April 16, 2015

Dear Fellow Investor:

Greek debt trades at the highest yields since the dark days of 2012 as that story of false hope faces the reality of a likely default. Nothing was fixed there, really, just like nothing was done to truly rectify balance sheets anywhere else after the crash of 2008. Speculative activity is the only thing the deciders can elicit and without it growth would be more apparently challenged.

The entire "house of cards" of the stock market rests on the hope that 100 years of valuation data is of no meaning in the heavily manipulated construct of recent years even as earnings fall. Global GDP is near the weakest it has been since the last recession, yet we are supposed to trust that the sustained growth the Fed promised countless times will arrive at any second now, though their forecasting errors have been stunning in their consistency. By jawboning pleasantries when any worries surface either about low economic growth or higher rates, the Fed is doing its best to hold the 2,050 S&P 500 peg it seems to have established as the level which assures its acolytes will blindly assume all is right with the world. Eerily, equity investors have turned to celebrating the idea that rates are stuck at low levels for longer and selling on any stronger economic data.

It sure looks to us like QE in its practical application is deflationary at this point and a crushing blow to the real economy's long-term prospects. This is the exact opposite of what the PhD's tell us about monetary policy and the very notion is heresy among the ranks of the Keynesians who have the controls. However, free money, not surprisingly, has led many in business to decide that they simply must build something. Capital decisions are being based on the cost of money, not the underlying dynamics of business and industry. When hurdle rates are zero many think anything is possible. That adds to overcapacity and destroys pricing power when the demand side, already severely burdened by over indebtedness, fails to meet the added supply. For instance, we are literally running out of storage for crude oil in the U.S. because too much is being produced as drillers borrowed vast sums of money that they thought was too cheap to pass up.

It is not just that oil prices have cratered as inventories hit 80-year highs in the U.S. We can also point to skyscraper mania in Asia and elsewhere, commercial jet production across the planet, student lending, and subprime auto debt as other clear examples of extremely reckless behavior. We wonder how many casual restaurant chains like Shake Shack (now trading near 1,200 times the average estimate for 2015) can IPO before that door closes. As if we did not have enough corporate restaurants that are struggling to fill seats.

Investor protection in junk bonds has hit the lowest level ever according to Moody's and a huge percentage of the massive amounts of corporate bonds being issued are low quality. Markets have learned nothing from 2008. We do wonder who will buy those very bonds when sellers multiply. Liquidity is already poor on the bid side.

A new endeavor, "crowd" financing has taken on a speculative frenzy in this cycle as retail investors are throwing hard-earned cash at private sector start-ups at a frenzied pace in the hopes of picking the next Twitter, Facebook or Uber (we could do without any of them). We do not think that phenomenon can end well.

Of course, savers are effectively being punished for their thrift and have less money to spend on goods and services. That is not pro-growth! Perhaps nothing sums up the current landscape better than the fact that Switzerland became the first country ever to issue a ten-year bond at a negative yield just as former Fed chairman Bernanke released the title of his upcoming memoir, *The Courage to Act*. He and his cronies acted alright and stagnation for much of the economy is the result.

We don't buy the idea that things would be worse now if emergency measures had been stopped years ago. Until the deciders admit that the trillions of legacy bad debt must be restructured and related assets are allowed to fall to clearing prices we cannot achieve sustainable growth. Greece is not the only problem that will not go away, incapable of being papered over with additional debt. Many years of bad lending cannot be made to vanish no matter how hard the Fed and other central banks try. For instance, the data indicates that in the bottom third of the housing market in the U.S. a high percentage of homeowners are still underwater on their mortgages despite all of the stimulus attempts. These are the same homeowners whose wages are not growing like those of the corporate titans and the bankers whose high end homes are doing just fine (for now) thank you very much!

We find it very amusing that Mr. Bernanke has now taken to blogging his views in an effort to explain (defend) the current state of affairs. CD's and short Treasuries in the U.S. offer nothing but a "stick in the eye" to savers and many blame him. That reality and the frustration it breeds, of course, pushes many investors to jump into stock land where the idea seems to be that returns there must be better than the virtually nothing in notes or bank savings vehicles.

Our guess is that the vast majority of investors would be shocked if told that a 10-year Treasury yielding near 2% will likely outperform the S&P 500 over that note's life based on historic valuation measures. Just because most investors do not know how valuation math works for stocks over time does not mean that those returns can be anything one hopes or needs them to be. Just like with bonds or any investment, the initial earnings yield (not dividend yield) one receives upon purchase explains most of the returns one can expect over a reasonable investment horizon. Right now, based on numerous metrics, the yield on the median stock has never been lower.

Looking back over the last hundred years, someone owning a portfolio of equities would be hard pressed to find investors willing to pay the multiples of the median stock today and low interest rates or easy policy do not guarantee high stock prices. History proves that. Some of the worst market performance occurs when the Fed is in easing mode. Besides, 30-40% corrections are the norm for a typical economic cycle let alone the bubble we are in now. Mr. Bernanke might just want to mention that on his blog.

We find it stunning that the Fed and other central banks now target a need for higher inflation as their excuse for zero-bound policies, but we come from the school of thought that likes lower prices. It will be fun to watch the former chairman try to explain on his blog why it is better that the average consumer spends more at the grocery store. We suspect he might quietly cheer for higher oil prices because it would boost gas prices and inflation measures, but we know very few consumers who would be excited about that. The reality is that the Fed needs to inflate assets to 2007 bubble highs or the banks that "butter its bread" will have to start provisioning for bad debt again as opposed to releasing loan loss reserves to goose earnings. That will be a tough pill to swallow and call into question the wisdom of all of those Greek lettered equations the FOMC members studied in their economics classes. Right now, all those Greek letters are spelling t-r-o-u-b-l-e not only in Athens, but also in the capitals of far too many countries.

We are left with the façade of an equity market held aloft by the hundreds of billions of dollars of borrowed money companies are using to buy back stock instead of growing their business thanks to a Fed policy that encourages that deflationary tactic. The computers still bid at what appear to be pre-established points throughout the day, making our market appear as rigged as the emerging markets we used to ridicule. However, as mentioned last month, earnings in corporate America are clearly turning meaningfully south and when the news is bad enough, the affected stocks are going that way too. With equities broadly the most expensive ever, we do wonder who will buy stocks from current holders when they need to sell. We call this "running out of greater fools" just as some important warning signs begin to flash. For instance, it appears that margin debt at the broker-dealers may be rolling over and we have found that is often a key early sign of the party ending.

We continue to hunt for investment ideas, of course, but in the equity market most of the value is still on the short side if you rely on normalized free cash flow valuation. That is no surprise when the median stock trades for more than two times historic averages on a price to sales basis. What we see now are some stocks getting interesting on the long side as they have corrected meaningfully on earnings worries, but when we dig through the numbers they are just not cheap enough for us to want to hold a meaningful position.

For purchase candidates, we look for high single-digit free cash flow yields and reasonable comfort with the future revenue picture. That is tough to find mostly because market participants are too willing to assume that a return to peak revenues and margins for the many cyclicals that we have researched is right around the corner. A common thought process in the market is that revenue weakness, if due to the massive rally in the dollar, will reverse itself soon, seemingly forgetting that it was the earlier weakness in the greenback that cast a positive bias to many companies' performance for many years. Energy producers are mostly way out of line with the current price of crude. We have added a few longs, but these are just small starter positions with one theme being that some are suppliers of equipment or services to the much maligned energy sector

We have also shorted a few more names in recent weeks in a number of sectors. We can see these stocks trading for less than half of current prices in coming years. For instance, we are now short a manufacturer of residential construction materials at over 60 times estimates for this year. In addition, free cash flow for this company has been quite paltry in recent quarters. In terms of our excitement level, we put this short right up there with the restaurant chain we mentioned a couple of months ago.

The Fed wants to raise rates this year just to be able to say that it did so, as if somehow that would be proof positive of its success. The weak jobs report for March was likely painful for the FOMC because it forced a deviation from its rosy script. After all, the Fed has trained the market monkeys and their computers to base any and all economic views on the high number of jobs that had been showing up in the lagging economic series known as the monthly employment report while ignoring the big picture. It has painted itself into a corner and will be loath to admit growth is softening yet again. Regardless of whether any rate hike occurs, a few hundred billion dollars of bonds is set to roll off of the Fed's balance sheet early next year, so further dollar scarcity is "baked in the cake" to some degree and that will be a tightening of policy.

If we were to sum up the biggest fact that many analysts seem to be missing or choosing to ignore it is that the central bank mechanism of keeping rates low and printing currencies is running into the reality that the enormous debt growth that resulted from those policies is having less and less positive impact on growth. The econ geeks would describe this as money velocity shrinkage overcoming the money printing. All that cash just sits in free reserves unless a banker lends it. The banks don't really want the cash based on the low rates they pay and high fees they charge for deposits. In Europe, borrowers are actually paid to borrow by some banks. Talk about distortion!

Some pundits are pointing to a pickup in C&I (Commercial and Industrial) loans as a sign of the malaise ending here, but we suspect that bump is likely tied to deal making and stock buybacks. We just do not see any convincing evidence of a major pickup in bank lending when we look at the balance sheets of the big banks and now a recently released forward looking survey of credit managers has us thinking the spigots are closing. No wonder small business optimism and hiring plans rolled over.

We suspect that some business owners and consumers who may not be versed in analyzing the big picture financial data are making decisions that they might not if more informed. Like us, Japan, China, and Europe have also seen each marginal unit of debt spurring less growth. What's more, if debt is just future spending brought forward, then real final demand in coming years is a major question mark. Importantly, much of the debt created has been low power because it was not used to buy productive assets that lead to future growth.

Suffice it to say that we suspect that a good portion of the business activity that has occurred since 2009 was predicated on the assumption that extremely easy Fed policy could continue with no negative effect to us from a QE counter-attack by our trading partners. They were forced into the same shenanigans by our QE zeal. The assumption has been that QE just must lead to growth! Debt growth was confused with real income growth. The notion that the music will never stop is still a common refrain, so any move to even a slightly less easy stance has and will produce an inordinately negative response.

Economists from the Austrian school of thought, who for decades have routinely received nothing but derision from the Keynesians that dominate positions of power, predicted this debt exhaustion outcome decades ago. The idea of solving over indebtedness with ever more debt, of course, has mostly been celebrated as brilliance by governments and central banks because it is what they like to do to stay in power and Keynes is still their hero. Oh, for just one Austrian economist at the Fed…or, even better, just one of us from the "unwashed masses" that helps meet payroll at a real company somewhere other than a Wall Street bank! We know, that's pure and utter heresy.

It now appears that with such a high percentage of the newly issued government debt being monetized through QE in places like Japan and now the EU, it is getting tougher for the central banks to find additional sources of debt to monetize. We still think the national central banks in Europe will struggle to buy enough sovereign bonds to meet targets because many sellers have so few choices for reinvestment and new capital requirements make alternatives much more costly to hold. These factors are enormously important in a world addicted to money printing and it may mean that we have reached an upper bound to these foolish policies.

Although we have learned that one can never be cynical enough in analyzing the realm of the deciders, we think the deflationary signal being sent by precious metals and other commodities may well be a sign that the central bankers are running out of room to manipulate markets and the news cycle at least for now. However, because it is foolish for us to underestimate their "creativity," we do own precious metals positions as insurance against more of the only trick the central bankers know and that is printing or otherwise debasing fiat currencies by holding short rates below the level of inflation.

We suspect the Fed must be concerned over the fact that it dominates stock market activity to a degree that would have seemed laughable not that long ago. We do wonder how long confidence can be maintained when it takes "sweet nothings" from the Fed to prevent panic every time the S&P 500 sells off even 1-2%. After all, stocks cannot continue to go one way while the economy and earnings go another.

We think investors are about as exposed to equities as they ever have been just as more doubts begin to surface about what QE has really accomplished. The Fed is in the astounding and untenable position of needing to tighten to restore some semblance of discipline to euphoric markets just as the economy hits the softest patch in years. Investors have been taught to fear nothing and leave risk management to the central banks. The gap between the real economy and equities has never been wider in our view.

We are optimistic that extremely compelling investment ideas await those willing to adopt the constructive view that rationality and longer term thinking will emerge from the current mania. Playing along with the current crowd by betting on continued irrational behavior will be left to others. We are 109% long and 37% short with a 67% exposure to closed-end bond funds and 7% of capital invested in precious metals-related positions. Our net equity exposure is 2%.

Sincerely,

Scott E. Brown, CFA