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I wanted to provide an update now that we are through most of earnings season and about half way through the second quarter. Economic trends are reasonably positive but there are a couple of issues that continue to create the potential for instability. I don't believe that these issues will cause much problem in 2015, but they should be paid attention to during 2016.

The economy continues to grow slowly. GDP was lowered to a negative number after the latest revision, but corporate earnings changed to a positive growth rate. Interestingly, both CNBC and Schwab reported in the last few weeks the fact that for some reason, first quarter GDP is lower than the other quarters. This despite efforts to seasonally adjust the data. This trend of lower first quarter GDP has occurred over the last 20 years. Perhaps being slightly negative is not indicative of a looming recession.

Meanwhile, corporate earnings show growth from last year. In my last note, I speculated that analysts had been too negative in dropping their first quarter earnings expectations, to the point where they showed negative year over year losses. As of last week, first quarter earnings were back on a positive note. This has helped stabilize the market.

The stock market has continued to oscillate but the drops have been to higher lows than before and we have set new highs on the upper end. Still, year to date gains have been modest. While the stock market is not cheap at current levels, it can move higher. Experiencing more certainty over earnings expectations helps. The biggest issue this year I believe is the Federal Reserve raising short term rates. This will likely cause some market turmoil, so the timing of this increase might impact 2015 market gains depending on the timing of the rate move and how much time is left prior to year end. While it will likely cause some volatility (let's assume a 10% drop for discussion purposes), it is possible for the market to rise 8% prior to this, or 12%.

I could argue that the current Price Earnings ratio is sustainable given an environment of lower intermediate term interest rates. Investors will have to believe, however, that interest rates will stay lower for longer. This is not likely to happen until we get through the first Fed rate hike and things calm down.

Do we want higher interest rates even if we believe that they will initially result in some degree of chaos? Yes. The current rate environment will create its own chaos. There are a few sources of this. When borrowed money is close to free, people will borrow too much of it. The longer it remains 'free', the more it will be overused. Of course, not everyone has access to this free money today. In the early to mid 00's it was homeowners that had access to easy credit. This supported over-borrowing and over investment in residential real estate, and subsequent price gains proved to be unsustainable. The pain was felt by a wide cross section of the U.S. population and resulted in a recession. A fracturing financial system did not help an appetite for risk either.

Credit is cheap today and likely being overused as a result. Instead of consumers, the users of credit today are institutional investors such as hedge funds, private equity funds, investors in institutional real estate and companies buying back their stock. Margin balances are still at highs. When rates

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rise, the math behind these investors' strategies will change for the worse, and their subsequent actions are what will likely cause some of the market chaos.

Interest rates remaining too low can cause other problems as well. Many institutional investors use financial models to help quantify and manage the risks that they are taking (especially important if you have borrowed money for your strategy). Many of these models incorporate the level of interest rates in their calculation, but the math does not work with negative interest rates. Several countries now are experiencing negative interest rates on their sovereign debt.

As an analogy, we all use our windshield wipers to manage the risk of driving in the rain. Consider driving on a rainy highway as being a levered investor. You are traveling at a reasonable rate of speed, but there is a cement median next to you and traffic ahead of you. The rain represents leverage, in this case raising the risk of driving a bit. Our wipers are operating and act as our financial model, allowing us to continue to accurately calculate the position of the median and other traffic. What represents negative interest rates in our story?

A large truck traveling the opposite direction throws up a large pool of water. When it hits your windshield, it is too much for the wipers to deal with and you are driving blind for a while. Where is that median and traffic? If you are using a lot of debt in your strategy, or in our case, driving fast, the sudden loss of your model (wipers) is a big deal. People tend to overreact potentially causing a chain reaction. If negative rates continue for too long, these model driven investors may begin to act unpredictably.

Low interest rates can also cause problems in the insurance industry. Rates today are lower than most of the last 70 years. Insurance companies often have minimum guaranteed payments they promise to policy holders. In order to generate the returns necessary to pay their commitments, insurance companies have access to the same securities as the rest of us. What happens when they can no longer earn as much on their investments as they are obligated to pay out? Their financial condition worsens. This is a potential problem to keep an eye on.

Higher interest rates, while potentially causing some market chaos, can be a good thing. I think that the volatility caused by the beginning of this process could make it difficult for the market to make much in the way of gains. After the dust settles, as long as nothing else breaks in the process, I think the market can continue its appreciation.

Sincerely,

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