Quarterly Report- 3rd quarter 2014

# On the Markets...

Poets may say that April is the cruelest month,* but investors would strongly disagree, shaking their heads wearily: confused and dismayed in October.

From July through September, the U.S. equity markets in the 3rd quarter finished virtually unchanged. This, despite a growing list of international concerns, including increasing Middle East violence, the conflict in Ukraine, slowing growth in China, the re-emergence of weakness in Europe and Japan and the grim shadow of an Ebola epidemic. Instead, our markets were sustained by a consistent flow of positive, domestic economic data on jobs, corporate earnings, and re-assurances from the Federal Reserve Open Market Committee that interest rates and inflation were to remain at historically low levels for the foreseeable future.

But markets represent the collective views of the crowd, where uncertainty breeds confusion, and confusion creates nervous behavior. The result is a spike in volatility which had been conspicuously absent from the market for the past 6 months. In such circumstances, even good news is apt to be viewed badly and cause market pullbacks of as much as 5- 10%.

Such ”corrections”- contrary to our most recent, and therefore our most compelling experience- are to be expected, and normally occur every 12-18 months. One significant element of the present confusion and nervousness is that U.S. stocks have not experienced even a 5% pullback in over 2 years.

This, in itself, is not particularly disturbing. We suspect that the “missing” correction is merely deferred. In any case its arrival is impossible to predict: especially given the unprecedented antecedent of the global financial collapse in 2008 and the unorthodox and previously un-tested remedies central bankers have seized upon to effect financial recovery.

* T.S. Elliot, *The Wasteland*

Some argue that the anemic pace of recovery and its duration- now more than 5 years on- is a critical warning sign. We reject this. There are two highly respected Harvard economists, Carmen Reinhard and Kenneth Rogoff, who are generally acknowledged to have produced the most penetrating and insightful analysis of the history of financial crises and their aftermaths. Their work suggests that the average recovery period from a credit-induced recession is about seven years. By this measure this recovery would seem to be on track, and given the severity of this last crisis, it should not surprise if the runway stretched further than average.

So while we remain vigilant and cautious, we want to avoid over-reacting to a correction. We are mindful of the warning by Peter Lynch, widely regarded as one of the most consistently successful portfolio managers of all time: *"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves."*

We also want to avoid mistaking a normal correction for a fundamental change in the trend of the market. As we have said in previous commentary: we continue to hold the view that we are in the midst of a long-term, secular bull market that has room to run. Historically, bull markets end as the result of either a recession (2 successive quarters of economic contraction) or a financial crisis.

The financial and economic indicators that we follow show no warning signs of impending recession or financial crisis, and they remain consistent with what has historically produced positive equity returns.

We regard the market at its recent peak as fairly valued and when adjusted for an environment with inflation at such low levels, it remains well below the average of the previous 11 market tops.

The historical evidence is that stocks typically enjoy a rather long period of price and multiple expansion following a period of negative 10 year returns. On average these periods of expansion last more than 15 years and deliver above-average annual returns, fueled by a growing economy.

Furthermore, every U.S. recession in the past 50 years has followed a period of very tight monetary policy- sharply increasing interest rates- and we are nowhere close to that. The Fed continues to pursue a cautious and accommodative policy, insisting, quite vigorously, that interest rates will remain low “for a considerable period” and will not be raised until there is strong economic data and compelling evidence of a need to restrain inflation.**

The consensus within the financial community has been guided by the Fed to expect that rates may begin to rise by midyear 2015. It’s important to remember that rising rates are not incompatible with a rising stock market, particularly if the increase in interest rates is gradual and it is recognized that rates are rising as a result of sharply increasing strength in the overall economy. It is when rates rise sharply and unexpectedly that lending slows, credit contracts, businesses reduce spending and stock prices fall.

We continue to expect that the market will end the year at a higher level than present, although we remain watchful and wary for, as always, there is an impressive list of serious concerns and considerable regard for “what could go wrong.” Our vigilance is based on 2 cardinal principles:

-A recognition that superior investment performance is the result of efficiently trading (some) risk for return.

and

-Keenly re-evaluating your personal portfolio to ensure that it appropriately captures your investment goals and your individual risk tolerance.

We encourage your questions and your feedback and we remain dedicated to protecting your capital.

Respectfully,

M Lieber                                                            William A. Boselli

Martin S. Lieber — Chief Investment Officer

William A. Boselli, Jr. — President

**The determined efforts of the contemporary Fed to communicate policy and intent in a “transparent” manner stand in stark contrast to the same body under the 1987-2006 leadership of Alan Greenspan who took pride in saying: “Since becoming a central banker, I have learned to mumble with great incoherence. If I seem unduly clear to you, you must have misunderstood what I said.”

585-662-4166
mlieber@strategicwp.net

70 Linden Oaks
Rochester NY 14625

585-662-4165
wboselli@strategicwp.net