Robshaw & Julian Associates, Inc.

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Investment Matters

For the quarter ended June 30,2013

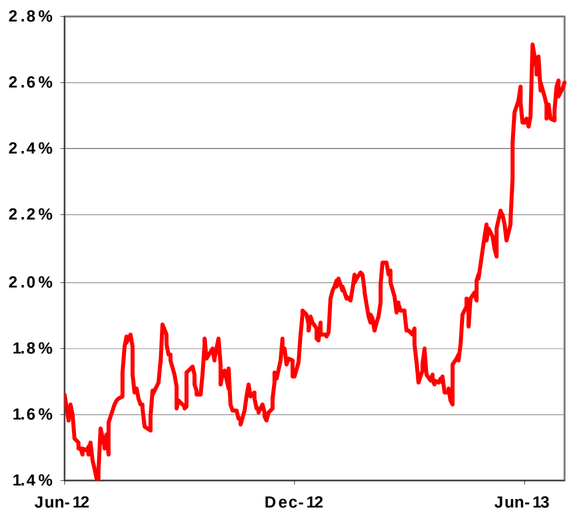
Taper Tantrum

On May 22nd Ben Bernanke, the chairman of the Federal Reserve hinted to congress that the bond buying program known as quantitative easing (QE) would soon be winding down and would likely be ended in mid-2014. The market reacted strongly. The S&P 500 Index which had reached a new all-time high earlier in the day, immediately dropped 2%. Over the next month it declined another 5%. Bond prices also tumbled. Bond market losses over the next month were similar those in the stock market.

Soon, speeches by Fed officials were emphasizing that the Fed had no intention of pulling the rug out from under the fragile economy and that if employment and inflation numbers do not continue to improve, the bond buying program will be continued. In July, Ben Bernanke emphasized that it was “way too early to make any judgment” about when the tapering process would begin.

Reassured, the stock market went to another new high on July 22nd. The bond market went up also but soon stumbled back to its earlier lows.

Clearly, something new is happening. When QE was initiated in 2009 it was an unprecedented experiment. The fed had never before attempted to manipulate long term interest rates; its previous efforts to stimulate the economy were entirely at the short end of the market. Now that the Fed is about to unwind its QE program it's important to ask what the effects will be.



TAPER TALK HAS INCREASED THE YIELD ON THE 10 YEAR TREASURY BOND A FULL PERCENTAGE POINT TO 2.6%

> Clearly, something new is happening...ending QE is bad for bond prices.

First, ending QE is unquestionably bad for bond prices, which explains why they haven't recovered. QE created an artificial environment for long term interest rates. In July, 2012 when the yield on the 10 year Treasury bond reached a more than 60 year low of 1.4%, future inflation was projected at 2.1% and the economy was growing at about 2%, enough to justify a 4% yield on the bond. Now that QE is projected to end, the yield on the 10 year bond has risen to 2.5%, an increase to at least 3.5% is likely to occur over the next 12-18 months depending on the exact pace of QE tapering. Every 0.1% increase in the interest rate should depress the price of the bond by about 1%.

Stocks are not so easy to figure. If equity investors are convinced that tapering and eventual termination of QE are based on an improving economy, stock market investors are likely to accept the transition without too much fuss. If however, as seen in May, the market loses faith in the Fed or believes they are tapering too fast, stock prices are likely to be very volatile, with few if any new highs.

Is tapering of QE the beginning of monetary tightening? Probably not. It's more like taking away the crutches, likely to make you feel unsteady but necessary if you're going to walk on your own. Actual monetary or credit tightening is different. Its purpose is to cool an overheated economy. However, our economy is not too hot; it's too cold. Tightening restricts credit, but the greatest impediment to credit expansion is not interest rates, it is lack of confidence. Even without QE, money will remain cheap and plentiful. Monetary tightening is designed to prevent inflation, but the threat of inflation is virtually non-existent.

Real monetary tightening of the sort which usually brings on a recession is years away, but as we transition from the artificiality of QE to normal economic conditions, stock investors are likely to sustain some painful bumps and bruises, but nothing which knocks them off their feet.

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Can Profit Margins Remain High?

U.S. non-financial corporations currently earn about $12 of profits for every $100 of sales, a profit margin near record highs. Many people believe that the high margins are based on squeezing workers to be more productive and that as margins inevitably fall to the historic average of 10%, stock prices will tumble.

A recent analysis says otherwise. The increase in profit margins is not temporary but is based on structural factors in the economy which are likely to prevail for an extended period of time. Two-thirds of the gain is due to low borrowing costs and reduced taxes. The remainder results from increasing sales to emerging markets and the growth and maturation of the technology sector, both of which have higher than average margins.

This suggests that we should expect margins to hold up during the economic expansion.

Hydrocarbon Realities

The U.S. currently gets 85% of its energy supply from hydrocarbons, 40% from oil, 23% from coal and 22% from natural gas. Nuclear (8%), hydropower (3%) and other renewable including wind and solar (3%) supply the rest.

World oil production in 2012 was 89.1 million barrels per day, up almost 12% in the last ten years. “Peak oil”, the idea that world oil production is about to go into a long decline is losing proponents rapidly.

North America currently produces about 20% of the world’s oil; 12% comes from the United States. Russia is the largest producer with a 13.3% share of production and Saudi Arabia is second with 12.6%.

The U.S. consumes about 18.8 million barrels of oil per day down about 10% from the peak level in 2005.

Prior to the introduction of hydraulic fracturing techniques in 2005, U.S. oil production had declined steadily for more than 40 years

A recent shale oil find in Australia is estimated to contain 233 billion barrels of oil, not far behind the estimate of total reserves in Saudi Arabia at 263 billion barrels.

Oil production in the U.S. has risen more than 36% since July, 2011, from 5.5 to 7.5 million barrels per day, an amount equal to the entire oil production of Brazil.

Oil production in North Dakota recently topped 800,000 barrels per day, more than double the rate in mid-2011. North Dakota’s economy grew 13.4% last year and it has the fastest job growth of any state.

U.S. oil **imports** from all countries are down 30% since hitting a peak in 2005. Oil imports from OPEC have dropped more than 50% in the same period but oil imports from Canada, three times the size of our next largest provider, have been rising steadily for decades.

In December, 2012 the U.S. **exported** three million barrels per day of refined oil products, chiefly gasoline and diesel fuel

The decline in natural gas prices due to expanded use of hydraulic fracturing in the U.S. is estimated to be saving consumers $125 billion per year compared to consumer costs in Europe which has not taken advantage of the new technology.

The U.S. Department of Energy recently reported that after one year of monitoring, there was no evidence that chemicals used in hydraulic fracturing moved up to contaminate drinking water aquifers at a multi-well western Pennsylvania drilling site. To date, no formal study has discovered any drinking water contamination from fracking chemicals. Fracking chemicals are injected into the earth to help fracture energy rich shale formations but at a depth of more than a mile below drinking water aquifers.

In 2012, U.S. emissions of carbon dioxide dropped to their lowest level in 20 years, 14 per cent below their peak in 2007. More natural gas use was generally credited.

The Bottom Line: 6/30/2013

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1606	20.6%
Small company stocks *(S&P Small Cap Index)*	550	24.7%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.5	From 1.7%
Inflation *(Consumer Price Index)*	232.9	1.8%
Energy *(West Texas Intermediate Crude Oil)*	$96.60bbl.	13.9%
The economy *(Inflation adjusted GDP)*	$16.0 trillion	1.6%

QUOTABLE

“The task of government is to create the climate in which enterprise can flourish.”

Margaret Thatcher

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