MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

The broad markets showed a slight gain for the first quarter of 2016, masking the significant volatility during the first three months of the year. At one point in mid-February, the Russell 2000 was down 16%. In a similar vein, crude oil was down 30% at the January low, only to rebound to up 3% for the quarter.

1st Quarter, March 31, 2016	**3/31/2016**	**% Change 1st Quarter**	**% Change Year to date**
Dow Jones Industrials	17,685.09	2.20 % *	2.20 % *
S & P 500	2,059.74	1.35 % *	1.35 % *
Russell 2000	1,114.03	-1.52 % *	- 1.52 % *
BC Aggregate BD Index		3.03 %	3.03 %
10 YR Treasury Yield	1.786 %		
30 YR Treasury Yield	2.620 %		

*** Includes reinvested dividends***

Limitations of Monetary Policy

As most students learn in Economics 101, the US Government has two divergent tools at its disposal for managing the pace of economic activity: fiscal policy and monetary policy. In an oversimplification, fiscal policies manage budgeting and taxes while monetary policies manage the supply of money. Historically, the government has utilized a mix of fiscal and monetary policy to promote sustainable growth and stable prices.

Towards the end of the 20th century, the primary task of managing the economy shifted from managing budgeting and taxes to managing the supply of money. The Federal Reserve Bank (the Fed), created in 1913 to supervise the banking system, directs United States monetary policy. In an effort to stimulate the economy, the Fed and their worldwide counterparts began to aggressively lower interest rates, particularly after the financial crisis of 2008. This extraordinary process has culminated in negative interest rates throughout much of the world. Negative interest rates occur when central banks or commercial banks charge depositors for the privilege of keeping their money in the bank. This is intended to incentivize banks to lend money more freely, and businesses and individuals to invest and spend money rather than pay a fee to keep it safe. The five year German Bund yields a negative 0.3% while two thirds of Japanese debt has negative yields. If held to maturity, bonds with negative yields guarantee a loss of principal.

Monetary policy is not symmetrical: stimulus provided at the depth of a financial crisis (as occurred in 2008) has a far greater impact than stimulus or negative rates have on a recovering economy (albeit a slow one). As noted in our year end letter of 2015, as the limitations of monetary policy become more apparent, investors transition from growth and momentum stocks to the relative stability of value investing.

Historically, earnings growth as measured by Generally Accepted Accounting Principles (or GAAP) has been the ultimate driver of future equity valuations. That model was somewhat disrupted after 2008 with the extreme monetary policy which allowed for valuations made on more aggressive pro forma accounting, stock buybacks and a dose of unrealistic growth projections. These valuations, by and large, ignored GAAP Accounting and inflated earning projections beyond reasonable expectations. *LinkedIn* and *Valeant Pharmaceuticals* are poster children for the perfect storm of easy money and aggressive pro forma accounting assumptions. Year to date, *LinkedIn* is down 48% and *Valeant Pharmaceuticals* has dropped 68%. These types of high growth aggressive accounting equities are not part of our core holdings. Our mission continues to be the identification of value through strong fundamental research and conservative projections. We expect that bottom-up research with an eye towards a yield advantage should allow us to perform well in the current environment.

Although the timing of a return to a better balance between fiscal and monetary policy is unknown, we are at a junction where monetary policy has reached its limits. We are well positioned for the eventual migration to a more normalized policy.