CARMICHAEL CAPITAL INC.

CLAUDE R. CARMICHAEL CFA, PRESIDENT
339 MAIN STREET, 2ND FLOOR, FRANKLIN, TN 37064
(615) 595-5800 – NYC (212) 580-5200 – FAX (615) 595-5825
claude@carmichaelcapital.net

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2013 Year End Review
"ZIRP & TINA"

Forgive me, Dickens, but it was truly a tale of two markets this past year with the best of times and the worst of times in the stock and bond markets, respectively. The Dow Jones Industrial Average had its best performance in 18 years (by gaining 28%) while the bond market had its worst year in the last 14 (by falling almost16% according to the iShares Treasury ETF).

As you have heard from us before, we have thought for some time that bonds were not the place to be and that stocks were. We finally started seeing the effects of "The Great Rotation" that we had suspected might be a huge source of buying for stocks, if and when investors ran from the bond markets (with very low yields and low upside) to stocks (with sometimes higher yields and certainly better upside potential). The risk/reward trade-off just wasn't in bonds' favor, in our opinion, and it was more so in stocks'. However, none of this likely would have occurred without the very aggressive response by the Federal Reserve Board to the weakness in the economic recovery, now in its fifth year. The Fed has basically pumped money into the system in an attempt to goose the economy into higher gear. Every time the pumping has subsided (at the end of QE1, and QE2, and at the first talk of "tapering" last May) the stock market has swooned. Every time the pumping resumed the stock market rose. This should leave us with no illusions as to the force behind the stock market's recent rise. It is not due to the fact that business has improved so much and that profits are climbing rapidly. It is basically due to "ZIRP" and "TINA."

This is not a 21st century version of "Mork and Mindy," although I wish it were as funny. ZIRP is a major reason that stocks have done so well and that we have been favoring them over bonds for low these many years. The Fed has undertaken, stuck to, and promised to continue for at least the near future what is essentially a "<u>Z</u>ero <u>I</u>nterest <u>R</u>ate <u>P</u>olicy." This means that all of the people who "did the right thing" and saved their money, avoided the tech stock collapse of 2000, the bear market of 2002, and the housing and stock market collapses of 2009 now have the privilege of depositing their money in the very banks that precipitated the financial crisis in the first place while being paid almost no interest. The irony (crime?) is that the policy was consciously designed to do just that: restore the banks' balance sheets that had been destroyed by their greedy and reckless practices by lowering the return paid to savers to almost zero. I'm surprised there have not been retirees rioting in the streets of Florida cities! (Worriers of the world, unite! You have nothing to lose but a miniscule amount of accrued interest!)

That brings us to "TINA," and it's unfortunately not Ms. Turner. With near-zero interest on deposits, falling bond prices with still-low yields, tightened lending standards for real estate, and falling precious metals prices, many investors have come to the conclusion that "<u>T</u>here <u>I</u>s <u>N</u>o <u>A</u>lternative"…to stocks, that is. Mr. and Ms. Investor have apparently shrugged and said, "Whadyagonnado?" while selling their bonds and buying stocks. The "Great Rotation" happened.

The problem areas for us as investors in 2013 didn't include large positions in bonds, because we have avoided that area pretty successfully. Not all stocks did well however, with the notable exception being anything related to precious metals. The price of gold fell 28% during the year while the mining stocks lost from 50% to over 60% of their value. Gold has historically been a “safe haven” from inflationary money creation such as we are now experiencing. Not so in 2013, at least. Since any positions we held were relatively small, the damage was contained and was much less than for those who were true believers and “gold bugs.” Our stable of high-dividend yielding, major international company stocks continued to do well as the money leaving bond funds poured into the stock market, though this rate of appreciation is unlikely to continue uninterrupted.

The Fed has successfully “reflated” the stock market and, to a certain extent, the real estate market. Pumping this much liquidity into an economy often creates bubbles in asset values. As we noted, the stock market is up quite a bit, but business isn’t. The Fed seems committed to using its one trick over and over until the economy revives. The problem is that history shows few instances where the government has been able to anticipate the future well enough to remove the stimulus before unintended deleterious consequences emerge. As investors, we are in the unusual position of having witnessed and survived the collapse of not just one, but at least *two* economic bubbles in the recent past. This may be another one developing. Bearish sentiment (people who think the market will go down) is at an extreme low while bullishness is at a similarly extreme high. We try to remain skeptical at extremes because markets always seem to “revert to the mean” by returning to a “normal” range of valuation. John Hussman, a very successful value investor whom I very much respect, recently said, “The problem with bubbles is that they force one to decide whether to look like an idiot before the peak, or after.” It is difficult to withstand the pressure, but it is usually cheaper to look like an idiot *before*.

It would be reasonable to expect any advance from these levels to be more selective after such a broad run up. The stock market has not had so much as a 10% “correction” in quite some time and I don’t think they’ve been outlawed. Legendary investor John Templeton cautioned to avoid buying heavily when the outlook is good. We raise the caution flag and continue our primary focus of searching for value in what looks to be a somewhat frothy market.

Time and space limit these letters largely to framing the context of the investment experiences of the recent past and the choices we may have to make in the near future. I would be happy to have an in-depth discussion with you regarding the specifics of your portfolio and any preferences you may have whenever you’d like to give me a call. As always, please let us know immediately if any change in your financial position or risk tolerance occurs, or if you have any other adjustment you would like to make.

Enclosed you will find your year-end summaries as well as a capital gains report for any taxable accounts. We would be happy to forward these directly to your tax preparer along with a copy of your Form 1099 if that is convenient for you at tax time.

We thank you for your trust and pledge to do our best for you in 2014.

Happy New Year!

Claude R. Carmichael CFA