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VIEWS FROM CAMELBACK MOUNTAIN

2013 Predictions.... a Year Later

One year ago today, we sent you our Views entitled, ***Investing for Safety***. Below are the first two paragraphs from that letter:

> *Investors are scared to death of stocks. Who can blame them after all the challenges the markets have faced over the past five years. They have been moving out of risk assets like stocks in search of safety.*
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> *Investors have moved into cash and bonds and to a lesser degree, gold and some other commodities or hard assets. Over the past five years, $425 billion has fled equity mutual funds and $1.178 trillion has flowed into bond funds. In order to make their investments "safe" they are earning almost 0% in money market funds and 0.5%-1.0% in CD's. In bonds they can earn 1.7% in a ten year U.S. Treasury. All of these assets are returning the level of inflation or less, before income taxes. In riskier bonds, like 30-year treasuries or junk bonds, they can earn 2.8%-5% per year. With interest rates at generational lows, it is most unlikely that rates can fall enough from current levels for bond investors to earn meaningful capital appreciation. In our view, these items are now far more risky than the average stock. The cash moving from stocks to bonds has left stocks relatively cheap in our opinion and made bonds extremely expensive.*

Looking back over the last year, assets formerly perceived as safe have not done very well. If you purchased a 30-year U.S. Treasury bond a year ago, you would have earned 2.9% in interest, but you would have lost 17% of your principal. Many municipal bonds and municipal bond funds are down 3.0% or more on a total return basis. Most bond funds are down a few percent while some have broken even, or are up 1% or 2% on a total return basis for 2013. Gold is down approximately 25%. In the meantime, U.S. stocks have produced a total return of approximately 30%. It is important to note that these developments have occurred in the year when the Federal Reserve has not actually done anything new. Back in May, Ben Bernanke indicated that at some time in the future the Fed might actually purchase less than $85 billion dollars of mortgage and treasury securities each month. This past fall we learned that Janet Yellen would replace Ben Bernanke as Chairman of the Federal Reserve and it is widely believed that she will be even more accommodative than the Bernanke regime. Finally, in mid-December we learned that the Fed would actually only buy $75 billion dollars of assets during the month of January, 2014.

Looking forward, we continue to believe that interest rates will eventually go up. If rates do rise, the arithmetic is unmistakable; bond prices have to continue to fall. There is much discussion in the bond market today about how much of future interest rate increases have been baked into current market valuations. We continue to believe that the average bond remains quite dangerous and that those with the longest maturities and poorest credit quality are the most dangerous.

The stock market is up because companies are performing well. On average, they have cut back on their work force and have been reluctant to add staff. They have "hunkered down" in their core businesses and

have been reluctant to expand, add branches, start new business lines or make additional investments. They have hoarded cash, paid off debt and increased dividends and stock buy-backs. These actions, on balance, have held back the growth of the U.S. economy, but they have served shareholders well in the short-term. We think companies are well positioned to maintain current profit margins and to gradually expand their businesses as economic growth continues to gradually take hold.

The Federal Reserve's Quantitative Easing Program has clearly helped boost stock prices, along with other asset levels, most notably real estate. As the Fed winds down this program during 2014, we may see a temporary dislocation in stock and other asset valuations until the marketplace can assess a fair valuation level, absent manipulative Federal Reserve policies. We continue to believe that stocks are approximately fairly valued, and if a dislocation occurs, it will be short-lived and stocks are likely to recover over six to nine months.

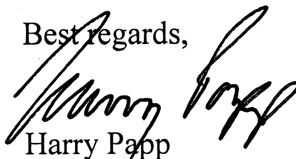
Unsustainable pension promises have caused catastrophic problems for numerous businesses over the last 20 years. The steel industry, airlines, automotive companies such as General Motors and Chrysler, and many others have been pushed into bankruptcy by bloated and unfunded pension liabilities. Focus now is turning to unsustainable pension obligations in the public sector. State and local governments that have been unwilling to deal with these issues are now reaching crisis levels. It started with small municipalities like Central Falls, Rhode Island; Stockton, California; San Bernardino, California and has now made its way to the city of Detroit. Looking forward, the state of Illinois, the city of Chicago and the commonwealth of Puerto Rico are all beginning to understand that their predicaments are reaching unfixable levels. The demographics of an aging population are only making matters worse. At the federal level it is generally well known that social security and other government transfer programs are not sustainable. The inevitable solutions are a mixture of the following:

- A migration from defined benefit pension plans to defined contribution plans
- An increasing retirement age, particularly for younger workers
- Some benefit reductions in the most troubled jurisdictions
- Higher taxes for wealthy people

2013 saw a stealth increase in federal income tax rates through rate increases, new taxes imposed for wealthy people and the reduction and phase out of tax benefits for wealthy people. Federal tax rates are now very high for wealthy people. Rational politicians on both sides of the aisle are aware that further increases in tax rates are more likely to result in decreasing tax receipts instead of increases. As our country is forced to deal with large segments of our population left behind by an improving economy, we expect an ever increasing demand for revenue for the Federal Government. This is why we believe that a national value added tax or sales tax is likely to be imposed in the coming years.

Here at our firm, we recently added a new Portfolio Associate, Matt Baum, CFA and we have redesigned our website located at www.roypapp.com. All of us at L. Roy Papp & Associates wish you a happy, healthy and prosperous new year.

Best regards,



Harry Papp
Managing Partner
December 31, 2013