

Third Quarter Investment Commentary

2013

What Are We Really Talking About Here?

It seems as though our National attention has been wrapped around nothing else but the battle over the Nation's budget and how we will go about borrowing even more money to pay for the money that we have already borrowed. Or at least just to pay for the interest on the money that we have already borrowed. While the budget and the debt ceiling are surely worthy topics of discussion, they are still only second order issues to the more important issue of the debt itself.

According to www.usdebtclock.org the total debt of the United States is \$17,038,244,984,742 and climbing rapidly, as I write this commentary on Saturday October 19th, 2013. I encourage everyone to check out this website because it is loaded with everything you need to know about our ballooning debt problem. If \$17 trillion is a number that is just too big for you to comprehend, then let me break it down for you into something a little easier to swallow: that much debt amounts to \$53,888 for every citizen. Since most of you who are reading this note are also actually paying taxes, \$17 trillion represents \$149,000 of debt for each taxpaying citizen. This website also shows rolling tallies of our largest budget items, including Medicare/Medicade, Social Security and Defense. Please check out this website and share it with everyone you know. If our collective attention does not turn to this first order problem, and soon, our Nation is in dire straits.

The U.S. stock market, as measured by the S&P 500 Index, finished the third quarter with a return of just over 5%. Since the end of the quarter, the stock market has broken out to all-time new highs in the month of October. As of October 18th, the S&P 500 is up 22% year-to-date. Some of this impressive return is the result of strong corporate earnings. Most of it though, in my opinion, is the result of the massive oversupply of easy money that the Federal Reserve continues to dump in to the economy. The Federal Reserve's balance sheet stands at \$3.886 trillion, and climbing, as of October 19th. All the talk of tapering over the summer amounted to naught and the Federal Reserve kept right on buying. So just how long can the stock market continue to make new highs? My guess is that stocks will continue to rise until the Fed decides that it no longer needs to maintain this \$85 billion *per month* of artificial demand and begins to taper their unprecedented additional liquidity.

Testing a New Tool

Although the Federal Reserve decided not to taper its massive Quantitative Easing when it last met in September, it has been preparing for that ultimate day to come. The Federal Reserve Bank of New York, which implements monetary policy on behalf of the Federal Reserve through the purchases (or possibly one day the sales) of securities it holds in what is known as the "System Open Market Account", has been testing a new tool since last month. This tool is intended to improve control of near-term borrowing costs. This new tool is called a "Fixed-rate, full-allotment overnight reverse repo facility" and it would allow banks, broker-dealers, moneymarket funds and even some government sponsored enterprises to lend the Fed unlimited amounts of cash overnight at a fixed rate in exchange for borrowing Treasuries in what is known as a reverse repo transaction.

By offering this new, essentially risk-free overnight fixed-rate investment, the Fed will be able to maintain control over short-term interest rates and the volatility that surrounds them. In particular, this will provide stability to the money-market industry. Under the massive quantitative easing that has been going on for the last year (remember that it has been \$85 billion per month), the Fed has been directing the markets desk at the New York Federal Reserve Bank to buy securities from the Primary Dealers, those brokers who are authorized to trade directly with the Fed.

The result has been a massive amount of bonds piling up in the System Open Market Account. One of the more concerning consequences of this flabbergasting bond buying has been an accumulating collateral shortage. The rate for borrowing and lending Treasuries for one day in the repo market averaged 0.058 percent between June 30th and the end of September, compared with 0.29 percent at the end of last year when QE3 was just beginning, according to the Deposit Trust & Clearing Corp.'s General Collateral Finance Treasury Repo Index. This collateral shortage could prove catastrophic to rates should the bond buying persist.

The Fed is not allowed to pay a deposit rate to non-banks but now with this new facility it can offer to pay non-banks what is basically a risk-free, overnight, fixed rate. What this means is that the Fed now will have greatly expanded its pool of reverse repo counterparties beyond just the 21 Primary Dealers. As of now, the Fed has 139 counterparties: 94 money-market mutual funds, 6 government sponsored entities, and 18 banks in addition to its traditional 21 Primary Dealers. I know this all sounds like a lot of Greek to anyone who is not in the banking business but believe me, you will be glad this new tool is available in the not too distant future. I'm glad to know that the Fed doesn't have its entire head in the sand. Now if we could just get them to work on the eventual great unwinding of their QE

Partial Shutdown

Starting October 1st, the Nation experienced a partial shutdown of non-essential government functions. While some citizens experienced a slight inconvenience, most citizens barely noticed. Perhaps a trip to a National Park was interrupted or delayed. I have heard a few grumblings that these "non-essential" government workers ended up with what amounted to a two week paid vacation. For me personally, access to certain economic government data was unavailable and I have a relative who works at the Smithsonian who was affected. However, the Post Office remained opened, Air Traffic Controllers kept our skies in order, Amtrak kept running and by and large everyone just kept calm and carried on. The stock market certainly didn't seem to be bothered much at all.

As we quickly approach the next possible partial government shutdown in just three months from now, I thought it might be useful to chronicle the past 17 partial government shutdowns we have had since 1976, prior to our most recent one:

<u>Date</u>		# of Days	<u>Senate</u> <u>Control</u>	House of Representatives Control
Dec.	1995	21	Republican	Republican
Nov.	1995	5	Republican	Republican
Oct.	1990	3	Democrat	Democrat
Dec.	1987	1	Democrat	Democrat
Oct.	1986	1	Republican	Democrat
Oct.	1984	1	Republican	Democrat
Sept.	1984	2	Republican	Democrat
Nov.	1983	3	Republican	Democrat
Dec.	1982	3	Republican	Democrat
Sept.	1982	1	Republican	Democrat
Nov.	1981	2	Republican	Democrat
Sept.	1979	11	Democrat	Democrat
Sept.	1978	18	Democrat	Democrat
Nov.	1977	8	Democrat	Democrat
Oct.	1977	8	Democrat	Democrat
Sept.	1977	12	Democrat	Democrat
Sept.	1976	10	Democrat	Democrat

So you can see that a partial shutdown of the government is really nothing new. Whether you believe our most recent partial shutdown was the responsibility of the Democratic Senate or the Republican House of Representatives, clearly both houses of Congress are guilty, once again, of acting stubborn and recalcitrant.

Big Oil (and lots of Natural Gas)

The United States is set to become the World's top oil producer in 2013, overtaking Saudi Arabia. When natural gas liquids and biofuels are added to crude oil production numbers, this year the U.S. will gain the top spot as a result of our surging domestic shale oil output. The U.S. is projected to produce an average of 12.1 million barrels a day of liquid fuels in 2013. That will be 300,000 barrels a day higher than Saudi Arabia and 1.6 million barrels a day more than Russia.

To what do we owe our new top ranking? The U.S. is forecasted to pump 2.5 million barrels a day of natural gas liquids in a surge of "shale oil" output. The combination of horizontal drilling and hydraulic fracturing (better known as "fracking") techniques has led to a boom of output of this cleaner fuel in shale formations throughout the central part of our nation. In total, shale liquids output has climbed 3.2 million barrels a day over the last four years. It is this natural gas output that has placed us in the lead. Were it not for our Natural Gas boom, we would still be trailing Saudi Arabia.

The New Benjamin

A new version of the \$100 bill has been rolling off the presses and is making its way soon to a wallet near you. The new high-tech version made its debut on October 8th and it includes numerous features meant to thwart the efforts of counterfeiters around the globe. Some of these major make-overs include: a depiction of part of the Declaration of Independence in script over Franklin's left shoulder, a color changing inkwell that changes from copper to green and back when the bill is turned, a 3-D blue security ribbon that is woven into the bill and runs vertically down the note just off center, and a texturized collar around Ben Franklin that is festooned with the words "The United States of America" in tiny lettering. There is also a watermark of Franklin that's on the right side of the note that appears when it is held up to the light, although that is not really a new feature.

The new notes are being produced at a facility north of Fort Worth, Texas. Here the notes are sorted into piles 100 deep, banded together and stacked into 4,000 note bricks worth \$400,000. Those bricks are then put on a palate that holds 160 bricks, each palate being worth \$64,000,000. Those palates are then shipped off to the various Federal Reserve Banks around our nation. From there the palates are often shipped abroad. In case you were wondering (I was), it would take more than 265,625 of these palates to cover our nations \$17,000,000,000 debt.

The New Dow Jones Industrial Average

On September 23rd, a newly constituted Dow Jones Industrial Average began trading. Nike, Visa and Goldman Sachs debuted as new components, replacing Alcoa, Hewlett-Packard and Bank of America. It was the biggest shake-up to the Index in more than 10 years, since April of 2004, when AIG, Pfizer and Verizon replaced AT&T, Eastman Kodak and International Paper.

Nike, one of the world's top athletic shoe and equipment makers replaced Alcoa, which had been a DJIA component for more than 54 years. Visa, a global payments company, replaced Hewlett-Packard which had been a member of the Index since 1997. Goldman Sachs replaced Bank of America, which had only been a member of the Index for 5 years. Part of the reason for the change was the poor performance of the three departing members. Over the last five years, Alcoa had declined 71%, Bank of America was off 55% and Hewlett-Packard had declined 51%.

Strong Quarterly Earnings

We are right in the middle of earnings reporting season and I am happy to report that many of our widely held securities are posting very strong earnings gains this quarter. Some notable examples include Noble Corp. (NE), Verizon Communications (VZ), Accenture (ACN) and Baker Hughes (BHI). Following are some insights into these companies supplemented with research notes from our partners at Morningstar Institutional Research:

Noble Corp. reported earnings that were up 88.9%. Total revenue increased to \$1.08 billion from \$1.02 billion in the prior quarter, thanks mainly to the commencement of operations for two new ultra-deep-water rigs. The company also benefited from lower operational downtime, which fell to 4.6% from 5.2% in the prior quarter. Utilization and day rates also continued to improve as floater utilization moved upward to 79% from 77% and day rates increased 6% to \$369,100.

Verizon reported earnings that were up 20.3%. Verizon has reached an agreement to acquire Vodaphone's 45% interest in Verizon Wireless for \$130 billion of cash and stock. Verizon Wireless is the clear leader in the industry, with 100 million retail customers and coverage of more than 95% of the U.S. population.

Accenture reported earnings that were up 14.8%. The firm generated \$1.2 billion in quarterly free cash flow and raised its semiannual cash dividend 15% to \$0.93 per share. The balance sheet remains solid, with \$5.9 billion in cash equivalents and no debt. Management has the financial flexibility to achieve its stated objective of

spending 15% of annual free cash flow on acquisitions. This level of acquisition spending would still leave the firm with ample cash to increase its dividend and steadily reduce share count over time.

Baker Hughes reported earnings that were up 11.0%. Net debt declined \$579 million during the quarter to \$3.2 billion, and capital expenditures of \$511 million were just under 9% of revenue. Internationally, the company had strong performances from Europe and the Middle East, where year-over-year revenue growth was 14% and 26%, respectively.

The Highly Improbable Come From Behind Victory

From July through September of 2013, San Francisco Bay was the home of the 34th America's Cup Challenge and Finals. In a highly improbable come from behind victory, Oracle Team USA retained the cup against a fierce competitor in Emirates Team New Zealand. By winning 3 of the last 4 races, Oracle Team USA was able to overcome what appeared to be an insurmountable Kiwi advantage.

This year's regatta featured new cutting-edge technology, literally. The massive vessels competing were dual-hulled ships, 13 stories tall, that would lift up out of the water on hydrofoils and could slice through the water at speeds of over 45 knots (approximately 50 mph). The battle for the America's Cup began in 1851 and it was a moment of great pride for our Nation as we won the venerable trophy, known to be the most difficult trophy in International sport to win. For some perspective, consider that there had been nine contests for the America's Cup before the first modern Olympic Games were held in Athens in 1896. Hip-Hip Hooray for Team USA!

A Terminal Reminder

Remember to check out <u>www.usdebtclock.org</u> and to share it with everyone you know. This ballooning debt should be at the front of everyone's thinking. If we don't start to do something about it now, it will eat us alive. Happy Halloween!

McKim Williams, Jr. Chief Investment Officer October 19th, 2013

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