AMI INVESTMENT MANAGEMENT
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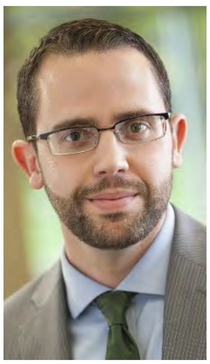

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U.S. stocks were up 0.95% in the first quarter of 2015.[1] International stocks fared better despite currency headwinds, with developed markets up 8.1% and emerging markets up 2.2%.[2] Bonds returned 1.25% during the quarter.[3]

At the beginning of 2015, market commentators were confident that this would be the year the Fed finally raised short-term interest rates. The 10-Year Treasury followed script, increasing from 1.68% in late January to 2.24% in early March. But after its March 18th meeting, the Federal Reserve Open Market Committee (FOMC) seemed to suggest that the economy wasn't tracking quite as strongly as they thought it would be. The *Wall Street Journal* reported that investors "were surprised about the cautious longer-term stance on rates," with many lowering their estimate of the probability the Fed would hike rates in June.[4]

On Friday, April 3rd, investors were treated to another economic data point – the U.S. economy added 126,000 jobs in March, versus a forecast of 248,000 from economists. Again, the *Wall Street Journal*: "The report was the latest in a string of economic indicators that pointed to softening growth, and it deepened doubts about the timing of a U.S. interest-rate increase that many market observers had pegged for midyear."[5] The 10-year Treasury is now back below 1.9%. (The chart below shows the yield on the 10-Year Treasury over the past decade.)

You might think stocks would fall on news of weaker than expected economic growth, but instead they rose around 1% following each event. Why? Because many stock market investors are more concerned with higher interest rates than slower economic growth.

It is important to remember that interest rates are like gravity to financial markets – lower interest rates, like less gravity, allow prices for all different kinds of investments to rise. If interest rates rise, it's like an increase in the gravitational force, and prices fall.

[1] As measured by the S&P 500.
[2] As measured by the relevant MSCI international indexes.
[3] As measured by the Citigroup 1-10 year Treasury index.
[4] "Fed Puts Interest-Rate Hikes in Play," by Jon Hilsenrath, *Wall Street Journal,* March 18, 2015.
[5] "U.S. Government Bonds Rally, Dollar Falls on Jobs Data," by Min Zeng, *Wall Street Journal,* April 3, 2015.

Imagine this: if we all woke up tomorrow and we could invest in a guaranteed 10-year U.S. Treasury bond with an interest rate of 10.9%, instead of 1.9%, many of us would consider selling our stock holdings and buying Treasuries. This would cause stock prices to fall. To some degree, *all investments compete with each other*. In a world of low interest rates, investors will bid up prices on other investments like stocks and real estate. Sure, investors will continue to expect stocks and real estate to offer higher returns than low-risk government bonds, but the differences will be reasonable. Historically, equities have returned around 4-6% more per annum than Treasuries.[6]

So naturally, when will interest rates rise is an important question. The only problem is that no one knows the answer! For a decade now, commentators have been confidently predicting that rates will rise "next year." Amazingly, their stunningly bad track record hasn't stopped them from trying to predict rate movements again and again.

We don't know when rates will rise, but our opinion has been that many investors underestimate the prospect that they stay low for an extended period. Investors seem to think that the Fed is artificially holding rates down. But in a recent series of interesting and insightful blog posts, former Federal Reserve Chairman Ben Bernanke explains:

> The Fed's ability to affect real rates of return, especially longer-term real rates, is transitory and limited. Except in the short run, real interest rates are determined by a wide range of economic factors, including prospects for economic growth – not by the Fed.[7]

The U.S. economy can't seem to achieve the kind of growth that would be needed to prompt higher interest rates. Part of the reason is that our economy doesn't exist in a bubble – slowness in the rest of the world affects our growth. The U.S. dollar has appreciated nearly 20% over the past year relative to a basket of foreign currencies.[8] This makes our exports more expensive and imports from foreign competitors cheaper. As a result, Fed Chairwoman Yellen stated:

> With respect to the impact of the dollar on the U.S. economy, I don't have a quantitative estimate to offer you, but I certainly expect net exports [exports minus imports] to serve as a notable drag this year on the outlook [for economic growth]."[9]

In discussing the short-term outlook for Berkshire's four largest stock holdings – American Express, Coca-Cola, IBM and Wells Fargo – Warren Buffett wrote "2015 will be a tough year for the group, in part because of the strong dollar."[10]

Just take a look at 10-year government bond rates witnessed in neighbor countries:[11]

- Germany: 0.19%
- France: 0.48%
- Italy: 1.30%
- Spain: 1.21%
- Netherlands: 0.36%
- Portugal: 1.68%
- Switzerland: -0.11%
- Japan: 0.33%

That's right, Switzerland has negative yields on 10-year bonds! You are actually paying the government for the right to lend them money. Emerging market constituent Mexico recently issued one-hundred year bonds, denominated in Euros, at a yield of just 4.2%! An Austrian bond that doesn't mature until 2062 yields under 1%. These are interesting times.

It is hard to imagine 10-year U.S. Treasury bonds at 5% or more while our developed neighbors sport bond rates in the 0-2% range. With a strong U.S. dollar, European and Asian investors would likely be happy to buy-up 10-year Treasuries if yields went much above 2-3%.

All interesting stuff, we know. But what does it mean for investment strategy? Unfortunately, not much. We don't think there is any silver bullet to escape the burdens of low investment returns. Yes, interest rates are low and stock prices look somewhat expensive. But the alternative of sitting in cash doesn't look appealing, especially if rates do stay low for an extended period of time. In a recent interview with CNN Money, Buffett gave the following response to the question of whether U.S. stock prices are too high and the market was in a bubble:

> Not yet, but they've moved a long way up…we're closer than we were before, obviously, when the

[6] Based on various estimates for the historical equity risk premium; see Aswath Damodaran.
[7] "Why are interest rates so low?" Ben Bernanke, March 30, 2015, www.brookings.edu.
[8] WSJ Dollar Index.
[9] HIGHLIGHTS-Fed chief Yellen's news conference after FOMC meeting, Reuters, March 18, 2015.
[10] Berkshire Hathaway 2014 Shareholder's letter.
[11] Bloomberg, accessed on April 6, 2015.

> market goes, on the S&P, from 666 or so to 2,100…that is a big move. But stocks were very cheap then, at that time, and they went into a range of modest undervaluation, fair valuation, they might be a little on the high side now, but they've not gone into bubble territory or anything of the sort…I do not regard us as being in bubble territory, but I don't find cheap stocks to buy either.[12]

With higher stock prices and lower interest rates, investors will need to moderate their expectations for future investment returns. But we have yet to see the evidence needed to make any drastic change to long-term investment policies. That being said, we are ever mindful of Buffett's admonition:

> [W]e do know that the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs.[13]

We don't think that full-blown "imprudence" has taken over markets, but it of course bears watching.

As always, thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay

[12] Interview with CNN Money on April 1, 2015.

[13] Berkshire Hathaway 1989 shareholder letter.