

AVENIR CORPORATION

INVESTMENT MANAGERS

February 2019

Dear Friends and Fellow Investors,

As we have noted in past communications, financial markets can do anything in the short run, and the stock market's performance over the past few months illustrates this precept vividly. After rising around 9% through the first nine months of 2018, equity markets dropped precipitously in October as market sentiment shifted abruptly, ushering in a remarkably volatile fourth quarter that ended with the S&P 500 down 4.4% for the year. Since year-end, markets have rebounded significantly, and are up around 8% through January. The sharp swings and rapidly changing sentiment both illustrate the fickle nature of markets in the short run and serve as a reminder of the challenges ahead as central banks attempt to normalize interest rates.

What Happened?

Towards the end of September, the Federal Reserve raised interest rates for the third time in 2018 and signaled its intention to continue on this path for the foreseeable future. Amidst fears of slowing global growth and spreading ill effects of the U.S. - China trade war, equity markets reacted negatively, with technology stocks leading the decline. As the fourth quarter progressed, though the U.S. economy overall posted decent performance as measured by third quarter employment and modest wage growth, certain sectors including housing, autos and industrials appeared to be deteriorating, adding to market anxiety. Market commentators and many investors became intensely focused on the December Fed meeting, and President Trump weighed in unnecessarily, all but forcing the Fed to raise rates for the fourth time in 2018 or lose its credibility. Market volatility in December intensified as additional signs of a global slowdown became apparent and year-end tax-loss selling occurred, and was made worse by the Administration's clumsy attempt to mollify markets, as well as the looming government shut-down. At one point in late December, one of the President's Wall Street confidants told him to simply stop talking about the Federal Reserve. The December sell-off was fairly indiscriminate, though value oriented businesses generally performed better.

In early January, the Chairman of the Federal Reserve, Jerome Powell, gave a speech indicating a shift to a significantly more moderate stance with regard to future rate increases, citing reduced inflation expectations, global headwinds stemming from trade concerns and rising uncertainty, among other factors. In short, the Fed reacted swiftly to the market swoon, reversed course and thus spurred markets higher. After the January Fed meeting, just six weeks after stating its intention to continue increasing rates in 2019, the Fed confirmed a much more dovish stance for the foreseeable future. Unsurprisingly, markets reacted positively to the Fed's U-turn and posted one of the best months on record. Sentiment changes fast, and more importantly, the Federal Reserve under its current leadership has become more reactive to market developments.

The Federal Reserve and Interest Rates

The obsessive focus on the near term actions of the Federal Reserve illustrates the shallow and fragile nature of financial markets propped up for years by easy money and ultra-low interest rates. Though rates have lifted off the bottom in the U.S., they remain historically low. After nine

successive quarter-point increases in the federal funds rate from near zero to 2.5% percent, it appears that the Fed discovered in December how far it can go for now.

The desire to return to a presumably higher “normal” level of interest rates makes sense, if only to position the Fed to be able to make accommodative policy adjustments in the future should the need arise. However, macro-economic trends, including disinflation resulting from rapid technological change, deflationary pressure from the world’s ever-increasing global debt burden and the continued low interest rate policies of central banks in Europe and Japan, imply that rates will stay low or even decline as global economic growth moderates.

Interest rates are the cornerstone of asset valuation; however, businesses with growing, sustainable cash flows are relatively less affected by shifts in interest rates than those with static or more cyclical cash flows. We avoid the latter and focus on the former, and as long-term investors, we are not acutely focused on the near-term outlook for interest rates or the actions of the Federal Reserve, except to take advantage of changes in asset prices as markets react irrationally to abrupt shifts in rate expectations.

Outlook

Despite trade and tariff headwinds, the U. S. economy is currently performing well, inflation is muted and both employment and wages are up. However, there are signs of weakness in cyclical sectors, including housing, autos, energy and industrials, and the stimulative effects of the 2017 tax cut have passed. Meanwhile, the outlook for global economic growth has clearly dimmed. In particular, economic growth is slowing in China, which will ripple through developing markets negatively, while parts of Europe, notably Germany and Italy, may be nearing recession. Continued trade tensions, highlighted by the U.S. - China trade standoff, and the looming issue of Brexit are additional headwinds for global economic activity.

Against this mixed business outlook, the polarized political environment, increase in social tensions both at home and abroad, rancorous trade disputes, and challenging geopolitical issues could easily spill over into financial markets, harming sentiment and sparking volatility. Moreover, with a sharply divided U. S. Congress, an unpredictable Administration and attention shifting to the next presidential election, we do not expect much, if anything, to change positively with regard to government policy over the next two years.

While we are pleased that equity markets have recovered much of their fourth quarter sell-off, we are also aware that the road ahead will occasionally be bumpy. Once, when queried for his views on the stock market, J. P. Morgan is said to have responded, “It will fluctuate.” Though unsettling, volatility is the knowledgeable investor’s friend, often presenting the opportunity to buy or sell pieces of great businesses at attractive prices. We welcome the return to a more normal capital market environment where the cost of money is determined more by the laws of economics than central banks and remain entirely focused on finding attractive opportunities to invest in superior businesses with sustainable, growing cash flows regardless of the winds of change around us.

We close with a note of remembrance. A few weeks ago, Steve Dodge, who founded and led one of the leading wireless infrastructure companies through its initial rapid growth phase, died tragically in a bicycling accident. Simply put, Steve was one of the best CEO’s we have ever met, a truly gifted visionary who strived to do the right thing for customers, employees and shareholders. Apart from helping create a new industry, Steve’s greatest gift to shareholders by far was his ability to attract Jim Taiclet as his successor. Named as president in 2001 and CEO in 2003, Jim successfully navigated through a crisis he inherited and has taken Steve’s original vision far beyond anyone’s wildest

imagination. Jim is peerless in our view, and when we last spoke with Steve a few months ago, he credited Jim with doing “the heavy lifting.” We agree, and thus, this final act of leadership continues to benefit shareholders. Steve will be missed.

If you have any questions about your portfolio, specific holdings or any other matter, please call us. We would love to hear from you. Meanwhile, please know that we remain ever grateful for your trust and will continue to work to compound your capital at an attractive rate.

We wish you all the best in 2019.

Respectfully,

Peter C. Keefe

James H. Rooney

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