October 7 , 2016

Dear clients and colleagues,

As we begin the final quarter of 2016, temperatures continue to register above normal, natural gas prices are now solidly above US$3 and oil prices are approaching $60/barrel as OPEC reached an agreement to curtail production. Inflation in the US should be above 2% next year if the Fed has any doubts.

The recent OPEC agreement signals that oil and gas is yet another market that is artificially maintained, similar to interest rates that are maintained artificially low by central banks. One of the main highlights of Q3 was the acknowledgement by the ECB, the Bank of Japan and the Fed that, although rates were not moved, quantitative easing was beginning to have a diminishing effect. The risks posed by keeping rates low and the uneasiness at what tools may be available to counter the next recession are now frequent topic for discussion.

The fourth quarter will be marked by the US elections in November as well as an important referendum on constitutional changes in Italy on December 4. Also, the Fed will likely hike interest rates before year end. All of these events have the potential to move the market. However, in the next few weeks companies will start reporting earnings and expectations for sales and profit growth remain muted as markets appear expensive. Should we worry? Taking a more in-depth look at markets, we see valuation extremes. Mega cap tech, staples and utilities are selling at substantial premiums to the market, often at record high valuations. Other sectors like financials and industrials are selling at a large discount so we would not be surprised to see a sector rotation in the market similar to what happened in 2000.

A few months ago, we wrote about major headwinds facing large multinationals, with the first being higher taxes. During the summer, we saw the European Union order Apple to pay up to $14.6 billion in back taxes. A new US Government Accountability Office report, released in August, found that one in five big companies do not pay any income tax. Also, last week the *Financial Times* reported that 136 companies warned investors in their 2015 annual reports that they will most likely pay higher taxes going forward. Technology companies such as Google or Facebook, but also KKR, Crocs, Hyatt and many more in all sectors, were among those making this suggestion given the OECD has made tax avoidance a top priority. Several countries are choosing not to wait and are therefore already enacting laws to capture more taxes. The UK just announced that tax breaks on interest costs will no longer be deductible, an impact of over 1 billion Pounds on the profits of multinationals.

Another headwind we discussed was increased regulations, particularly for the financial and healthcare sectors.

Like many, we watched the congressional hearings with Heather Bresch, the CEO of Mylan, and were appalled at her defense of her company’s raising the price of an EpiPen from $50/pen in 2007, when Mylan bought the EpiPen maker, to over $600/pen in 2016. In comparison, a European competitor’s epinephrine autoinjector costs less than $100/pen.

Abuses like this are now coming under more scrutiny, as we saw with Valeant over the summer. With both US presidential candidates agreeing on this point, we believe it will have a large impact on the sector.

In the last few weeks, we also saw Deutsche Bank's stock price reach an all-time low as markets worried about the impact of fines and penalties levied on the bank for regulatory breaches. As other banks come under scrutiny, fears of systemic risk have returned as a result of the Deutsche Bank fallout. We suspect we will see more regulations, not less going forward.

As a reminder, the Financial and Healthcare sectors are over 29% of the MSCI World Index.

Global Alpha is a strong proponent of responsible investing. We feel investors must ask the right questions about product pricing or tax planning as well as executive compensation. With ESG analysis integrated into our fundamental analysis, we are asking these questions, and we take the answers into consideration before making investment decisions.

To close our weekly, we offer our opinion on a popular current topic, the advent of self-driving or autonomous cars.

Having had the opportunity to meet with many companies that supply the technologies required to produce autonomous cars, we see that the technology is almost there and a fully autonomous car will probably be available in the next five to seven years. However, we think it likely that the US will not be able to make use of this feature that may become ubiquitous in other countries.

Why do we think this? We must consider the interpretation of regulations and liability in different countries.

To illustrate this point, we will use the recent Takata airbag recall in the US. In the last year, Takata, one of the largest airbag manufacturers in the world with over 20% market share, had to recall over 69 million cars equipped with its airbags, effectively bringing the company to technical bankruptcy.

We doubt anyone would drive a car today that is not equipped with airbags. It is estimated that in the US alone airbags save over 2,000 lives each year and help to avoid serious injury for at least 100,000 people.

In the last 10 years, as a result of defective airbags known to have an adverse effect on vehicles in hot and humid locations, 10 people died and 139 have been injured in the US. As a result, the recall and subsequent lawsuits arising from these unfortunate incidents have bankrupted the biggest airbag maker in the world.

Now, turning to self-driving cars, the rationale of increasing safety and saving lives will still not be sufficient to bring about adoption of these cars in the US, despite the benefits outweighing the risk, if companies can't be released from their liability.

We do not foresee carmakers being able to drop their responsibility in case of accident nor will suppliers of the technology or the NHTSA (National Highway Transportation and Safety Authority) be able to assume the liability. So the US will most likely be forced to watch countries like Germany drive on autopilot while drivers in the US will continue to have to drive themselves.

Have a Happy Thanksgiving.

The Global Alpha Team