

July 1, 2016

Greetings,

Other than the financial crises of late 2008 and early 2009, this is easily the most difficult, irrational market since 1999. In many ways, the markets behavior resembles 1999 and that is a concern. I will elaborate. In 1999, the S&P 500 on the surface did very well. Looking beneath the surface, not so well. The reason being the technology sector did so remarkably well, it made the broad markets return appear to look better than it actually was. This despite the fact that the entire sector was extremely overpriced. Just think about going to Peter Lugar's and paying \$500 for a Porterhouse steak for two or in your case, a Filet Mignon? A pretty good piece of meat but at a \$500 cost? In 1999, if you didn't have a portfolio dominated by tech. stocks, you underperformed the index and you didn't look all that smart. For full disclosure, there were some high priced growth stocks outside of tech. such as Home Depot and Walmart that also did well but for the most part, it was either own tech. or underperform.

In the present environment, it is either own defensive stocks or underperform. In our case, underperforming by a lot. While the broad market isn't doing that badly, the overall weakness is masked by the strength of the defensive stocks which are now over owned. The Utility sector is doing especially well. This despite valuations that are stretched based on any type of methodology that you choose to use. In general, I have zero issue with owning a portion of a portfolio with some defensive stocks. Not all defensive stocks are alike and in my view it is imperative to own the correct companies to achieve the best long term results. In the present environment, retail investors as well as large institutions have gone overboard chasing these overpriced stocks in a similar manner as technology stocks were chased from late 1998 to early 2000. Individuals as well as public pension funds are starving for yield thanks to the zero interest rate environment. Yield can't be found in the bond market (without incurring a huge risk in junk bonds), that is for certain. They are purchasing whatever stocks they can find to quench their thirst for income. If they have to over pay then so be it. What I find so disturbing is the fact that so many intelligent, supposedly informed people either don't understand the risk they are taking or if they do, somehow think that they can get out of these supposedly safe securities without suffering huge losses once market conditions change. I can assure you with 100% certainty that the current market conditions will change. I just don't know when.

Another item I find quite disturbing is that similar to the tech bubble, once again people are chasing the best performing stocks with zero regard for valuation. Even if you have the cash to purchase a BMW without financing, will you pay \$ 350,000 for a top model even if you are crazy about that car? If not, why? For some reason, when it comes to stocks, if someone wants to purchase a company that fits their criteria, more often than not (at least in this environment,) they buy it. A BMW or a Peter Lugar's steak no. Duke Energy or Proctor and Gamble, no problem. After all, part of what makes a "defensive" company "safe" isn't just that it pays a nice dividend or that their earnings are predictable, but that it is cheap or at worst, reasonably priced. This is not the case now with defensive stocks, especially the mighty Utilities. The devil is in the details. Con Ed is trading at a PE (price to earnings multiple) of 19 which is a historically a high valuation and a premium to the broad market. Its' dividend is only 3.3%

and its earnings are growing at a paltry 3% per year. Yet, the stock price is up an astounding 22% YTD. In a nutshell, people are paying a huge premium for a dividend and its paltry earnings growth to own this company. In my view, that is a premium that I am not willing to pay.

The news both night and day has been that the U.K. has left the European Union. This is a huge deal, IF you live in Europe. No one knows for certain how this will affect the U.K. and the rest of Europe. People like to talk as if they know for certain but the truth is that they really don't. My best guess is that on the economic front, it will work out badly for both the U.K. and the rest of Europe. The uncertainty for Great Britain is now huge and Europe has just lost its second largest economy. I believe that the effect on the US economy will be minimal in the long run. Of course, the stock market hates uncertainty and since there is so much uncertainty right now, there will be a huge amount of stock market volatility over the next 3 months.

The Federal Reserve has for the most part lost all credibility. They have, at least as far as economic forecasting. In my January investment letter, I wrote that zero interest rates were now over, good bye and good riddance. Not so fast. Technically, short term interest rates are no longer at zero because of the December rate hike. Now they are barely above zero so they might as well be zero. The FED indicated that four rate hikes were on the horizon for this year and at least four for next year. I didn't believe that for a second, not in this economy. I figured, two at the most, most likely one in December. Some smart people figured it was one and done and unless the economy shows some significant improvement, I don't see any rate hikes until well into next year. The bond market certainly sees it that way with the 10 year Treasury yield now down to a paltry 1.46%. Half of the stocks in the S&P 500 have dividend yields in excess of the 10 year Treasury bond. Not to be out done, two thirds of our portfolio also have dividend yields above that level.

Over the long term, it is all about earnings growth. Earnings growth for the broad market has not been good this year. The first quarter was the worst for earnings since the recession. This was primarily because the energy sector is in a recession. Other than the energy sector, earnings last quarter weren't that bad. We don't own any energy stocks. What is so frustrating is that the vast majority of our holdings (as reported in the mid quarter update) reported pretty good earnings in a tough economic environment last quarter, yet our holdings continue to be ignored as if their earnings were bad. Second quarter earnings which will be reported in 3 weeks, are expected to be bad because of the weak economy. I expect most of our holdings to do reasonably well. I have a concern about third quarter guidance. Earnings were supposed to pick up in the second half of the year but with the U.K. leaving the European Union, the CEO's may issue cautious guidance just so that they can beat a lower bar in October. I have seen this tactic many times in the past. The stock market is in a real show me mode, more now than ever. While I can't make short term market predictions, my gut feeling is that the market will be a very bumpy ride until at least Labor Day.