January 6, 2014

Stock prices were very strong last year while bond prices were weak. Fortunately we were heavy in stocks and very light in bonds. Please refer to the enclosed performance report for your investment results.

One thing is for sure, economic reality is always unique and never boring. For example, we are still undergoing a highly abnormal condition in the debt markets owing to intrusion by our government as it repurchases about one trillion dollars per year of national debt, thereby forcing interest rates to unnatural lows. This tool is popular at the Fed, perhaps because they have few available tools and this one is easy to use. The general expectation is that the so called quantitative easing, will taper off in 2014 as economic vitality becomes more evident. The effects of the practice are of questionable merit but it is clearly disruptive in some ways. Consider the harm done to those who live on life savings in bank accounts, or pension funds and insurance companies which depend on carefully structured bond portfolios to prepare for long term commitments.

Recent changes in industrial production, real estate values and auto sales are unanimously positive. In the months ahead we should see an awakening of demand for bank borrowing despite rising interest rates, and the economy will be on a path to normalcy…unless it is derailed along the way.

A second unique condition: The American public is beginning to confront the accumulation of US debt incurred to fund rising social welfare spending. The alternatives are : a) revise entitlement programs and other government responsibilities to affordable levels in order to regain economic health; or, b) increase taxes in pursuit of social leveling, and continue expanding the size and responsibilities of the government. A world history of bad results from plan b) is evidence that plan a) is the way to go. The logic is gaining converts, some of whom will vote this year.

One more unique condition is Japan's manipulation of the Yen which so far seems to be helping their economy. The idea is to cheapen the currency by deliberate, forced selling, thereby encouraging exports and domestic production. Japan's cost is the reduction of the international buying power of Japanese capital. If successful, this economic strategy will be emulated, threatening more competition among nations to gain trading advantage by manipulation of the currency markets. The US has been behaving similarly in its debt buying but because the dollar is still the safest place to store major wealth, that reality tends to insulate the currency and allows unsound practices to some extent…depending.

700 East Ocean Blvd Suite 2703   Long Beach, California 90802
Phone 562 435 5650   Facsimile 562 495 0462   alcap.management@verizon.net

In retrospect, the danger of impending financial failure became clear enough to scare some sense into the public psyche. For the past twenty years government policy has sought new highs in home ownership which gradually led to bad financial policy. One recalls Finance Committee Chairman Barney Frank famously saying, “Let’s roll the dice a little” while encouraging fellow law makers to be lenient toward ill-financed home buyers. When the word got around that homes could be bought with no equity in a rising real estate market, people acted the way people act when they see opportunity with no personal risk. The feeding frenzy was abetted by abuses among underwriters and rating agencies, and enabled new strategies designed by hedge funds and other finance industry participants, based on the ease and cheapness with which highly leveraged asset positions could be financed. Now we know. Perhaps our next batch of elected lawmakers also will know.

We have been wrong on this subject in the past, but the political tide seems to be turning toward common sense reality, based partly on an evolving evaluation of the current administration, but also on economic logic and an emerging sense of responsibility. As a society, we must finally determine the extent to which we can support pensions, medical care and welfare. On the heels of our current financial problem, for which we are still borrowing 40 cents of every dollar spent, is coming an even more formidable test: The large demographic bulge of baby boomers is becoming eligible.

The elections this year may reveal the extent to which reality is sinking in. If an appropriate batch of political winners clears a path for sustainable economic policy, prosperity will be encouraged. Bond prices will continue shrinking to accommodate rising interest rates and stock values will rise to reflect the prospect of healthy earnings growth. And we will be gratified.

On the other hand, if many of those elected were supported by labor union funding and the votes of government workers and other recipients of government support, then we may be in for real trouble. Many of us are becoming accustomed to government support by way of Medicare and Social Security. We work them into our plans for the future. If that is what becomes evident in the elections this year, the essence of risk will intensify. Inflation will move from code yellow to code orange, so to speak. And investment policy will have to adjust. So, we will stay tuned.

Meanwhile, we have enjoyed good investment results in the past year and expect those trends to continue for awhile longer.

Sincerely,

John May

700 East Ocean Blvd Suite 2703 Long Beach, California 90802
Phone 562 435 5650 Facsimile 562 495 0462 alcap.management@verizon.net