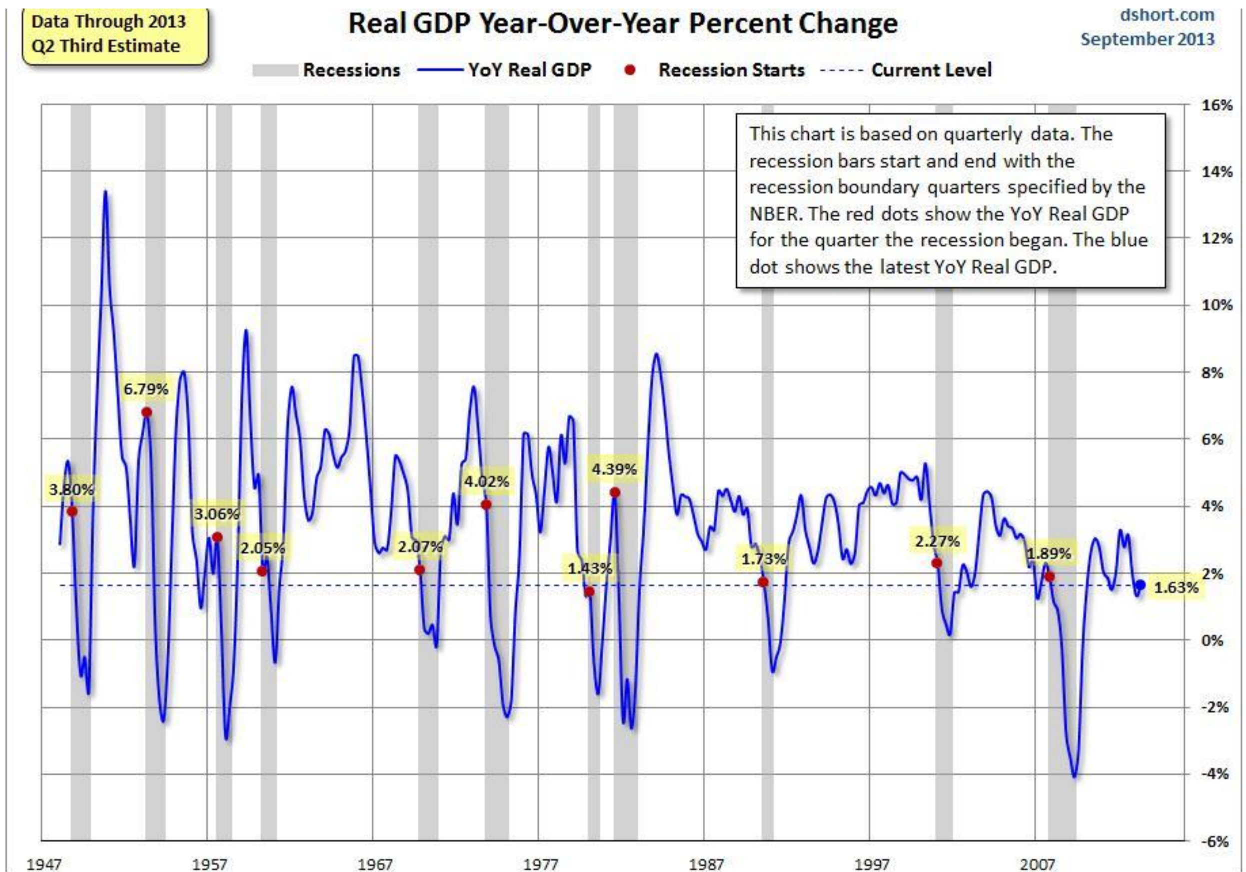
Quarterly Review and Outlook – Third Quarter 2013

Economy

The US economy continues to nudge along with Q2 GDP coming in at 2.48%. This is slightly improved over Q1. The federal government impasse will likely have a negative effect on the economy. The longer the impasse drags out, the more the negative impact to our economy. In Europe and Japan, economic activity is now slightly positive. The chart below, from Advisor Perspectives, shows real GDP (excluding inflation). Note how weak our recovery is at this point in the economic cycle compared with previous periods.



Capital Markets

US capital markets have experienced a slight hiccup, primarily due to the logjam in Washington and the resulting uncertainty. Into the second week in October, all of the summer's gains had been erased. If you doubted whether the US stock market has been dependent on QE, take a look at the following chart from Global Financial Data.

Since 2009, as the Fed Balance sheet has risen, so have US Stocks. Given the negative market reaction in Q2 when the Fed hinted at tapering its bond purchases (or reducing QE and perhaps the size of the Fed balance sheet), and the current uncertainty surrounding the Federal budget and debt limits, we think that it is unlikely that the Federal Reserve will slow its bond buying anytime soon. The economy is just not strong enough yet to stand on its own feet. A key question is whether the relationship shown above will continue. We believe that owning a market that is artificially supported by government largesse is a dangerous proposition.

As we have discussed repeatedly, over-priced and over-bullish stock markets have very poor prospective returns. As of the end of September, the prospective annualized returns for the next 7 years are as follows (and for US stocks, less than they were 3 months ago):

GMO Annualized 7-year Return Projections for:	As of: 9/30/2013	Historical Return
US Large Equities	0.2%	9.8%
US Small Equities	-1.6%	11.3%
Int'l Large Equities	4.1%	9.8%
Int'l Small Equities	3.8%	N/A
Emerging Market Equities	8.7%	12.8%
US Government Bonds	2.5%	5.4%
International Government Bonds	0.2%	6.9%
Inflation Indexed Bonds	2.5%	7.1%

Portfolio

Our portfolios rebounded in Q3. In particular, cheap countries Greece and Ireland were up by 25% and 15% respectively. By the end of August, gold stocks had rallied 30% off their June 30 lows before settling back down and ending Q3 with 2% to 10% gains. We sold our last Tocqueville Gold fund buy for a 19% gain. We continue to believe that the gold market is basing and the bull market will resume. Japan was up 5% as were emerging markets. Bonds rallied off their early September bottom and ended up a little less than 1%. Surprisingly, in one of the worst years for bonds on record, bonds are on track to end the year in positive territory.

We continue to be wary of allocating capital to US stocks in general given our belief that the prospective returns do not justify the risk. Our main exposure to US stocks is via our sector model which YTD is up approximately 27%. We continue to look for and invest in cheap assets that present attractive prospective returns. A look at some of the cheap assets we like follows.

Platinum & palladium: We bought SPPP, a physical platinum and palladium trust. Platinum and palladium (P&P), in addition to being considered precious metals, also are very important industrial metals. Each is a key element in the production of pollution-reducing catalytic converters on cars and trucks. Virtually all of the world supply comes from three countries: South Africa, Zimbabwe and Russia. All three countries have serious supply problems. Most of the mines in the largest supplier, South Africa, are unprofitable today and are faced with demands for higher wages from the miners as well as the government. Zimbabwe is in the process of nationalizing their mines and “driving them into the ground”. Russia’s mines, although profitable are old and increasingly less productive. All the while, the world demand for P&P continues to increase. China, in an effort to try to reduce its pollution problems, has mandated that all new cars must have catalytic converters. China is now the world’s largest new car market. The average cost of P&P used per car is approximately $200. Given the benefits of catalytic converters, there is plenty of room to increase the cost of P&P used in a new car – the P&P cost will still be a small percentage of the total. The current situation is one where supply is severely constrained and demand is strong and rising. We believe that is an attractive scenario for investing in physical platinum and palladium. Note that we are investing in the metals, not the struggling, unprofitable miners.

Uranium companies: We bought a uranium miners ETF, URA. URA is down 76% from its highs in January 2011. The price of Uranium is down from a “normal” $85 per pound to $40 per pound. The catalyst for this decline was Japan’s Fukushima disaster. After the earthquake and tsunami in March of 2011, Japan closed all of its nuclear plants and sold all of its stockpiled uranium. Other countries also revisited their nuclear power plans, most notably Germany. However, nuclear power continues to be one of the most efficient forms of power production available today. It is also very clean. In the absence of nuclear power, Japan’s energy costs have skyrocketed. Two Japanese reactors have been restarted and there appears to be government support for restarting many of the other 48 remaining reactors. According to the International Atomic Energy Agency, there are 436 nuclear power plants worldwide with another 73 under construction and at least another 55 proposed.

The industry consensus is that the uranium price needs to be around $80 per pound (double its current price) to be economically viable to continue to mine. Today the mining output only meets 85% of current demand. The balance is supplied from military stockpiles and recycling. A major source of military grade uranium will be ending later this year as the agreement between the USA and Russia to each dispose of 34 tons expires. We like uranium mining companies because the marginal ones have gone out of business and the solid ones are poised to earn very attractive profits as uranium prices rebound. The World Uranium Association is forecasting a 48% increase in Uranium demand between 2013 – 23.

Sprott Resources (SCPZF): Sprott resources is very much like private equity trading in a public vehicle. Sprott owns portions of a variety of "real assets" including farms (cattle and crops), oil and gas companies, fertilizer producers, a drilling company, a new uranium mine and gold bullion. Sprott participates in several of our favored long-term themes, particularly agriculture and energy. Investing in farms via the public markets is particularly challenging – there just are not a whole lot of options. We initially bought Sprott down 33% from its 2011 highs and again down 50%. The real asset nature of the holdings in Sprott Resources also provides a measure of inflation protection for the portfolios.

Another cheap country: Toward the end of September, we purchased a small cap India ETF, SCIF (down 75% from its highs in 2010).

Just because an asset is cheap, doesn't mean it can't get more so. However, when investing capital to create and grow wealth we think that buying good assets when they are extraordinarily cheaply priced provides the best probabilities for success. As an illustration of the potential, the following table from Cambria Research shows the average 3 year nominal returns and annualized returns when buying:

	A Cheap Sector		A Cheap Country	
Decline from top	3-year return	Annualized return	3-year return	Annualized return
-60%	57%	16.2%	107%	27.4%
-70%	87%	23.2%	116%	29.3%
-80%	172%	39.6%	118%	29.7%
-90%	240%	50.4%	156%	36.8%

One of our cheap country holdings, Greece fell 90.5% from its high in October 2007 to its low in May 2012. Since then, Greece has rebounded 127%. Greece is still 78.5% off its highs. Home builders reached a high in March 2006 and then fell 82% into March 2009. Since then they have rallied 262% or 33% per year. Junior gold miners declined 80% from November 2010 through July 2013. The prospective are very attractive!

In the event that the market corrects, our already underweight stock allocations will be reduced as the sector model signals "risk off" and we expect the managed futures strategies will provide downside protection by going short stocks. We believe that we have put into place a diversified strategy that has good potential to be rewarding regardless of the market direction.

Thank you for your continued trust and support,
Trevor Holsinger and Steve Small