December 18, 2013

Dear Fellow Investor:

The FOMC decided to slow the pace of QE a bit today. We have expected that sooner or later the Fed would attempt to throttle back on bond buying for a period of time. We have also expected that regardless of any near term policy shifts, the FOMC would likely continue to stimulate with extremely low rates for quite some time and may well step on the QE gas again at some point.

The quote below did ***not*** come from us, but it typifies the investment climate.

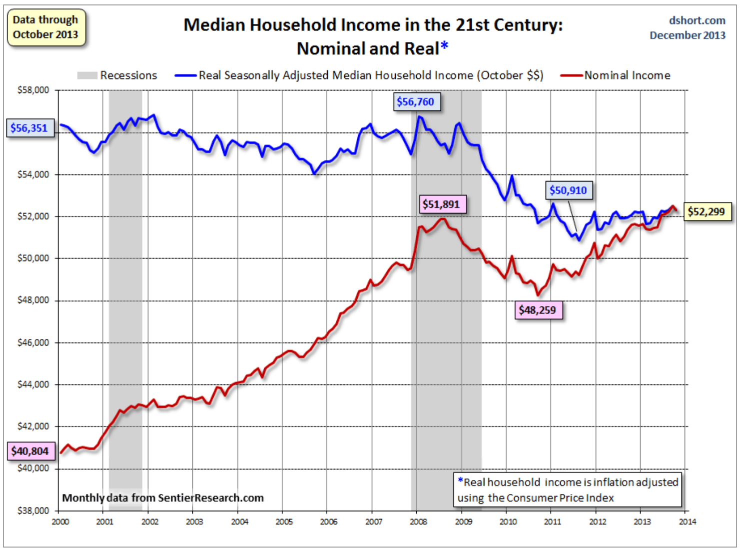
"I cannot look at myself in the mirror; everything I have believed in I have had to reject. This environment only makes sense through the prism of trends. You have got to be in things that are trending. Crashing is the least of my concerns. I can deal with that, but I cannot risk my reputation because we are in this virtuous loop where the market is trending. I may be providing a public utility here, as the last bear to capitulate."

- Hedge fund manager November 22, 2013

Many well respected investors can identify with the above quote. We are not trying to poke fun at anyone, but these days the investment life for those who place a high priority on risk management, like us, is similar to being the designated driver at a raucous Holiday party. In both cases, one is serving a critical function that goes unappreciated by most while the good times abound. Just how wild has this party become? Last month we mentioned that on a price-to-sales basis the median stock in the S&P 500 has never been more expensive in looking back at about one hundred years of history. We can now add to that the fact that margin debt just hit a record high. Also, the percentage of bearish investors at 14.4% neared the lows of 1987 according to Investors Intelligence, yet earnings warnings are running at an alarming 10-to-1 versus positive earnings comments.

Bull markets tend to bring out movies about the world of finance. However, like the bullish *Time* magazine cover we have mentioned in recent months, they can be powerful contra-indicators. For instance, *Wall Street* came out in 1987 and *Boiler Room* arrived in 2000, marking critical turning points after significant market surges. This cycle has brought us a remake of *The Great Gatsby* (eery timing given our view that we are re-living the 1920's in many ways) and more recently *The Wolf of Wall Street*. We have seen neither, but they reminds us how tightly scripted markets have become, as if the writers, directors, and producers somewhere have a story to tell us each trading day, and boy do they stick to the plot. Markets in cycles past have had a similar feel, but nothing like today. Perhaps it is because computer algorithms dominate trading completely and are quite adept at managing prices around the story line 24/7.

You have likely tired of hearing us mention the “talking heads” playing up each piece of remotely positive news though we have continued to have subpar economic growth for years, but it is an important element of the story. Third quarter GDP was just revised higher to a respectable 3.6%. Many pundits praised the strong growth without mentioning that most of the upward revision was due to a massive inventory build, which does not bode well for future growth, particularly as Christmas sales have been poor by many accounts. The employment report for November showed a decent gain in jobs, but left out of many discussions is the fact that headline unemployment would have been closer to 8.0%, not the reported and still weak 7.0%, if the labor force participation rate had been held constant from one year ago. As always, step back from the script and a different picture emerges, another storyline that is truer to the secular reality that no policy maker seems ready to acknowledge because such honesty would indicate that current strategies are woefully ineffective. Real median income (see below) has been stagnant at best for years and makes many of the daily instantaneous responses to pieces of data seem surreal when one considers that most of them are statistical noise because seasonal adjustment factors trump the raw numbers.



We call the current market movie “Mirage.” The script goes like this: the Fed is the heroic protagonist, dropping cash on Wall Street. The prime beneficiary of QE is the S&P 500. The Fed creates an illusion of well-being. Central bankers and policy makers in Europe and Japan wear the white hats too as they play up any signs of growth and promise to do anything they can to support markets. The private sector and the real economy do not even play “bit” parts. According to the script, the FOMC, in its infinite brilliance, will stop printing money at the exact perfect time in the distant future and equities will to continue to thrive as rates remain ultra-low. Villain bonds and precious metals are to be feared because QE might end today and the Fed might actually tighten policy tomorrow.   Please pardon the disconnect between our last two statements because that's what the markets do every day. It's a gaping hole in the plot, we know. The storyline includes no mention of the massive overbuilding in China, which helped corporate profitability in the U.S immensely, or any other factor that was outside of Fed control, like FASB easing mark-to-market rules for banks. The computers relentlessly trade all asset classes in a tight band around this storyline, as if the movie was completely nonfiction. Huge sums of money are placing identical bets as the herd grows larger, drawn into the engrossing plot. The intrinsic value of securities is not important, just listen to Bernanke. How the computers treat asset classes most days is the only thing that matters in this flick. Momentum rules the roost.

By our best measures, this "movie" has pushed equities to all-time high valuations. Other metrics are also sounding a major alarm. We were reminded by fund manager John Hussman in a recent piece to double check our weekly *Value Line* report. According to him: "the 'Median 3-5 Year Appreciation Potential' for the stocks it covers is now the lowest since the 1960's. Statistically, if one subtracts about 55% from the VLMAP, the result approximates the actual subsequent 4-year total return of the S&P 500. At a VLMAP of just 30%, the implication is a loss, in total return, of about -25% in the S&P 500 over the coming 4-year period." Yet apparently many participants feel compelled to buy stocks. Although some are skeptical of this year's price move in equities and other risky assets like EU bonds, few seem willing to leave the party just yet. What strikes us as astounding is that just about every professional believes they can get out the door and "safely into a taxi" at just the right time and are even advising investors to do the same. That doorway will get mighty crowded at some point and there will not be enough "taxis" and "aspirin" to go around.

We think we know how the sequel goes. Tepid growth fades to recession because massive global debts simply cannot be overcome in spite of central banks' liquidity binge. Consumers, businesses, and governments are already overly indebted in the U.S. and many other nations, but the powers-that-be attempt to create ever more debt to grow our way out of the chasm. However, both the desire to borrow and the desire to lend have passed their peaks and additional debt would be quite difficult to service. It is a "Catch 22" that central bank balance sheet expansion cannot defeat; the critical limit has been reached. According to this script, after a few painful years, only debt restructuring can clear the path for future growth. To avoid this pain, every country will continue debasing its currency in a "beggar thy neighbor" strategy to repay obligations with cheaper money, but this just leads to more asset bubbles and future crashes. The sequel will likely include an earnings collapse because of the slowing economy and the unsustainability of current record profit margins. Stocks should correct, but may just go mostly sideways for years. High quality bonds should do well in a flight to quality. Precious metals should rise in a flight to safety, as well as their relative scarcity versus the ever increasing supply of fiat currencies backed by nothing.

If we ever wondered about the long-term impact of QE, we think the cratering of mortgage applications to the lowest levels in twelve year answers the question. *Inman News* reported that Trulia's Chief Economist recently tweeted that "increased mortgage rates — which jumped in the spring over worries that the Fed would dial back its stimulus program — have 'whacked' refinance applications, and the housing recovery has been too weak to fill the gap with purchase loans." How real was any supposed housing recovery anyway? It was facilitated by a bunch of hedge funds buying properties and artificially driving up prices in major markets. For instance, the *New York Times* quoted a local broker who said "maybe 70 percent of the sales we were seeing were to hedge funds, investors and others taking advantage of what was happening in Brooklyn**.** Only about 30 percent were actual end users or first-time buyers." This is going on all over the country to various degrees and that's a problem. What a mirage! Have we learned nothing from the bubble of 2006-2007?

We are at the point when worries about less Fed largesse impact interest rates and thus the real economy, while stock investors continue to believe in the magic of QE. Extreme policy options have failed, but the Fed won't quit. The recent departures of key advisors to the Minneapolis Fed chief probably highlight the tension within the Fed itself. Regardless, those who railed against the creation of the Fed in1913 are being proven right. As time goes on, the Fed has become another arm of the government and a "rubber stamper" of fiscal policies. It's about politics and Wall Street; it's not about a sound currency.

A devout student of history, Mr. Bernanke, learned the wrong lesson from the 1920's. Then as now, the Fed bought what were then considered large sums of government debt to foster growth. In the end, during the 1927-28 timeframe, it realized that speculative excesses were occurring in the stock market. In response, the Fed tightened policy and ultimately the crash of 1929 followed. Current policy makers blame the Crash on the tightening alone, not the imprudent liquidity that preceded it. Chairman Bernanke's strongest desire is to avoid the market collapse caused by less Fed largesse without recognizing that it was New York Fed's Ben Strong's ultra-loose policy of the mid-1920's that caused the trouble in the first place.

The mistake of the 1920's was that the Fed became too involved in markets, thinking itself invincible as the center of growth creation! As Paul Johnson wrote in *Modern Times: The World from the Twenties to the Eighties*: "The New York Fed reduced its rate by a further half per cent to 3-1/2; as Strong put it to Rist [Deputy Governor, Bank of France], 'I will give a little coup de whiskey to the stock-market' -- and as a result set in motion the last culminating wave of speculation. Adolph Miller, a member of the Federal Reserve Board, subsequently described this decision in Senate testimony as 'the greatest and boldest operation ever undertaken by the Federal Reserve System (which) resulted in one of the most costly errors committed by it or any other banking system in the last seventy-five years." What would Miller say today?

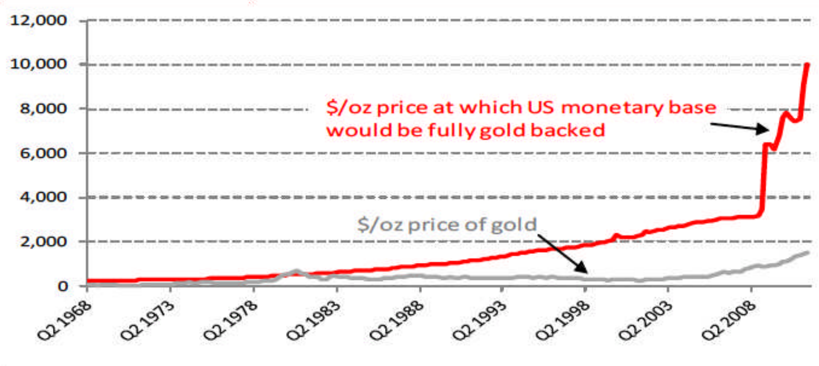
The wealthy of the 1920's did quite well in the stock market until the Crash, as the masses sat out the party like the present day. Monetary policy was celebrated then, as now, because of exuberant equities, as if the Strong and his cronies had overcome immutable economic realities. Because policies are not powering the real economy presently, we expect the profit cycle to roll over. With that, the Fed will lose credibility. We suspect that the mistake of the current Fed will be to remain too loose for too long; taking things to the point that markets treat QE as largely irrelevant. Over the past twenty years, Japan has tried various QE measures until the markets had just gotten bored with it. In the last year, the Japanese central bank has been printing massive amounts of currency, but it appears that the novelty has already begun to wear out as it did after prior attempts to "QE" their way to sustainable growth.

We fear that history will repeat itself. The Fed does not recognize bubbles because too many of its leaders think a bubble economy is normal given that we have been in one for large portions of the last twenty years. We advise the Fed to look no further than the Russell 2000 index trading at 77 times trailing earnings or 28 times forward estimates, even as most retailers and restaurants see sluggish sales and long-term unemployment remains at over 30-year highs. Maybe letting savers earn something on their savings would help just a bit, but the Fed apparently wants to push consumers into more debt. They are simply pulling demand forward to drive growth. Auto lending is up about 15% year over year and credit quality of new borrowers is approaching the lows of 2007. Buyers appear to ignore the fact that most car prices have jumped to more unaffordable levels because auto loan rates are so low, easing monthly payments. I was shocked to walk a lot and see so many cars priced near $30,000 when median income in this country has been stuck near $50,000 for over ten years. We see serious inflation in auto prices and mostly disinflation in wages.

In days gone by, inflation used to be thought of in terms of growth in the money supply. Now, many rely on government price data which seems to defy every day experience. Based on prior measures of inflation, we have quite a lot of it showing up in money supply and bank assets. For instance, Chinese bank assets have increased about $15 trillion since 2008, while U.S. banks have witnessed about $2 trillion in growth. Yet global silver inventories are valued below the market cap of Twitter, near $20 billion…with a "b." According to Kyle Bass of Hayman Capital, investable gold is probably worth $1-2 trillion, while the global monetary base has ballooned to roughly $70 trillion. In a complete show of disdain for the Fed, the virtual currency known as Bitcoin was up about 100 times in 2013, to over $1,200 before crashing today. We even heard that Fidelity was accepting Bitcoins in IRA's for a brief time. Still in its infancy, the total value of Bitcoin outstanding is already in the $5-10 billion range or, in other words, up to almost half that of silver inventories.

We will leave Bitcoin for others to figure out and stick to the precious metals. They were currency for thousands of years before any of the fiat varieties, which have had no gold backing since Nixon removed all tethers between the dollar and the metal in 1971. We do not expect the dollar to be gold-backed anytime soon. At the same time, as the graph below suggests, it is not too difficult to imagine gold and silver at much higher prices in coming years.

“Fair value” for gold now $10,000 p/oz



Source: SG Cross Asset Research

Prices of the precious metals have been manipulated by central banks and other players for many moons. In the 1930’s gold was confiscated by the government in the U.S. before the price was reset much higher in dollar terms. During the late 1960’s and into the 1970’s, the eight member nations of the London Gold Pool attempted to contain the price of gold until France stopped playing “team ball.” In the 1990’s former Fed Chairman Greenspan discussed with members of the FOMC that a good way to manage market expectations was to manipulate the price of gold. Of course, central bankers would never do that! Regardless, gold has rallied from about $35 in the late 1960’s to over $1,200 today (around Bitcoin’s peak value). That’s not too shabby and that’s in the face of efforts to control prices. In recent months China has been buying up a large chunk of global gold supplies even as the West sees its reserves dwindle. We do wonder why Germany was told that it would take years to return a relatively small amount of its gold stored in the U.S. since World War II. In the end, we are investors, not traders. We see our positions in miners and the metals (about 10%) as required insurance against policy mistakes. This approach should work for us over time as central bankers grapple with the global debt trap. For instance, if money velocity were to increase suddenly (from current record lows) precious metals should provide a welcome hedge.

In spite of QE, all of the major issues of recent years remain. They have just been cast aside by a belief that central banks and politicians can fix everything. Debt problems in Spain and Italy remain just as malignant as ever, but are simply ignored as their economies stagnate. For instance, Spain’s unemployment remains near 25% and bank bad debts stand at 13% of loans. The powers that be in the EU are setting the stage for future bank bail-ins in. Depositors will be on the hook for losses at failed institutions. Debt deflation zombie, Japan, has supposedly righted the ship with a massive QE reflation effort, but growth appears to be slowing back to 1% and the only inflation they are really getting is in energy prices, a crucial import. China has way too much capacity in so many industries that we have lost count. In time, all of these issues will matter again. Faith in the global muckety-mucks can only go lower.

Because the risks are so high in sticking to the script of the current movie, including a possible 50% drawdown in equities by our estimates, we are much more content to position ourselves for the sequel by investing in “taxis” and “aspirin.” Each should enjoy a bull market of its own in coming quarters. Valuations are too compelling as few see the need for them now. Like everything we do as value investors, we can never know for sure when or if we are correct. But we can endeavor to always put ourselves in the most favorable portfolio position based on the historical math, which is our only road map. We presently have over 80% of our capital invested in securities at multi-year low valuations. That total is spread between closed-end bond funds (about 70% of capital) at 85-90 cents on the dollar with 4-6% yields and precious metals-related positions which are off 25-50% on the year. The miners trade at five-year lows and many of our bond funds were down 20-25% before we bought them. Current yields on our higher quality funds seem quite compelling versus long-term expected stock returns, low quality corporate bond yields that are in the same vicinity, and nominal global growth rates.

Roughly 40% of our capital is allocated to the short side in equities at very high valuations. The most heavily shorted positions in the market have outperformed by over 15% this year as participants covered in a panicked frenzy. To any contrarian it looks like quite an opportunity because it appears that many investors have thrown in the towel on the idea that stocks might ever retreat. We expect to profit handsomely in coming quarters as reality sets in. Finally, about 50% of our capital is presently invested on the long side in mostly higher quality equities whose valuations have lagged the broad P-E levitation. We have taken handsome profits on roughly half of our positions from the start of 2013 and will likely continue to do so. We have made nice gains on our longs and now we hope to do the same with our short positions.

As students of history ourselves, we have mostly maintained a modestly positive exposure to equities in order to participate in any Fed-induced rally (though such a rally was not our base case). However, we did not bank on the fact that low quality stocks would leap so dramatically even as earnings became more questionable. I have been surprised this year by the fact that our short positions did not help us as 10-year treasury rates rose by over 100 basis points. If our shorts had merely held steady after the rate jump, our year would have progressed much better. At the same time, with rich valuations and persistent questions about the soundness of the global financial system, we simply could not allow ourselves to go with an unhedged “gut” view that stocks were headed higher. With precious metals and commodities suffering this year, breaking their prior correlation with stocks and our short equity positions continuing to rally against us, we struggled. We did not become involved in the bond market until mid-year after bonds had already collapsed.

From what we have read, hedge fund returns are in the high single-digit range for this year and trail equity market by the most since 2005. We have no way of knowing for sure if the Fed or any other central bank may permanently or temporarily stop quantitative easing. Equities may continue to rally, but our position as “designated driver” and the valuation metrics demand we step away from that party and try to drive us home safely. Mixing the same cocktail as Ben

Strong in the 1920's, Bernanke's current "coup de whiskey" is going to lead to one painful "morning after" for revelers who stayed too long. It always does.

Our disciplines will not allow us to "fly by the seat of our pants" and buy stocks just because they have been so strong. Equities began the year as quite expensive and just became much more expensive as the year progressed. We simply do not take risk unless we are being compensated to do so, particularly when valuation measures are at such extremes. Regardless of what the Fed does from here, we reiterate that to be owners of a broad portfolio of equities, without a hedge, is a bet that the most expensive market in history will become more expensive.

We thank you for your trust in us and wish you a Merry Christmas and a Happy New Year! Please call with questions and comments.

Sincerely,

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