

April 1, 2015

Greetings,

There is a tremendous amount of uncertainty with the markets now. Wall Street detests uncertainty. Uncertainty leads to increased volatility. The more uncertainty, the greater the volatility. It is a simple formula. A combination of the imminent end to zero short term interest rates and poor corporate profits are a bad mix. Many people (myself included) figured that once the Fed was ready to start raising short term rates that the economy would be buzzing along. That is not the case. The “buzz” is closer to a murmur. Fourth quarter GDP was a tepid 2.2%. The first quarter of 2015 was not much better. Please keep in mind that it has been 5 ½ years since the great recession ended. Historically, the deeper the recession, the stronger the recovery. This paradigm has eroded in what has easily been the worst economic recovery ever. While the domestic economy is lousy, it is far better off than other economies around the world, effectively making us the world’s “tallest midget”.

Much of the chatter by the media’s talking heads continues to be about short term interest rates and when the Federal Reserve will finally pull the trigger and begin the new interest rate cycle. Most of the intelligent people I listen to and chat with state that it shouldn’t matter whether the Fed raises rates in June, September or October. The market expects it so things should be ok with the markets. The assumption with that theory is that the market acts rationally in the short run and that in my view is not a valid assumption. The market participants who control the big money (anyone mention the words Hedge Fund manager??) like free money and when these people don’t get what they want, they throw a temper tantrum similar to how a toddler does when you take away his or her candy. Consider the low interest rates the equivalent of candy. For full disclosure, the short term focus of the hedge funds has not been to the benefit of their clients as they as a group have vastly underperformed the broad market the past six years so I wouldn’t put much credence into what they do when rates do go up.

The Federal Reserve has pretty much cornered itself into a box, intimating that this is the year when short term interest rates will begin to rise all the while saying they will be “patient” and their decision will be data dependent. In its last meeting, the Fed dropped the word “patient” from its language but during Janet Yellen’s recent news conference, she made it clear that the Fed won’t be “impatient”. Huhh?? George Orwell in his famous novel “1984” would have referred to this as double speak. Reactions to Janet Yellen’s news conference were just as extreme. The best line was “the Fed should just say that they have no idea now when they will raise rates but we will know it when we know it”. The reason the Fed is in such a box is because if they put off raising rates until next year (which is what some people think they should do), they would only would they lose credibility, but threaten the stock market because markets would fear that the economy is

worse than it is. Meanwhile, the Fed is reluctant to raise rates too soon for fear of halting this feeble economic recovery.

Corporate profits for the fourth quarter (reported last January and early February) were not good. As reported in the mid quarter update, our holdings experienced very good earnings and in some cases, they were outstanding. One of the reasons I don't put much credence in what the "market" does is because we don't own the "market". We own a concentrated portfolio of high quality companies, most of them currently at reasonable prices. Some of the pundits said that corporate profits were good last quarter other than those of energy and financial companies. Those two sectors make up just over 25% of the market, so it is difficult to exclude them. We have minimal risk exposure in the energy sector, in fact one of our energy holdings is up nearly 30% in 4 months. Subsequent by one day to this letter, our other energy holding was just sold as to prevent a small loss from becoming a large loss. We have no exposure to financials (the sector that killed the economy in 2008 and 2009 and is a piggy bank for the Justice Department) nor will we ever. Corporate profits are actually expected to be worse this quarter (to be reported this month) than they were last quarter. Energy stocks (because of lower energy prices) are expected to have their earnings drop by 63%. Large cap multi national's earnings will be weighed down by the strong dollar. The dollar index is up 5% this year against a basket of all major currencies and 13% against the falling Euro. Since sales abroad are translated into higher priced dollars, there will be a drop in Revenue for most companies in the first quarter. The higher dollar also hurts because much of the expenses are in dollars. Exports are also adversely affected and is also part of the reason why the domestic economy has been worse than what was expected. Again, we don't own the market. I expect most of our companies to do well despite the strong dollar as they did last quarter. There will be much week to week and month to month volatility with the prices that the market is willing to pay for our holdings.

Back in the fall when energy prices began their collapse, many people expected the fall in prices to benefit the consumer, thus benefiting the overall economy. Well, six months later the pundits go the first part right. Approximately half the savings from lower energy prices has gone to pay down consumer debt and much of the rest has been saved. Very little has been spent (as was expected) so the economy has seen no benefit. The reason for this is twofold. Most consumers are living pay check to pay check and are still heavily in debt. While the extra cash is a welcome site, it is still preferable for most people who are tight to pay down those credit card balances (at a crazy high interest rate while the lenders are legally allowed to borrow money at zero interest from the government) or keep some extra money in their pockets. The second reason is that nearly six years after this so called "economic recovery", people are still scared. When people are still scared at the prospect of losing their jobs and have had their wages grow less than the real inflation rate, then the extra money in their pockets won't be spent, not yet anyway. I won't even address all of the people who are now earning significantly less than they were 5-10 years ago because they are forced to take jobs to earn something, as opposed to nothing. This is occasionally referred to as the "underemployed". I believe that if energy prices remain low through the summer driving season, then the consumer will most likely open their pockets, thus strengthening the economy for the second half of the year.



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Please either call me or send me an email if you have any questions or if there is anything that you want to discuss