CARMICHAEL CAPITAL INC.

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2014 Third Quarter Review
"The Pause that Refreshes, or The Party's Over?"

The party atmosphere that prevailed among investors at the end of last quarter has taken a decidedly somber turn. Although the stock market sailed blithely higher in spite of last summer's troubling news, investors now appear to have awakened to the reality that all is not perfect in investment-land. Although the S&P 500 eked out a gain of 0.6% for the third quarter, the index fell 1.6% in September, a slide that has carried through into October. Still more troubling is the decline in small company stocks, which may turn out to be the canaries in the coal mine of this market. While the Dow Jones Industrial Average gained 1.3%, the Russell 2000 "Small Cap" stock index fell almost 8% during the quarter, and now shows a loss of 6% so far this calendar year. Bond prices improved through a combination of slowing economic growth, lower European yields, and the "flight to safety" trade. Whichever way the recent volatility resolves, at least the bull market in investor complacency appears to be over for the near term.

We have been navigating in extremely unusual economic times since the great recession ended in 2009. The unprecedented coordination by central banks to ease monetary policy worldwide has continued apace. Each country, including ours, is attempting to devalue (debase?) their own currency in order to encourage economic activity and to make their own exports more affordable to those in other countries. Interest rates are kept artificially low in order to stimulate economic activity. Interest rates in Europe are at their lowest level in *centuries*. Unfortunately, the economic activity this easing has created has been more of the speculative, asset-bubble-creating kind than the job-creating kind. The jobless rate has declined, but only with record numbers of people "leaving the work force;" that is, they are no longer being counted as unemployed. The portion of the populace engaged in paid labor has dropped to the lowest level in 10 years (66% to 62%).

"TINA" is still very popular ("There Is No Alternative," to stocks, that is), but the end of each round of quantitative easing (i.e. printing money) has coincided with a downturn in equity prices. The Fed is trying to get the patient off the morphine drip, but the patient complains so violently each time that the Fed issues soothing forecasts, promises to keep interest rates at zero for the foreseeable future, and then initiates a new round of easing. Because of the cheerleading by the Federal Reserve Board, many investors have depended on what they called "The Bernanke Put" (now with "Yellen" substituted) which meant that the Chairman of the Federal Reserve would step in and rescue investors upon any swoon in stock prices. That strategy has been remarkably successful, if perilous to pursue. The S&P 500 Index has not suffered a 10% correction in almost 3 years. We fear that price dips much less severe will now seem to be more painful simply because of their absence for so long.

We concentrate on valuation levels in making individual investment decisions. When applied to the market as a whole, it can provide context to help place the present within the historical pendulum swing from under-valued to over-valued. A case can be made that stocks and the market are not priced too high and there is "room too zoom." While that may be true, we have been seeing a shift in the perceived risk/reward ratio such that we don't want to bet heavily on a continued rising tide, even with the Fed seemingly standing by as lifeguard.

The domestic economy is experiencing one of the slowest recoveries on record, China's growth is slowing, and Europe seems near to tipping into recession. Corporate profits have grown, but have been goosed by short-term cost cutting and stock-buybacks, neither of which are the healthy "top line" revenue expansion that produce high-quality earnings growth. The U.S. Dollar has been strong partly because we have the best house in a bad neighborhood. The rising dollar may crimp profits of multinational companies whose stocks have done so well until now. Part of the market's advance has been due to "P/E expansion," which simply means investors are willing to pay a higher price than they used to for a stock with the same old dollar amount of earnings. There is a logic to that when your alternative is investing at almost-zero interest rates. But it is an artificial condition that may prompt meaningful adjustments to valuations whenever it changes.

For these and other reasons, we have remained conservative in our allocation of assets to equities. Until September, we would have done better to have been more aggressive. However, if this squall turns into a full-blown storm, we will appreciate having some dry powder we can use to defend ourselves. In preparation for rougher markets we sold out of the auto manufacturers and trimmed over-weighted positions in Corning and other core holdings. Commodity prices, including those of precious metals, have declined worldwide as industrial demand has lagged and the dollar has strengthened. Small stocks have fared poorly in general, and small stocks linked to any commodity have fallen especially hard. That includes energy stocks as well. Although the Fed's policy would seem to be inflationary, those very stocks that would benefit from inflation have performed poorly. We will monitor them and make adjustments in the coming quarter.

We still like the outlook for our core holdings such as Oaktree, Baxter, Potash, and others, although they are not immune to general market corrections should they occur. Our sole holding in the emerging technology of mobile payments, Monitise stock has not done well but our initial position was taken with the intention of adding to it if the price were to dip. Visa decided to put up for sale their investment stake in the company, which prompted a sell-off. But IBM has been integrating more deeply with Monitise, and their transition to subscription based revenue model is on-track. Monitise still counts Europe's largest bank, the largest UK banks, and 5 of the largest 10 US banks as their customers. We may add to positions in the fourth quarter if tax-loss selling creates bargain prices. At any rate, the ride may get bumpier than it's been. We will continue to try to preserve your capital in this shifting investment climate by reacting to the risks and opportunities the market may present.

Enclosed you will find your portfolio reviews and statements. Please review them at your leisure and give me a call if you have any questions or would like to discuss details or strategy.

We appreciate the opportunity to work with you on your investments and we will continue to do our best for you.

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