CARMICHAEL CAPITAL INC.

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2014 Second Quarter Review
"Party On, Garth!"

During the second quarter, investors seemed to have caught the spirit of Mike Meyers' "Wayne's World" cable show host from the old Saturday Night Live skits. International events that might have caused a swoon in previous times have barely registered this year. The general trend for stocks has been up since the first day of 2014, with substantial dips in late January and early April the only interruptions in the general advance. With all the hoopla, the Dow Jones Industrial average has gained only about 1.5% for the year as of the end of June. The S&P 500 fared better with an over 5% advance, while the smaller stocks in the Russell 2000 gained about 2.5%. Bonds continued to recover from the drubbing they took last year as interest rates have declined steadily on medium and longer term government bonds.

Why the party atmosphere? In what appears to be an unprecedented exercise in coordination by the central banks of the world's largest economies, there has been a concerted effort to engender economic growth by pumping currency into the system while keeping interest rates low. The idea is that the loose money will spur economic activity. So far, the effects have included tepid economic growth while penalizing savers and retirees who have to take increasing risk to get the income they need, and inflating assets from real estate to art. Those of us who were around during the 1980's saw what it took for Paul Volker and the rest of the Federal Reserve to wring the evil of inflation from our economy. Now the mantra is that 2% inflation is "dangerously low." First, inflation for the basics is running higher than that. Second, the Federal Reserve Board claims to be willing to reduce the monetary stimulus before inflation gets out of hand. Students of history have to remain extremely skeptical of any claim that the Fed can fight "the evils of low inflation" and also manage to turn off the tap just in time to avoid problems on the way out of this policy. However, the keg is still flowing so "Party on, Garth!"

The prices for financial assets are affected by many things including economic growth, the pace and stability of that growth, interest rates, inflation expectations, and the returns available from competing investments. As we've discussed in recent reports, "ZIRP" (zero interest rate policy) leads to "TINA" (there is no alternative). One great difference between this bull market and others in history is that it is not being accompanied by above-average economic growth. Some fear that this represents a disconnect between economic reality and market valuation. As David Weidner wrote recently in the Wall Street Journal, what we may be seeing is "a warped market distorted by the extraordinary measures used to create an economic lift."

As you know, statistics can be tortured into saying anything. There are many indicators that we watch that are flashing caution signals. Other analysts opine that the market is not at an extremely high valuation and there is plenty of room to run. Suffice it to say that our crystal ball is cloudy as always, and we try to stick to our knitting of finding individual investment values at good prices that we judge will bear fruit over the next several years.

Among the investment ideas of recent interest to us is Baxter International. Baxter is a high-quality, dividend-yielding healthcare company that is planning to boost innovation and shareholder value by splitting into two parts by mid-2015. The stock split will separate the biopharmaceutical business from the medical products division and allow greater management focus as well as separate valuation for the two enterprises. We estimate the sum-of-the-parts value to be about $90 per share in a 12 to 18 month time-frame. The dividend, as well as the underlying value, may provide some protection in any “summer swoon” we might experience. At any rate, we are plan to accumulate shares and would welcome the opportunity to do so at lower prices.

Oaktree Financial is a premier asset management company headed by Howard Marks, a legendary value investor. The stock has lagged the market as they unwind their extraordinarily successful investments in distressed assets that they took during the recent financial crisis. They also own 22% of highly regarded Doubline management company run by Jeff Gundlach. Our opinion is that their expertise is highly scalable and the current 8% payout (even if lowered somewhat) provides a nice return while we wait for the next cycle.

Potash Corp. is a large Canadian fertilizer and feed products company sporting a decent dividend yield in a business rebounding from a scare caused by the breakup of a Russian cartel. It also provides a product that is essential to feeding the world. We like the prospects for their business over the next several years.

Occasionally we find smaller companies whose stock meets our investment criteria. One such case is the stock of mobile banking company Monitise PLC which is based in London and traded both there and in the U.S. Monitise provides services that connect banks,vendors, and payment companies over mobile communications. They have over 350 financial institutions as clients, mostly in Europe, including VISA and Mastercard. Analysts at Barclay’s estimate that Monitise will capture 10% of the rapidly growing mobile payments market in the next several years. The stock has dipped recently as the company makes the transition from upfront fees to subscription pricing. We think it represents an opportunity as the near-term reduction in revenue sets up a long-term growth trajectory that could be explosive.

Even though there is some reason to believe that the future may be bumpier than the recent past, we are still finding some values that are attractive. However, we should not be surprised if the market takes a “summer swoon” after such a good run. Consequently we will not throw caution to the wind and bet the ranch. We love a party as much as Wayne, Garth, or anyone else. We just want to be able to function the next day without suffering any debilitating hangovers.

We have enclosed your quarterly reports as well as “form ADV” for Carmichael Capital. The new “post-Bernie Maddoff” regulations require that we send you this once a year. It is also available on our website should you have an emergency need.

Please review the enclosed reports at your convenience and call with any questions, suggestions, or changes in preferences or financial position. Also, as this bull market ages we would urge you to make it clear to us if you would like to set a limit on the percentage of equities held in your portfolio, or make any other preference known. Until then, we will do our best to invest wisely and well for a profitable future.

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