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2013 Third Quarter Review
"A Head Fake and a Flu Shot"

The third quarter continued the basic trends we discussed last quarter, with stocks a little higher and bonds a little lower. The S&P 500 Index gained a little more than 4% for the quarter while long-term US Treasury bonds (as represented by the Barclays ETF) continued their decline, falling a little more than 3% further. The trends in both markets were a continuation of the changes we reviewed last quarter, with one fairly significant surprise.

Last quarter we noted that the seemingly unflappable bond market, after having advanced for 30 years, went into a tizzy when the head of the Federal Reserve mentioned the possibility of "tapering" their purchase of bonds sometime this fall. This was by no means a threat to severely tighten credit. It was merely the first sign that the Fed has yet given that they might, at some point in the future, have the courage to turn the spigot down (not off) on the massive pumping they initiated in the depths of the "Great Recession." Last Spring the economic numbers were firming a bit and the Fed wanted to prepare markets for the inevitable need to survive in the absence of such massive government intervention. However, two things happened on the way to the September meeting where the "tapering" was to be voted on. Economic data weakened as higher interest rates took effect, and the budget battles loomed in the U.S. Congress. The Fed, after having roiled the bond markets, decided NOT to reduce their bond purchases for the time being. Some economists saw it as a deft move given the continuing tepid growth in the economy. Others thought it was a mistake since the markets had already "priced in" a tapering and the Fed could have shown that they have the fortitude to start "taking the punch bowl away" when appropriate. Like a running back charging down the field, the Fed gave a head fake (toward less monetary easing) and then continued on down the field in the same direction. Investors went with the fake and adjusted their expectations accordingly. With no fear of mixing metaphors on our part, we guess that Bernanke et al wanted to give the economy a 'flu shot" in an attempt to inoculate it from the ill-effects of a possible government shutdown and budget impasse. It is probable that the Fed members were afraid of piling more trouble on the markets when there was enough trouble already scheduled. Whatever the reason, the stock markets cheered the decision and rallied nicely after the September Fed meeting, as if the Fed had scored a touchdown.

The troubling aspect of this latest market bounce is that none of the reasons that led the Fed to its decision reflect good news for the economy. It's not good that the economy is growing so slowly and the recovery is so fragile that the Fed feels they can't risk the slightest move away from massive intervention. It's also not good that the government can't agree on a budget and that deficits are continuing to mount. So, short-term the markets rose, but for reasons that cause us concern in the longer run.

As one skeptic put it, "With profit margins 70% above the five decade mean, top-line growth of only about 2% (ex-financials), corporate profits -1% (ex-financials), a P/E ratio that has risen from under 14x to over 16x, and given that the U.S. political leaders in Washington are inert, irresponsible and more partisan (than at any time in history), do you see a compelling need to buy stocks now in light of the S&P 500's rise from 666 to 1680 since the generational low?" We tend to see the merit in that caution.

Precious metals and natural resource stocks continued to be a drag this quarter as gold and silver bounced up a bit, then gave most of the gains back. Natural gas prices still appear cheap and are probably a good long-term value, but the trend is still lower and the stocks have drifted lower as well. We have maintained a small percentage of investments that benefit from inflation and they have generally been a disappointment so far. We don't know if the resolution of our present economic conundrum will resemble that of the Weimar Republic or Japan (inflation or deflation), but it makes sense to be prepared for either.

It is becoming clear that the intervention by the Federal Reserve providing massive injections of liquidity may not be enough to restore normal growth to the economy. There has been a massive shift of indebtedness from corporations to governments. As countries have fallen into financial turmoil, large multinational corporations have, to some extent, become the new "sovereign" issuers of securities. That has played well for our holdings of those dividend-paying core positions that we have held for so long in our portfolios. However, as price/earnings ratios have increased (the stocks trade at a higher price vs. earnings) and as growth in the economy has slowed, it has increased the risk in those same positions that have done so well for us up to now. For that reason, you have seen and may continue to see some profit-taking as we nail down some of those gains and wait for prices to move back to cheaper levels. Recent data continues to show tepid growth in jobs and non-manufacturing activity. If the market exhibits some flu symptoms this fall, we want to protect ourselves a little and be ready to take advantage of any swoon by Mr. Market, whether it's due to a virus or a head fake in unpredictable events.

Speaking of unpredictable events, we assume there will be some resolution to the budget fight in Washington D.C., but there is likely to be plenty of drama leading up to the deadline of October 17th when the "debt ceiling" will be reached and either raised or not. Markets tend to become very "newsy" around these events and short-term volatility will likely increase. Many investors seem to have become inured to these periodic crises (since we've now been through so many) and are now assuming that all will be well (as we suspected it might turn out a year ago when the media were running disaster stories every day.) However, after recent market advances we would rather not rely too much upon sailing through with sunny skies one more time.

Your quarterly reports and statements are enclosed for your review. We are happy to discuss the specifics of your investments at any time, so just give us a call at your convenience. We also take this opportunity to satisfy an annual regulatory requirement by stating unequivocally that we share none of your personal information with anyone without your express consent. (That is a lot simpler than any other privacy policy notice you are likely to receive!). And thank you again for the opportunity to work with you on your investments in these eventful times!

Sincerely,

Claude R. Carmichael CFA