

April 1, 2014

Greetings.

In my last investment letter, I made it clear that things would be different this year and at this point in time, my forecast is correct. The stock market experienced its first pull back in longer than I can remember last quarter as the broad market dropped by just about 6%. I expect at least a couple of more pull backs in that range this year so please get used to the volatility, it is here to stay. It has been a sloppy market so far in 2014.

There has been a lot of noise with the markets lately. While I generally don't agree with Warren Buffet's politics, I can't think of any investment professional I admire more for his investment knowledge although Carl Icahn is catching up because of all of his recent great stock picks. One thing that Mr. Buffet frequently says is to tune out the noise when it comes to the stock market. I do my best to tune out the noise but I have to admit, it isn't easy sometimes.

Some of the loudest noise lately has to do with the Federal Reserve and its new chairwoman, Janet Yellen. I will say this; Ms. Yellen certainly made a big splash with her initial testimony before Congress. She was appointed by President Obama (his second choice after Larry Summers) and even the Congressional Republicans seemed to be impressed. Once Congress was impressed, then the markets were thrilled. A talking head on CNBC described Ms. Yellen "as an intellectual stud". Bob Pisano, who covers the NYSE floor for CNBC said people on the stock exchange were describing her as a combination of a sharp college professor and a wise grandmother. Then came her first press conference two weeks ago and wow, talk about a change of events. During the last few years, Ben Bernanke (the man who she replaced) has been making it clear that the Federal Reserve would keep short term interest rates at the present levels for the foreseeable future. The markets view on this has been that short term interest rates would remain at near zero for well into 2015. My call has been that they will most likely remain at these levels until early 2016 because I think that the Fed will be scared to pull the trigger and prefer to be a little late than too early. At the recent Fed press conference, Ms. Yellen at first said that rates would remain low for six months and the Dow Jones newswires picked up on that. Then, later on in the news conference, Ms. Yellen corrected herself and explained that short term rates would remain at their present level for six months after tapering is over. She explained that the game plan was for the tapering to be over by November or December which means that rates will begin to go up in the middle of next year, which is 15 months from now. I believe that after the press conference was over, Ms. Yellen wished that she could have a mulligan. A mulligan is a golf term for a do over after a bad drive. The reason I feel that way is that just yesterday, in a speech she stated "That an extraordinary commitment is still needed and will be for some time" and "The job market in some ways now is tougher than in any recession".

Needless to say, the stock market rallied on those dovish statements. The problems are two fold. First, for the first time, the Fed is putting a precise time table on when short term rates are going up. Ms. Yellen later on in the press conference attempted to explain that her decision will also be data dependent but by then, the genie had already been let out of the bottle. Second and more importantly, the Fed is indicating that they have the intention to raise short term rates quicker than what was expected. Now, let me make this perfectly clear. Logically, three months shouldn't make a bit of a difference as far as stock prices. If a stock is worth X amount of dollars, raising short term rates a few months earlier isn't going to make that company worth any less. The problem is that other than some smart value managers, very few people purchase companies based on what they are worth so the market doesn't act logically. Interest rates, both long and short term are going up. Whether it is in mid to late 2015 or early 2016, it will happen.

Much of the reason for the great returns of the stock market over the past 2 years has been because of the easy monetary policy of the Federal Reserve. Like it or not, the easy, cheap money is coming to an end. Since the stock market is forward looking, the volatility is occurring now in anticipation of the spigot being turned off later.

Speaking of forward looking, historically the bond market (which determines long term rates) has been a great indicator of future economic activity. The Federal Reserve historically has been a terrible predictor of future economic activity. One of the reasons why the Federal Reserve is "tapering" its bond purchases is because it sees the economy picking up later this year. I am not sure what they are basing their views on but I don't see very much evidence of a pickup in the economy right now. I see it just plodding along at a snail's pace. I think another reason which the Fed won't acknowledge is everyone (the Fed included) is tired of Quantitative easing. The theory behind QE from the start was to inflate all asset prices by keeping long term interest rates as low as possible and also pumping liquidity into the system. I have seen the HBO movie "too big to fail" many times (also referenced to in previous investment letters) and one of my favorite parts was when William Hurt (who played ex Treasury secretary, Hank Paulson) says to another Treasury official at the end of the movie, "the banks will lend the money, right?" Well, 5 ½ years after TARP (TARP was the massive government, taxpayer funded, bailout of the entire banking industry), the answer is no, the banks aren't lending. Even when you are approved for a loan, the process is now so onerous that in my view, unless you are truly not liquid or really like using other people's money, you are better off using your own capital. I just went through the process with an affluent client that I have known for 30 years and the process was worse than I could have imagined. That is one of the reasons why there has not been any inflation (at least according to the governments definition), because the banks aren't putting very much of all of this liquidity back into the system. They are holding much of it as part of their reserves and using much of it to purchase fixed income products and make profits on the difference between the 0.25% cost to them to borrow and the return on their investments. In theory, inflating assets was supposed to increase economic growth and job creation. In reality, all that the massive bond buying program did was help the stock market and make the hedge and private equity managers (who were able to borrow money at 3.25%, these people use leverage, unlike me) a lot more wealthy than they already were. While the economy is significantly better than it was 5 years ago (about when the recession ended), isn't

much better than it was 3 years ago. Even Janet Yellen acknowledged (without saying so explicitly) that the unemployment rate is not truly accurate as far as the strength of the labor market. So while the Fed sees economic activity picking up, the bond market sees no pickup in growth. If the bond market saw growth picking up, then the yield on the 10 year Treasury bond would be significantly higher than the 2.7% it is right now.

Other than the Fed chatter, there hasn't been too much else going on. The market is pretty much ignoring Russia's threat to invade Ukraine as well as the annexation of Crimea. Fourth quarter corporate profits were decent and better than what was expected. There were very few profit warnings for the first quarter and with many earnings estimates already ratcheted down because of the weather, my feeling is that it will be a pretty good quarter for corporate profits.

Very truly yours,

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