CARMICHAEL CAPITAL INC.

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April 3, 2018

2018 First Quarter Review
"Fasten Your Seat Belts!"

Last quarter's report warned that volatility was likely to return after an abnormally calm market year in 2017, and that what we had experienced last year was likely "the calm before the storm." 2017 was the first year in history that the S&P 500 Index was up every single month of the year. Even though that had never happened before, it was easy for investors to be lulled into a false sense of confidence that this was the way that markets should and probably would continue to behave. The gyrations of the stock market in the first quarter have proved the aptness of that analogy. For most of January, the market continued to advance as if there were not a cloud on the horizon. The S&P500 index peaked on January 26th at a closing price of 2,873 before plummeting 10% to 2,581 less than 2 weeks later. Stocks recovered a portion of that decline to close the quarter down almost 2.5% for the Dow Industrials and down 1.2% for the S&P500, and at a level that remained 8% below the peak of late January.

Interest rates rose and, consequently, bonds fell for the quarter with the 20 year US Treasury Bond index falling over 4% in price. Short term interest rates continued their dramatic rise over the last few years, with one year treasuries rising to a yield of 2% from a low of almost zero yield just a few years ago. The rise in short term yields has many implications for us in that it may provide a headwind and competition for stocks, it may impair the profitability of debt laden companies by increasing their interest expenses, and it can provide a more acceptable yield for us on cash that is not invested in stocks or bonds. Consequently, we have added some short term treasury investments to large accounts with ample cash reserves.

During the dramatic sell-off in late January/early February you may have heard news reports about the huge losses that were suffered when "the volatility trade" went bust. What this amounted to was the fact that many large institutions had made huge bets that volatility would stay abnormally low, and they made those bets through "derivative" investments tied to a measure of stock price volatility referred to as the "VIX," short for "volatility index." This volatility index is also sometimes referred to as "The Fear Index" since volatility and fear tend to rise together. Fear and volatility did rise and those playing "the volatility trade" were caught off guard. Financial derivatives designed to move inversely to the VIX were decimated, with some stopping trading entirely. It was one of those moments when you have to wonder whether some large financial failures might result. So far, however, the system seems to have survived better than the last time we had a "derivatives meltdown" in 2008. At that time, the culprit was mortgage derivatives. If history does not in fact repeat itself, it does indeed seem to rhyme.

Bitcoin may also prove to be the line that rhymes with the tech stock bubble that burst in early 2000. After peaking at almost $20,000 per coin in December, the price of a Bitcoin has recently fallen to $6,800 for a drop of 66% from its recent peak. A number of savvy investors believe that Bitcoin's price action may be a harbinger of things to come as were the tech stocks were when they peaked in March of 2000. If so, they warn that speculation may have recently peaked and that prices of asset classes such as stocks and bonds may begin to revert to levels closer to historical norms as they did after the tech stock bubble began to deflate in early 2000.

Suffice it to say that there is enough going on in the political world to provide entertainment, if not enlightenment, almost every day. It often reminds me of the ancient Chinese curse, “May you live in interesting times.” The current administration has provided the stock market with a huge boost in the corporate tax rate cut, but now may be demanding some payback while stoking fears of an international trade war. Rising tariffs can hurt profits and this issue has given investors another problem to worry about, and has contributed to uncertainty that has helped roil the markets.

Infrastructure legislation was supposed to be a high priority for the new presidential administration, but prospects for passage of that legislation (and fiscal stimulus) have dimmed greatly in the short term. It now appears that there will be no rush of infrastructure legislation that we had though possible while the Republicans still control both houses in Congress. The political capital needed appears to have been spent on other issues and an infrastructure bill will now have to wait until after the mid-term elections in the fall.

Inflation pressures appear to be picking up slightly, with employment being tight and the dollar weakening. However, inflation still hasn’t lit a fire under our precious metals positions as we are anticipating it may. The price of gold itself has held up well, but the companies that mine the metal have not yet risen as they often do as inflation picks up. If inflation does rise in this cycle, our precious metals positions should provide somewhat of a counterbalance to the negative effects on other holdings.

We are finding a few investments that still seem to represent good value, but when markets are as elevated as this one has been, the few values we find are often cheap because of some adversity that the company has been through. If we judge that the price more than adequately reflects the risk, we may establish small positions and monitor their progress in anticipation of buying more if the story unfolds favorably. Currently we are nibbling at such positions as Newell Corp (the old Rubbermaid), CenturyLink (a telecom company) and even an ETF called “Alternative Harvest” which may profit from the growth of the marijuana industry. We will continue to monitor the performance of what we own and look for good values that may emerge with any decline in price.

Your statements and reports for the quarter are enclosed. If you need an extra copy of any of your statements, reports, or tax forms just give us a call and we will get it to you and/or your tax preparer quickly. As always, just give me a call if you have any other questions or suggestions.

Sincerely,

Claude Carmichael CFA