CARMICHAEL CAPITAL INC.

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April 8, 2016

2016 First Quarter Review
"Hang On To Your Hat!"

2016 began with the worst start for the stock market in decades. Equity markets began to plunge from the first trading day of the year and didn't turn around until half way through February. However, the slide did halt on February 11th and the U.S. market indexes marched almost all the way back up. Like the proverbial rollercoaster, it was a scary ride just to get back to near where we started. The S&P 500 Index ended the quarter up less than one percent, while the Russell 2000 and the NASDAQ fell almost 2 and 3 percent respectively. Interest rates began to decline again as the Fed has had to back away from last year's tough talk about rate increases. It appears that after 7 years of "recovery" the economy is still too fragile to restore anything like a reasonable "riskless" rate of return on savers' capital invested in things like CDs or treasury bills.

Although our domestic stock markets fought their way back from the beginning-year slump, other major world markets did not fare as well. European stocks have fallen about 10% on average, while Japanese Nikkei and Chinese Shanghai Composite are down 15% so far this year. The U.S. markets once again appeared to be the best house in a rough neighborhood. The near-term economic outlook holds some problems as well. Fourth quarter earnings reports (announced in January and February) were generally not very good, but first quarter results are expected to be worse, estimated by some to decline 8.5% in profits on a 1.1% decline in revenues for the S&P 500 companies. Seven years of money-pumping by the Fed has also produced only tepid GDP growth. The economy is estimated to have grown only 1.4% in the fourth quarter of 2015, while the Atlanta Fed's estimate for first quarter growth is an even weaker 0.7%. It appears that there may not be a rising economic tide to lift the boats of stock investors in the near term.

However, every experienced investor knows that the investment markets do not move in lock-step with the economy. The gyrations of the market do not reflect equal gyrations in economic activity, particularly on the short-term. Volatility was very high in the first half of the quarter and began to abate somewhat by March 31st. Also, this is not your father's stock market. Recent market volume is dominated by hedge funds, "quants" and algorithmic trading, and "dark pools," all of which can exacerbate short term swings and create a very bumpy ride for the longer term investor. Many of these traders live only for the short term swings and don't care a bit about the fundamentals or the long-term direction of investments. Today's investor needs to be prepared for more volatility just in order to keep fear from forcing untimely or ill-advised investment decisions. However, that is much easier said than done.

Last year we took some positions in financial and bank stocks in anticipation of the interest rate increase that the Fed imposed in December. Bank stocks would ostensibly benefit from slightly higher rates by making more profit on the spread between their investment income and their cost of funds. However, the economy appears to be so weak and the Fed appears to be so timid that the December rate increase may be a "one and done." At a minimum, the interest rate hikes that the Fed had planned appear to now be delayed and spread out over a longer period of time. The implication here is that interest rates are likely to stay lower longer than projected in the fourth quarter of 2015.

Since all investments are valued against what an investor can receive from a "riskless" investment, the prospect of rates staying lower was a relief for equity investors and may have helped propel stocks higher after the January/February swoon. Even after the rally to the end of the first quarter, the S&P 500 Index is still about 3% below the levels they reached in May of 2015. This brings some analysts to believe that the market is "topping out" and will make lower highs and lower lows as it "rolls over." If the S&P were to climb above 2,126 anytime in the near future, it would represent a new high and would possibly help settle the case. Of course, to find out you have to wait and see, but by then the move has already taken place. It reminds me of Mark Twain's advice to "Buy stocks that go up. And if they don't go up, don't buy'em!"

Central banks have played such a large role in the behavior of investment markets for so long that some believe they are beginning to "run out of bullets." Almost unbelievably, there has recently been mention of possible "negative interest rates" being imposed in the U.S., like they have already done in Europe. Europe's Central Banker Mario Draghi has proposed that the central bank actually pay commercial banks to borrow money from the ECB if the banks will increase their lending. Kuroda of the Bank of Japan recently joined the Europeans by instituting negative interest rates while making substantial investments to prop up the Japanese stock market by using government money to buy shares of exchange traded funds. These are extraordinary measures. Some of the long-term unintended consequences include the real possibility that insurers and pension plans will not be able to make enough income on their investments to meet their long-term obligations. Consider the large company pension plans that must make 7% or more every year in order to have enough money to pay retirement benefits to millions of pensioners. With zero-to-negative interest rates, that task becomes harder if not impossible. This could have a long-term effect on corporate solvency, not to mention its effect on ordinary savers. It is truly an extraordinary time to be an investor.

Commodities markets were pummeled in 2015 with energy being in the forefront of the decline. Oil prices fell further to new lows in January and have rebounded a bit since then. One commodity market that appears to have finally turned up is that for precious metals. Although last year was a terrible one for almost all commodities, gold has begun to shine again this year. Spot gold prices have risen more than 15% so far this year. We had expected gold prices to rise before this, as central bank interventions have effectively devalued paper currency. We wouldn't be surprised to see gold do better in the months and years ahead as currency debasement continues.

For all of the above reasons, we think it is important to be careful in this environment and keep some powder dry for the values that should emerge in any decline. As the old saying goes, "When you should buy them, you won't want to." That is certainly true if you have suffered an impairment of capital in a decline. To the extent that we have kept some cash reserved for such a case, our courage may remain proportionally greater as well.

As is our annual regulatory duty, we hereby inform you that there have been no material changes to our informational ADV form (brochure) that you have already received and that is on file with regulatory authorities. Nonetheless, we offer to send you a copy anyway if you simply request it. A copy of our most recent form can also be viewed on our website at www.carmichaelcapital.net. We also take this opportunity to inform you that we share none of your personal information with anyone beyond those legally required without your consent.

We have already been in contact with many tax advisors and we stand ready to provide you or them with extra copies of the forms they need to complete your tax return. Just give us the approval to send them your information and we will save you that trouble.

Best regards,

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