MIDWAY CAPITAL RESEARCH & MANAGEMENT LLC
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July 10, 2015

Dear Fellow Investors,

June marked the end of our seventh full year of investment activity for Midway Capital. Every year and every quarter we face a different set of challenges. Reading the performance numbers from last quarter (our portfolios down a fraction) and listening to the global economic news (Greece, China) might lead you to think the outlook is for rough and stormy weather. However, we don't think that's the case. So we wanted to devote this letter to addressing the macroeconomic climate and the likely impact on our investments. Long story short, the global economy has some rough spots, but they are not too scary right now, and the US economy is doing quite well.

Midway Capital Value Portfolio Returns

	Midway Composite (net of fees)	S&P 500 TR Index	Difference
Q2 2015	-0.76%	0.28%	-1.04
2015 Year to Date	1.42%	1.23%	+0.19
Annualized Return Since Inception	10.66%	9.42%	+1.24
Total Return Since Inception	103.17%	87.79%	+15.38

Data reflect total returns (including dividends) net of fees as of 6/30/2015. Inception date is 7/1/2008. Returns are unaudited. Your individual returns reported on your statements may vary from the composite depending on when you invested and upon any special instructions or restrictions applicable to your account. The composite return is the time-weighted return of all our accounts added together into one big pool. We believe it is the best indication of how the average client fared during these time periods.

Your Portfolio and the Global Economy

Let's take Greece first. The amount of news on the Greek debt crisis is out of all proportion to its importance to the global economy. Whatever happens to Greece, it is unlikely to affect us at all. (Maybe exported bottles of retsina will be cheaper if Greece leaves the EU.) We'll go into more depth about Greece below because it is an interesting saga. But the Greek crisis is a tempest in a teapot.

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Next on our list is China. As you know, the Chinese domestic stock market has been melting down. That sounds bad to us because our markets are firmly connected to our overall economy. Stock market capitalization in the US is over 100% of GDP. However, the Chinese market is very different from western markets in important ways. The Chinese stock market equates to around 30% of that country's GDP and most of the money in the Chinese stock market belongs to individuals who are arguably speculators. On top of that, the Chinese government has been pushing its citizens to invest, hoping to fund more of its domestic business with people's savings rather than state money. State newspapers have trumpeted the meteoric rise of the market as a victory for the party regime. Now that the stock market is melting down, the government has pulled out some of its biggest guns to try to curtail the drop.

There is certainly something at stake here – many people's savings and the image of the Communist Party. But in reality, the stock market is not yet big enough to impact the overall economy very deeply. It represents less than 15% of household assets and less than 2% of the assets in Chinese banks.[1] Meanwhile, the economy is still growing, property values are recovering, and the banks are stable. A stock market crash is not good news. But it is likely to be more a sign of an immature and speculative market than serious economic trouble. We're more concerned with the longer-term trends of China's economy maturing. As spending patterns change in this emerging market, we need to make sure our investments that rely on Chinese trade – or compete with Chinese goods – are positioned to benefit from the changing mix of goods and services that China will be buying and selling a decade from now.

Coming back home to the United States economy, the bigger picture is still fairly rosy. Both economic and company fundamentals are solid. Unemployment is gradually decreasing. Consumers are spending. Banks are lending. Janet Yellen may even decide to raise interest rates this year. She is carefully monitoring a number of indicators on her "dashboard" including the unemployment rate and inflation. If the economy looks healthy, the Fed may raise rates as soon as the September meeting. Indeed, interest rates across the board have already begun to rise in anticipation of the Fed's action.

If the Fed does hike rates, it would be a sign that they see a strong economy on the horizon. Essentially, the Fed would be expressing its confidence that the economy can stand on its own two feet without the government propping it up. At the same time, rising interest rates may have a dampening effect on the stock market prices in the short term. We've seen some of this already as Wall Street prepares for Yellen to withdraw some of the cheap money we've enjoyed for many years. However, over the longer term, market

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[1] A red flag: China's stockmarket crash. *The Economist*. July 7, 2015. http://www.economist.com/blogs/freeexchange/2015/07/chinas-stockmarket-crash

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returns tend to correlate with the direction of interest rates. In other words, as rates rise, we would expect stock prices to do the same. All of this is a good sign for the stock market.

That said, we are taking a more cautious approach to investing that we did when stocks were selling at deep discounts. When stocks are very cheap, we get paid well for taking on risk. There is always risk in investing. We can earn our highest returns when we buy stocks below their fair values. When stocks are selling at prices close to their fair values, we stand to earn a smaller reward for the same amount of risk. Given the current market valuation, we feel that a more conservative approach is prudent. We can always move into higher return stocks if prices fall and values remain the same. It's like waiting for that "stock-up-and-save" sale at your favorite store. When the sale is on, you might stock up on all the toilet paper you can possibly fit in your cupboards. When there is no sale, you buy only what you need. To be clear, we still think stocks offer the best investment value of anything on the market. But this isn't the blowout door-buster sale we had in 2009.

The Saga of Greece

Like a reality TV star refusing to fade from the limelight, the Greek debt crisis has reached new levels of hysteria over the past months. The financial press seems like "all Greece all the time." As we said above, this is really a tempest in a teapot and it won't have much effect on those of us who don't live in Greece. But given the media dominance of the Greek story, we thought we would offer our insights into what's going on and what's actually at stake.

The first indications of something amiss came back in 2009 when bond-rating agencies lowered Greece's credit rating below "A". Six years, seven austerity packages, and two bailout packages later, the debacle continues. As we write, Athens has offered an olive branch to its creditors amid dire conditions in Greece with the banks shut down. By the time you receive this letter, the details may have changed, but situation will still be the same. Prime Minister Tsipras is stuck between a bad choice and an awful choice – between Scylla and Charybdis. On one hand, he could accept the continued austerity, heaping more misery upon his populace. On the other hand, Greece could bow out of the currency union. Hyperinflation and disorder would surely follow.

So Tsipras has sought a third road. He wants more loans from the European Union to keep his country and banks afloat rather than have to face the music. This is really the only palatable option right now. But European patience is running short.

In a referendum on Sunday, Greek voters rejected the most recent bailout offer, eliciting howls of protest throughout the EU. To understand this, we have to go back to the roots of the EU. They can be traced to a cooperative union between French and German coal and steel companies that was signed shortly after World War II. This union gradually expanded to include much of Western Europe, and in the 1990s, was officially dubbed the European Union, touching all industries and many social aspects of European life. Centuries of military conquest and domination were gone. The new buzzwords were cooperation and unity: partnership. As Europe's biggest economy and most populous country, Germany was bound to play a major role in the budding union. And considering the historic strength of Germany's currency, many of the EU's bankers and economists were either German or adherents to German orthodoxy.

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So when Greece found itself in trouble, it asked its "European Partners" for help. In return, Greece received two bailout packages. Germany and its like-minded neighbors were not happy about this situation. Criteria for adoption the Euro included sustained rates of low inflation, low debt-to-GDP ratios, low budget deficits, a slew of other metrics. Greece was widely accused of fudging its numbers to meet the criteria for adopting the Euro, and as more reliable figures emerged, the extent of fiscal mismanagement in Greece became clear. Greece was cooking the books. Understandably, the three organizations lending Greece its emergency funds did so with many strings attached. Greece had to agree to raise taxes, actually collect the taxes it was owed, and slash government spending. Such "austerity" has proven extremely unpopular and the Greeks soundly rejected it in Sunday's referendum.

At this juncture, Greece could be kicked out to the currency union. No mechanism exists for ejecting a member, but the outrage of member states could lead to unprecedented action. Still, the concept of European unity and cooperation is the cornerstone of the EU. Asking a member to leave or having a member depart is completely contradictory to this theme. Prominent French economist Thomas Piketty suggested Germany is being hypocritical in its demands for Greece to repay its debts in full. After all, postwar Germany saw all its Weimar and Nazi-era debts forgiven. Meanwhile, new entrants to the Eurozone like the Baltic States have been particularly galled by Greece's behavior. These states spent years fixing their fiscal houses in order to join the currency union, and now find themselves being asked to bail out a wealthier partner who lied about the state of its finances.

A Greek exit (dubbed the "Grexit") is still a real possibility. Yet, reading through the various European media outlets, we get the impression that partnership will carry the day. At least, no one will be cast out of the monetary union wearing a scarlet "D" (Default). The various national media sources have done a good job reporting on other countries' wishes and demands, and following a brief period of outrage and belligerence, we see a greater sense of cooperation and reason on the horizon. That's good news for the Greeks, because the other alternatives must look just as terrifying as Scylla and Charybdis did to Odysseus.

Yours,

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and the Midway Capital team

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