Quarterly Report-2nd Quarter 2016

On the Markets...

This has been a very difficult market environment; some might say impossible. And so we are reminded of this quote from the late, great(est) Muhammad Ali: "Impossible is just a big word thrown around by small men who find it easier to live in the world they've been given than to explore the power they have to change it. Impossible is not a fact. It's an opinion. Impossible is not a declaration. It's a dare. Impossible is potential. Impossible is temporary. Impossible is nothing."

But it *has* been something. Even legendary hedge fund champions, like Bill Ackman & John Paulson have been humbled by a market that has confounded conventional expectations & singularly frustrated both the bulls and the bears.

In a pattern of failed breakouts and breakdowns stretching beginning in 2014, the markets have repeatedly broken the observable trend line, moving higher to build conviction, then selling off in a steep decline to shatter confidence, then reversing course once again. As a result, for more than 2 years, the market has been stuck in a trading range and made little real progress despite a marked pickup in investor anxiety and price volatility.

At the beginning of June we moved back to the top of the trading range once again only to sell off more than 5% in 2 days following the British referendum to leave the European Union (Brexit.) Then the market reversed itself once more. U.S. stocks gained more than 1% for three days in a row so that by the closing bell at month's end, the S&P 500 had nearly fully gained back what it lost.

As Jeffrey Saut notes, markets are instruments that process information. That means they tend towards short periods of freaking out and long periods of indecisive vacillation. Market behavior following the Brexit vote was a freak-out. All across the world, investors dumped stocks and ran to the safety of conservative assets. The U.S. dollar soared. So did the Japanese yen. The yield on the 10-year Treasury approached its lows from 4 years ago, which were the lowest yields since 1790! The world assumed the British would vote to stay in the EU, and the world was wrong. The selling was exaggerated because the areas of the market seen to benefit from a Remain victory had been rallying.

We can't claim any foresight. We thought the Remain side would pull it out as well. The difference is that our portfolio strategy of generating income and protecting principal isn't dependent on a particular election outcome. We understand that the key to managing assets successfully is to focus on carefully managing risk.

Two interesting points of note: Google searches of the term "EU" spiked in Britain immediately following the announcement of the vote suggesting that despite a rugged 3 month campaign, voters were confused and highly emotional. No less surprising, less than a week after the sell-off, the major British stock index, the FTSE 100, was actually higher than where it was before the vote. This is probably a small gift wrapped in a similarly misunderstood package. We believe it is largely the result of a globally devalued British pound which shall make English exports more competitive, but foreign goods more expensive, and Britain is largely a service-oriented economy centered in London.

The first half of 2016 is now over and the S&P 500 has gained 2.69%. Including dividends it is up 3.84% for the year. Against a backdrop of weakening fundamentals and conflicting economic data, the markets have drifted from one Central Bank action to the next. Interest rates have been driven to historic lows. The 10-year bond in Germany has a negative return, meaning that depositors do not receive interest; they pay banks to hold their funds. Japan has negative rates out to 15 years and Switzerland's are negative out to 30 years! At present, 40% of the world's governmental debt sits at negative interest rates. Rates in the U.S. are not nominally negative,

but the real return, after inflation, is negative. We have written before about the predictable consequences. Savers and conservative investors have been forced to reach for yield, purchasing riskier assets as “bond equivalents” and pushing them to historically elevated prices. As an example, utility stocks now trade at a higher (P/E) valuation than technology stocks.

Welcome to the new normal. Interest rates will remain lower than we all expected for longer than we all expected. Central Banks across the globe, including the U.S. Federal Reserve have tried to resuscitate their fragile, anemic economies with the ether of low rates. But cheap capital alone is insufficient. Capital is indeed the fuel to a sustainable recovery, but the engine itself is growth- growth which is stimulated by meaningful investment driven by real confidence in the future. Regrettably, confidence was the immediate victim of the global financial debt crisis 8 years ago and is still MIA.

We believe there is a clear link between the present distortions in our global economic system stemming from that financial crisis in 2008 and the social malaise that is evident throughout the developed world. When growth slows, production falls, the economic pie shrinks. The financial security of the middle class is threatened. Income disparity and inequality is exposed in vivid clarity. Popular sentiment turns negative. Institutions and politicians lose the public’s trust. Populist, protectionist, anti-immigrant movements gather momentum. This is the world we live in today. As Peggy Noonan, in her weekly column for The Wall Street Journal recently wrote, “Everything feels upended, the old order that has governed things for 70 years since World War II [is] being swept away. Borders have disappeared before our eyes. Terrorism, waves of immigration transforming whole nations, Islam at war with itself and parts of it at war with the world. In the West, the epochal end of public faith in institutions, and a dreadful new tension between the leaders and the led. In both background and foreground is a technological revolution that has actually changed how people experience life.” To put a finer point on it, we enter an American election season facing significant, systemic problems, with public confidence in our legislators at an all-time low and 2 of the most unlikeable candidates facing off in a presidential election. To quote Bank of England Governor Mark Carney, "It now seems plausible that uncertainty could remain elevated for some time."

It may well be that markets will continue to reflect that uncertainty, but we remain vigilant and cautiously optimistic. We believe that the US economy is still managing a sluggish recovery, and is not facing an imminent recession. We base this on a slowly improving employment picture, the healthy pace of consumer spending and the consequence this has with a strengthening US housing market. There are other encouraging signs. Investors' bullish sentiment is low; cash levels in portfolios is high; earnings expectations have been lowered too much; more than 65% of the stocks in the S&P 500 have a higher dividend yield than the 10-year T'note; we are still in a low inflation environment, and EVERYONE is defensively positioned.

We appreciate the trust you place in us and keenly focused on protecting the resources you place in our care. We encourage your comments, your questions and your feedback.

Sincerely,

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