ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
October 9, 2013

Dear Clients:

The third quarter of 2013 ended with our federal government embroiled in a political stalemate over the current level of federal debt, annual federal government budget deficits, and implementation of the Affordable Care and Patient Protection Act. Investment markets were somewhat volatile during the period but the full quarter outcomes were quite positive. Somehow, this contrast seems tenuous and fraught with risks of unpleasant surprises in the future.

Investment Market Returns as of September 30, 2013

The total return of the S&P500 Index for the third quarter of 2013 was 5.2% as share prices continued to benefit from a rising price to earnings (P/E) ratio. Investment returns on US Mid and Small Cap stocks were even higher as evidenced by the 10.2% return on the Russell 2000 Small Cap Index. Foreign stocks also performed well with the MSCI-EAFE Index generating an 11.6% return in USD; the MSCI-Emerging Markets Index was up 5.8% in USD. Returns on foreign stocks benefitted from a falling USD.

Returns on fixed income assets were mixed, but generally positive as prices remained stable in the US and improved on a global basis. The Barclays US Aggregate Bond Index returned 0.6% for the quarter, essentially equal to its average yield to maturity. The Barclays US Municipal Bond Index was -0.2% as worries about state and local finances pushed up credit spreads. Given the severity of state and local financial imbalances in key jurisdictions such as Detroit and Chicago and for most public pension plans across the country, we are surprised the negative returns were this modest. Return on the Barclays Global Aggregate exUS Bond Index was 3.9%. Despite this “good” news for the recent quarter, year-to-date returns for the aforementioned bond indices remained decidedly negative.

Quantitative Easing, Budget Deficits, and Unintended Consequences

From our economics training, we have come to embrace the following simple equations for disaggregating our nations’ annual economic output, also known as Gross Domestic Product (GDP). Thus,

$$GDP = C+I+G = P*Q = M*V$$

Where, C=consumption, I=private investment, G=government expenditures, P=prices paid for goods and services, Q=quantity of goods and services produced, M=money supply (M2), and V=velocity of money supply turnover.

“Quantitative Easing” represents unconventional actions by the US Federal Reserve Bank (Fed) to stimulate GDP by increasing the money supply following the financial crisis of 2008. Since the fall of 2007, M2 has risen at a compound annual rate of about 6.6%, while GDP over the same time period has rise at a 2.1% annual rate. To accomplish the increase in M2, the Fed has created dollars and used that currency to purchase long term mortgaged-back bonds and US Treasury bonds. As a consequence, the Fed’s asset holdings have ballooned from around $862 billion in 2007 to $3.7 trillion today. This change in holdings by the Fed closely tracks the increase in M2 over the same time period. Also, beginning in 2009, the Fed has maintained a near zero return on overnight funds and US T-Bills. The Fed’s actions in 2008 may have averted a disastrous collapse of our economy, but the desired GDP boost in the ensuing years has not been realized.

During this same time period (2007-2013), the outstanding debt of the US Treasury increased from $9.1 trillion in 2007 to $16.75 trillion today (virtually equal to our annual GDP), a 10.8% compound annual rate of growth. By comparison, between 1996 and 2007, the debt increased from $5.2 trillion to $9.1 trillion, a 5.1% annual growth rate. The order of magnitude of the debt increase is unprecedented in our post World War II economy.

These combined extraordinary measures by the Fed and the US Government have not yet resulted in more rapid economic growth as intended. The reasons are perhaps many, but we can observe a significant decline in the velocity of money (Vm) and an unheard of level of excess reserves held by commercial banks. Vm currently is about 1.5x compared to a long time average of about 2x, including the 1980-1982 period when interest rates were very high. Excess reserves historically have been near zero, reflecting the high opportunity cost of idle funds. Beginning in 2008, excess reserves have risen from $68.8 billion to over $2.2 trillion today. In short, capital is not being aggressively deployed despite negative real returns on cash and bonds and declining future returns for equity investments. We believe creative capitalists are increasingly wary of the unsustainable level of monetary and fiscal stimulus being injected into our economy and ultimately unwilling to invest aggressively. As an unintended consequence, this one must surely be worrisome.

At some point in the future, the Fed will revert to defending our “faith-based” currency with higher interest rates in the face of uncomfortable price inflation. In June of this year, we witnessed first hand the market reaction to just the hint of stimulus withdrawal by the Fed. The markets will remain volatile until the Fed restores normalcy to the money markets and a sustainable agreement about the federal debt limit and annual deficits is reached in Congress. Voters across the country perhaps should consider whether the magnitude of recent governmental intervention in the US economy is the path to long term prosperity when elections are next held.

Our View Looking Forward

We remain cautious about equity and bond valuations over the next 12-24 months and continue to believe the odds favor, at best, low single digit returns for equities and near zero returns for intermediate term bonds. Accordingly, we expect to remain under-weighted for equities and intermediate to longer term bonds, with a bias for high quality issuers.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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