April 15, 2015

The items mentioned above (low inventory, reluctance to extend credit, etc.) make it more likely that a crisis will cause more volatile market movements with a rapid decline in valuations even in what are very liquid markets. It will be harder for banks either as lenders or market makers to "stand against the tide."

Jamie Dimon, Chairman and CEO
JP Morgan Chase, 2014 Annual Report

* * * * * * *

Just as the Federal Reserve has removed the word "patient" in its March policy update in describing when it is going to raise the federal funds short-term interest rate up from 0%, I have removed the words "next year" from my conversations about when I will replace my aging flip phone with a new Apple smart phone. Just as I have challenged the Federal Reserve in past letters about the inherent conflict of a 0% interest rate policy with the basic risk/reward dynamics of capitalism, my thirteen year old daughter has challenged me about my lack of mobile internet connectivity and my inability to take decent pictures and video with my current cell phone (while my wife and older daughter already have iPhones, my thirteen year old is in line behind me and her fourteenth birthday is coming up next month!).

Is this comparison ridiculous? It has been six years since the worst of the financial panic of 2008-2009. Real gross domestic product (GDP), the full measure of economic output of the United States adjusted for inflation, recovered to a new high in 2012 and has continued to improve since then. The crisis is long over. And, regarding the various structural and potentially deflationary issues dragging on our economy (including aging demographics, globalization of the work force, disruptive technologies and growing mountains of debt), a 0% interest rate policy that penalizes savers and incentivizes poor investment decisions is not going to solve those problems. On the smart phone side, the first iPhone was launched in June 2007. From a base of $0, iPhone sales have accumulated to over $400 billion. The iPhone, along with other smart phones and accompanying applications and content, has been and continues to be a great business and, effectively, a market-driven economic stimulus package. At the user level, it is a proven and well developed tool as well as a beautifully designed device. It has the potential to enhance my connectivity, my creativity, and (at least some of the time) my productivity. So I pose these questions to the Federal Reserve: What are we waiting for? If I buy a new iPhone, will you raise the federal funds interest rate up from 0% at your next meeting? The only thing ridiculous about that would be if they said "No."

* * * * * * *

The strange ongoing tale of global bond yields reminds me of an old Monty Python skit called the "Four Yorkshiremen." In the skit each of the men tells about the difficult youth he endured. Each successive story gets more absurd, and ends with the last man bragging that he had to get up in the morning at ten o'clock at night half an hour before he went to bed, drink a cup of sulphuric acid, work twenty-nine hours a day down at the mill, and pay the mill owner for permission to go to work. In our financial world, the willingness to accept negative returns on "safe money" has taken on a life of its own. It began with the European Central Bank lowering its bank deposit rate to a negative (-0.10%) last June, basically telling banks to go do something else with their money -- but the money kept coming. Then negative yields started showing up in the short-term bonds of various European countries. In February, Germany issued a 5 year government bond with a negative annualized yield of (-0.08%). And finally, last week, Switzerland sold the longest duration government bond with a negative yield ever -- at an annualized yield of (-0.055%). If held to maturity, investors have locked in a nominal loss on their money over ten years for the privilege of owning a Swiss government bond denominated in the Swiss franc. Let's hope it doesn't get more absurd than that.

* * * * * * *

In the 1st quarter of 2015, the S&P 500 US stock market index returned a little under 1% with dividends. The lackluster performance is actually fairly impressive considering that 1st quarter 2015 earnings on the S&P 500 are expected to be down -4.5% from the 1st quarter of 2014. The two major factors negatively affecting earnings are: 1) a drop in earnings from oil and oil service businesses in response to the 50% drop in oil prices since last July; and 2) a drop in earnings from overseas in response to the 20% increase in the value of the US dollar versus a basket of other currencies, including the euro, since last July. A higher valued dollar makes US exports relatively more expensive, which can depress sales and/or profit margins, and it also lowers the value of overseas earnings when they are converted back into dollars. Throw in the big winter storms in the North East and the "slowdown" at the West Coast ports, and I believe that stock market investors have chosen to look beyond the 1st quarter with a hopeful eye to the rest of the year. As always, employment and consumer spending hold the key to sustainable economic growth, and while hiring showed some weakening in March, the momentum from the last couple of years appears to still be with us. If that were to materially change, particularly given our extended stock market valuations, I don't believe that stock market investors will continue to be so forgiving.

* * * * * *

It is the time of year when our office gets overrun with annual reports and proxy statements. While many are painfully dry, I recently read two of my favorite CEO annual letters, Jamie Dimon's from JP Morgan Chase and Warren Buffett's from Berkshire Hathaway. If you have an interest in learning about the perspectives and insights of these two business leaders, I think you will enjoy reading them. Jamie Dimon spent much of his letter addressing the pros and cons of the regulatory changes our banking system has been going through. At one level, he believes that our banking system is stronger and better positioned for a financial crisis than it has ever been. On another, as noted in the quote that opens this letter, he believes that the regulatory changes will negatively affect the ability and willingness of banks to provide liquidity to the broader markets in the next financial crisis. It will, he believes, lead to more price volatility in the financial markets in the next crisis. In his letter, Warren Buffett continues to emphasize a long-term approach to accumulating well priced, cash generating businesses to build wealth. In a classic Buffett quote, he reaffirms his ongoing faith in US businesses:

> *Indeed, who has ever benefited during the past 238 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, real per-capita U.S. output has sextupled. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket).*
>
> *The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.*

* * * * * * *

At Peak, we appreciate your business and we continually work hard to earn the trust you have placed in us. Please let us know if you have a friend or family member that could use our assistance.

John McCorvie, CFA