CARMICHAEL CAPITAL INC.

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2013 First Quarter Review
"Muddling Through Very Nicely"

During the latter part of last year I received a much larger than normal number of calls from nervous investors who were shaken by the fear-mongering economic headlines, most notably those regarding the looming "fiscal cliff," and were ready to sell everything if I thought we should. Our last quarterly letter discussed how "investing by the headlines" is by its very nature a very unprofitable way to manage a portfolio and that the end of the world may not be a great bet because it doesn't happen very often. Seriously, we simply judged that the probability of disaster was lower than generally thought, and that the probability of "muddling through" was higher than it was given credit for. Well, muddle through we have, at least so far!

For the first quarter of this year the S&P 500 index rose 10% while the "tech-heavy" Nasdaq Composite rose 8.2%. Bonds did not fare very well as the Barclay's 20 Year US Treasury ETF fell by 3%. The prospect for improved economic activity put some upward pressure in interest rates, bringing a decline in bond prices.

A classic example of the often counter-intuitive nature of profitable investing was presented to us at the beginning of this quarter when we actually DID go over the much-dreaded "fiscal cliff" (like Thelma and Louise in that gorgeous '66 Thunderbird) and the equity markets proceeded to go UP by 8 to 10%. The reason? Fear was high (expectations were low) and the reality turned out to be not-so-bad-after-all. The economy actually ticked up a little (i.e."muddled"), and as we suspected and intimated in last quarter's letter, the effects of the Federal Reserve's policy of "easing to infinity" simply overwhelmed any countervailing factors. The whole process shows that "just muddling through" can pay very nicely, especially when expectations are low as they were then.

Our strategy of focusing on a core of high-quality, dividend-paying stocks has continued to…well, pay dividends. The large consumer non-durable/staples sector has continued to do well with advances in the stock prices of P&G, Pepsico, Coca-Cola and the pharmaceutical companies like Bristol-Meyers, Pfizer, and Merck. Some of our insurance and industrial/tech holdings like AIG and Corning have moved up as well. Stocks of economically sensitive companies (which we have planned to add to but held off) have struggled while precious metals have generally declined, contrary to the expectations of inflation watchers.

With the strong and persistent advance in the stock markets in recent months, and especially with the trumpeting of each new record high that the indexes attain, we are in a very different place than we were last fall when fear was high, expectations were low, and prices were lower. Anyone who thinks that a strong and rising market insures its own continuation should take a look at two charts: gold and Apple.

In September of 2011, the Federal Reserve had been pumping money into the economy for well over 2 years. Inflation seemed inevitable according to the simple recognition of the fact that more money would be sloshing around in the system to bid up the price of everything. It certainly looked that way as gold, the classic inflation hedge, hit $1,900 per ounce. Today, after much MORE money printing, pumping, and "easing" by the Federal Reserve in the intervening 18 months, the price of gold closed at $1,557 per ounce (down by 18% from the high).

Just six months ago Apple's stock traded for over $700 a share and the company seemed universally loved and admired with exciting new products and the aura of a rock star. Today it closed at $432 a share, down almost 40% from the recent high. It's still a great company with great products. It is also still very profitable. Expectations simply outpaced reality. That can be expensive to an investor. And that is what we try to avoid.

Expectations may now be too high in a general sense. "Quantitative easing" is powerful medicine, but it may not be the cure-all that many have come to believe it is. What follows (in no particular order) are some of the factors that cause us concern and lead us to expect and plan for a correction sometime in the coming months: Investor sentiment polls are almost uniformly bullish (fear is low as prices are higher), short-term Treasury rates have fallen to 1.86%, which often signals slowing economic growth, the stock market advance appears to have narrowed to fewer stocks, cyclical stocks have recently been hammered (Caterpillar, Federal Express) and have lowered their profit projections, small capitalization stocks have started to underperform, bank and brokerage stocks are lagging, Goldman Sachs now sees the global industrial cycle in a "slow down" phase, hedge funds are now at their most heavily invested levels in the recent past, and corporate profit margins have reached historically high (and historically unsustainable) percentages of revenues (an "earnings cliff" ahead?). Lower profit margins could result in lower earnings than expected for companies such as those comprising the S&P 500. Overall, we have an aging advance in the market and in the economy, an unsustainable fiscal policy, a political log-jam in Washington, limited policy options, and more chances for geo-political upheaval (ranging from deposit confiscation by banks in Cyprus to nuclear threats from the likes of the nuts in North Korea.)

Just as last fall was not the time to panic and sell everything, now may not be a good time to "put the pedal to the metal" and be more aggressive. On the contrary, we plan for caution ahead with the knowledge that our cash reserves may allow us to take advantage of the situation the next time that fear strikes the heart of Mr. Market. We know that sooner or later, it will!

We have already sent along your capital gains reports with last quarter's review, but if you need copies sent again we can do so quickly and easily. Also, remember that any management fees charged to your taxable account are also tax deductible. We can provide you with additional reports that you may need for any tax-related issue you encounter while preparing your return. Just let us know and we can email documents directly to you and/or your tax preparer.

As always, if you would like to discuss your portfolio, individual investments, or your strategy just give us a call at your convenience. It is a pleasure for us to work with you on your investments.

Sincerely,

Claude R. Carmichael CFA