Quarterly Review and Outlook – Second Quarter 2013

Economy

The US economy as measured by GDP was revised downward to 1.8% from 2.4% in Q1. For reference, the average US GDP growth since 1948 is 3.2%. Across the many indicators used to gauge the health and direction of the economy, the readings are mixed. Although home prices have risen significantly from the 2009 bottom, housing starts are still at approximately 50% of the average going back to the late 1950's. The Federal deficit, although improving over the past year, is still well above $1 trillion or approximately 7% of GDP as Federal government outlays remain at record highs. In other words, without the federal deficit, the economy would be declining. Bank loans are growing 33% less than a year ago. The median duration of unemployment has fallen from a high of 25 weeks to 16 weeks. The private sector (non-government) continues to create jobs and the unemployment rate slowly declines. At the same time, many of the new jobs are part-time because employers are unwilling to make full-time hiring commitments. The Institute for Supply Management Purchasing Managers' Index, a gauge of business strength, was 50.9 in June and has bounced around the expansion/contraction level (<50.0 signifies contraction) for 4 months now.

Capital Markets

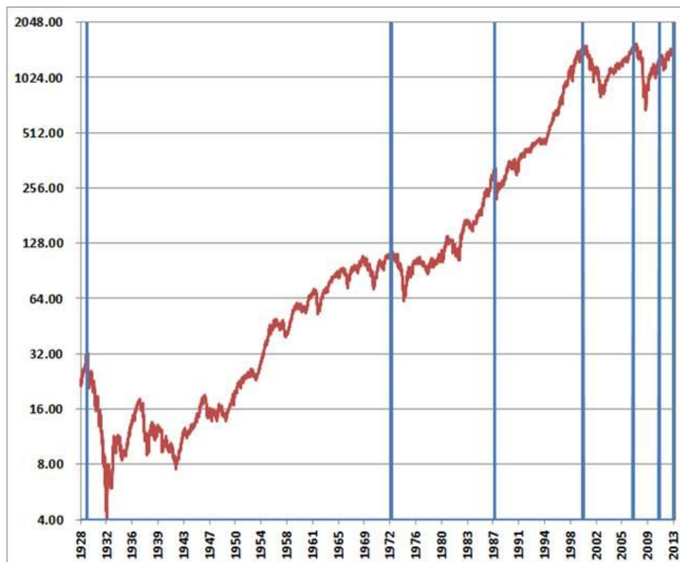
US capital markets are nearing another zenith. This time, the "Bernanke Bubble" will be what pops. Both the bond and stock markets have been greatly influenced by the various Quantitative Easing (QE) initiatives put forth by the Federal Reserve, led by Chairman Ben Bernanke over the past four years. The massive bond buying spree (mainly mortgage bonds and Treasury bonds) undertaken by Bernanke's Fed has served to keep bond interest rates punishingly low – so low that savers have not been rewarded and in fact have lost purchasing power to inflation. The follow-on affect has been that savers and investors have been forced to take on more risk to garner some return. Savers and investors have been directed toward stocks, particularly over the past few years. In fact, Bernanke publicly stated that encouraging people to buy stocks was a prime objective of the Fed policies. The problem is that by keeping the price of bonds artificially high and forcing people to take stock risk, the Fed has effectively created expensive bond and stock markets. In May and June, the Federal Reserve's threat of ending QE as soon as September this year caused tumult in the markets. Both stocks and bonds declined simultaneously – usually they counterbalance each other. The performance of "safe" investments in May and June provided no place to hide. As the following table illustrates, conservative investments declined precipitously.

913.491.0500 ● 7300 College Boulevard ● Overland Park, Kansas 66210

Asset	May & June	2013 YTD
Mortgage bonds (MBB)	-2.74%	-2.02%
Total US bond market (AGG)	-3.53%	-2.54%
US Government Bonds (7-10) (IEF)	-5.57%	-4.03%
Municipal Bonds (MUB)	-5.65%	-3.98%
International Treasuries (BWX)	-6.00%	-7.02%
US Corporate Bonds (LQD)	-6.38%	-4.61%
US TIPS (TIP)	-7.84%	-7.21%
Utility Stocks (XLU)	-8.24%	9.80%
US REITs (IYR)	-8.72%	4.57%
US Government Bonds (20+) (TLT)	-9.81%	-7.85%
Emerging Bonds (PCY)	-11.27%	-11.27%

US Stocks declined 7.5% between May 22 and June 24 before recovering after Bernanke back-pedaled on his QE tapering comments. Globally, the two best-performing stock markets YTD have been Japan, followed by the USA. The US stock market is now the 3rd most expensive in the world! In fact, the current US stock market is now among the 6 most expensive and high risk US markets of the past 84 years! Historically, in markets with similar overvalued, over bought, over bullish sentiment, and rising bond yields similar to today's market, we find a Who's Who of major market tops and their subsequent losses:

2007 – October 2007 high followed by 57% loss into 2009,
2000 – March 2000 high followed by 49% loss through March 2003,
1987 – August high followed by 35% loss through December 1987,
1973 – January high followed by 50% loss through October 1974, and
1929 – October high followed by 89% loss through July of 1932.



There was also an instance in 2011 that was followed by a near-20% market decline which was mitigated by Fed intervention.

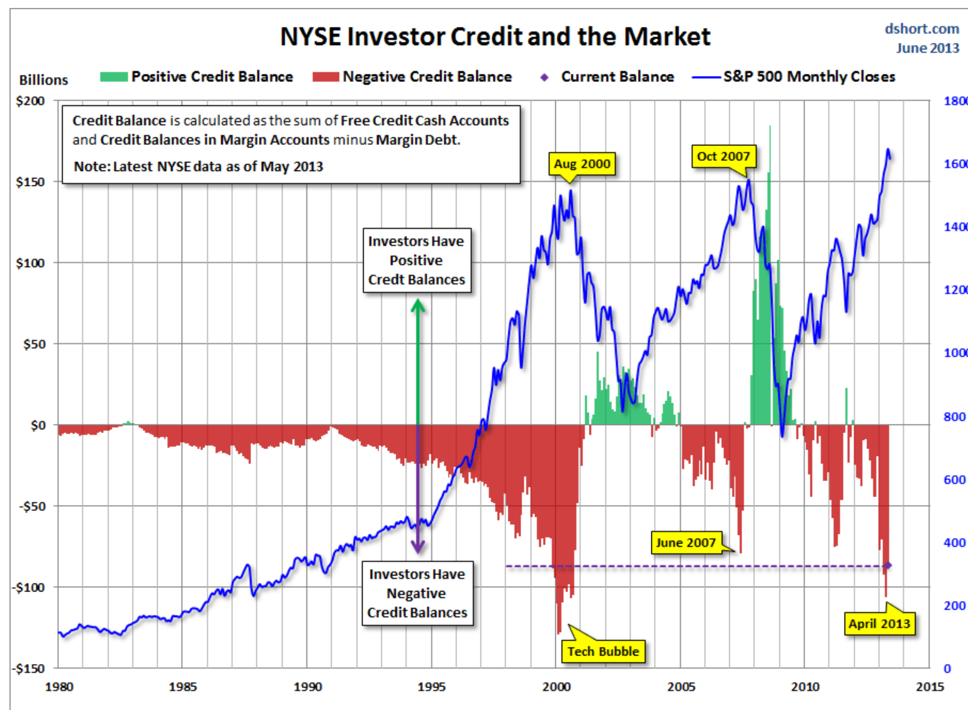
The vertical blue lines in the chart (from Hussman) indicate when the warning signs first appeared.

Notably, the set of characteristics which defined the aforementioned major market tops often first appear months in advance of the top. Also in these past instances, it was quite common for one or more 10% pullbacks which were quickly recovered on the way to the final top.

Over-priced and over-bullish stock markets have very poor prospective returns. As of the end of June, the prospective annualized returns for the next 7 years are as follows:

GMO Annualized 7-year Return Projections for:	As of: 6/30/2013	Historical Return
US Large Equities	1.0%	9.8%
US Small Equities	-0.5%	11.3%
Int'l Large Equities	5.2%	9.8%
Int'l Small Equities	5.3%	N/A
Emerging Market Equities	9.2%	12.8%
US Government Bonds	2.0%	5.4%
International Government Bonds	0.1%	6.9%
Inflation Indexed Bonds	1.9%	7.1%

In addition to greatly inflated profit margins which we have discussed in previous newsletters, we see cause for concern in the large amount of borrowed money being "invested" in the stock market. Excessive leverage (debt) used by investors often precedes market peaks:



In short, our concern is that both the stock and bond markets are overpriced today, primarily because of the policies of Ben Bernanke's Federal Reserve. The price of the general stock market today, expensive and getting more so, is not being driven by the fundamentals, but rather by government policies. This sort of bubble is not likely to end well.

Portfolio

Our portfolios underperformed in Q2 because of our weighting to "safe assets", exposure to gold stocks and emerging markets, and our underweighting of US stocks (see above). We are in the midst of a long-term or secular bear market which began in 2000. The following S&P 500 charts compare the current secular bear market with the previous one.

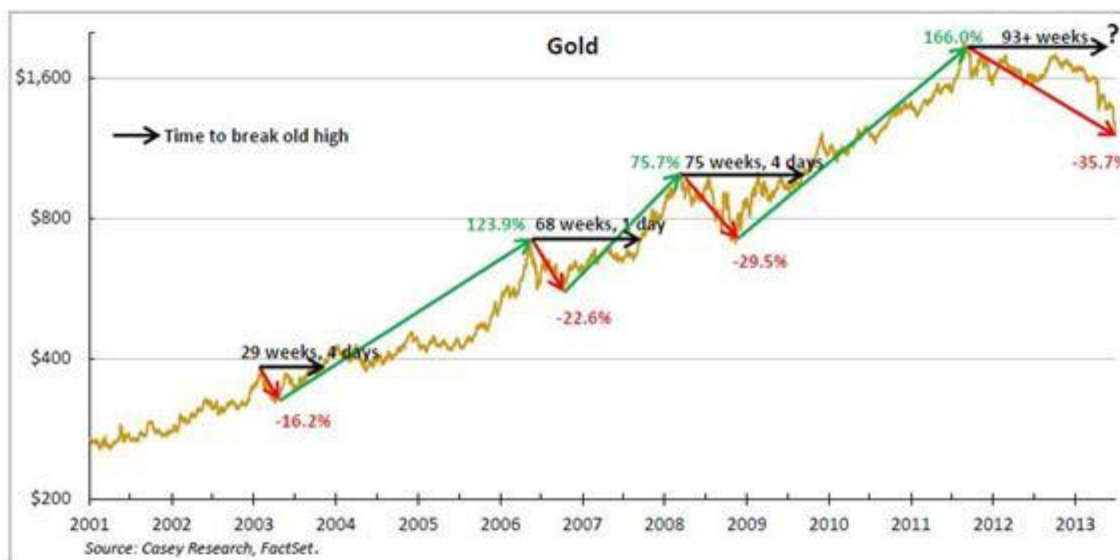
Long-term bear markets include a series of short-term bull markets followed by bear markets during which most, if not all of the preceding gains are lost. Historically, cyclical bear markets within secular bears lose an average of 38%. Some members of the financial press have been touting that we are at the beginning of a new secular bull market. We disagree. No secular bull market has ever begun with starting valuations at today's levels (Shiller PE10 of 24). In fact, the four secular bull markets since 1900 all began with PE10 values of 8.5 or less – a long way away from where we are today.

The biggest drag on our portfolios YTD and particularly in the second quarter has been our exposure to gold stocks. We have been buyers of gold stocks for over a year now. We started buying when the price of gold had declined 10% and the gold to gold miners' ratio exceeded 10 – a level of undervaluation only reached once before (in 2008). That previous

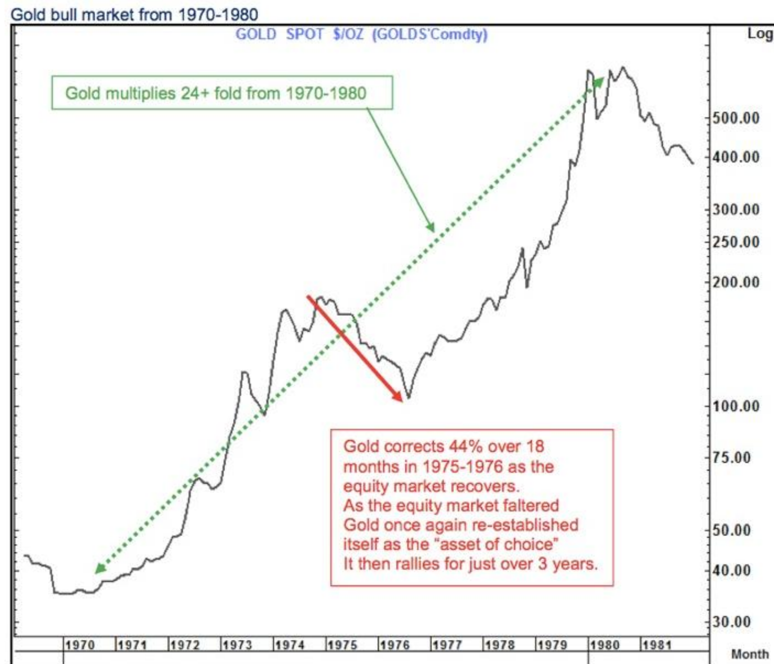
undervaluation in 2008 resulted in a 104% return over the following 18 months and an annualized 34% for three years. Our thesis contended that the massive amount of money printing by world central banks would serve to devalue fiat currencies and increase the relative value of gold as priced in those currencies. Further, if the European crisis (or others) worsened, gold-related investments would prosper as investors sought gold as a safe-haven store of value. The increasingly affluent Indians and Chinese are traditionally strong buyers of gold. We saw this growing demand and ability to buy as a support for the price of gold. We continue to experience negative real interest rates, a condition that historically has been very positive for gold.

Since its high price of over $1900 per ounce was reached in August of 2011, the price of gold has fallen 36% through the first week of July 2013. Gold stocks have fallen 60-80% since their 2011 highs. We have been buying gold stocks periodically throughout the decline at progressively cheaper valuations. Our last gold stock buy was in May at a ratio of 13.7 and in a fund that then was 57% below its highs.

We did not sell gold stocks as they declined further because we believe that the secular gold bull market which began in 2001 is still intact and the correction over the past 2 years is normal and healthy (although painful). In fact, the latest decline in the price of gold is the 4th significant price decline since 2001 and each previous decline was recovered and new highs were reached:



During the last gold bull market from 1970 to 1980 gold went up 2300%, but not without significant pullbacks. Gold experienced a 44% decline in 1975 & 1976 after which the price of gold rose another 400%.



Source: Aspen graphics/Bloomberg May 22, 2013.

Gold stocks are very volatile and they can go up and down in price quickly as can be seen in the previous charts. We bought gold stocks as a long-term investment because of their compelling valuations at the time of purchase and our belief that the secular bull market in gold has several years remaining. Now that the store is on sale, everyone is running for the exits. The gold stock sector has the best prospective forward returns of any stock sector we follow. The sentiment for gold mining stocks has been zero of late! The 30 largest Gold stocks as a group are now selling for less than book value – lower than 2008 or 2001. The price of gold may go lower still and if it does, the price of gold stocks will likely follow. The main concern that will cause us to rethink our stance on gold stocks is if we see concrete evidence that the world is going into an extended deflationary period.

As discussed in the Capital Markets section above, most "safe assets" got beaten up in May and June, including our bond holdings. The bonds funds in our portfolios lost anywhere from 2.6% to 6.1%. The bonds in our portfolios are mostly investment grade and of shorter durations, so credit risk and interest rate risk are both mitigated. The spring selling was overdone and our bonds have begun to recover their losses.

In summary, cheap assets are getting cheaper and expensive assets are getting more expensive.

Thank you for your continued trust and support,

Trevor Holsinger and Steve Small