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OCTOBER 2014 INVESTMENT COMMENTARY

WHAT IS SEPTEMBER'S STOCK MARKET ACTION TELLING US?

September was a very interesting month in the world of investing. The broad markets were buffeted by a myriad of geo-political concerns regarding Russian sanctions, expanding military action against ISIL, the Scottish independence vote, and large pro-democracy protests in Hong Kong. On the economic front, concerns have surfaced over mixed U.S economic indicators and the announcement by the Chinese government concerning their lack of plans for further fiscal stimulus to fight their economic slowing. Likewise, Europe's economic news continued to worsen with increasingly visible deflationary pressures and a continued unwillingness of Germany to heed the advice of the European Central Bank and U.S. Officials that fiscal stimulus needs to be applied in order to avoid prolonged economic stagnation.

This weakness in Europe has pushed the value of Euro currency down to multi-year lows against the U.S. dollar thus, strengthening the relative value of the dollar. The stronger dollar has exacerbated the fall in commodity prices such as gold, oil, and copper, which is a double-edged sword for stocks. However, from our perspective, the bigger concern is the effect that the stronger dollar will have on many large U.S. multi-national companies whose products and services will become less competitive in the global markets as a result of the strengthening greenback.

Well-functioning markets will always react to changes in economic outlooks, geopolitical events, and currency market dynamics. Markets in real time also reflect the cumulative emotions of investors. Once again, terrorism has become a prominent concern for many investors due to the very public beheadings of hostages held by ISIL. This radical "so-called" Islamic group has used video images of these horrific murders in attempts to outrage and terrorize the civilized world. I believe that the intent of such terror tactics is to provoke countries (like the United States) to enter into war so that they can more easily portray "Western" countries as the enemy of Islam. Through these attempts, I believe that they aim to divide the secular nations of the world from those nations that identify as Islamic states. So far, I think that the U.S. has shown remarkable restraint from a more forceful unilateral military response and has enlisted many regional Islamic states to join in a military effort to defeat ISIL. Although President Obama has indicated that defeating ISIL will likely take years, this conflict will quickly wane as a material concern for the markets if the current military strategy begins to successfully thwart ISIL's advances in Iraq and Syria.

On a more positive note, September marked a U.S. stock market milestone with the Alibaba IPO becoming the largest IPO of all time. Alibaba raised around $25 billion and the resulting share price valued this 15 year-old Chinese internet commerce company in excess of $200 billion. The Alibaba IPO was lauded for how well it was priced by the underwriters and brought to market by the NYSE, which typically signals a healthy, well-functioning stock market. However, given the enormous size of this IPO, the stock market has struggled to digest such a large issuance of stock. Many growth stocks, particularly in the area of internet commerce and social media, sold off ahead of the Alibaba launch. As a portfolio manager, it was interesting to watch the effects that this repositioning had on the market over the span of several days as asset managers made room for the Alibaba investment in their portfolios.

At Seven Summits Capital, we did not directly participate in the IPO due to many questions related to the convoluted ownership structure of the company; however, many of our portfolios have been the beneficiary of a decision to purchase Yahoo stock over a year ago in anticipation of this IPO. This decision was made due to our belief that, at the time, Yahoo was inefficiently priced when compared to a "sum-of-the-parts" valuation that included the company's 34% ownership stake in Alibaba. Since the purchasing of our first shares, the Yahoo stock has risen over 50%. Thus, our initial analysis has proven to be correct. However, we have yet to take profits on our Yahoo position because, we believe that the shares remain under-valued based upon our sum-of-the-parts valuation and other possible value-enhancing activities that we anticipate will occur.

As a value-seeking active investment manager, Seven Summits Capital must continually weigh month-to-month changes in macro and fundamental factors to determine if they change our long-term outlook. September threw an extraordinary number of variables at the markets and capital markets have reacted erratically. At times like this, our long-term fundamental focus on value dictates our behavior as an investor.

At the individual security level, we stay focused on determining whether or not the fundamentals of our investments remain poised to exceed the long-term expectations that the market has discounted into the current share price. One of the analytical screening tools that we use when evaluating individual equities compares the growth rates implied by the current share price with our expected three and five year growth rates. This analysis also can prove to be very effective in assessing whether a current stock investment is inefficiently priced at current levels and whether we should be adding to our position or redeploying the capital elsewhere. In many cases, short-term corrections in the broad markets increase this long-term capital appreciation opportunity for many of our holdings.

If the current stresses on the markets lead to a correction of more than 5-7%, we will be on the lookout for oversold stocks that we are either currently holding or ones that we have been monitoring to establish as new positions. Over the years, I have been asked by clients as to how I decide when a correction might be the beginning of a more serious downturn. My answer is that prolonged downward-trends in the stock market have historically been precipitated by high inflation and tightening by the Federal Reserve as happened in 1980 and 1991 or a large asset bubble bursting such as occurred in 1999 and 2007. However, non-financial events also can act as a psychological tipping point. For example, the recession of 2001 only lasted a little over two quarters and may not have been classified as a recession had the September 11th terrorist attacks not disrupted the financial recovery process. But, since it is impossible to predict such non-financial shocks, all that we can do to protect our clients' assets is to use our experience to identify trends that increase either risks or opportunities as early as possible. Acting more impulsively would inherently be speculating on the unknowable and this applies to efforts to grow money or to avoid losses. When we become convinced that the risk of a recession over the next six to nine months has risen above thirty or forty percent, we will slowly begin to lock-in a certain level of profits, accumulate a higher than normal level of cash, and reconfigure a portfolio's stocks away from those companies that will typically perform the worst during an economic contraction.

The most challenging aspect of looking for signs of the next recession are that today's economy and the global backdrop are unlike anything that investors have experienced in the past. What this means is that the next recession will probably not be triggered by typical events and policy actions. Instead, I am closely watching deflationary forces here and abroad as I view those forces as being the greatest economic risk that we currently face. There are pockets of deflation present in most mature economies despite the extraordinary efforts by governments and central banks to stimulate demand and commerce. Right now, in regards to the U.S. economy, we appear to have succeeded in producing a sufficient level of growth to keep deflation at bay but, both Europe and Japan appear to losing their battles. In Germany, which is the most economically influential nation within the European Union, its history of suffering with hyperinflation appears to be inhibiting the country's policy-makers from providing the leadership necessary for the European Union to address the threat of deflation. In the United States our independent central bank has been focused on the deflation threat since 2008 and this focus has thus far kept economic growth and inflation at much healthier levels than has been experienced in Europe.

The U.S. economy posted second quarter GDP growth of 4.6% following a slightly negative first quarter GDP that was largely attributed to very harsh weather conditions

in the highly populated Northeast. Expectations are that the second half of the year will generate an annualized GDP growth in the United States of slightly above 3%. So long as the U.S. economy can continue to grow in excess of 2.50%, the risk of deflation remains very low. As I look into 2015, I believe that the risk that hangs over the U.S. economy is that the combination of a stronger U.S. dollar, the end of Federal Reserve QE bond purchases, and the beginning of gradual interest rate hikes, will pull down economic growth to levels that cannot fend off deflation.

In conclusion, it is safe to say that September was a challenging month when looking at it on a stock by stock basis, especially in comparison to the very strong month in August. As I have stated many times in the past, stock price volatility driven by markets as opposed to fundamental changes at the company or industry level are at most opportunities to add to positions on weakness or harvest profit on strength. Many pundits will point to one or two especially worrisome factors that were the cause of the market difficulties in this month. ***As I assess what factors are currently present and the market's reaction to these known issues, I do not believe that the recent volatility and weakness is sending any particular message to investors about what to expect in the future.*** Many times market volatility increases after relatively long market advances simply because those investors who are accustom to attempting to trade such market volatility look to get out ahead of what they believe might be a brief correction. This tendency then serves to exacerbate volatility levels. Unlike other speculative activities such as wagering on particular roll of the dice, attempting to time the markets through buying and selling is not an independent action from the dynamics of the market itself. The cumulative selling of stocks, mutual funds or ETF's will have a direct effect on the price levels reflected by the market over the short-term.

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