



Is This *Another* Bubble?

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Webster's best 'in context' definition. Bubble: State of booming economic activity that often ends in a collapse.

U.S. Investors experienced two bubble-bursts in eight years: dot.com in 2000, and real estate in 2008. Both followed by stock markets that plummeted 50% +. By the way, these two were chronologically much closer than usual. Ostensibly, the substantial pain from bursts is supposed to sober-up everyone for a generation or so. Not so far this century.

The main causes of financial bubbles are greed and low interest rates. Greed is obvious: some or most asset classes start appreciating. Other opportunistic investors start piling-in, thereby driving prices higher. This reaches manic levels.

Low interest rates are not as obvious, but in some ways, particularly Central Bank engineered low rates, more pernicious. First, they permit a lot of folks, consumers, companies and investors alike to borrow. This ramps-up consumption, capital expenditures, and margin loans. Additionally, income and risk-

averse investors become frustrated with low returns on savings accounts, CD's, bonds, etc., and are 'forced' to move-out on the risk-continuum for higher returns.

So what about 2015, is this another bubble? My response is a qualified yes, and here's my reasoning. Our Federal Reserve Bank, along with the Central Banks of most of the rest of the world, kept interest rates at near-zero since 2008, the longest period in history. One outcome: the U.S. added over \$ 7 Trillion of new debt. If you're looking for the conditions to cause a bubble, this is about as clear as you can get.

The result is that most of the world's stock, bond and real estate markets have risen, some by large amounts (Chinese stocks + 53% last year). The U.S. 30 year Treasury Bond was one of the best investments last year (+ 40%) and today yields just 2.4% (would you lend money for 30 years at that rate?). Sovereign debt yields in 11 European countries, including Germany and Spain, are negative (you lend them money now, and later get back less). I could go on and on.

This is a simple description of the

causes of bubbles and current bubble-like conditions, but it's not simple-minded. A significant add-on is that in most parts of the world, economies are weakening not getting stronger. Europe, for example, looks ready to embark on an experiment with Quantitative Easing, and Japan is accelerating theirs. (I could go on and on...)

One problem with bubbles is it's all theoretical, until they burst. By their nature bubbles can continue to grow far beyond what seems natural. Eventually, however, something 'always' comes along and pops them. Often it's higher interest rates, which simply reverse the appreciation into depreciation. But there are other catalysts as well.

My current suggestion: be cautious. Check all your current and future investments carefully to make sure you're not paying too much. If you have a high-quality, low-priced asset, you can ride-out most price volatility. It's those who are fully invested in high-flyers who get hurt permanently when bubbles burst. Call us if you have questions about your holdings, we're happy to give you an experienced opinion.

The Price of Carbon

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Most all of us of a certain age are continuously aware of fluctuating gasoline prices and their connection to the fluctuating prices of the oil from which it is refined. For the past 6 mos., both have been in steep decline.

As I've written in recent quarters, the size and ubiquitous nature of this largest and most widely used energy source makes it integral to all but the tiniest and least developed economies. Agricultural productivity and transportation networks worldwide rely almost exclusively on

petroleum's refined products – gasoline, diesel and jet fuel. The other plentiful fossil fuel, coal, is still the dominant power source for electrical generation and steelmaking. For much of the past 150 yrs., burning cheap carbon has produced growth, prosperity and a path out of poverty for much of mankind.

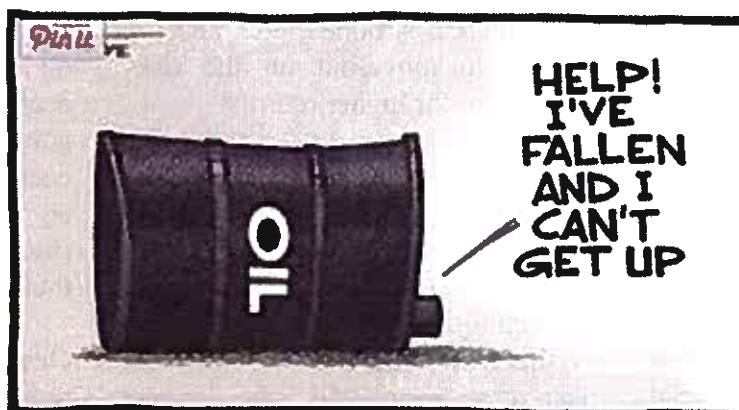
This era of continuous access to low-cost non-renewable energy is drawing to a close. Despite the steep drop in oil prices since mid-2014, the supply glut that caused it will prove temporary because high-cost producers will simply stop exploring and producing at current levels. Econ 101 taught us that supply and demand must balance at a price where most players are profitable in any given market. Despite the fact that geo-politics can trump economics for a while (see last quarter's column), revenues must eventually exceed production costs and the societal commitments said revenues support. We'll see \$100+/bbl. oil again soon enough, esp. since the current lower prices will spur consumption and slow the pace of the necessary migration to alternative renewable energy. But it's clear that once we're through this latest (and

maybe last) cycle of cheaper oil, we'll need to do far more to account for its economic and environmental costs. At the very least, Congress must raise fedl. gas taxes to pay for the maintenance of our crumbling transportation infrastructure. It's been widely reported

that the Federal Highway Trust Fund is almost depleted while the current 18.4 cent/gal. tax has not been raised since 1993. This huge drop in gas prices is a golden opportunity to raise this tax without hurting drivers, given they'll simply be giving back a minor portion of

their recent windfall. Maybe we'll be able to repair or replace most of those "structurally deficient" bridges before they collapse and kill more people. I'm generally a fiscal conservative, but this is a no-brainer for this Congress. Talk about your shovel-ready projects.

Over the longer run, we must seriously consider a carbon tax that places the burden on the biggest emitters of atmospheric carbon in industry and power generation. This is both acknowledgement of the large body of evidence that supports mankind's contribution to climate change and the clear path we're on toward high energy costs becoming a serious impediment to prosperity. Solar and wind power generation is now competitive with coal and nat. gas, so the migration toward these alternatives will gather steam as coal/gas steadily lose share for anything other than meeting peak seasonal power demand. Leaps in battery and fuel cell technology should eventually displace carbon completely for fueling our power grid. This is a big deal by itself, but the main use of oil is motor



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\$ 2 Gasoline ?

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If you were producing a specific type of good, and it cost you \$ 85 to make each unit, how long would you continue to produce and sell it at \$ 46 before deciding operating at a loss was not a good business idea? (Probably not very long)

This is what is going on in the oil industry. Most oil companies in the U.S and Canada need AT LEAST \$ 85 a barrel for their oil, currently they are receiving near \$ 46. Sure the low oil translates into lower prices at the pump, more spending money in our pockets, and the openness to travel or drive more based on the cheaper cost. The consequences take longer to show themselves, but they will be felt by many American's who work in this industry.

Many different factors go into this steep and dramatic price drop. One probable theory is that Saudi Arabia, who can produce oil for less money than the U.S and whose oil business is government operated, is trying to push U.S producers out of the market. Their government backing means they can tolerate lower prices than U.S companies which are not nationalized, and once the competition is out, let prices return to normal. They don't want the price at \$ 46 either, but

are willing to wait out other companies. They've done this before, and with all the new oil companies and rigs in the U.S over the last decade, they are likely doing it again.

This is one of those moments investors need to really be thinking long term. First, does \$ 2 premium seem right to you? It's nice, but don't you wonder why pump prices are 50% cheaper now than 2007? Did some magic alternative to fuel get created? Was there a massive oil find that tripled the reserves currently being held? Well supply is up, with more rigs and drillers finding oil. The issue is their oil is expensive to bring out of the ground, and the Saudis forcing the oil prices down is their way to eliminate the excess supply. The question is how long will this last?

This price drop will eliminate many of the rigs and companies currently operating in the U.S. Those who survive will be key holdings for their investor's portfolios when prices correct. It will cost thousands of jobs, and eventually oil will return to its natural value. Call me if you would like to talk about investing in the oil companies we think are best suited to survive and thrive in these conditions.

The Price of Carbon *(Continued from pg. 2)*

fuels, so higher gas taxes and a separate carbon tax should go to fund both infrastructure and the necessary R&D costs to move our car, truck and rail fleets to emission-free electrical and fuel cell propulsion. And remember, sun, wind and hydrogen are everywhere, unlike the carbon we now burn. It may take the rest of this century to accomplish, but some day petro-states – whether friendly or hostile – may no longer exist. None of us will be around to see it, but clean, renewable energy must one day be our grandchildren's economic and environmental salvation.

“When investing, pessimism
is your friend, euphoria the
enemy.”

Warren Buffett

Advice from Bob Rodriguez: Liquidity is Important!

William Mason CFA

I have been fortunate enough to have known Bob Rodriguez since 1985. I typically meet with him once a year. In 2014 I met with him in June. Bob is currently the CEO of First Pacific Advisors. To give you an idea of his performance when he managed FPA Capital this is a comment he made in a speech on October 30, 2014: "When I stepped down from day to day active money management at the end of 2009, my equity fund, FPA Capital fund, had outperformed various measures of stock market performance by approximately 400 to 600 basis points (4%-to-6%) compounded annually since June 30, 1984, while finishing as the #1 diversified equity fund for that period."

In that speech, Bob indicated he had been cautious since 2011: "I wish I could be optimistic but I just can't bring myself to it. Too much has unfolded during the past decade that dictates a far more cautious outlook, in my opinion. For the record, I've maintained this view since 2011, so some of you may think that I am unwilling to throw in the towel. You may be right but I don't think so."

Bob had the following to say about the current situation created by the Federal Reserve. QE refers to Quantitative Easing which is money printing: "I've been highly critical of the Fed's monetary policies for years and particularly the various add on QE programs since they first began. I believe this policy will lead to one of the present day future shocks. Many an unintended negative consequence will be the result of this unwise and unsound policy. Like the lead up to the 2007-09 crises, at

FPA, we see many credit market sectors that exhibit the presence of unsound underwriting standards that are quite similar to that which took place prior to the Great Financial Crisis."

In regard to liquidity, Bob had the following to say: "With heightened pressures to be fully invested, I believe the utilization of liquidity as a proactive investment strategy is warranted. There will come a time when it will be wonderful to be investing again. My recommendation to you is the classic value saying--be cautious while others are greedy and be greedy when others are cautious."

Bob has spoken to me many times of his value stock screen which takes into account many things such as the p/e ratio. In a January 2, 2015 interview with *Investor's Business Daily* he had this to say: "In fact, when I run a value screen that I use, it had recovered to just 30 names from an all-time record low of qualifiers of just 27. To put that in perspective, when I got very cautious in May-June of 2007, the number of qualifiers was 35. In the first week of March '09, it hit 462. We are a far piece from that."

In the same interview he indicated the following regarding the currency (dollar): "Within two or three years, QE will be shown to be errant policy that's devoid of effectiveness. That leads me to the likely outcome that we face a currency realignment, currency crisis, potentially currency wars."

He also stated the following regarding liquidity: "I realize that maintaining a large level of liquidity requires patience but I think it will be well rewarded."

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