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October 12, 2016

2016 Third Quarter Review
"The Election and The Fed"

By the end of September the Dow Jones Industrial Average had gained 5% and the S&P 500 6% since the beginning of the year. Bonds prices continued to climb as the Federal Reserve talked tough but failed to act to raise interest rates after their one and only post-crash hike last December. Although markets seemed to stabilize and remain relatively calm after the brouhaha over the Brexit vote of the previous quarter, the drama is building toward the resolution of at least two major events in the fourth quarter, the presidential election and the Federal Reserve's December decision on rates.

The conventional wisdom is that a Clinton victory is probably already "baked in" to the current market. Investors usually demand a "risk premium" for higher uncertainty, and Clinton is considered more of a known quantity with probably less impact on financial assets if elected. Trump is more of a wild card and his election would probably cause a short-term sell-off as investors reassess the possible changes in policy and their impact. We should keep in mind that polls were in error regarding the outcome of the Brexit vote, and the surprising outcome accompanied a tumbling British pound and market. We are not betting on the election one way or the other, but we are prepared to respond to either outcome.

As an example, the election may have an effect on pharmaceutical stocks since a Hillary Clinton presidency might include actions to control prices of drugs and healthcare products. Pharmaceutical stocks have been very good to us over the last decade and we recently saw Shire PLC take over Baxalta at a nice premium to the prevailing market price. However, the higher valuations of the stocks and the possibility of regulatory headwinds have prompted us to take some profits in those stocks and reduce exposure as the election nears. We have trimmed some long-term positions to smaller sizes and have sold out of any remaining Shire PLC stock to book some profits from that sector. It is possible that there will be a resurgence of infrastructure spending with a new presidential administration, although this has been anticipated several times recently without major market impact. We will be researching opportunities in that and related industries for potential investment in the months ahead.

In addition to news about the election and the Fed, the end of the third quarter brought a little drama reminiscent of the "Lehman Moment" of 2008. We have been watching Deutsche Bank stock with some trepidation as the price had fallen by 60% since the beginning of this year. Some analysts believe that Deutsche Bank, once considered one of the strongest world banks run by some of the world's most conservative bankers, is now a bellwether of the European financial system. The U.S. Justice Department recently hit the bank with a multibillion dollar fine for misconduct that led to the housing collapse of 2008. Unfortunately, the fine was twice the amount that the bank had placed in reserve to cover it. Talk of a liquidity crisis made the rounds and it looked like Deutsche Bank might have to be rescued or Europe might suffer a collapse similar to what we experienced 8 years ago.

However, there was always little chance that the Justice Department would follow through with any action that could jeopardize the health of the world financial markets, so the amount of the fine was reduced. Also, central banks are now so accustomed to intervening with massive programs to counter market forces that the fear of a collapse passed quickly. Still, it is sobering that such systemic risk must also be considered in addition to the company, industry, and economy-specific risks that are always considered, but such are the times we live and invest in.

Our current investment world includes a market that appears to be captive to the Federal Reserve Board's decisions, and a Federal Reserve board that appears to be a captive of the markets. By historical measures, stocks are statistically expensive. They are so expensive primarily because interest rates are so low. Interest rates are the price of money, and we usually let markets set most prices. However, interest rates have been held artificially low by central bank intervention for so long that a return to market rates may not be as smooth as the Fed has planned. As for stocks, virtually any high price can be justified when compared to zero or negative interest rates as an alternative. Even with ultra-low interest rates, however, the economic recovery is one of the most anemic on record. Corporate profits have actually been in decline for the last five quarters in a row. The Fed wants to wait until the economic recovery is stronger before raising interest rates. They are also terrified that they will raise rates and be blamed for any subsequent market declines and/or the next recession. The last time they raised interest rates (last December), the stock market fell hard and they were frightened out of acting on the several increases they had planned to follow. Once again, the Fed failed to raise interest rates this September, but strongly suggested they will do so at this December's meeting.

This push/pull between the markets and the Fed leads us to believe that the Fed will talk tough but act timid, and that interest rates will likely move up in an erratic fashion but stay lower for longer than previously thought. The disruptive nature of rapidly increasing interest means that it is probably not an option the Fed would consider. We may see a halting series of increases where the Fed proceeds only if and when markets don't react strongly negatively. Consequently, interest rates may rise from here, but may do so at a slow enough pace to warrant purchase of some income securities with short to medium length maturities. Prices for bonds have been declining since a peak in July which some think will prove to be a generational low for interest rates. A rate increase in December might provide a sell-off between now and then that could prove to be a good time to establish new positions in short to medium term maturities of fixed income investments as well as perhaps in stocks with cheaper prices. Precious metals have recently pulled back after a good rally and may be a good way to provide some protection against the programmatic debasing of the dollar represented by the Fed's 2% inflation target.

The Fed is trying to extricate itself from the extraordinary and massive intervention that has had a huge impact on markets. Unintended consequences often abound as these massive economic experiments unfold. The Fed's failure to foresee the tech stock boom and crash of 2000, or the housing crisis of 2008 should temper our faith in their ability to navigate these times without a hiccup or two. As this fourth quarter unfolds, we would do well to expect the unexpected.

Enclosed you will find your third quarter reports and statements. As always, please give us a call with any comments or suggestions you might have.

Sincerely,

Claude R. Carmichael CFA