Saybrook Capital

First Quarter 2016 Review & Outlook

The Saybrook Capital stock portfolio, like the broad U.S. stock market, did a round trip in the first quarter – declining during the first six weeks of the year and then rebounding to end the quarter up about 1%. This was the second time since August that the S&P 500 plunged over 10% and then swiftly recovered its losses. Most global stock markets also rallied beginning in mid-February, but still ended the quarter in the red, with declines in China (-15%), Japan (-12%), and the eurozone (-7%).

Financial market turmoil early in the year reflected fears of decelerating global economic growth spilling over into the U.S. economy, Chinese devaluation leading to emerging-market debt defaults, and widespread bankruptcies of indebted energy companies due to the collapse in oil prices. Any of these events would have reduced liquidity throughout the financial system and led to further stock market declines.

Despite these concerns, the U.S. economy continued to show its resilience. Payrolls remained strong, with the U.S. labor market averaging 210,000 new jobs for each of the last three months, while income gains, along with low energy prices, supported consumer spending. This positive data contributed to the quarter's stock market recovery. Another factor may have been the surprising reversal of the U.S. dollar, which had been strengthening versus a basket of other currencies since mid-2014. The dollar's recent weakness, due to the Federal Reserve's signal that it will raise interest rates more gradually than expected, has calmed financial markets, as the decline in commodities (oil is priced in dollars) has subsided and emerging-market currencies have strengthened. Also, the U.S. manufacturing sector may become less of a drag on the economy, after six consecutive quarters of currency and energy headwinds.

However, the dollar is likely to remain relatively strong, with greater demand for higher-yielding U.S. government bonds versus European and Japanese equivalents. In an attempt to stimulate their persistently weak economies, some central banks are now adopting policies of *negative* interest rates, epitomized by Japan's 10-year government bond dropping below zero for the first time and Germany's 10-year government bonds yielding only 0.15% at quarter-end. While low interest rates are good for borrowers, they are extremely negative for banks that loan money and insurance companies that must invest premiums in lower-yielding long-term bonds. As a result, financial stocks around the world have sold-off significantly in recent months. The broad economic and policy implications of negative rates are unknown but concerning.

While fears from earlier in the year appear to have abated recently, underlying financial market strains remain. As Federal Reserve Chairwoman Janet Yellen reiterated in her March 29th speech: "Global developments pose ongoing risks." Consequently, regarding our market outlook, not much has changed since our lengthy year-end letter. We expect overall equity returns from current levels will be moderate, at best, in 2016. U.S. stocks continue to digest the advances of the past several years, as indicated by the S&P 500 Index, which ended the first quarter unchanged from its level one year earlier.

In this climate, we like the attributes that our core portfolio companies share: solid revenue and earnings growth prospects, strong balance sheets, and the ability to payout a growing stream of dividends. To maintain flexibility in what has become a more turbulent market environment, we are glad to be currently holding some cash, where appropriate, in client portfolios. Although cash reserves offer no immediate return in an era of extremely low interest rates, cash provides us with valuable optionality as attractive investment prospects inevitably arise.

Annual Compliance Update:

As an Investment Adviser registered with the Securities and Exchange Commission (SEC) we are required each year to update our "Form ADV Part II," which is a detailed description of our business, how we are organized, and the investment strategies we deploy. The latest version of our ADV was filed with the SEC on March 31, 2016. We would be happy to send you a copy at your request.

Saybrook Capital votes in all proxy elections for each portfolio company. We represent you, as shareholders, and take seriously this annual opportunity to have a voice in companies' board elections, executive compensation, and other internal governance. Upon request we can provide you a copy of our Proxy Voting Policies and Procedures.

Finally, Regulation S-P of the Security Exchange Act of 1934 requires financial institutions to notify clients of the firm's practices concerning the treatment of personal information. It is Saybrook Capital's policy to hold in complete confidence all information concerning our clients. The only exception to this is that, upon the establishment of a new account with Saybrook, a client's information will be provided to the custodian to open a brokerage account. Please contact us if you have any questions about these procedures or require further information.