

July 1, 2014

Vladimir or Narendra?

A lot has happened in the second quarter!

Russia, under the leadership of Vladimir Putin, has annexed the Crimean Peninsula by sneaking unmarked Russian military personnel into the area and holding what appears to be a sham election. This action along with further Russian insurgency in Ukraine has resulted in the United States placing travel restrictions on some dozen Russian oligarchs.

The second major event of the quarter was the election of Narendra Modi, leader of the Bharatiya Janata Party (BJP) as Prime Minister of India. This is indeed a huge event. India, the world's largest democracy has been ruled, with one brief exception in the 1970's, by the socialist National Congress Party (NCP) since obtaining independence from Great Britain in 1947. Since inception the NCP has been dominated by the heirs to the Ghandi family dynasty.

The election of Narendra Modi is a momentous event for a number of reasons:

1. Modi has won the vote with a mandate sufficient to assume the Prime Minister post without having to form a coalition with competing parties.
2. Modi spent years as the governor of the state of Gujarat where his free market ideas were implemented with great success.
3. Having majority control of the legislative branch of government will give Mr. Modi a better chance of getting changes passed.
4. As recently as last year the import tariff on gold was raised from 4% to 10% by the NCP. This is the type of nonsense that Modi has campaigned to remedy quickly. This along with the retroactive taxes that the NCP government has attempted to collect from international companies such as Nokia have prevented others from moving into the Indian market to provide much needed jobs.

All of these reasons have caused both James Grant's Interest Rate Observer and Barron's to quote people referring to Mr. Modi as the next Ronald Reagan.

There is no question that the potential is there. Back in 1990, India's economy was approximately the size of China's. Since that time the ruling NCP has squandered opportunity after opportunity. Today, China's economy is roughly 4 times that of India.¹

So, what is the Mountebankery to do with client money? Invest in Russia of course!

There are a number of issues with India. First of all the stock market is at all-time highs, and up some 36% from August. Second, the ability of anyone, even the real Ronald Reagan, to pull off a major change would be a challenge especially considering the built in expectations. One has to look back to 1982 when the Dow hit its low of 777, almost two years after Reagan was in office. Reagan didn't have the expectations built in. And thirdly, India has a lot of problems. The stock market is at a high, but the underlying economy is a basket case. While Modi has a lot of opportunity to help the economy, activity in the stock market will be rocky in the short term. A stock market priced on anticipation and economic potential is not a good mix.

Russia on the other hand is in a semi depression. The stock market is at a predictable low point. Russia is being shunned by much of the world and there just isn't much going right there. Those features combine to make extremely low stock prices! Gazprom, one of the flagship natural resource companies sells for just two times cash flow. As one wag put it: all it needs to do is sell at four times for a double!

Remember, good news and low stock prices don't go together.

Energy, India, and Electric Cars

The Mountebankery has a good deal of client money invested in energy. Our government is pooh-poohing

¹ Barron's

fossil fuels and talking up wind and solar energy while putting restrictions on coal and other hydrocarbon fuel sources as if wind and solar were the solution.

India, with its 1.3 billion people produces some 245 gigawatts of generating capacity. The United States as of March of this year, had some 1,247 gigawatts of installed capacity for some 1 billion fewer people. That works out to five times the power output for a quarter of the people or a multiple of 20. India has around 400 million people who do not have access to electricity. One area in northern India had a solid week in the last 30 days where the temperature didn't get below 115 degrees Fahrenheit! There are currently riots protesting the brown outs and black outs from the overloaded system.² Mr. Modi has a tall order.

Anyone who doubts that the demand for energy in India is going to abate should go and take a shower without hot water and call me.

This brings us to the third topic of this section: Electric Cars. The Mountebankery is endorsing Electric Cars. The reason is that Electric Cars are great wasters of energy and the Mountebankery has investments in oil, gas, nuclear, and coal companies. We need more energy consumption to get the profits and stock prices of these energy investments up and a major contributor to this will be Electric Cars.

Electric Cars get their electricity from the same electrical grid that delivers electricity to homes and businesses. This electricity comes from the burning of fossil fuels to generate power, which is sent down power lines at high voltage to transformers along your street. The transformers step down the voltage for use in your home where electricity is consumed.

There is a tremendous loss of energy when fossil fuels are burned, and sent down wires to distant users. There is a further massive loss of energy when electric energy is used to charge batteries later used to power Electric Cars. This may come as a revelation to those who think that driving electric cars saves energy. If this process saved energy, it would be somewhat like a perpetual motion machine and most of us know that this doesn't exist. So please tell all your friends to purchase an Electric Car to save (our) energy (investments).

Market Comment

Political problems have historically posed problems for stock markets. There is no current shortage of political problems:

1. At the Veterans Administration where government healthcare is surprisingly like government healthcare, patients needing care are instead given the run-a-round due to operational inefficiencies. The Left will claim that there just weren't enough funds and the Right will claim that there are never enough funds if there is no profit motive to maximize patient flow and manage costs.
2. The Benghazi Embassy Massacre where the State Department under then Secretary of State, Hillary Clinton, refused numerous requests for beefed up security, sent no support during the attack, sent out party minions to blame the whole affair on a spontaneous attack caused by a supposedly offensive internet video. Military personnel who complained have been sacked. It now turns out that the offensive video charade was the brainchild of a White House speech writer. A congressional investigation is underway.
3. Gross Domestic Production fell in the first quarter indicating that we may be headed back into a recession. Even though the money printing is being cut back, \$45 billion per month is still a lot of money, and interest rates continue near all-time lows. It is disturbing given all this support that we still have a drop in GDP! Pundits have blamed the slump on the first quarter weather and they may be right.
4. Problems abound in the Middle East and the situation could hardly be more bizarre. Sunni rebels in Syria, yes the ones that the Administration wanted to help after Assad's gas attack have now moved into Iraq under the name of the Islamic State of Iraq and al-Sham (ISIS) taking control of major Iraqi cities and a good deal of the land mass. In addition our enemy of a few months ago, Syrian President Assad, has launched attacks on the ISIS inside Iraqi territory.

² The Wall Street Journal

After the American troop withdrawal, the Prime Minister of Iraq, Nouri al-Maliki, a Shiite, allied his government with the world's leading sponsor of state terrorism, Iran (also Shiite) for protection. This relationship led to the Iranian Revolutionary Guards being deployed in Bagdad to defend against the ISIS. The US has now sent 300 additional "advisors" into Iraq to help with the situation. Yes, you read this right. The US is now effectively allied with Assad's Syria and the Ayatollah's Iran in defense against the Sunni based ISIS in Bagdad, the capital city of Iraq.

- The scandal at the IRS is by far the most troublesome. The moral fiber of the entire country is based on the voluntary tax collection system and the integrity of the institution in charge of collections. If the taxpaying citizenry fail to have confidence the entire country will be at stake.

President Obama is on record as saying that there is "no corruption" at the IRS. Treasury Secretary Lew who is in charge of overseeing the Internal Revenue Service said that "sometimes a broken hard drive is just a broken hard drive."³

The dog ate my homework defense is best described by the NY Post: *"The thing about dogs eating homework is, it could actually happen. This can't. This is 'The dog ate my hard drive, broke into another building, ate the backup of the hard drive, then broke into six other top officials' offices and ate their hard drives also."*

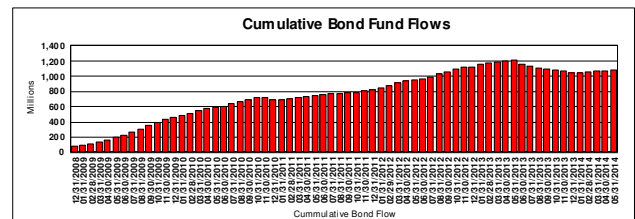
The tax collection system is clearly broken and must be fixed.

These five problems would normally pose a threat to high priced US stock markets. However, with the Administration being so anti-business, the loss of power will hinder the President's ability to further his agenda. This will be viewed as positive for the markets at least for the short term. Should this result in a change in control of the Senate things could get interesting.

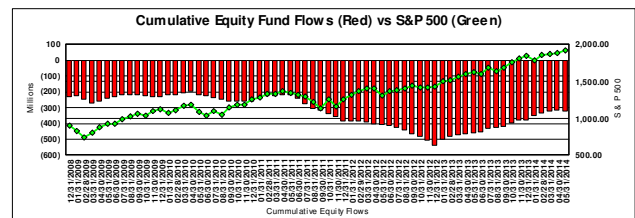
Mutual Fund Cash Flows

Bond funds have been the net recipient of cash for each of the three months ending in May, while stocks funds experienced net inflows in March and April, and a withdrawal for May.

Cash flows into bond funds helped our recent entry into the four high yield bond funds.



The flow of cash into equity based mutual funds has been inconsistent of late.



Positions initiated in the quarter:

Central Europe, Russia and Turkey Fund, Inc.

(NYSE: CEE) a long position was established in this closed-end fund that has recently concentrated its investments in Russia. Among the fund's top ten holdings are Gazprom mentioned earlier selling at two times cash flow, and Russia's Norilsk Nickel Mining & Metallurgical (Norilsk). Norilsk is the world's largest producer of nickel, and palladium where prices are near multi-year highs. Norilsk sells for 11 times earnings and yields 7%. We entered the fund at a price almost 10% below the net asset value of the underlying investments.

Positions exited during the quarter:

Kulike and Soffa (Nasdaq: KLIC) The holding in this manufacturer of copper based ball bonders and related manufacturing equipment used in the electronics industry were sold after a sharp run up resulting from a decent earnings report and involvement by a venture capital firm. I like the industry and the company and hope to reenter the positions at a lower price.

³ Zerohedge

I will write to you again at the close of the next quarter. As always, please feel free to call or email if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Martin C. Kendall". The signature is written in a cursive, flowing style.

Martin C. Kendall
Managing Member
July 1, 2014

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