For everything there is a season and a time for every matter under heaven…
---Ecclesiastes 3:1

October 13, 2014

Dear Fellow Investor:

This line from *Ecclesiastes*, written in ancient Israel perhaps 2300 years ago by that most prolific of poets, Anonymous, set to music by Pete Seeger in the 1950s, and rendered into a top-40 hit by The Byrds in 1966, comes to mind as we contemplate the financial markets in the second half of 2014. It is the season, the time, for a corrective phase.

The S&P 500 turned in a respectable performance in the third quarter of 2014, up 1% for the quarter, but up 6.73% on a year-to-date basis (8.4% with reinvested dividends). Other indices, however, paint a less rosy picture. The blue-chip Dow Jones Industrial Average was up only 2.8% at the end of the quarter, and, as I write, has slipped into negative territory year-to-date. The Russell 2000, which tracks small-capitalization U.S. stocks, was *down* more than 5% on a year-to-date basis at the end of the quarter, and *down* more than 9% as I write. Foreign markets fared a little better with the Morgan Stanley All Country World Index down about 2% through September 30. Here at Weybosset Research & Management LLC (WRM), the accounts we manage, which include big and little, foreign and domestic stocks, came in somewhere in between, behind the S&P 500 but ahead of the other averages. Our accounts were up low-to-mid single digits year-to-date at quarter end.

So we have large U.S. companies, represented by the S&P 500, hitting all-time highs in September as broader gauges turn south, not auspicious for the S&P 500. Sure enough, today the S&P 500 closed more than 7% below its high, well on the way to the minus-10%-from-the top reading generally acknowledged as qualifying as a "correction." In addition, as I learned in my days trading bonds, volatility tends to increase near market turning points. Last Wednesday was the best day for the stock market in 2014 and Thursday was the worst day. But you don't need statistics about last Wednesday or Thursday to tell you market turbulence has picked up markedly—check your newspaper, TV news or computer screen!

Why this sudden *sturm und drang*? Things got a little wobbly over the summer as concerns about prospects for global growth grew. Europe may be tipping over into yet another recession. Japan's latest drive to break the decades-long cycle of deflation and sluggish economic activity appears to sputter. And who in the world knows what is going on in China? At a minimum growth there has decelerated from the heady pace of the last decade, and certainly parts of the world that in the past benefited by selling various commodities to China are struggling. Add in the fact that in the U.S., the Federal Reserve plans to wind down quantitative easing (QE), the most aggressive edge of its massive post-crash monetary stimulus program, this month, and uncertainty, abhorred by markets, mounts.

The bright spot in a murky global economic picture has been North America, the United States in particular. Growth here has been far from robust, but has remained steady, even picking up some momentum in recent months. (The employment numbers, for instance, have actually been getting better). Central to our fair land's improved prospects has been the revolution in energy recovery techniques—2014 may be the first year North America surpasses Saudi Arabia in oil and gas production.

But, as with any commodity, as supply increases and demand decreases, the latter due to slowing economic activity, the price falls. Brent crude peaked in early June and began a descent. In September it broke below $100 per barrel and is down 15% so far in October alone. Decline turned to rout when the Saudis indicated they would be content to see prices as low as $80. At these levels some of the more adventurous exploration and production projects are no longer profitable and may have to be curtailed or cut off. Some speculated the Saudis seek to drive out marginal producers in an attempt to maintain their status as the world's swing producer in oil, the power that determines whether oil prices rise or fall. In any case, it is no surprise that energy stocks have led the way down in the current correction.

The steep decline in oil prices looks to be the final chapter in a multi-year chronicle of crumpling commodity quotations, beginning with the drop in industrial metals in 2011 as China's growth rate slowed; followed by the collapse of gold in 2012 as a speculative mini-bubble burst; then high drought-induced agricultural prices caved as we enjoy a record harvest this year. Here at WRM, we have been gradually reducing our exposure to commodities--and profitably so—which, since the 2008 melt-down, we held as hedges against the threat of inflation arising from the ballooning global money supply. Our remaining oil and gas producer hedges its production years in advance—in effect, it has already sold at yesterday's prices what it pumps out of the ground today and tomorrow. We have several investments in pipelines, but in these cases the price of oil or gas is irrelevant--the only thing that matters is whether the oil and gas move and pay the pipeline for passage. Logic would suggest that the cheaper the (vital) commodity, the higher the demand, and therefore the more movement. Nevertheless, the market prices of our hedged exploration and production company and our pipelines have all suffered in the current market correction. We believe economic reality will eventually reassert itself (as it tends to do) and our energy investments will work out fine.

So we are treating the current correction as just that, a correction in an otherwise up trending market. In prior epistles I have gone on at length about why current conditions are not characteristic of a market top: valuations are reasonable, the U.S. economy is OK, competing asset classes are not competitive, and, to my mind, most importantly, sentiment and positioning by investors large and small do not indicate the kind of euphoria typically seen prior to a crash. We are busy using this fall's volatility to acquire above average assets at prices we think you may not see again.

Our anonymous poet tells us in *Ecclesiastes* that there is a time and a season for everything. We believe we are in the season, due season, of a market correction. Elsewhere he laments, "Vanity of vanities! All is vanity. What does man gain by all the toil at which he toils under the sun?" (Ecc. 1:2-3). We aim to see that *our* toil on *your* behalf is *not* in vain, but that we use the occasional, inevitable and seasonal market tantrum to your advantage.

Thank you for your continued support and, as ever, do not be shy about contacting us with any questions, comments or complaints. We're always glad to hear from you.

Yours very truly,

Fla Lewis III
Principal

P.S. On October 1st Justin Deutsch joined the squad here at Weybosset Research and Management LLC after five years at Baycrest Partners LLC, a New York research and institutional brokerage boutique. We've worked with Justin throughout his time at Baycrest and long-time WRM clients have already benefited greatly from his insight and skill—think trains, think diesel engines, think restaurant equipment. Thus I was delighted when Justin expressed an interest in coming to Providence to work for us full time. He brings new blood and energy to our firm and I am sure you will enjoy getting to know Justin.