July 23, 2013

Dear Fellow Investor:

In prior epistles I remarked that, absent some exogenous shock, it feels as if the stock market "wants" to go up; and that, furthermore, because stock prices ultimately are tied to the fortunes of the underlying businesses, and because the direction of business has generally been up since the end of the Middle Ages, the "normal" direction of the market is up--again, absent exogenous shocks. The second quarter of 2013 validated in a small way my contention.

After setting record highs in late May, the market underwent what some dubbed the "Taper Tantrum." U.S. Federal Reserve Chairman Ben Bernanke mused at a press conference in June that the Fed *may* begin to" taper" its purchases of Treasury securities and mortgage-backed bonds later this year. He emphasized that such tapering would in no way amount to an actual tightening of monetary conditions or an increase in official interest rates any time soon; only that monetary conditions could become a little less accommodating (an interesting distinction!).

Markets failed to see the humor in the Fed chief's remarks and the S&P 500 closed the month of June down nearly five per cent from the late May highs. The bond market reacted much more violently with the benchmark ten-year Treasury note spiking from around 1.6% to above 2.5%. Because bond prices move in the opposite direction of interest rates, bond prices dropped precipitously for the first time in years.

Events on the opposite side of the planet exacerbated the problem. China, long the engine of global growth, has a new government and that government understands that China's growth model must change. Following the example of Japan in the 1960s and 1970s, and subsequently sundry "Asian Tigers", China has relied on a large and cheap labor force to manufacture and export goods to the rest of the world. When the rest of the world, thanks to the global financial crisis of 2008, became less of a market for Chinese exports, the government turned its attention to investment in Chinese infrastructure. This policy worked in that it limited China's suffering in the severe recession that accompanied the financial crisis, but you can only build so many new roads, new airports and new skyscrapers before you have far more roads, airports and skyscrapers than you are ever likely to need. (For years more than 50% of Chinese Gross Domestic Product consisted of investment, versus about 20% in the developed world.) Thus the goal of the Chinese government, and rightly so, is to focus on growing domestic demand, which in turn requires higher incomes for the average Chinese.

Even the heirs of Mao Tse-tung cannot simply wave a wand and effect such an outcome. Time will tell whether the new approach in China will work, but in the meantime, growth in China has slowed, partly because of the transition the new government seeks and partly because export markets are weak. Other emerging economies, particularly those that have relied on shipping commodities to China, slowed in tandem. The prospect of higher interest rates and less liquidity in the world's largest economy, the U.S., only made the situation appear worse.

So while the U.S. stock market hiccupped, markets abroad shuddered. The Shanghai composite finished the first half of 2013 *down* nearly 13% while the Brazilian market ended *down* more than 22%. Back in the U.S.A. (as Chuck Berry put it), market participants decided that, after all, maybe Bernanke's bark would not carry much of a bite, so in recent days the S&P 500 surpassed its late-May high and now approaches 1700, more than 155% above the lows set in the first quarter of 2009. (This market "wants" to go up!) But bond prices remain depressed.

The brouhaha I outline above has been accompanied by a number of notable side effects, some in the form of unanticipated collateral damage. For instance, as bond prices dropped, so did the prices of income-producing equities, of which we own plenty here at Weybosset Research and Management LLC. Thus the accounts for which we are responsible were actually down a few percentage points in the second quarter of 2013 (on an absolute basis we are substantially ahead year-to-date) versus a small gain in the quarter for the S&P 500. I am never happy to begin a quarter ahead of the market and end behind it, but neither am I likely to abandon our dividend –paying stocks just because they had the bad fortune to follow the bond market down in the month of June. If you've monitored our thinking at all for the past few years, you know the premium we put on receiving "rent" on our property. It has been, and I believe will continue to be, a primary source of return in the equity market, particularly in an environment of "financial repression", an environment in which central banks hold interest rates unnaturally low for a prolonged period in an attempt to stimulate sluggish economies and keep the cost of servicing enormous government debt low. I am confident our income-producing stocks will fully recover and then some; while I wait I will be cashing my dividend checks.

A second consequence of slowing growth in the emerging world, especially China, together with little or no growth in the developed world, is that demand for most industrial commodities is not particularly good. Demand had been robust for more than a decade, and so, all the way around the world, new mines have been opening. Rising supply accompanied by falling demand means even lower prices for commodities. Here at Weybosset Research we have been gradually trading out of our various commodity-based investments. A year or more ago, we took profits in our mining stocks. This past April, the price of gold abruptly collapsed, so we took profits there, too. (We had been holding gold as a hedge against the depredations of heavily indebted governments against their own currencies, but how to insure against our insurance policy? Best to say goodbye.) We remain invested in domestic oil and gas reserves and timberland as a way to participate in the recovery of the U.S. housing market.

A third effect is that with Europe in seemingly perpetual recession, growth in the U.S. tepid and halting, Japan a zombie since 1989, and now the emerging markets slowing, growth in the investment sense is very hard to find. There is the occasional company selling really innovative restaurant equipment, or the warehouse membership club in Central and South America adding more and more shoppers all the time, but these are the exceptions, not the rule. From a business point of view, things are pretty flat out there, not down much but not up much, either. (One more reason to relish rent checks!)

Finally, there is the issue of fresh highs in the U.S. stock market. For some time there has been talk in investment circles of "The Great Rotation", a movement out of bonds, which have been the darling of investors, particularly for the past decade, and into stocks, which have been out of favor since the bursting of the tech bubble thirteen years ago. (See my letters of October of last year and April of this year.) Although there has assuredly been movement into stock funds in recent quarters, there had been no evidence of investors losing faith in bonds until just recently, concurrent with the Bernanke-induced "Taper Tantrum." Indeed as investors begin to experience losses on their bond holdings—remember, as interest rates rise, bond prices fall—and notice successive record highs in the stock market, the rotation could well accelerate. People tend not to buy stocks when stocks are cheap, but when they are popular.

Here at Weybosset Research, we are for the most part content to sit tight. Our portfolios were assembled when their constituent parts were certifiably cheap. Our portfolios have gradually adapted to changing circumstances. For instance, a few years ago, every account held substantial amounts of fixed income. But as prices there rose and returns fell, we let the fixed income component "roll off", either by trading the bonds and preferred stocks or waiting for them to mature. (There are still some tag ends in many of our accounts.) As I mention above, in similar fashion we have cashed out of much of our commodities investments, and may continue to do so in the future.

The "Taper Tantrum" reminds us that exogenous shocks can still disrupt happy markets. Eventually interest rates *have* to normalize, which will cause plenty of problems. Europe is peaceful from the point of view of financial markets these days, but remains highly fragile due to enormous debts. China has some daunting adjustments to make, and whether or not China is successful remains to be seen. Markets in Japan have been on a tear lately as newly-elected Prime Minister Abe has introduced sweeping changes in Japan's monetary policy—the Bank of Japan is looking to outstrip the rest of the world's central banks by becoming hyper-hyper-stimulative—and promises structural reform as well; but it will take a lot to turn Japan around. And, back in the U.S.A., the national government remains dysfunctional. So far we investors have survived the dysfunction, but it could come back to bite us at any time.

Therefore we are mindful that we need to stay with the highest-quality investments. Things can go wrong quickly, and we do not want to be found swimming naked when the tide goes out. All well and good, but we also have to understand that in "hot" markets, the best quality securities do not always perform best. Over the long haul, they *always* do.

As ever, thank you for your support, Fellow Investor. We hope you are enjoying a pleasant summer. Please do not hesitate to get in touch with any comments, complaints or questions. We'd love to hear from you.

Yours very truly,

Fla Lewis III