Third Quarter 2013 Commentary: Slow Growth & Another Government Shutdown

Government: As the third quarter comes to an end, Americans are once again faced with a shutdown of our federal government. What a shame—but at this point in the game no one should be surprised. Furthermore, if our elected leaders have this hard of a time managing OUR money then maybe they shouldn't be there in the first place.

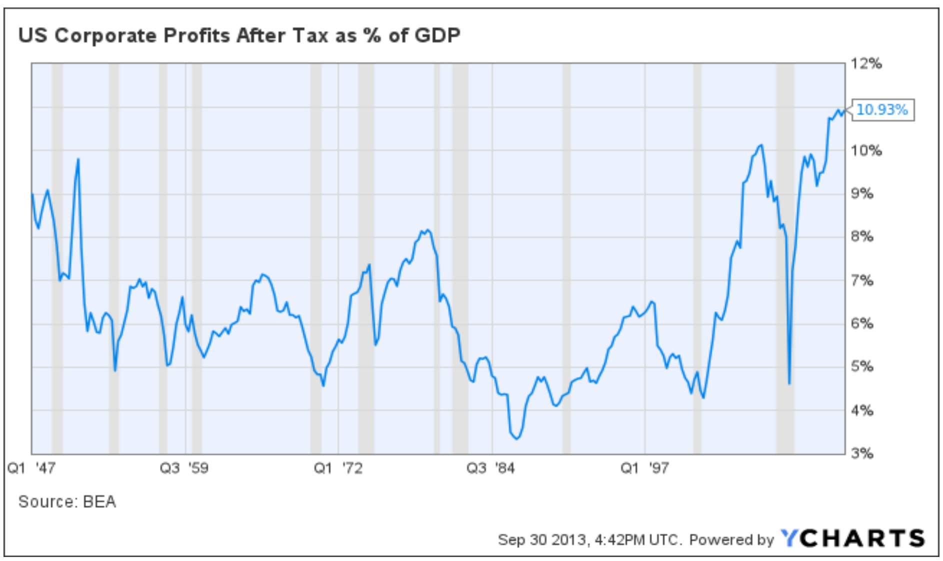
Assuming they cannot come to a resolution by the end of September 30, 2013 then a full 1/3rd of governmental spending will be cut. This will have broad consequences.

Stock Market: Since the stock market bottom in March of 2009, we have experienced a powerful rebound in stock prices. Back then we could easily cast money to a variety of assets recognizing strength and significant value. Viewed in isolation, this should have us all smiling.

Unfortunately, we are getting a queasy feeling in our gut—somewhat like we had in 2005 and 2006. We can see storm clouds on the horizon. We do not know if they will produce thunderstorms—or tornados—but the warning signs are there.

Price to Earnings Ratios: In 2009, the broad market traded at a PE Ratio of 14. Today, ***the market is trading for 19 times earnings***. This is a 35% increase just in PE expansion. This ratio can only go so far before gravity pulls it back in. If the PE Ratio of the entire market increases to more than 25 times earnings, it will indeed be reason for broad concern.

Profit Margins: At the same time corporate profit margins have expanded to unbelievable and unsustainable levels. ***At 11% of GDP, corporate profit margins are at their highest level in the past sixty five years and nearly double their long term average***.



Unfortunately, these record profit margins are not attributable to fantastic innovation. Rather, they are the result of "Quantitative Easing" or the government's manipulation of the interest rate markets. This has encouraged companies to leverage up (again, similar to 2005 – 2007).

These historically high margins can also be attributed to the increasingly lean corporate culture since 2008 in which there has been significant under investment into staff and inventory. This lack of reinvestment is unsustainable. Given this, we expect corporate profit margins to revert back to their long term averages.

Quantitative Easing: Currently, the Federal Reserve is "buying" up $85 billion each month of debt issued by the US Treasury (yes, this is simply moving money from the right hand to the left hand) as well as mortgage debt. By increasing the "demand" for fixed income securities by $1 Trillion each year this effectively has put a ceiling upon interest rates. The goal of this practice is an attempt to stimulate demand for expansion and hiring as an end result of cheap borrowing.

However, corporations and investors alike all know that this game can end at any time. We witnessed this first hand when the Fed said they may back off on Quantitative Easing. Once mentioned, interest rates increased from 1.6% to 3% on the ten year US Treasury.

Once the government saw how quickly interest rates reacted to the government's plan to reduce interest rate manipulation rates settled back down to 2.6%.

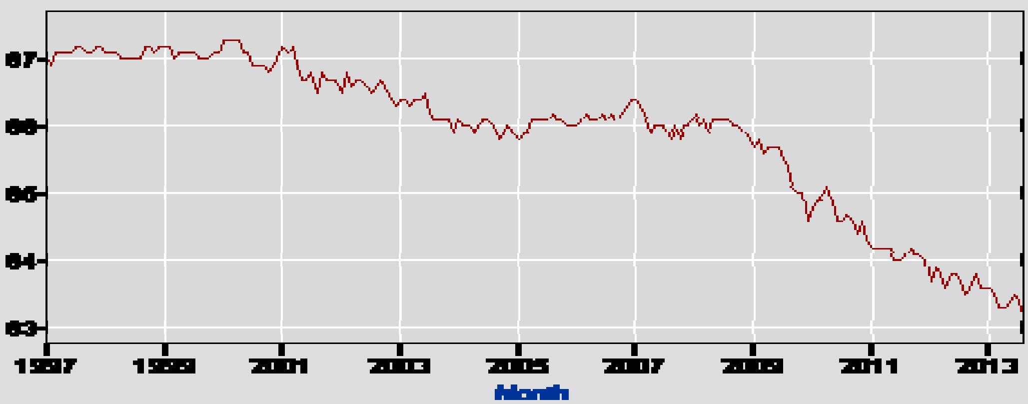
As long as the government continues this manipulation, the stock market will be the only logical investment vehicle for long term investors. The government continues to pour copious amounts of booze into the punch bowl making us all feel good for the time being. ***However, once the government pulls the punchbowl away, there will most likely be one heck of a hangover***.

Federal Reserve Chairman: It is pretty obvious that President Obama does not want Ben Bernanke to continue as Fed Chair. The odds on favorite at this point is Janet Yellen—however, if that appointment occurs we do not see any material changes in strategy or philosophy. It will just be another chapter of interest rate manipulation.

Unemployment/Labor Participation Rate: The official unemployment rate stands at 7.3% and the government says they will not back off of quantitative easing until unemployment his 6.5%. Although this seems like the economy and employment picture are getting better—they are not.

Our preferred metric for assessing employment is the Bureau of Labor Statistics Labor Participation Rate. Unfortunately, this metric shows that ***only 63.2% of all American's are actually working—the lowest level in 35 years! This confirms ShadowStats metric that true unemployment is running about 24%***.

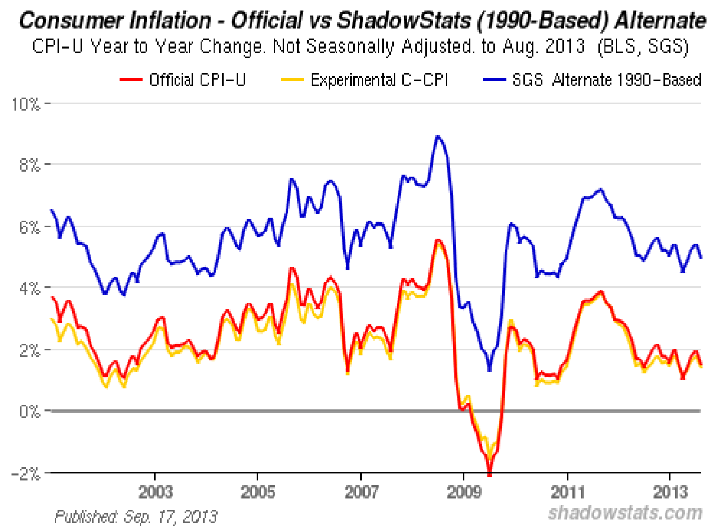
Labor Force Statistics from the Current Population Survey—Data extracted Sept 28, 2013
Labor force status: Civilian labor force participation rate
Type of data: Percent or rate
Age: 16 years and over

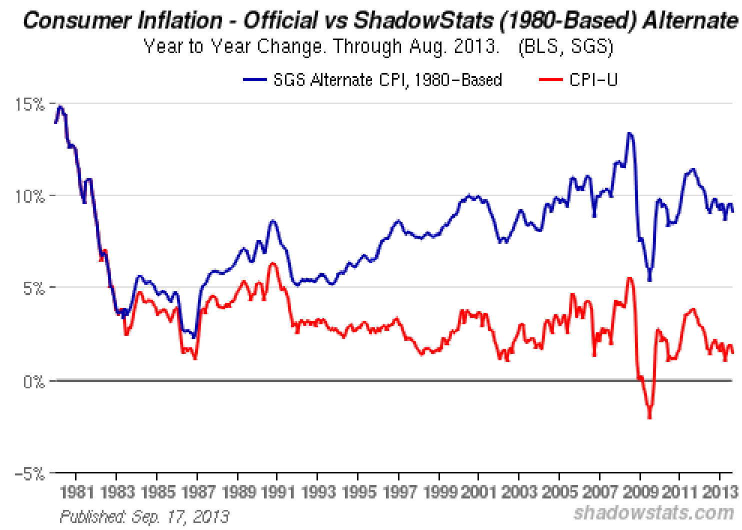


GDP Growth: Given the headwinds of high unemployment and low corporate expansion it should be no surprise that Gross Domestic Product increased a slim 1.1% in the first quarter and 2.5% in the second quarter. At this point in a supposed economic recovery GDP growth should be quite a bit stronger.

Inflation: Another metric the government assessed for ending the quantitative easing program is inflation. However, this too, is a manipulated metric. From time to time, the government will change the components that are included in the official inflation calculation.
Currently, the government tells us inflation is running under 2%. Maybe our clients are just extremely unique—but none of them are experiencing just 2% cost of living increases.

According to ShadowStats, if we calculate inflation based upon the official formulas used in 1980 or 1990 then ***inflation is running somewhere between 5% and 9%***. Based upon personal experience and lifestyles, we can believe that figure.





This puts an even larger burden upon the average American to stretch a buck.

Student Loan Debt: As we still struggle to bring stability to the mortgage and housing market after five years of calamity and chaos, we now have an even larger debt obligation hanging over American's. The total value of student loan debt is more than $1 Trillion.

However, unlike a mortgage, student loan borrowers cannot file for bankruptcy or give back the keys to homes they can no longer afford.

Hopefully, this will mean that there will not be a collapse from the student loan market. However, ***it will zap the normal economic productivity*** from the people that owe these debts. This will hurt GDP growth that much more.

Regulation: If we haven't identified enough economic headwinds, we also need to factor in new costs associated with Obamacare, Dodd-Frank or increased taxes. Whether these programs, taxes or regulations are positive or not is open for significant debate—however, they are expenses which will further slow economic expansion.

Where to Invest: Given all of the hurdles, interest rate manipulation, taxes, unemployment, etc. investors are left scratching their heads on where to invest.

Admittedly, we are finding fewer and fewer bargains. However, even in an elevated market you can still find reasonable investments.

The best place to outpace taxes and inflation continues to be the stock market. However, as we have always said, investments into stocks require intestinal fortitude and a ***long time frame***. If you are going to invest in stocks, you must have a ***ten year, or longer, time frame.***

If you are not going to invest in stocks, there is little else. We see little opportunity in the fixed income market. As such, we would keep maturities very short as you don't get paid to incur the additional risk associated with long term fixed income assets.

Sincerely,

Dave

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