CARMICHAEL CAPITAL INC.

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2016 Second Quarter Review
"Risk Rising"

Most of what we do as investors is to try to gauge the magnitude of the risk in relation to the potential reward of any investment. That normally goes without saying, but these are not normal times. The Federal Reserve Board has not been able to "normalize" interest rates as they proposed they would when they began their easy money program in 2009. Negative interest rates on bonds are not normal. The British vote to leave the European Union shocked the world and caused the U.S. stock market to sell off by about 6% over two days, only to recover almost the entire sell-off in the subsequent four trading days. The thinking is that, with heightened risks to the world economies posed by Brexit, the Federal Reserve will have to cancel the four rate hikes that they had previously planned for this year. In fact, they may not be able to raise rates until early 2018 according to some analysts. Investors appear to be celebrating the bad news because it means that interest rates will likely be lower for longer. Easy money is back on the table and it floods back into stocks.

Stock indexes have recovered to about the level they traded at before the Brexit vote. However, by many obvious measures, the risks to investments have risen. Stocks don't normally go up just because risks to the international economy have increased.

Central banks around the world have become one-trick ponies. Easy money seems to be the only trick they have left, and lower interest rates have broken through the theoretical limit of 0% interest rates that has been the lower boundary for over a thousand years. Now there are trillions of dollars-worth of bonds issued by various countries (in worse financial shape than ours) that yield a *negative* interest rate. That means you lend them your money, and pay them for the privilege of doing so. In over a thousand years of bond market history, this has never happened. This is decidedly not normal. It does mean, however, that low rates in the U.S. (low but still positive) become relatively more attractive to foreign bond buyers, thereby possibly pushing our rates lower still.

U.S. stocks have been a mixed bag so far this year with the S&P 500 index rising 2.69% while the NASDAQ index is down 3.29%. Bonds have rallied as interest rates appear set to remain lower for longer, and precious metals have started to rise as confidence in the central "easy money" bankers begins to fade. Other countries' stock markets have not fared so well. The German DAX stock index is down 13% so far this year, the Swiss are down about 11%, and the Japanese Nikkei stock index has dropped by 19%. As good a deal as negative interest rates are for the borrowers, they do not appear to be a sign of a healthy economy. Consider the fact that major European banks' stocks have plummeted, losing from 20% to over 30% of their value just since the Brexit vote. Alas, those stocks have NOT recovered in the recent rally, and that is not a good sign.

The S&P 500 stock index posted a record high in May of 2015. Since then it has dropped and rallied, but has essentially gone sideways while earnings have declined and international risks appear to have increased. Last December the Fed raised interest rates for the first time in a decade and was on track for several interest rate hikes which would ostensibly benefit the earnings of the banking industry. Those rate increases are now highly improbable. Accordingly, we used the recent bank stock rally after the positive "stress test" results to substantially reduce our investments in financial and bank stocks. This was also a move to shield us from possible "contagion" from major bank problems in Europe. Remember, in 2008 it was the collapse of Lehman that triggered problems spreading from our shores to theirs. It's possible that this time it might be the other way around.

We feel the need to point out the rising risks because they have prompted us to proceed with, as they say, an abundance of caution. It is very possible that, with interest rates remaining lower for longer, the stock market will continue to climb. If the U.S. economy begins to show signs of more vigorous growth we could have a combination of low rates and increasing earnings, which could boost stocks to new highs. It is also possible (although, until recently it would have seemed unbelievable) that yields on U.S. Treasury bonds could go *below zero*. After all, a good portion of Japan's and half of Europe's sovereign debt ($6.4 trillion) now trade with a negative yield. But their stocks are down.

J.P. Morgan just released their economic and stock market forecasts and concluded that there is an 80% chance that the stock market will be lower a year from now. Goldman Sachs just cited investor complacency after Brexit, a maturing economic cycle with elevated valuations, decelerating corporate stock buybacks, and growing political uncertainty as reasons to expect at least a reasonable decline. Granted, they don't know the future any better than you or I do, but it appears that they agree that the risk/reward trade-off has shifted.

Like many other investors with cash reserves, we would welcome a sell-off and were somewhat disappointed that the recent Brexit dive didn't continue beyond two days' trading. It will likely take patience, but there are good reasons to believe that we should continue to keep reserves to use in case we get a chance at prices which might better reflect the risks that investors are actually taking.

Our main concern remains preservation of your capital. We have seen risks rise before while markets continued to advance. We saw it in 2000 as the technology stock rally enticed investors even as risks were rising with the stock prices. We saw it in 2007-2008 when there was so much certainty that housing prices would never decline. When markets are rising or holding steady, keeping ample cash reserves when they yield so little is not a comfortable investment position. It only seems prudent in retrospect, after a sharp sell-off like the one we saw recently and may very well see again. Since truly no one knows which way the general market will go, we try to mitigate risk by concentrating on the cheapest investments and sectors. The bargains have been harder to find of late, which is typical when markets have advanced. Hence, our higher cash reserves. If you would rather be more aggressive in your portfolio, please feel free to give me a call and we can adjust the investments accordingly.

Enclosed you will find your second quarter reports and statements. Please give us a call with any comments or suggestions you might have.

Sincerely,

Claude R. Carmichael CFA