The Double Edged Sword of Low Rates
Second Quarter 2013 Commentary

Summary

1. We have derived a year's worth of returns in six months—although we are thankful, it should not be expected to continue.

2. The Federal Reserve's practice of buying $85 billion per month of fixed income securities is an outright manipulation of interest rates. This has forced many investors into stocks. This "juicing" of both the bond and stock market's cannot last forever.

3. Given the great migration into anything that produces cash flow or yield, the better opportunities exist in companies that pay no dividend. Low interest rates do not make stocks any more profitable—but they may make them more attractive in comparison. The risks associated with stock market investing are still as prevalent today as ever.

Inflation

1. For quite some time we have believed that the "official inflation" figure is greatly understated. Whether we are right or wrong—we continue to be confident that the average family has lower purchasing power.

2. There are many components that go into calculating "official inflation". In analyzing these, one of the largest and most important figures is wages.

3. Currently, there is such slack in the economy due to high unemployment and weak demand—that the official inflation figure remains quite modest.

4. Even if inflation is 2%, the average family continues to hurt.

5. The combination of low "official" inflation and high unemployment makes us realize that deflation and erosion of purchasing power are possibly the biggest fears an individual can have in today's market.

Purchasing Power

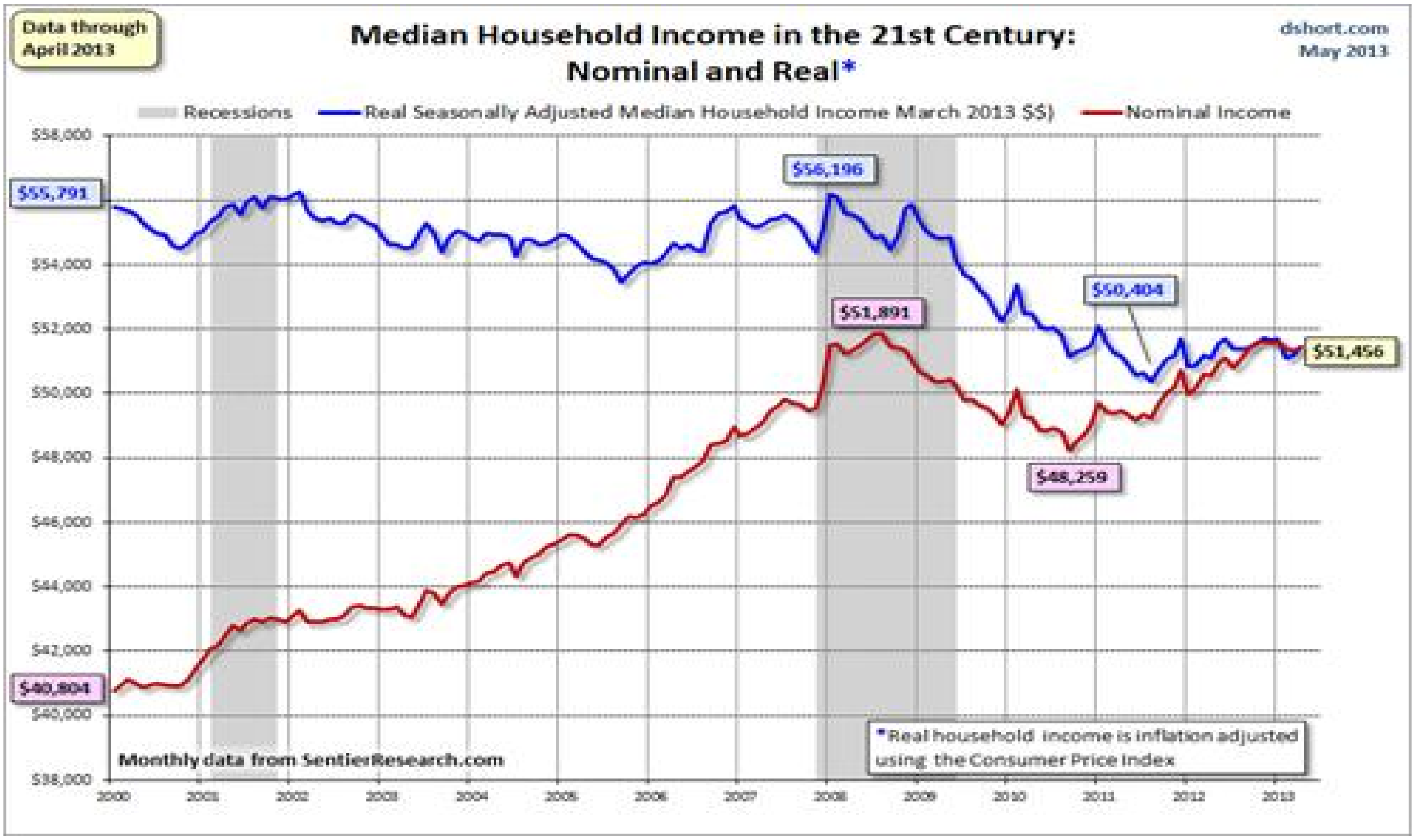
1. Although the stock market has come back to record levels the average family is still struggling just to pay their bills. Because of their financial predicament they have little in the way of financial assets and therefore have not benefitted from the rebound. US stock ownership is down to its lowest level since 1998—indicating many average families have either given up on investing in financial assets or simply cannot afford to invest when evaluating all of the other demands for their resources.

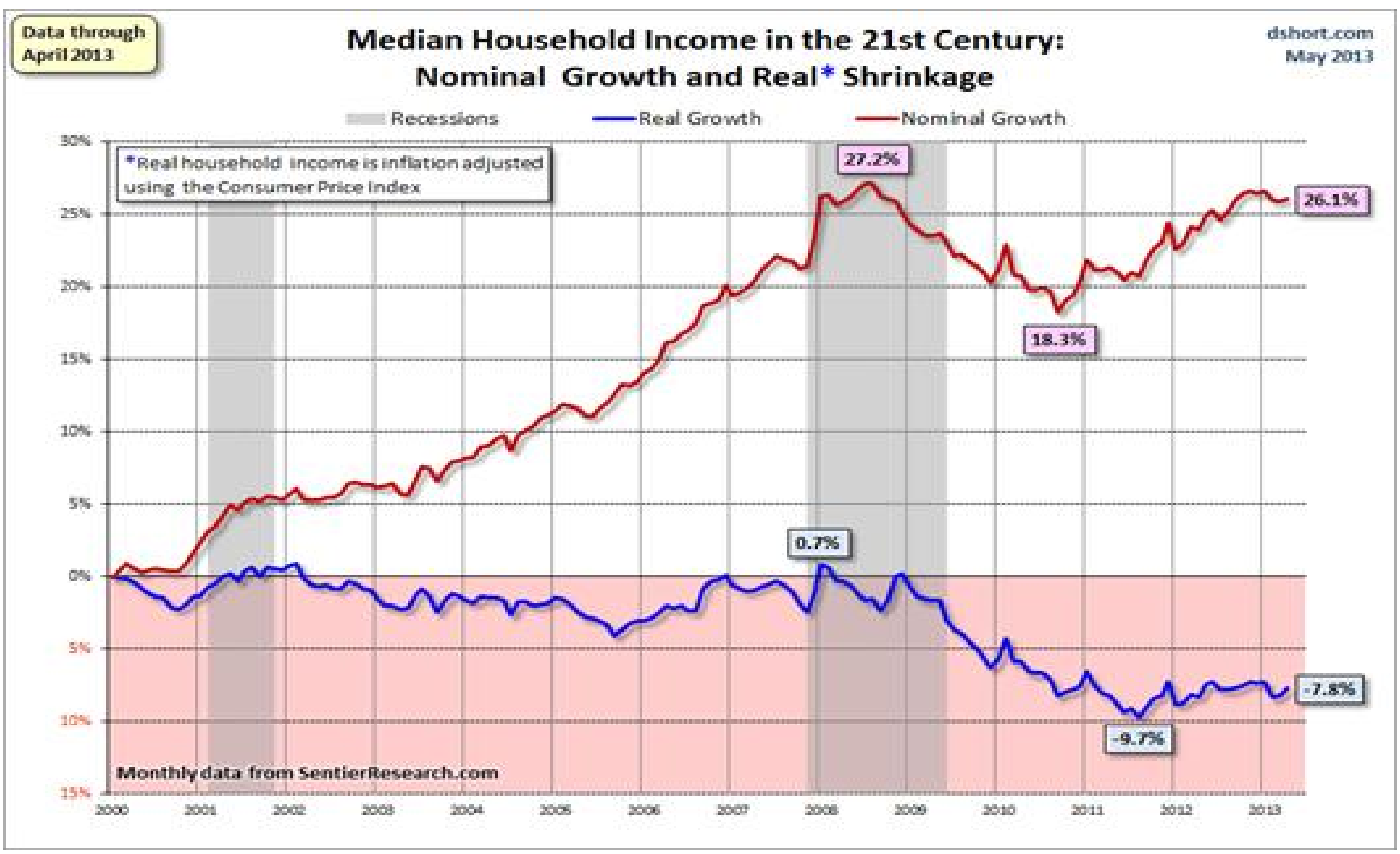
2. Housing has bounced back, however, this is a rather misleading figure. Average home ownership is now at the same level it was at in 1997. As such, the rebound in pricing could have more to do with investors buying up property than actual single family home ownership.

3. Real (inflation adjusted) median household income has declined 8.43% since early 2008 and is down 7.7% since 2000. This means that the average family has spent the last 13 years slowly losing purchasing power.

4. The Rogers Commodity Index has increased 44% since March of 2009—or 9% per year.

5. The expiration of the 2% FICA tax has put a substantial hit on disposable household incomes.





Stock Market Valuations

1. In the first quarter 73% of the companies in the S&P 500 met, or beat, their expected ***earnings*** per share figures. However, of those reporting, only 43% met, or beat, their expected ***revenue*** figure. This tells us a couple of things. First, ***companies are watching expenses very closely—but not expanding***. Over the long run, there is only so much that can be cut before you start to affect long term viability. Secondly, much of the "earnings per share" figure has been boosted due to massive stock buyback programs. Although these programs can be legitimate ways to boost earnings per share—it does not mean that a company is experiencing good growth.

2. The S&P 500 (a market capitalization weighted index) is about 14.6 time earnings. However, the Value Line Index (a US index of 1700 equally weighted stocks) is closer to 18 times earnings. This means ***the "average" company is priced quite a bit higher than what the S&P 500 Index would indicate*.**

3. In evaluating the differences between the S&P 500 and the ValueLine Index we can see that large defensive, dividend paying stocks are some of the most overvalued. Conversely, cyclical companies (tech, energy, chemicals, etc) and especially ones that pay little or no dividend still offer up good opportunities.

4. This will cause us to shift our portfolio holdings as we exit some of the higher valued names in favor of other opportunities that are clearly cheaper to buy.

5. Investors in the "large, defensive" companies should expect very little in the way of returns from this point forward.

6. Warren Buffett's favored market valuation metric, market capitalization-to-gross national product, has passed an unwelcome milestone: the 2007 valuation peak.

   The index topped out at 110.7 percent in 2007, and as of May 22nd it stood at 111.7 percent. The Total Market Index then was **$ 17624.4 billion**, which is about **111.7%** of the last reported GDP. At this point, the overall US stock market was positioned for average annualized returns of **2.2%**, estimated from the historical valuations of the stock market.

   As of the end of June, the Total Market Index is at **$ 16992.1 billion**, which is about **106.2%** of the last reported GDP. The US stock market is positioned for an average annualized return of **2.8%**, estimated from the historical valuations of the stock market. This includes the returns from the dividends, currently yielding at 2%.

7. ***Margin debt in the United States — money borrowed against securities in brokerage accounts — has risen to its highest level ever***, at $384 billion, surpassing the previous peak of $381 billion set in July 2007 according to New York Times. Margin debt as a proportion of GDP is not quite yet at the peak set in 2007, but it has exceeded 2.25% only twice previously in the last 50 years–2000 and 2007.

Interest Rates

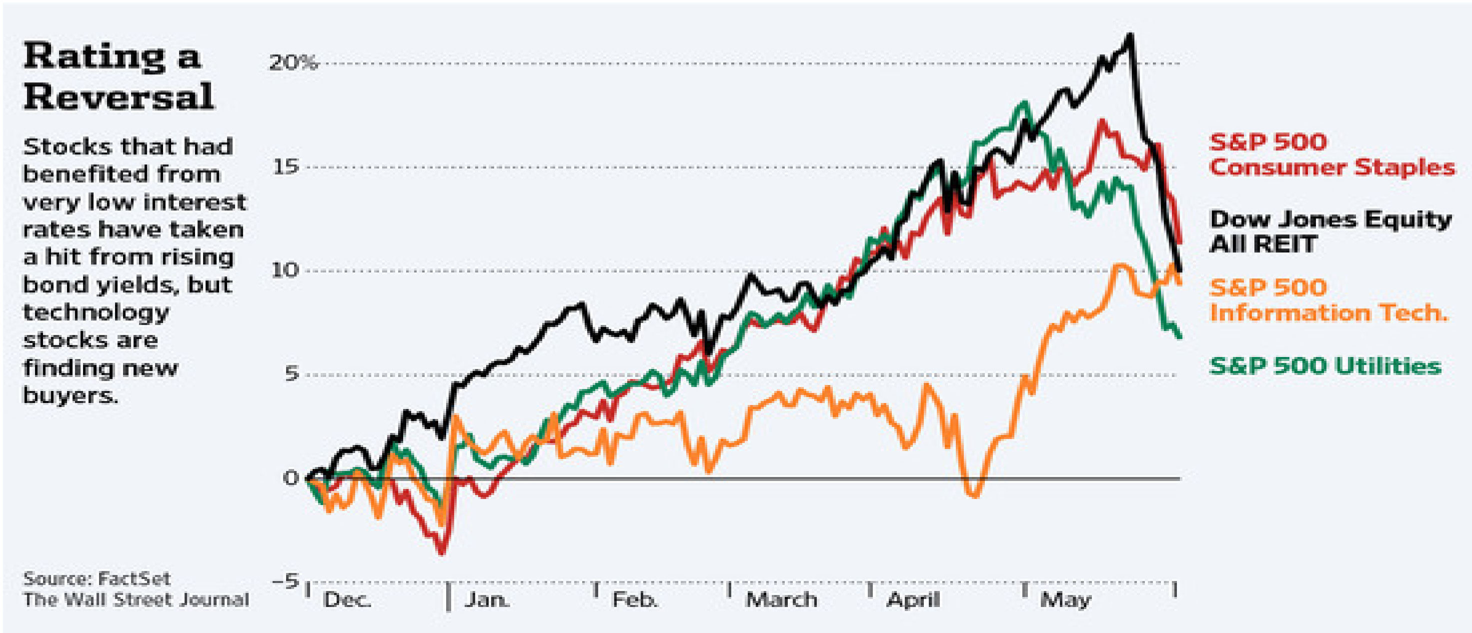
1. Currently, the Federal Reserve is openly buying up $85 billion per month of US Treasury notes and mortgages. This process is known as "quantitative easing" and we have now had multiple rounds of QE. This is done in an attempt to keep interest rates low in order to stimulate demand.

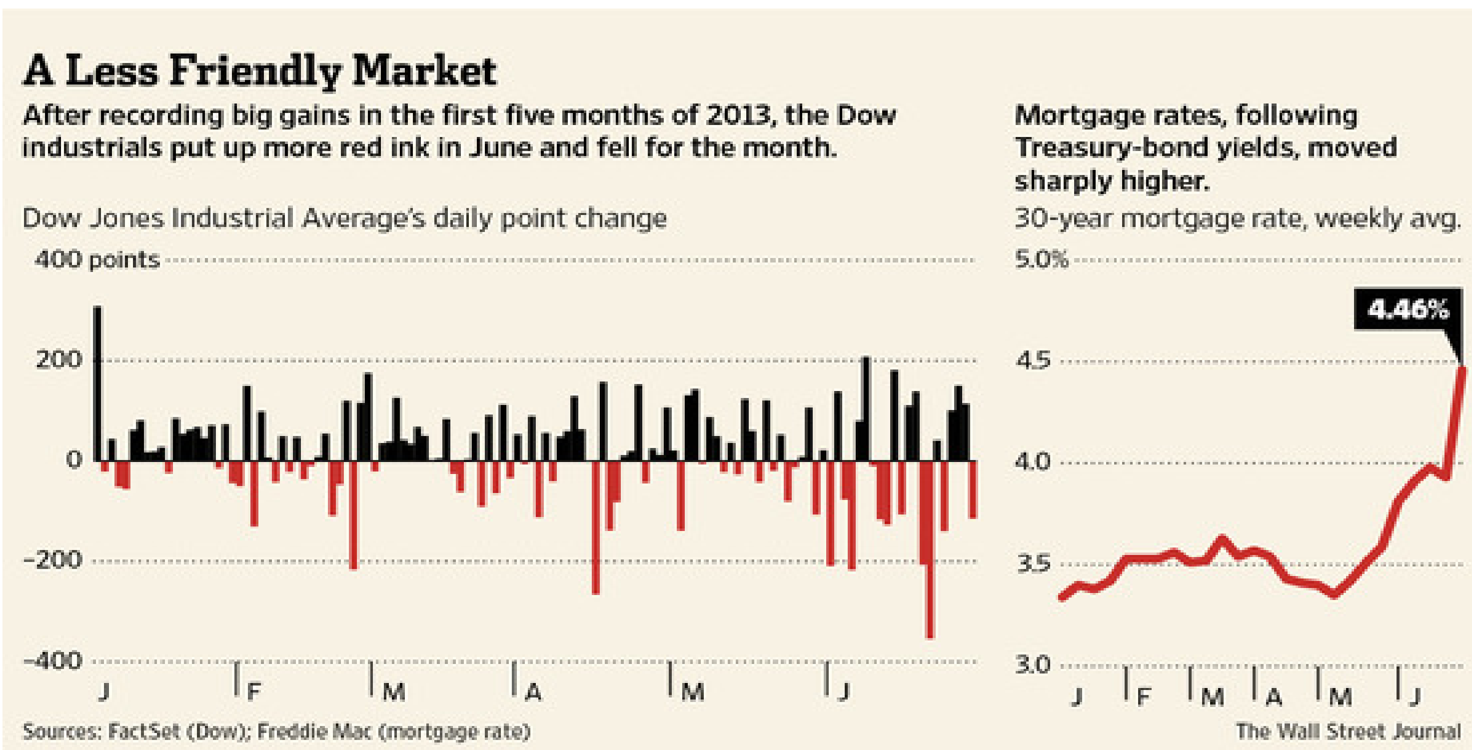
2. The Fed knows they cannot continue QE forever. As such, in the past month there have been some discussions about discontinuing QE—or at least backing off of the purchases.

3. The mere discussion of altering the QE process brought a swift and measurable response from the open market relative to fixed income securities. ***In two month's time the yield on the 10 year US Treasury increased from 1.67% to 2.48%. This is more than a 50% increase in rates in two months!***

4. This also brought a sell-off in utilities, real estate investment trusts and mortgages.

5. If and when the Fed does back off of QE you can expect an even bigger interest rate reaction.





Let us know what questions you have on this or anything else.

Sincerely yours,

Dave *Warren*

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