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Investment Matters

For the quarter ended March 31, 2014

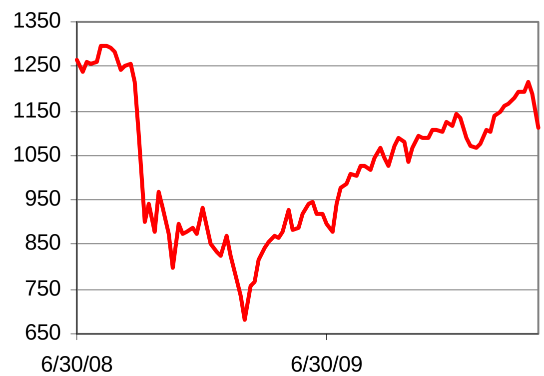
The Day The Market Bottomed

On Monday, March 9, 2009, the stock market, which had declined more than 56% in the previous 355 sessions, abruptly turned sharply upward to begin the bull market which we are still enjoying five years later.

Up until that day investors had seen no sign that either extreme monetary easing by the Federal Reserve, or the Stimulus Bill, which called for $787 billion in new federal spending, would be effective in ending the recession.

Recessions do not end until bank lending begins to recover. During a recession, banks, stung by rising loan defaults, dramatically curtail new lending. Until they start to lend again the economy remains starved for credit and cannot grow. Usually, all this requires is easy money from the Fed and enough time to heal the financial wounds caused by the recession. But in 2009, another unique problem was preventing the banks from initiating the recovery.

Beginning in 2007, banks were required by the government to 'mark to market' the value of their assets, mainly mortgage loans. What this soon came to mean was that the value of every bank's assets was directly tied to the illiquid and rapidly declining market for mortgage securities. As housing prices dropped the value of these securities, which formed the asset base of banks, plunged.



The Stock Market Decline Was Quickly Reversed After Strict Mark-to-Market Accounting Ended

With every decline in capital assets, the banks were forced to further curtail their lending. Reduced lending further depressed the mortgage market which fed the spiral of decline. As long as the rule was in place, the problem continued to snowball There seemed to be no way to resuscitate lending and restart the economy.

On March 9, 2009, responding to a chorus of complaints from bankers and financial executives throughout the country, the House Banking Committee under Chairman Barney Frank finally scheduled a meeting to consider moderating the 'mark to market' rule. The following day, speaking at the Council on Foreign Relations, Fed Chairman Ben Bernanke said that, "modifications to the accounting rules might reduce their pro-cyclical (i.e. downward spiral) effects without compromising the goals of disclosure and transparency". The logjam was finally broken and on April 2nd the rule was relaxed to correct the problem.

Any doubt that the strict 'mark to market' accounting rule was prolonging the recession and preventing the banks from doing their part in restarting the economy should have disappeared based on what happened next. On March 10th the stock market was up nearly 8% from its recession low two days before. By the end of the month it was up 18%. By the time bank lending turned up and the recession officially ended in June, it was up nearly 38%.

The Equity Risk Premium

Over the years we have learned to keep our eye on something called the Equity Risk Premium or ERP. The basic idea of the ERP is that stocks, because they are more risky than bonds, should normally be priced to yield higher returns than bonds. As their reward for taking on more risk, stock investors have historically enjoyed better returns than bond investors, who value stability over high returns.

The ERP is calculated by comparing the earnings yield of the stock market with the interest yield on 10 year government bonds. For 2014, the earnings of the S&P 500 Index are expected to be about $120. On 3/31/14 the S&P 500 Index was priced at $1,870, so that the earnings yield of the stock market is now 6.4%. Comparing this to the current 2.7% interest yield on the 10 year Treasury bond results in an equity risk premium of 3.7%. This is the yield advantage which stocks have over bonds.

The key thing to know is that the average historical ERP is 3%. At a 3% ERP the normal demand for higher returns from stocks is evenly balanced with the normal demand for safety from bonds. At 3.7% the ERP is suggesting that either stocks are cheap or

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Equity Risk Premium:continued

bonds are expensive or both.

This indicator has been very good are spotting excessive valuations in the markets. At the market peak in 2000, the ERP was negative 1% and stocks did badly in the subsequent 10 years, while bonds did very well. At the stock market bottom in 2009 it was over 6% which pointed to the exceptionally good market we are now experiencing. At 3.7%, the ERP suggests that stocks are still the investment of choice.

The Congressional Budget Office estimates that under current law the annual federal budget deficit will rise to one trillion dollars by 2022.

Not Well Known

March data on auto and truck sales were reported at a 16.3 million annual rate, the fastest pace in seven years.

The labor force participation rate (the percentage of working age people who are either working or looking for work) was recently reported at 63.2%, the same as it was six months ago. Perhaps the worrisome decline has halted.

In the past sixteen weeks bank lending has grown at an 8% annual rate, healthy enough to propel a stronger economic growth.

Placement firms are reporting that wage pressures (i.e. for higher wages) for permanent employees are above normal levels for the first time in six years.

According to the recent employment report, the total number of hours worked in March was up 0.7%, a clear sign that bad weather depressed economic activity this winter.

The market value of a single New York City taxi medallion is now $1,050,000, about four times what it was in 2004. There are fewer cabs in NYC today than in 1937 when the medallion system started.

Total U.S. nonfarm payroll employment is back to the peak employment number in 2007. Employment in the oil and gas industry has risen 58% over the same period.

The upcoming college graduating class of 2014 is estimated to have about 140 females for every 100 males.

Total U.S. net imports of energy, measured in terms of energy content, declined in 2013 to their lowest level in more than two decades.

The land area of Africa is greater than the area of the USA, China, India Japan and all of Europe combined.

Since 1950, the American economy has grown on average by 3.3% annually. To break it down: real GDP grew by 3.6% in the 1950s, 4.3% in the 1960s, 3.2% in the 1970s, 3.3% in the 1980s, and 3.5% in the 1990s. Since 2000, however, things have slowed markedly. Real GDP growth has averaged just 1.8% through 2013.

Recent data released from the Bureau of Labor Statistics show that the average pay for America's 248,760 chief executive officers in 2012 was only $178,400, about equal to what a member of Congress earns

In Japan one third of all workers are employed on a temporary basis, a very unhealthy condition. In the U.S., temporary workers make up only2.5% of the workforce.

Weighing in at more than $1 trillion, student loan debt is now larger than total credit card debt. Student loan debt has more than quadrupled over then past decade.

In 1970, carbon dioxide emissions per person in the U.S. peaked at 22 tons per year. Today they are down 23% to 17 tons per year, due mostly to displacement of coal by natural gas.

It is estimated that Americans will spend 6.1 billion hours this year complying with the income tax code. This is more than all the hours worked by all employees of the federal government in one year.

The Bottom Line: 3/31/2014

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1872	21.9%
Small company stocks *(S&P Small Cap Index)*	671	27.3%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.7%	From 1.9%
Inflation *(Consumer Price Index)*	233.2	1.1%
Energy *(West Texas Intermediate Crude Oil)*	101.56bbl.	4.5%
The economy *(Inflation adjusted GDP)*	$17.1 trillion	2.6%

QUOTABLE

"The first lesson of economics is scarcity: there is never enough of anything to full satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics"
Thomas Sowell, Economist

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