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Vega 2012 Annual Newsletter

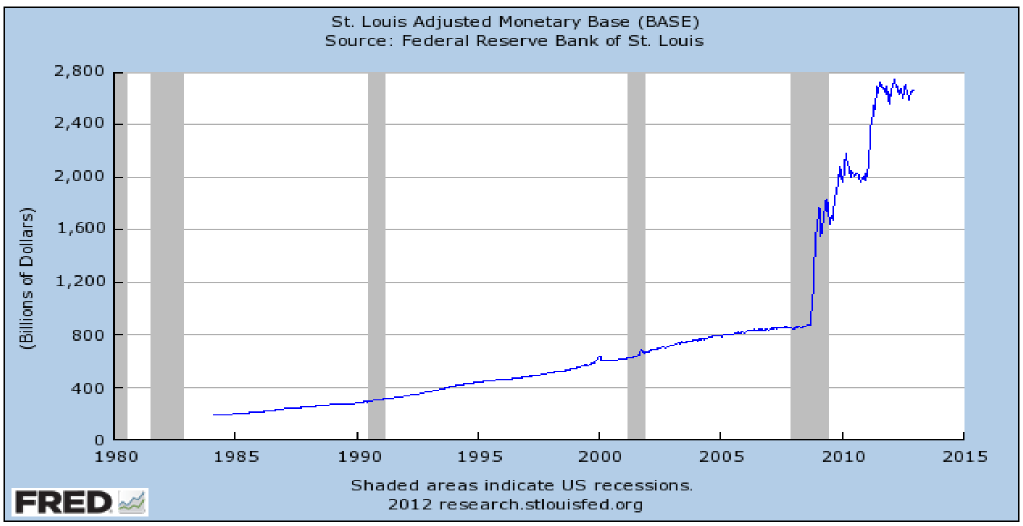
Succeeding in Times of Uncertainty

Part I: Fiscal Landscape

Introduction

Regardless of what transpires in the near future, it's obvious that developed countries will continue highly-accommodating policies, which in practical terms mean extremely low interest rates and quantitative easing. This has either already been announced, or is implicit in the actions of all central banks.

In a December 12 press release, the Federal Reserve Board announced its intent to "continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month [and] longer-term Treasury securities…initially at a pace of $45 billion per month." Unsurprisingly, the Fed stated that its actions should result in "downward pressure on longer-term interest rates."[1]



As the graph shows, the monetary base of the United States has increased unimaginably as a result of continued quantitative easing. The differences are even more apparent when compared to the markedly lower rate of monetary base growth 20-30 years ago.

On December 6, the European Central Bank "left its key interest rate unchanged at a record-low 0.75% for a fifth straight month," and the Bank of England "kept UK interest rates at 0.5% [but] held off from announcing another round of quantitative easing."[2]

Finally, the Bank of Japan announced an "additional 10 trillion yen [~$116 billion] expansion of the asset purchase program to 101 trillion yen [~$1.15 trillion]" and "left the overnight call rate range at 0.0% to 0.1%."[3]

This process will definitely continue, because developed countries have no way out of the black hole except to continue printing money and debasing their currencies.

[1] http://www.federalreserve.gov/newsevents/press/monetary/20121212a.htm
[2] http://www.icis.com/Articles/2012/12/06/9621906/european-central-bank-holds-key-interest-rate-at-0.75.html
[3] http://www.nasdaq.com/article/boj-increases-ap-program-by-10-trillion-yen-cm200757#.UNs5DaxZy3k

United States: Fiscal Cliff and Implications

As we write this newsletter, a totally dysfunctional U.S. government (according to a Gallup poll, "Congress' approval rating hit an all-time low of 10 percent in August…and hasn't been above 20 percent since June of 2011"[4]). No matter what kind of agreement will be reached, several things regarding taxes and their implications on investment decisions are obvious:

1. There will be substantial tax increases for the "wealthy" — the definition of wealthy is being debated, but it is clear that the tax increases will have significant impact on investment portfolios.

2. Taxes on capital gains will go up.

3. Taxes on dividends will go up.

4. The Estate and Inheritance taxes will go up.

5. What has become known as "loopholes for deductions" (AMT, charity donations, and thousands of other items in the IRS code) might disappear.

Essentially, we are wandering around in a thick fog — we can't see anything in front of us. The longer our wise and mature politicians delay the decision, the more difficult it is for businesses to purchase new equipment, hire new employees, donate to charity, or calculate contributions to the new Obamacare plan.

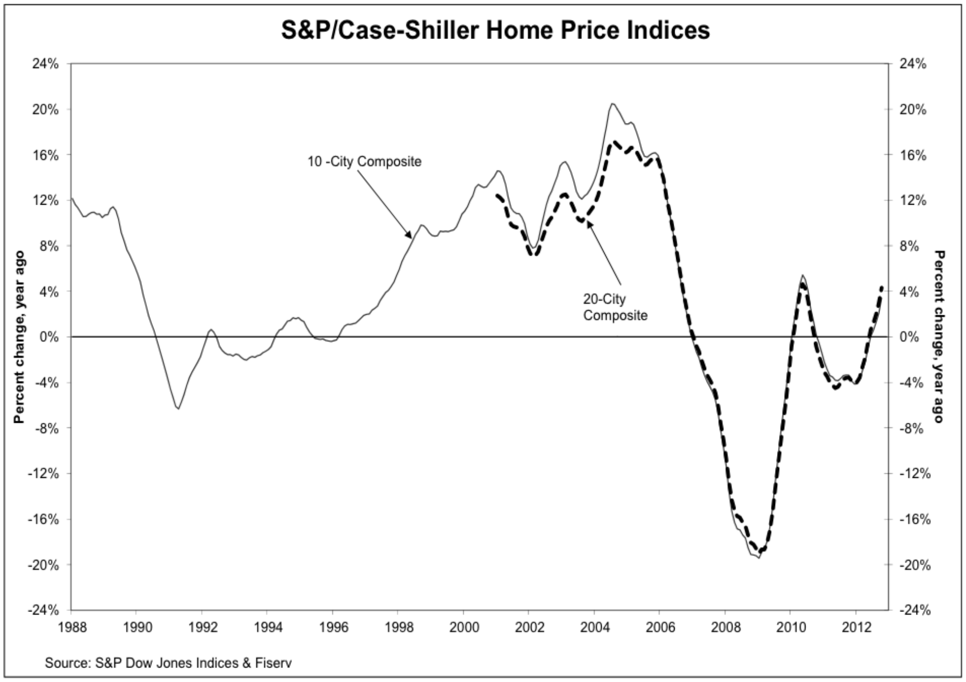
The majority of CEOs and CFOs make their decisions based on logic and data — and now, they are paralyzed.

The rest of us are asking questions like: Should I contribute more to my retirement accounts? Will the contributions be deductible? Should I set aside more money for my medical plans? How much will my medical insurance cost? All fair inquiries, the answers to which are still unclear.

United States: Housing Recovery

While the objective data (Case-Schiller 20-city Index shown below[5]) shows that housing prices continue to improve in some areas of the country, we are still not sure about the number of houses that are in foreclosure or going through short sales. Banks are still very rigid in extending real estate credit to potential homeowners. Housing construction companies claim that a recovery exists, but is it real? Is it robust? Who are the buyers — real estate investors, or tenants?

[4] http://www.baystatebanner.com/natl17-2012-12-13
[5] http://www.businessinsider.com/october-case-shiller-index-2012-12



Vega's position: The crash in housing prices was so significant, that a recovery is inevitable. Given the fact that "Helicopter" Ben (Bernanke) and his colleagues continue to print money (as described above), real estate will hopefully remain one of the few asset classes that will appreciate to keep pace with inflation, but there are processes that might contradict this correlation.

Europe

The only solution to the combination of a developing social and political crisis and the desire to keep the integrity of the European union will lead the European Central Bank to do "whatever it takes" — which in practical terms means the debasement of the Euro via creation of numerous stabilization mechanisms (printing money). While the president of the ECB, Mario Draghi, has stated that "the Eurosystem has sufficient tools at its disposal to absorb excess liquidity,"[6] withdrawing money that has been injected into an economy is very difficult, because austerity measures are not nearly as inviting as "charitable contributions" to the economy by the ECB (quantitative easing).

Asia

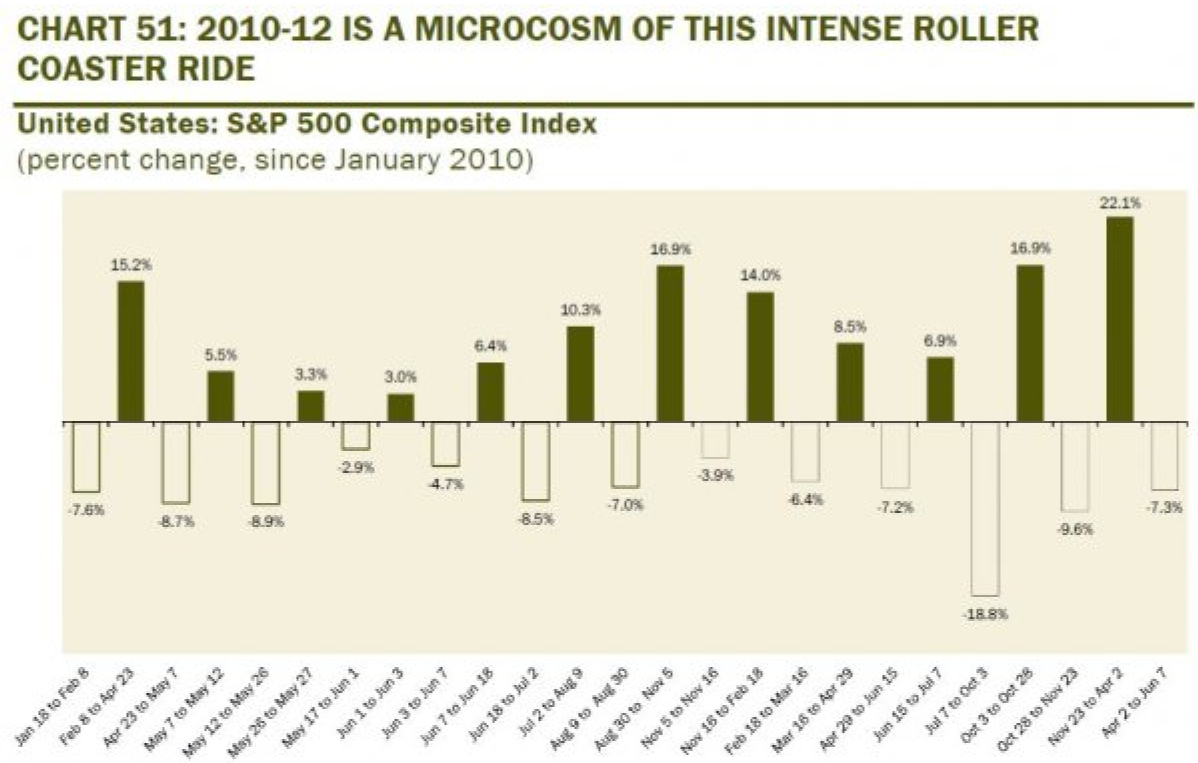
China is driving the world economy, but without a healthy middle class, an internal bubble is growing. The concentration of wealth creates a dynamic system that is extremely fragile. Again, the only solution for the Chinese is to continue printing money in order for the government to prevent social unrest. On one hand, they will have to produce internal currency (Yuan), but on the other hand, pressure from the World Trade Organization (developed countries) will force pegging the Renminbi (external exchange currency) to free-flowing currencies.

[6] http://www.forex-tribe.com/forum/viewtopic.php?id=37342

Part II: Traditional Investment Instruments

Equities

Historically, it has been reasonable to determine the level of the stock market using a formula: Earnings x P/E. The discrepancy in earnings reports across various industries and geographical regions has rendered this calculation imprecise, at least for now. Therefore, today we look at the stock market as another vehicle for the preservation of capital.



Source: Haver Analytics, Gluskin Sheff

The graph above[7] shows how the S&P 500 index changed over the past three years. Clearly, the recent volatility of the stock market has become extremely noticeable and significant. So much so, that the famous philosophy "stocks for the long run" (advocated by professor Jeremy Siegel) has outgrown investors' emotional patience — in an unstable market, the "long" in "long run" has become *too* long.

The implications of tax reform are forcing patient investors to reconsider their philosophy of investing in dividend paying stocks. For example, retirees collecting 5-6 percent dividends in an investment account and paying a 15 percent tax would generate 4-5 percent steady net revenue. If, however, the tax on dividends increases significantly, it's not clear whether or not it will still be possible to live comfortably on income from dividend paying stocks (granted that the future of social security benefits is also unclear). In addition, since the number of retirees is increasing, the hesitation to invest in dividend paying stocks might have unpredictable consequences for the stock market.

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[7] http://www.businessinsider.com/chart-david-rosenberg-stock-market-volatility-2012-6

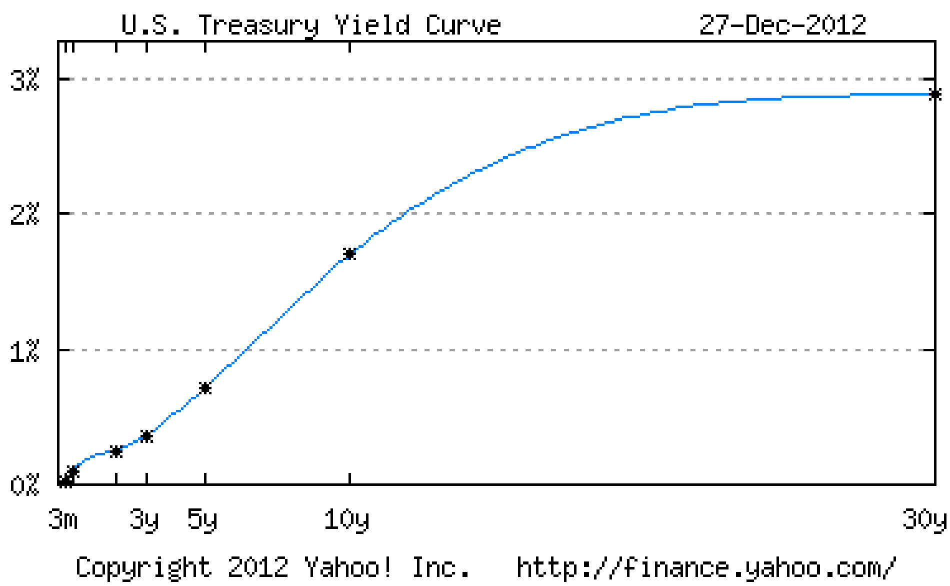
Fixed Income

We feel that fixed income instruments have had an incredible run for over 30 years. The graph below shows monthly U.S. bond prices from 1978-2007[8]:

However, they are definitely at the end of their run. Basically, we feel that they have no place to go but down, and the most sophisticated and successful money managers agree.

Here are just a few facts to justify this assessment:

Rates on U.S. Treasury Bonds are at their lowest point in decades — for example, rates on 2-year and 5-year bonds are well below 1%, and even on a 10-year bond, the yield is only 1.75%.[9]



The current inflation rate is estimated to be around 1.5%[10], so the effective return on the bond amounts to almost nothing (0.25%). Nothing, that is, until inflation starts to rise and the effective return becomes negative.

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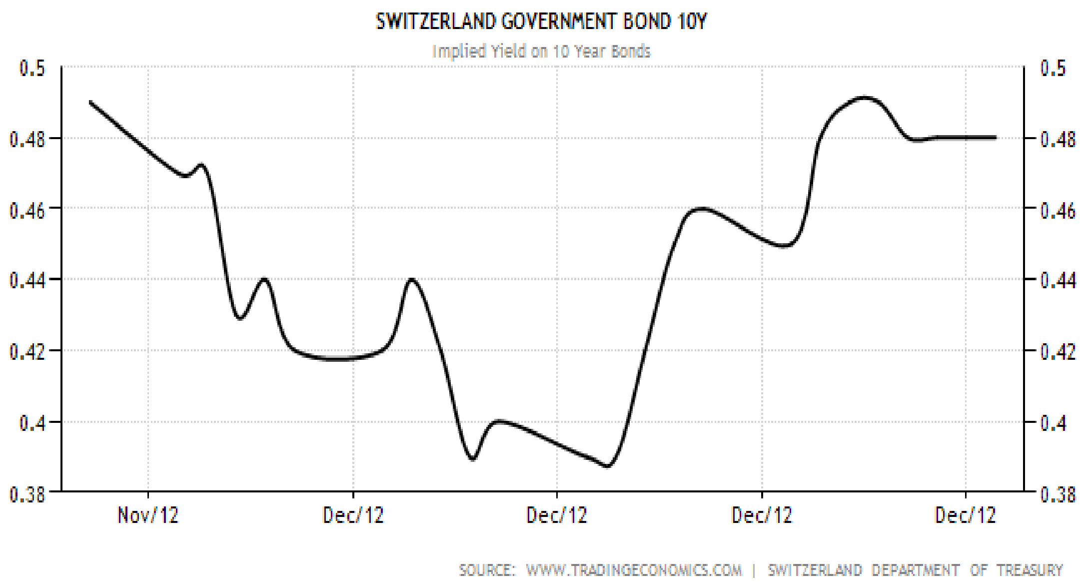
8 http://www.thedigeratilife.com/images/bigbondpriceschart.jpg

9 http://www.bloomberg.com/markets/rates-bonds/government-bonds/us

PIMCO founder and co-CIO Bill Gross has no doubt that there is a bubble in the bond market. Gross doesn't believe that "rates are going to go much higher…the Fed is blowing lots of [hot] air and constantly inflating the bubble." Therefore, Gross predicts that "ultimately, over time, not necessarily in next three to six-months, [quantitative easing] creates an inflationary impact."

Based on his predictions, he cautions against "longer-term assets in the 10 to 15 to 20 to 30 year area which are sensitive to debt." After all, as Gross astutely observes, "It's difficult to squeeze much juice from an orange that yields 1.7%."[11]

The United States is not the only developed country dealing with rock bottom rates. The graph[12] below shows the yield (two month history) for a 10-year Swiss government bond. Even without adjusting for inflation, the bond's yield is perilously close to zero.



Furthermore, due to a rapid movement of investors into the safe haven of the Swiss franc, the major Swiss banks (such as UBS) decided to "start applying a charge for credit balances maintained by financial institutions in their Swiss franc cash clearing accounts."[13] In other words, the effective interest rate on Swiss deposits has gone *below* zero.

Even though keeping money in money market accounts has not made you rich, at least you preserved your wealth. Now, however, money held in cash deposits will produce a negative return.

[10] http://www.forecasts.org/inflation.htm
[11] http://finance.yahoo.com/blogs/daily-ticker/bill-gross-fed-hot-air-keep-bond-bubble-171450627.html
[12] http://www.tradingeconomics.com/switzerland/government-bond-yield
[13] http://www.ft.com/cms/s/0/706b61b8-4379-11e2-a48c-00144feabdc0.html#axzz2GBNtzVP9

So, what should investors do?

First of all, it's important to accept that conventional fixed income instruments are not producing enough income to keep up with inflation. The train has left the station, and there are a few specific options remaining.

If you want to stay on course with your fixed income allocation, you can either:

1) Take larger risks with the quality of the underlying issuer;

2) Increase the duration of the bond;

3) **Admit to the reality that a fixed income portfolio will be earning 2-3% annualized return going forward.**

Or, alternatively:

4) Wait patiently and sit on cash until interest rates start going up, and then gradually start to build a fixed income portfolio. The danger in this approach lies in the fact that if you wait long enough, the cash flow you sacrifice foregoing investment now might be greater in value than the increase in yield you hope to see in the future.

Fixed Income: High Yield Investment Funds

The profits of High Yield Funds are based on a high degree of leverage — the fund borrows at market interest rates (please see above remarks about the interest rate environment) and lends to portfolio companies, hedge funds, or others at higher rates, creating an earnings spread.

Obviously, if the interest rates that the High Yield Funds have to pay to borrow money will go up, they would want to charge higher interest rates from their borrowers in order to preserve the earnings spread.

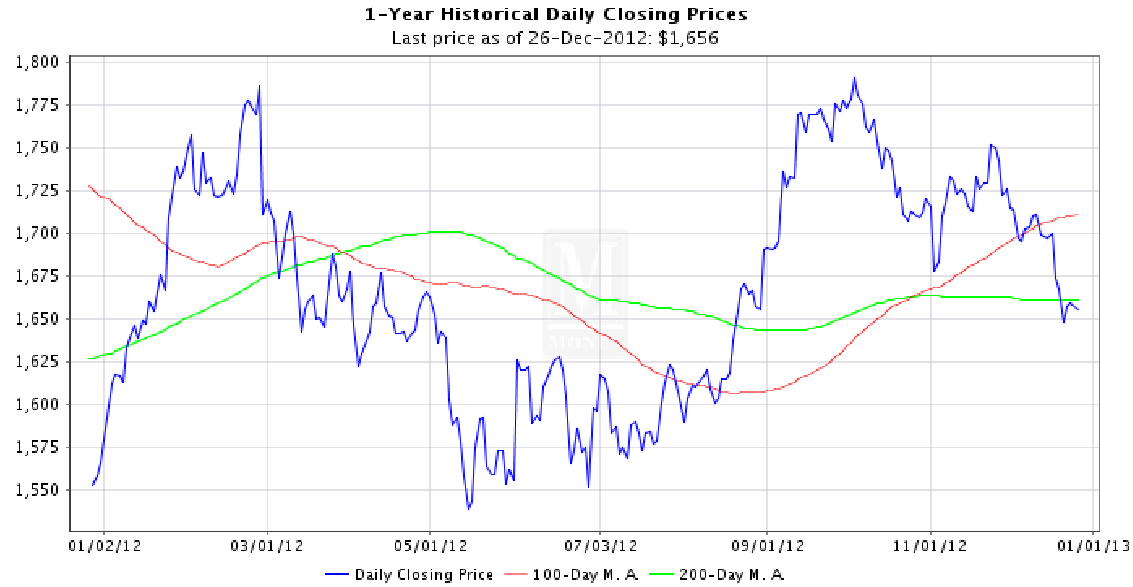
In a healthy economy, the demand for credit among corporations is relatively inelastic (companies will continue to demand credit even as rates are increased), so an uptick in rates is fine — the adverse effect isn't as noticeable. However, our economy is far from healthy (it is still connected to a liquidity IV drip, courtesy of the Federal Reserve), which means that high yield funds cannot push the spread higher — companies will simply stop borrowing. Therefore, high-yields will likely start earning less and less.

Part III: Alternative Investments

Commodities

While historically, investments in precious metals have always been considered as a hedge against volatile markets and political instability, this has not been the case since 2011. The correlation between the prices of precious metals and other assets has increased significantly, and therefore, they can no longer be considered as a hedge. In absolute terms, gold has done very little in the past year (a 3.5% change from $1,598 on January 3rd, 2012 to $1,656 on December 26th, 2012).

However, as the graph below[14] shows, the volatility during this time period has been extremely high.



Natural gas (XNG Natural Gas index[15] shown below) has had a similar experience over the past year — volatility was high, but the overall change in price was minimal:

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[14] http://www.monex.com/prods/gold_chart.html
[15] http://www.nasdaq.com/symbol/xng/stock-chart?intraday=off&timeframe=1y&charttype=line&splits=off&earnings=off&movingaverage=None&lowerstudy=volume&comparison=off&index=&drilldown=off&sDefault=true

Investing in commodities involves the psychological perception of the preservation of money (such as investments in Gold, Silver, Platinum, Palladium) and the interplay between the desire to preserve wealth and the actual consumption of natural resources (such as oil, gas, coal, solar energy, etc.). The prices of such commodities are determined by several factors: actual economic conditions, natural disasters (e.g. Hurricane Sandy), the political landscape (e.g. Arab Spring), possibly unsuccessful attempts by developed countries to tap alternative energy sources (wind & solar), the switch to cleaner sources of energy such as natural gas, and the absence of infrastructure to satisfy the bourgeoning market of motor vehicles running on alternative energy. **Therefore, to make a bet on any single source of energy is like playing the lottery.**

Currencies

There are three major classes of currencies:

1) Free Floating Currencies (such as U.S. Dollar, Euro, Yen, Canadian and Australian dollars). Their cross rates are determined by well-known parity principals.

2) Pegged currencies (and Swiss franc has suddenly become one of them). Their cross rates are linked to other free-floating major currencies.

3) Artificially manipulated currencies, such as the Ruble (linked to a strange combination of the Euro and the Dollar), the Yuan (determine by the central committee of the communist party of China), the Venezuelan Bolívar (determined by the mood of Mr. Chavez), and many other currencies whose underlying economic factors have become more and more meaningless.

Historically, the rates of exchange of major currencies have rarely moved by more than a few percentage points per year. If one looks, for example, at the Swiss franc (graph[16] below), $100 was equal to CHF 116 the week of May 24, 2010, $100 was equal to CHF 87 the week of May 23rd, 2011, then came back up close to a one-to-one scale, and now, $100 equals CHF 92 (December 27, 2012).

These drastic percentage swings are unprecedented.

[16] http://www.advfn.com/p.php?pid=qkchart&symbol=FX^USDCHF

Why is this happening? After WWII, global macroeconomic events usually helped us to forecast the cross rates of at least major currencies. Now, random actions (such as government decisions, political events, etc.) define these rates of exchange, making them totally unpredictable, and we are faced with the following questions:

Will the Euro self-destruct? Will Greece leave the Eurozone? Will Ireland, Spain and Italy be next? Maybe not. However, the patience of hardworking and income-generating northern European countries (e.g. Germany, Denmark, the Netherlands, and Norway) is gradually running out, and the pressure could easily lead to political conflict. We have all witnessed the rioting and protests in Athens, Madrid, and Barcelona. Will we see the same in Berlin and Copenhagen?

Vega's Position: One thing we can suggest is to diversify your investments across international companies that make money in various regions of the world and generate revenues from selling gold, oil, gas, earth metals, agricultural commodities, etc. Such diversification across demographics will help to stabilize the incredible volatility of conventional investment portfolios.

Part IV: Conclusion

From the analysis presented above, it's important to emphasize that for many countries, the only road ahead is one paved with mountains of printed currency. The active political pressures (e.g. riots on the streets of Athens, Occupy Wall Street movements, etc.) will force governments all over the world to placate the growing social discontent by imploring the central banks to continue infusing the economy with fresh liquidity.

As a result, it's highly likely that inflationary pressures will increase and money kept under the mattress will begin to lose value even more rapidly (and the people who own the money will quickly lose purchasing power).

Therefore, since the economic analysis presented above might herald a grim outlook, professional guidance is more important than ever. Logically speaking, the stock market should appreciate, as people try to protect their wealth from inflation.

The key to success in 2013 is to invest, or face gradual losses brought about by inevitable inflation.

Of course, we are not attempting to claim that we can anticipate future events with complete accuracy, but we adamantly insist that diversified investing is much better than inaction.

We hope that 2013 will be a very prosperous year. As always, we appreciate your business and your trust. Do not hesitate to call us with any questions you might have, and refer us to your friends.

Vega Capital Group Team

December 28, 2012