Pinnacle Capital Management, LLC

April 2016 PCM UPDATE

Equity Strategy

The first quarter of 2016 ended on a positive note. This is especially gratifying given the way the year began. At its low point in mid February, the S&P 500 had generated a negative return of 10.3%. It seemed as if the sky had fallen. We once again heard the cries that the economy was going to sink into oblivion - that the decline in oil prices was signaling economic activity grinding to a halt. And just as suddenly, the situation reversed itself. Oil prices and the stock market drifted (sprang?) upward, and lo and behold, the markets finished the quarter on the plus side. While not a roaring bull market, stocks as measured by the S&P 500 returned 1.35% for the quarter. Do you even remember the dismay of late January / early February?

In our January 2016 Update we cited the auto sector as having underperformed despite auto sales achieving record levels. We believe that the market was taking the position that peak sales would be followed by a rapid collapse in sales. While we are inclined to agree that we've either hit peak sales for this cycle or we're very near peak sales, we believe that a high level of sales will be sustained for some time. As a result, we find the auto sector to be one of the cheapest sectors of the market. Going into year end, the Fund held positions in both Fiat Chrysler Automobiles NV (FCAU) and auto parts manufacturer Tenneco, Inc (TEN). On January 4, FCAU distributed its holdings in Ferrari NV (RACE) to shareholders. We subsequently sold our holdings of RACE and took a new position in Ford Motor Co (F). While the price of FCAU fell 19.7% for the quarter, it had recovered sharply from its early February lows. Our holdings of F and TEN, on the other hand contributed positively to performance.

In our last Update we also cited returns linked to the oil industry as a drag on performance. We bemoaned the fact that our industrial holdings were acting as if they were oil stocks even if only a small portion of their revenues were derived from the oil sector. This, to us, was irrational. Whether or not this market link still exists, we can't say for certain. What we can say is that crude oil, as measured by the near term West Texas Intermediate futures contract, advanced by 3.5% for the quarter. Meanwhile every one of our industrial holdings, except for Barnes Group (B) which fell less than 1%, advanced for the quarter. Returns in this sector were led by Terex (TEX) 35.1%, Xylem (XYL) 12.5%, and MSA Safety (MSA) 12.1%.

Another sector in clients' portfolios is the telecommunications industry, including both Verizon Communications Inc (VZ) and AT&T Inc (T). Both stocks had been weak in 2015 as fears of a price war resulted in weak stock prices. We have always felt that the price wars wouldn't be ruinous and that the firms would find increasing methods for capturing profits from the transmission of voice and data. In the first quarter, both stocks rebounded - VZ returning 18.5% and T returning 15.4%.

Thus far we've discussed mostly winners; but what didn't do as well in the quarter? Our generic drug company holdings, Teva Pharmaceutical Industries LTD (TEVA) and Mylan NV (MYL), were both gainers in the fourth quarter of 2015 but generated negative returns in the first quarter. The losses of 14.3% and 18.0%, respectively, are likely the result of both being tarred with the same brush as certain firms that were solely in the business of buying up old drugs and then hiking the price several hundred percent. We can assure you; this is not the case here. We still have great confidence in these holdings. Meanwhile Plantronics, Inc (PLT), a manufacturer of communication headsets, declined by 17.0% for the quarter, having reported disappointing earnings early in the New Year.

Before we move on, we'd also like to point out a few other stocks and note their performance. Caci International (CACI) is a provider of technology to the government, and in particular the defense sector. Among its work it helps rationalize the multitude of systems and enhances overall security. We don't talk much about this stock, but it has been a long term holding in client portfolios. Over the last 4 years ending March 31, 2016 it has an average annualized return of 14.4%. The first quarter was no disappointment, as the stock returned 15.0%. Meanwhile, our two chemical companies, Eastman Chemical (EMN) and Dow Chemical (DOW), were a mixed bag. While EMN returned 7.7%, DOW generated a negative return of 0.3%.

As we head towards the elections, and as quarterly earnings come in, we wouldn't be surprised if the markets return to a higher level of volatility. Portfolios are positioned with respect to our outlook that the economy should continue to advance modestly. As always, we'll stay true to our disciplines and remained focused on the long-term.

Fixed Income Strategy

While yields on bonds began to rise in the 4th quarter of 2015 (the 10 year U.S. Treasury yield advanced from 2.04% to 2.27% in that quarter), in the first 3 months of 2016, interest rates once again reversed themselves. By March 31, 2016 the 10 year U.S. Treasury yield had fallen to 1.77%. We think there's a couple of things going on. First, it is apparent that the Federal Reserve will not follow through with their four targeted rate increases in 2016. Readers of this Update will not be surprised. Second, the race to the bottom overseas continues. Rates in several countries have turned negative. With competitive rates so low it's difficult for U.S. rates to go higher. It now costs the governments of Spain and Italy less to borrow than does the U.S. government. It was not long ago that these two European governments were commonly known as the "I" and "S" in "PIGS". If you recall, we're referring to (P)ortugal, (I)taly, (G)reece, and (S)pain - the 4 European nations whose credit was so shaky that they threatened to bring down world economies.

We have to admit, this is a tough situation. Bond yields just aren't that attractive. We hate taking on unnecessary risk, and we believe we've kept risk down to reasonable levels. There are no easy answers. There's no question that we've been surprised how long interest rates have remained so low. Eventually, there will be repurcussions from such an extended period of low interest rates. But for now, we continue to keep a bias towards credit risk as opposed to duration (long maturity and cash flows) risk. We have utilized bond funds for many accounts, and we've tended to pick those that have had shorter durations such as the Vanguard Short-Term Corporate Bond ETF (VCSH) and the Lord Abbett Short Duration Income Fund (LDLFX). We've also invested client moneys in funds that either focus on taking on more credit risk such as the Fidelity Floating Rate High Income Fund (FFRHX) or funds that take on a wide spectrum of credit risks such as the Pioneer Strategic Income Fund (STRYX).

Going forward we'll have to keep our eyes open for two distinct possibilities. The first is that rates begin to rise as the business cycle continues upward. In that case, we believe we're nicely positioned. This is our expectation. Still, we recognize the persistant downward pressure on rates that continues to exist. Still, at some point, the economy will soften. There will be a next recession. We don't expect it soon, but it will happen. In our second scenario, if it appears that a general economic slowdown occurs prior to a general rise in interest rates, we'll likely focus more on underlying safety. In that case we may change the funds we invest in and / or change weightings in some of our holdings.

Within the context of the above scenarios and the current environment, we have to avoid getting caught up in short-term movements, panics, or even bouts of euphoria. The markets don't always make it easy - in fact they rarely do; so we'll continue to filter the noise and parse the signals to build the most prudent portfolios that we know how to for our clients.