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QUARTERLY INVESTMENT OUTLOOK
JUNE 2018

SUMMARY

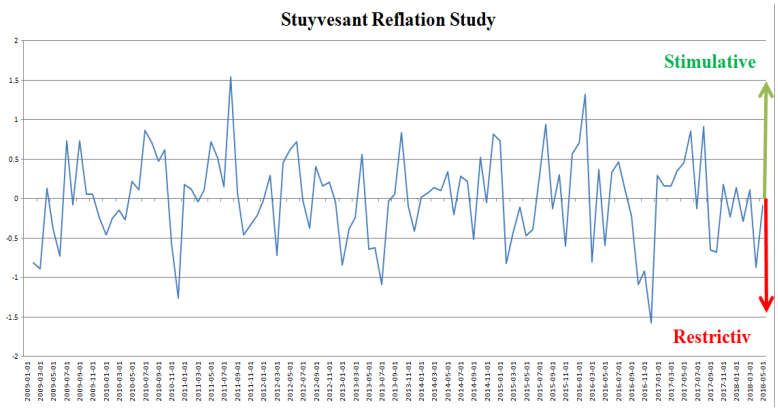
- In the May 16th FOMC policy statement, the Fed implied it will foster monetary policy that allows inflation to rise modestly above 2%, consistent with its symmetric objective. This policy is equivalent to price-level targeting, which has been advocated in recent years by former Federal Reserve Chairman Dr. Bernanke.
- The U.S. administration's recent announcement that it would be investigating tariffs on auto imports, as well as the lack of the clear trade policy with China, raises the risk of a "trade war".
- 1Q18 earnings were strong, supported by an 8% yoy revenue gain. While earnings growth is forecasted to slow into 2019, profits should continue to support equity prices, which should lead to another increase in the stock market into 2H18. Normally the best gains in a mid-term election year occur in Q4.
- Global growth is diverging. The U.S. is strong while the Eurozone and China have lost momentum. The recent decline in the euro should benefit European growth/equity markets in the second half of the year. It should be particularly helpful to the weaker members. China should be aided by a lower bank reserve requirement (with the release of additional reserves), coupled with the potential for more fiscal stimulus, which we are anticipating.
- We believe the dollar has entered a multi-year bear market driven by long-term deterioration in both our fiscal and current accounts. Gold miners should be an excellent hedge against future dollar weakness and the growing possibility of monetizing the expected increase in Federal debt.
- We expect bond yields to resume their upward climb later in the year after a brief consolidation, driven by an increase in inflation. This is supported by the trend in the Fed's Underlying Inflation Gauge, a leading indicator that is currently at 3.2% yoy. BCA Research recently noted that for the first time in the 17 year history of the BLS JOLTS Survey, job openings exceeded the number of unemployed workers. A surge in the proportion of workers willing to leave their jobs,

at a time when it is getting more difficult for employers to find skilled labor, should also foster higher wages leading to increased inflation.

- Our favored domestic sectors include Energy, Financials, Materials, and Healthcare. Following a 16% gain in oil prices, the Saudi oil minister stated that OPEC was likely to increase production quotas at their June meeting, which has led to profit-taking. We believe that OPEC production will increase by several hundred thousand barrels in the second half of the year in an effort to offset the expected loss of equivalent Venezuelan production. With strong demand, oil prices should rise above $80/bbl with risk to the upside. There has been insufficient investment in ex-shale energy producing assets, causing an increase in the fragility of the oil production system.

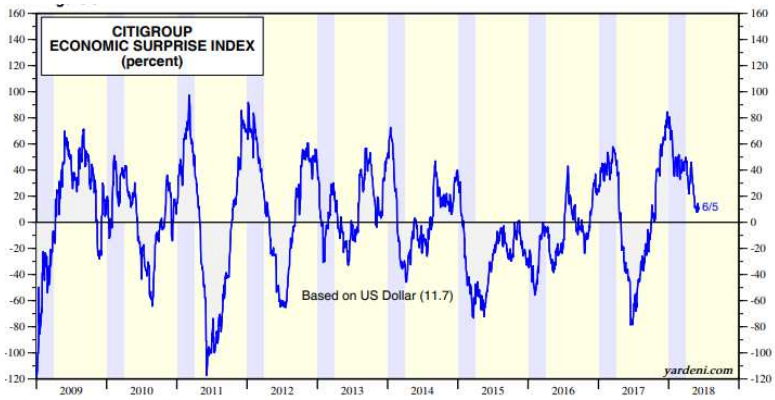
MACRO TRENDS

Recent strength in the U.S. dollar, Treasury yields, and oil prices caused our Reflation Gauge (chart below) to decline into restrictive territory in April, although it has since recovered to neutral. This means that monetary conditions were too tight and needed to loosen in order for stock prices to continue trending higher. We use the Reflation Gauge in conjunction with other intermediate-term signaling indicators to measure the impact of policy change on the financial markets.



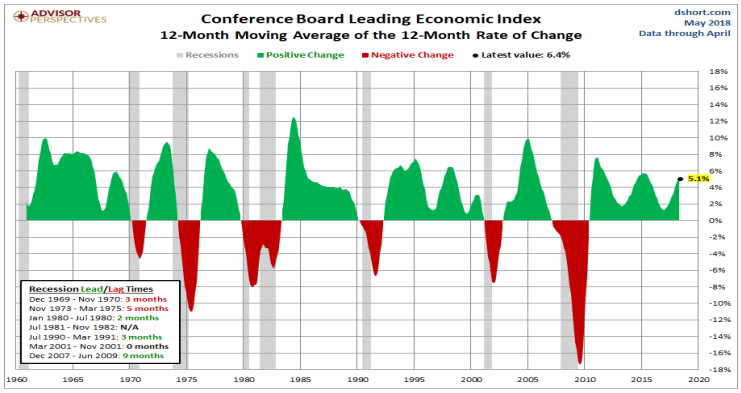
Source: Stuyvesant Capital Management

Shown on the page to follow is the U.S. Citigroup Economic Surprise Index, which measures the difference between actual reported economic data and analysts' estimates. It is a leading economic indicator and is mean-reverting, tending to fluctuate between ± 60. The current reading is +11.7 and has been trending down during 2018. It also tends to correlate positively with both the forward S&P 500 price/earnings ratio and the 10-year Treasury yield. We anticipate this index will remain weak over the short-term, which should provide a momentary reprieve from the increase in yields and temporarily limit the equity market's upside.



Source: yardeni.com

We also monitor key economic data series such as the five Regional Fed Manufacturing Surveys, capital goods orders, unemployment claims, consumer confidence etc. All are trending higher, signaling that the economy is on firm ground. The Conference Board's Leading Economic Index is shown below. When the rate of change turns negative it has historically signaled the advent of a recession. The latest data through April 2018 is +5.1%. As such, we can be confident that a recession in 2018 is a low probability event.



Source: dshort.com

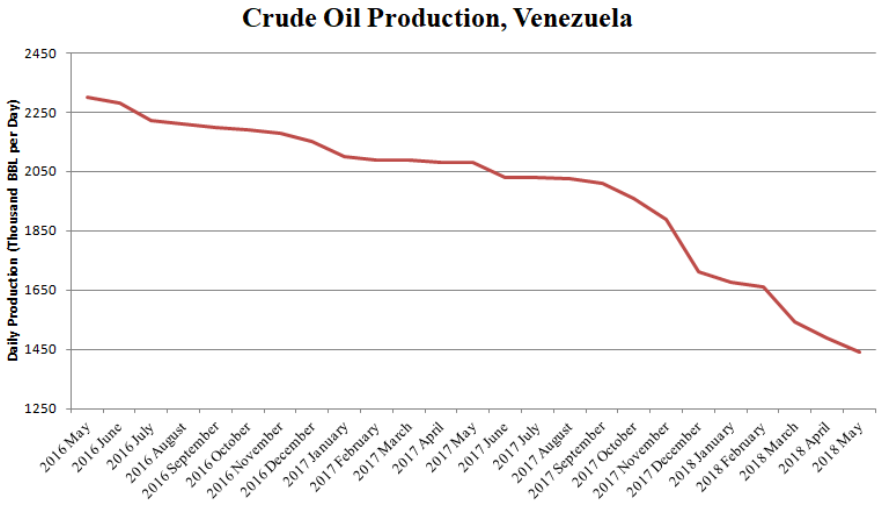
Nevertheless, the fact that the average of the New York Fed Staff Nowcast and the Atlanta Fed GDPNow is forecasting 2Q18 GDP growth at 3.9% (significantly above economic potential of approximately 1.8%) coupled with the fact that the US Economic Surprise Index has peaked, leads us to believe that we are close to peak growth. As a result, we expect economic momentum to cool in the latter half of this year.

This is in stark contrast to the G-10 Economic Surprise Index, includes eight European countries plus Japan and Canada, which peaked in late 2017 and is currently at -32. Since 2013 the G-10 Economic Surprise Index has bottomed at roughly -30. Therefore we expect the index to begin a new cyclical upturn in the next several weeks, which should be favorable for both European and Japanese equities and their respective currencies.

CAPITAL DEPLETION IN THE ENERGY SECTOR:

Businesses are formed when capital is invested to create an infrastructure that allows a product or service to be brought into the global marketplace. Continuous reinvestment of capital is necessary in maintaining this infrastructure. Capital depletion occurs when this investment is withheld. In this situation the business may appear to generate large sums of excess cash that can be used to reduce the firm's leverage or reward its owners (dividends/share buybacks). However, if inadequate levels of capital re-investment occurs, then eventually the infrastructure will degrade and the business will be unable to bring a product or service to market, which will prevent its continued operations.

The most pressing example in the energy sector is currently playing out in Venezuela. Although the country is home to some of the largest and lowest-cost reserves in the world, it incurred massive fiscal liabilities to support the populace under the current socialist regime. In fact, while the breakeven cost to produce oil in Venezuela in 2016 was $27.62 per barrel, when consolidating the business with the state's liabilities the cost of production rose to $117.50. As a result, when the price of crude oil plummeted at the end of 2014 the state was faced with a choice: cut public expenditures or cut capital investment? Venezuela opted to cut capital investment and although the price of crude oil has since rebounded, it is still dramatically under a level that would allow the Venezuelan state to operate. In the meantime the infrastructure has eroded which has caused production to decrease, further diminishing the state coffers.



Source: Data taken from OPEC

The market has treated the underinvestment in Venezuela as an isolated event and has focused on the surge of production that is coming from the U.S. unconventional shale play. However, even major oil companies have deferred capital investment.

One ratio that the Stuyvesant Heat Map tracks is the Capital Depletion ratio. It looks at the trailing four quarters of fixed capital investment and divides it by the trailing four quarters of depreciation, depletion, and amortization. The rationale behind the ratio is to determine if a firm's capex is sufficient to support or grow the business on a continuous basis or if cash flows are being artificially bolstered by capital depletion. When capex is significantly greater than depreciation the ratio is green, when it is approximately equal to depreciation it is yellow, and when it is insufficient it is red. Below are the trailing ten quarters of the capital depletion ratio for exploration and production companies that have a significant part of their production in the U.S. shale patch:

Capital Depletion	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
Anadarko Petroleum Corp. (APC)	1.32	1.14	1.04	1.15	0.81	0.86	0.91	0.79	1.18	1.30
Concho Resource Inc. (CXO)	2.08	1.69	1.36	1.05	1.54	1.6	1.69	2.22	1.43	1.39
Devon Energy (DVN)	1.7	1.58	1.41	1.33	1.3	1.43	1.68	1.87	1.33	1.59
EOG Resources (EOG)	1.51	1.21	1.03	0.94	0.73	0.86	0.98	0.95	1.21	1.38
Pioneer Natural Resources Co (PXD)	1.73	1.56	1.54	1.28	1.39	1.39	1.56	1.96	1.93	2.15

Source: Stuyvesant Heat Maps, data taken from quarterly financial statements

Clearly the ramp-up in production has been supported by a massive capital investment. However, the same trend does not hold true for major integrated companies whose production comes predominantly from non-shale sources:

Capital Depletion	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
Chevron Corp. (CVX)	1.13	1.08	1.06	1.19	0.79	0.57	0.6	0.15	0.42	0.51
Exxon Mobil Corporation (XOM)	1.5	1.34	1.16	1.06	0.79	0.79	0.74	0.76	0.77	0.71

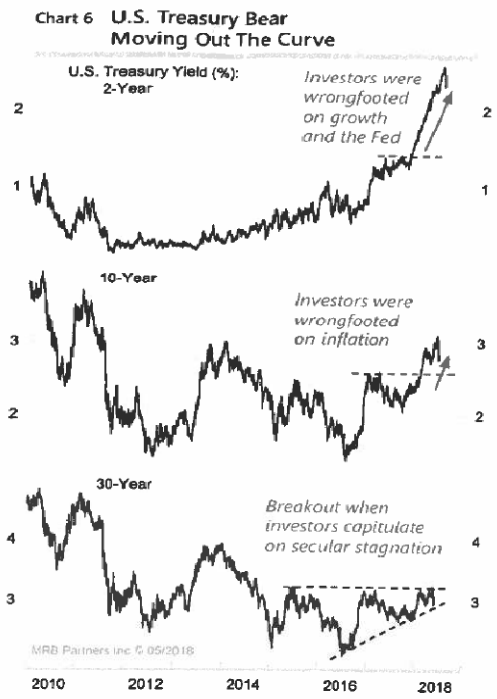
Source: Stuyvesant Heat Maps, data taken from quarterly financial statements

These firms have been perpetually under-investing. This trend will limit production growth of ex-shale plays if it continues. Though productivity is unlikely to collapse, upside is limited. Meanwhile the growth in oil demand continues to expand at approximately 1.6% per annum, which will have to be filled from the U.S. unconventional shale oil patch that is currently responsible for 6% of global production. Moreover, all of the major growth is emanating out of the Permian play that is only 3% of the total global output. This concentration risk could lead to significantly higher oil prices. For example, a recent headline out of Bloomberg highlighted that shale drillers are offering to increase new worker's paychecks by 100% since they don't have the manpower to increase production. It could be hard to meet production forecasts if firms are unable to find qualified workers. Interestingly, this means that incremental global demand growth may not be able to be satiated due to a lack of workers in one oil field in Texas / Oklahoma. This could cause oil prices to rise dramatically as we move into 2019. We continue to favor companies in the energy sector that maintain a strong level of fixed capital investment, are growing their production, and have undervalued assets.

THE BOND MARKET

Since yearend the 10-year U.S. Treasury yield has risen 56 basis points to 2.97%. Virtually the entire increase was due to a rise in the real yield component. This has benefitted the U.S. dollar, which has appreciated 3.1% since yearend. During the same period the yield on the 10-year German bund has increased 3 basis points to 0.46%. This resulted in an increase in the spread between U.S./German 10-year maturities from 198 basis points at yearend to 251 basis points currently, another factor that supported the increase in the value of the dollar.

We believe the increase in yields since yearend is due for a pause. We look for yields to trade in a narrow range until the U.S. Economic Surprise Index reaches an oversold level. The next move higher in yields should be in response to an increase in inflation expectations. We eventually expect inflation breakevens to rise from 2.02% to 2.4%-2.5%, a level that existed prior to the Great Financial Crisis. Over the past three years the 2-10 yield spread has flattened to roughly 45 basis points. An increase in inflation expectations should result in the curve steepening, with the most upward pressure occurring at the long-end of the yield curve. As shown in the chart below, courtesy of MRB Partners, the 30-year bond yield has yet to break out of its sideways trend, capped at 3.25%. We expect this breakout to occur thus confirming the secular rise in yields.



Source: MRB Partners

INTRODUCTION TO A NEW TOOL: The Stuyvesant Heat Map

The Stuyvesant Heat Map is an combination of past investment screens such as the Stuyvesant Ratio Analysis and the Stuyvesant Margin Tracking Study. The goal behind the study is to expand the universe of securities that we cover across multiple sectors and industries. The system currently follows one-hundred of the largest non-financial securities in the S&P Value Index, with the aim of expanding to cover 150 large-cap and 50 small-cap firms. The system does not cover financial firms as there are difficult to compare and contrast with non-financial firms.

The metrics that we follow seek to determine if the company is being run in a way that makes it better or worse at generating cash. It allows us to view each company as a machine, irrespective of the sector or industry in which it operates, whose purpose is to more efficiently generate cash from invested capital. In doing so we can augment our top-down macro-driven approach with a bottom-up micro approach. This should allow us to identify potential investments that may be in a sector or industry that we otherwise would have missed.

The system works as follows:

1. Quarterly financial data from 1Q14 through present is inputted into the program, which generates approximately three years worth of annualized quarterly financial ratios.
2. The financial ratios are imported into the Heat Map spreadsheet so that they can be analyzed across time.
3. A programmed set of heuristics follows each ratio over time and automatically colors the ratio either green, yellow, or red (improving, neutral, deteriorating).
4. Newly reported financial data is added after 10-Qs or 10-Ks are filed by the firm on a quarterly basis in order to follow the quarter-to-quarter fundamental trends.
5. When trends largely shift from red to yellow and ultimately to green we would consider the stock as a potential investment. Conversely, if trends deteriorate from green to yellow to red we would look to exit a position. If trends are absent we simply follow the security

The ratios we follow can be broken-down into seven categories. All data is inputted in accordance with U.S. GAAP and few adjustments are made unless they are material across the investment space (ex: Tax Cuts and Jobs Act had a significant impact on 4Q17 that resulted in adjustment). The categories are as follows:

1. **Liquidity Ratios**: analyze whether the firm has adequate levels of working capital that would allow them to maintain their business operations in potentially adverse environments. The heuristics favor firms with a comfortable level short-term assets relative to their short-term liabilities.
2. **Activity Ratios**: seek to determine how efficient the firm is at generating cash using their assets. Three of the four ratios can be combined to show how many days it takes for the business to buy inputs, create a product, and then monetize the product or service through a sale. The heuristics favor firms are able to perform this task at a faster and more stable rate.
3. **Solvency Ratios**: analyze the capital structure of the firm. The heuristics favor businesses that are both reducing debt levels over time and whose capital structure is maintained at an absolute level that we consider to be investable. This should minimize the risk of investing in firms that are prone to experiencing bankruptcy events and simultaneously gain exposure to firms that are building shareholder equity.
4. **Profitability Ratios**: analyze the firm's pricing power and how that pricing power translates to the bottom-line. These ratios favor profitability metrics such as free cash flow, which show the true nature of a business's ability to generate cash, as opposed to earnings that can be manipulated. Using the trailing four quarters as opposed to the most recent quarter also smoothes out aberrations. Heuristics favor firms with increasing top and bottom lines.
5. **Accruals Ratios**: detect whether management is prematurely recognizing revenues or delaying expense recognition by comparing items across the income statement, balance sheet, and statement of cash flows. The heuristics favor businesses that do not appear to have earnings that are manipulated by management, which is important since pay packages often depend on annual corporate performance.
6. **Valuation Ratios**: favor firms that have a high level of cash flow per share relative to the price per share, above market dividend yields whose payments are easily covered by cash generated, and low-priced stocks relative to the value of the shareholder equity.
7. **DuPont Expanded ROE**: looks at activity, solvency, and profitability ratios to determine the source of the ROE (Net Income / Equity). This allows us to detect if increasing returns are being generated from improving profitability and if those improvements are emanating from the operations, or if the profitability has come from decreased interest expenses/tax payments. It also allows us to determine if the returns are improving due to increased levels of debt (a potential negative for equity holders) or because the company is more efficiently utilizing its assets. The heuristics favor firms that are experiencing higher profitability and capital efficiency, but lower levels of leverage.

An example of the Heat Map can be shown below for core holding Freeport McMoran (FCX):

	Freeport McMoran (FCX)	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
Liquidity	Current Ratio:	1.73	1.63	2.36	2.56	2.45	2.02	2.11	2.02	2.14	2.33
	Quick Ratio:	0.62	0.61	1.53	1.74	1.53	1.24	1.37	1.32	1.37	1.43
Activity:	Days of Sales Outstanding:	55.63	54.29	50.71	44.63	52.69	44.12	38.22	37.78	33.79	28.94
	Days of Inventory on Hand:	123.13	121.76	115.57	118.91	116.31	122.33	114.95	116.70	114.46	110.04
	Number of Days Payables:	88.39	79.90	84.76	86.65	86.83	74.97	69.85	67.79	70.14	56.85
	Capital Depletion:	1.79	1.67	1.55	1.26	1.11	1.00	0.84	0.89	0.82	0.87
Solvency	Debt-to-Capital:	0.72	0.85	0.83	0.80	0.73	0.71	0.70	0.68	0.62	0.57
	Interest Coverage:	(20.75)	(20.45)	(15.96)	(9.87)	(3.70)	2.30	3.36	3.57	4.54	5.75
	Net-Debt to EBITDA:	(2.04)	(1.86)	(2.14)	(3.71)	(44.97)	2.94	2.47	2.11	1.62	1.26
Profitabili	Revenue:	$ 15,877.00	$ 15,251.00	$ 14,337.00	$ 14,533.00	$ 14,830.00	$ 14,644.00	$ 15,021.00	$ 15,454.00	$ 16,403.00	$ 17,930.00
	Revenue Growth:	-25.94%	-25.93%	-25.84%	-16.08%	-6.53%	-3.98%	4.77%	6.34%	10.61%	22.44%
	Gross Profit Margin:	5.26%	4.02%	-1.05%	4.64%	10.81%	15.54%	21.94%	23.68%	26.76%	29.26%
	Net Income:	$ (12,236.00)	$ (13,946.00)	$ (12,505.00)	$ (8,458.00)	$ (4,154.00)	$ 258.00	$ 936.00	$ 999.00	$ 1,514.00	$ 1,978.00
	Free Cash Flow:	$ (3,026.00)	$ (2,243.00)	$ (1,627.00)	$ (292.00)	$ 916.00	$ 1,583.00	$ 2,242.00	$ 2,559.00	$ 3,272.00	$ 3,722.00
	Free Cash Flow Payout:	(0.09)	(0.10)	(0.03)	-	-	-	-	-	-	0.02
	Return on Assets:	-26.28%	-32.69%	-30.28%	-20.43%	-11.13%	0.71%	2.53%	2.68%	4.06%	5.40%
DuPonts	Tax Burden:	0.87	0.93	0.99	1.02	1.20	0.26	0.57	0.52	0.52	0.52
	Interest Burden:	1.05	1.05	1.06	1.09	1.24	0.60	0.70	0.72	0.80	0.84
	EBIT Margin:	-84.29%	-93.73%	-83.02%	-52.29%	-18.83%	11.36%	15.41%	18.59%	22.15%	25.16%
	Asset Turnover:	0.34	0.36	0.35	0.35	0.40	0.40	0.41	0.41	0.44	0.49
	Financial Leverage:	5.95	11.56	10.32	8.75	6.17	5.79	5.55	5.35	4.68	4.23
	DuPont ROE:	-156.31%	-377.74%	-312.39%	-178.74%	-68.65%	4.08%	14.03%	14.33%	18.98%	22.85%
Accruals	NOA Balance Sheet:	(0.27)	(0.51)	(0.39)	(0.32)	(0.44)	(0.31)	(0.28)	(0.29)	(0.07)	(0.07)
	NOA Income Statement:	(0.28)	(0.36)	(0.38)	(0.30)	(0.22)	(0.06)	(0.06)	(0.08)	(0.10)	(0.10)
Valuatior	Share Price:	$ 6.77	$ 9.89	$ 11.35	$ 10.86	$ 13.19	$ 13.36	$ 12.01	$ 14.04	$ 17.29	$ 17.20
	Shares Outstanding:	1,177.00	1,251.00	1,269.00	1,351.00	1,401.00	1,454.00	1,453.00	1,454.00	1,454.00	1,458.00
	Book Value / Share:	$ 6.65	$ 2.95	$ 3.15	$ 3.50	$ 4.32	$ 4.35	$ 4.59	$ 4.80	$ 5.49	$ 5.94
	Price-to-Book:	1.02	3.35	3.60	3.10	3.05	3.07	2.62	2.93	3.15	2.90
	FCF Yield:	-37.98%	-18.13%	-11.30%	-1.99%	4.96%	8.15%	12.85%	12.54%	13.02%	14.84%
	Dividend Yield:	3.85%	2.13%	0.44%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.29%
	Total Expected Return to Shareholder	-34.13%	-16.00%	-10.86%	-1.99%	4.96%	8.15%	12.85%	12.54%	13.02%	15.13%
	FCF/S to EPS:	0.23	0.15	0.13	0.03	(0.25)	1.27	2.34	2.55	2.17	1.89

Stuyvesant Heat Map for FCX

RISK FACTORS

- "Tit for Tat" trade restrictions morph into a trade war.
- Rising oil prices raise inflation expectations leading the Fed to tighten monetary policy too quickly.
- A rapid breakdown in the dollar.

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