Since Inception	116.65%	110.56%	+6.09

Data reflect total returns (including dividends) net of fees as of 12/31/2016. 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.

The Trump Trade: Market Sentiment Around the PEOTUS

The Trump victory was unexpected. The pollsters didn't expect it, the pundits didn't expect it, and the stock market didn't expect it. So when it happened, there was no telling how the markets would react. As you know, the stock market seemed to love it. The major stock indexes climbed immediately higher (The Dow up

TELEPHONE 312.445.8562 ⁜ FAX 773.345.3637 ⁜ WWW.MIDWAYMGT.COM

7.8% and the S&P 500 up 4.6% through the end of 2016.) Since we have yet to reach "Day One" of the Trump administration, you may be wondering why investors would be so optimistic about the future of business. It seems unlikely that the president-elect himself knows what he will be accomplish, so why are investors placing bets on future stock market earnings increasing? The short answer is that investors have chosen a few key promises made by the president-elect and assumed that they will be fulfilled, or not fulfilled. Underpinning the recent rally are the following assumptions of coming changes:

Deregulation. Both the Republican Congress and Mr. Trump have promised to dismantle much of the Dodd-Frank financial reform act. Dodd-Frank has placed a heavy regulatory burden on financial firms and banks in particular. Whether or not this might be good for the economy in the long-run is a matter for debate, but it has undoubtedly been costly for financial firms. Gutting these reforms will almost certainly give a short-term boost to the bottom lines of banks and we've seen financial sector stocks rally 21% since the election. The president elect has also vowed to do away with environmental and labor regulations, and his Cabinet picks affirm that he intends to pursue a pro-growth, pro-business agenda, partially by easing up on regulation. That will likely mean dialing back regulations on oil drilling and mining, as well as pollution controls. We'd also expect the Obama labor reforms to be under attack, such as the mandates for overtime pay and higher minimum wages.

Lower Taxes. Trump has talked about lowering both corporate and individual taxes. For companies, the president-elect and his nominee for Treasury secretary, Steve Mnunchin, have floated a 15% tax rate, a reduction from the 35% rate in effect now. They have also talked about allowing companies to repatriate their foreign earnings at a favorable tax rate. The money companies save on taxes is likely to increase profits, but could also go toward capital spending and hiring. For individuals, Trump's tax plan calls for cutting marginal tax rates and increasing the standard deduction. Most of the benefits would go to higher-income earners, would likely provide more incentives to work, save, and invest, and would put more spending money in the pockets of consumers.

Government Infrastructure Spending. If Trump's plans are vague, the infrastructure plan is especially so. He has proposed spending anywhere from $500 billion to $1 trillion on infrastructure improvements, particularly transportation, with the hook being that these projects would employ many Americans and use American products like steel. The actual mechanics of this are fuzzy, but the plan seems to involve less direct government spending on projects and more tax breaks for private companies which undertake such projects. Trump has also blasted the regulatory red tape that holds up these projects from proceeding. There could be some benefits of improving infrastructure, but it is unclear to us that anything will happen in the near term. Nevertheless, Wall Street sees it as a boon for construction-related firms.

No Trade War. We are most perplexed at Wall Street's assumption that there won't be a global trade war. Granted, it's not easy to pick winners and losers in such a scenario, because nearly everyone loses. Perhaps this is wishful thinking on the part of investors, but it seems to us that this is a real risk given the consistent Trump rhetoric about import tariffs and dismantling trade deals like NAFTA. If the next administration were committed to global free trade, it would be much easier to see the combination with lower taxes and lower regulations spurring growth.

TELEPHONE 312.445.8562 ⁘ FAX 773.345.3637 ⁘ WWW.MIDWAYMGT.COM

Perhaps the bond market has the most reasonable view. Bonds are pricing in higher inflation, but not higher economic growth.[1] This would be a likely consequence if the U.S. imposed tariffs on goods imported from China, making them more expensive for American consumers. If China retaliated by taxing U.S. goods, that would hurt growth here at home, leading to a scenario where prices rise but the economy stagnates.

We need to emphasize that all this is speculation. Wall Street has no special crystal ball that allows it to envisage what the next administration will do. In fact, Wall Street is often wrong. The one key takeaway from the foregoing discussion is that the so-called "Trump trade" is a speculative rally. One of our cardinal rules of investing here at Midway Capital is to never buy a company that is dependent on the government for its prosperity; by the same token, we aren't making any investments based on putative changes in government policy. Trump likes to talk a big game. This could mean that he makes big changes, but also that he could be prone to make big mistakes. Like the bond market, we remain cautious on the Trump trade.

Still Bearish on Bonds

Speaking of bonds, we've been bearish on bonds for years now. In fact, we wrote on this very topic in the fourth quarter of 2012. Back then, we pointed to former Fed chair Bernanke's statement that he'd keep rates low until at least 2015. (That seemed impossibly long at the time, but it turned out to be an understatement.) We also noted back then that treasury bonds yielded less than 3%. It's still less than the 3% we passed up four years ago, so it should come as no surprise that we still dislike that proposition.

Why should you care? There is a lot of 'conventional wisdom' out there about investing in bonds. You may hear from very reliable sources that you need to hold a certain percentage of your portfolio in bonds for various reasons. Most of this is well-intentioned advice based on a century of data on how bonds and stocks perform. However, bonds are moving into uncharted waters now. We are at a place where a lot of things that worked for your parents and grandparents don't apply. So we urge you to ask questions before you follow rules of thumb and make sure your bond allocation makes sense. In today's environment, we would recommend bonds for clients who have a very short time horizon – something less than five years – or for those who knowingly choose to sacrifice higher returns in favor of reduced volatility.

We noted that bond yields are not attractive at present. There are several things conspiring against them. First of all, the risk of default (permanent loss) is mispriced. Anyone investing in U.S. government bonds is buying dollars. In return for taking on the risk of investing in the U.S., investors receive interest of about 2.5%. Since the risk of America not paying its debt is low, the interest rate is also low. On the other hand, South Africa's 10-year bonds yield about 8.5%. The difference between the South African rate and the U.S. interest rate is a combination of how risky investors deem South Africa relative to the U.S., as well as the risk of losing money while holding Rand instead of Dollars.

It follows then, that America, the world's largest economy with the most widely utilized currency, should have just about the lowest borrowing costs in the world, right? That isn't currently the case. An investor today could buy a U.S. 10-year bond and receive annual interest of around 2.5%. Or, an investor could buy an Italian 10-year bond denominated in Euros, backed by the full faith and credit of the Italian government, and

[1] Zeng, Min. 'Real Rates' Show Real Concerns Over Trump Economic Rebound. *The Wall Street Journal*. Monday, January 16, 2017.

TELEPHONE 312.445.8562 ⁘ FAX 773.345.3637 ⁘ WWW.MIDWAYMGT.COM

receive 2%. Spain's yield is closer to 1.5%, and Japan basically yields nothing. Spain, Italy, and Japan have been suffering from fiscal mismanagement and large debt burdens for decades, so why can they borrow more cheaply than the U.S.? The simple answer is that Europe's central bankers have taken steps to keep rates artificially low for member nations – an action taken by the Bank of Japan decades ago.

While they've met their objective, the result defies logic. Who would lend money to Japan for free, when they could lend to the U.S. and get paid a higher interest rate? If central bankers would stop their intervention, we believe the market would demand more compensation for lending to Japan and Italy. Or perhaps the U.S. would keep rates lower longer, and interest-free borrowing becomes the norm.

Indeed, central bankers around the globe have done a great job lowering borrowing costs. Here in the United States, we paid $223 Billion in interest on our national debt of $19 trillion for the fiscal year ended September 30, 2015[2]. This is roughly the same amount the United States paid in 1995, though back then, our borrowings totaled $5 trillion[3]. Also, bear in mind that $223 billion from 1995 would be about $360 billion in today's dollars thanks to inflation. So we are actually paying less to borrow $19 trillion than we paid 20 years ago to borrow only $5 trillion.

This has been good for taxpayers, but bad for bond investors. If the Federal Reserve – or any central bank, for that matter – were to raise interest rates dramatically, government borrowing costs would go through the roof. While bond buyers might rejoice, we think that is unlikely to happen. The most likely outcome, is low interest rates, inflation, or some combination of the two. That adds up to lousy returns for bonds.

Back in 2012, we didn't like bonds because they offered paltry upside and a huge downside. Today's market is in essentially the same spot it was back then, though it took a circuitous route to get back to its starting point. Investors the world over have been looking for ways to generate income from their portfolios, so the recent rise in interest rates has come as a welcome relief to some. But looking over a time horizon of a decade or two we don't see many circumstances under which bonds would outperform stocks, certainly not from this starting point. Central bankers no longer follow your grandfather's monetary policy. Likewise, your grandfather's portfolio may not be as relevant today. We continue to recommend a limited role for bonds until prospects improve.

Your partners in investing,

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

---

[2] U.S. Office of Management and Budget, Federal Outlays: Interest [FYOINT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/FYOINT, January 10, 2017.

[3] U.S. Department of the Treasury. Fiscal Service, Federal Debt: Total Public Debt [GFDEBTN], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEBTN, January 10, 2017.

TELEPHONE 312.445.8562 ⁘ FAX 773.345.3637 ⁘ WWW.MIDWAYMGT.COM