Ashdon Investment Management

Q3 2013 ECONOMIC COMMENTARY

October 2013

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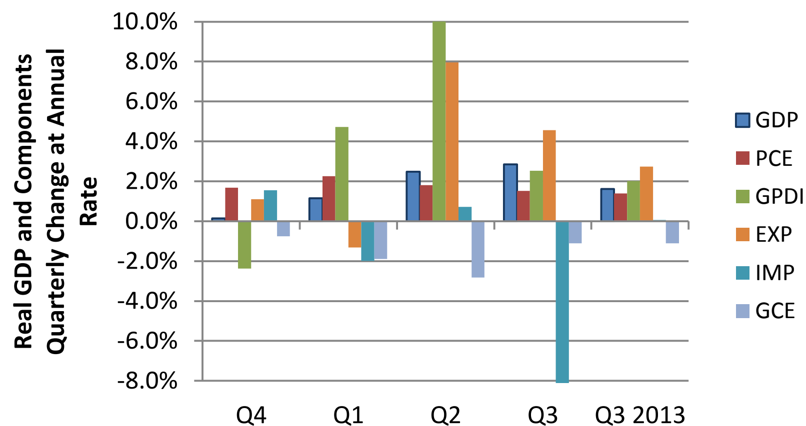
Third Quarter 2013 Economic Commentary

For an observer looking at objective data, the third quarter of 2013 concluded with little changed. However, that sort of calm and rational view is not how the quarter will be remembered. The volatile economic dialogue that began early in the second quarter continued in the third quarter. The nosiest events of the quarter surrounded the needless and inexcusable six week “shutdown” of the US federal government during negotiations of the continuing budget resolution. These events certainly confused “Fed Watchers” who were looking for clear signals of the FOMC policy intentions. “Taper” has become the term da jour for the news media. Taper’s definition is a combination of a point in time and a forecast of economic and market events. We think investors are missing the real picture here. This will be the primary topic of this commentary, but first, we will review the data from the quarter.

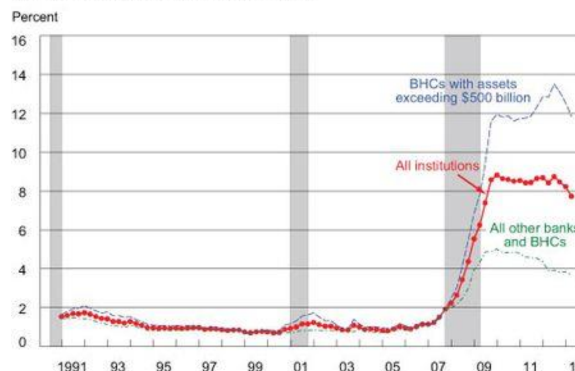
Despite unusual volatility, the 10-year yield was 2.61%. This level is somewhat lower than the peak levels of almost 3% experienced in early September, but in the range of what we have expected as interest rates begin to move higher as economic conditions stabilize. The US equity market advanced through the quarter to a level that is broadly characterized as neither “cheap” nor “expensive”. The advancing trend remained in place as the fourth quarter began. The advance GDP release for Q3 was issued on 10/31 and showed a modest growth rate of 2.0% - somewhat stronger than the 1.7% rate for Q2 and consistent with the ongoing recovery pattern. Labor markets continued to improve and inflation remained tame. These same comments are mostly applicable to developed economies around the world.

Regarding GDP, the most recent release included some notable data. GDP data for the trailing year are shown in the figure below.



Given the likelihood that GDP growth will continue, many are confident that the FOMC and the world's central bankers will begin to unwind or reverse the unprecedented policies that have been in place since 2009. While we agree that the US economy is on a self-sustaining growth path, we do not think that the FOMC will change its policy any time soon. The FOMC's comments have indicated that policy changes would be announced as inflation and unemployment targets were achieved. We find it notable that with stable and modest inflation and unemployment levels approaching the FOMC's target level, several FOMC members have begun to talk about lowering the unemployment targets.

Some may think that it is disingenuous of the FOMC to change the rules of the game just before the end. Our view is different. One must understand that monetary policy is much more nuanced than can be expressed in one or two simple metrics (like unemployment rate or inflation rate). Central bankers are also banking system risk managers. Our view is that the FOMC sees very real risks in the banking system, particularly among large banks. Consider the following chart of the level of non-performing residential loans from a recent research paper from the New York Federal Reserve Bank:



More than four years into the recovery, residential loans continue to reflect the stress of the financial crisis. For the largest banks, the stress has worsened. We believe this data and other data showing similar kinds of banking distress are the data that the FOMC is watching. The large banks have not yet been made whole. The impact of the credit crisis on the large banks' balance sheets is taking a great deal of time to heal. Ultralow interest rates with unprecedented monetary policy are the only medicine.

We are not on "Taper Watch" – at least not in the same way as the media. We are much more interested in taking note of the real risks for capital loss that are present in this environment. This is not a time for careless investing in bonds for "safety" and it is not a time for simple-minded investment theses that expect to profit from the bank stocks. More than ever, this is the time for careful – and at times - courageous, value-focused investing.

214 E Grundy Street • Tullahoma, TN 37398
931-461-5733 phone • 931-461-5735 fax
info@ashdon.com