Marble Harbor Investment Counsel, LLC
Excerpt from
Second Quarter, 2015 Letter

We are pleased to send an excerpt from our second quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, Suzanne Coleman, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

In attending the rise in interest rates, it can seem as if we have been, like the characters Estragon & Vladimir in Beckett's play, *Waiting for Godot*. In 2013 we experienced the "Taper Tantrum" after the Federal Reserve Bank began to *talk* about decreased purchases of bonds through its Quantitative Easing (QE) program. Rates briefly spiked up and then receded, eventually reaching all-time lows last year. This was despite the consistent, and ever-more frequent, pronouncements from the Federal Reserve that they intended to raise interest rates. As the market waits, stocks have crept to new highs with very little volatility. Why such a long dance and what does it mean for your investments?

Interest rates have largely been determined by market forces over the centuries. If there were more people who wanted to borrow money than there were lenders, if lending money entailed a great deal of risk or if inflation was rampant, interest rates were generally high. Contravene any or all of these conditions and interest rates tend to be lower.

During the past several years, however, natural market forces have been circumscribed through massive intervention by the world's central banks to depress interest rates and to stimulate the moribund global economy. It has worked – economies are now growing modestly.

Unemployment and consumer debt levels have fallen. Bank balance sheets have healed. The cost, though, has been a dramatic ballooning of the debt owned by the Federal Reserve, the Bank of Japan and the European Central Bank.

With an improving economy, the Federal Reserve would now like to transition to a more normalized interest rate regime: one that responds to market forces. Challenging the central bankers are the conflicting issues of maintaining the fragile economic recovery, keeping the US Dollar from rising too rapidly, controlling inflation and stimulating job growth.

While some pundits lament the impending collapse of the Dollar, it is still seen as a safe haven. As rates rise, global investors will see the promise of a safe currency with above average yields. That is a win-win for foreign investors. However, as the dollar rises, US exports will be hurt, oil (which is sold in dollars) will become more expensive for the rest of the world, slowing those economies and leading to lessened demand to borrow money – which depresses interest rates.

At the same time, there has never been more excess capital in the world looking for a place to invest. This cash is depressing rates and will continue to do so no matter what the central banks would like to see happen. Additionally, the slowing demographic growth of most large and developed countries is weighing on demand. The US and Europe don't need to build new infrastructure (though they do need to maintain it!). China's population is set to start shrinking in the near future. This will further depress the demand for consumption and borrowing and so tend to keep a cap on economic growth, inflation and rates. The Federal Reserve's wait for the right time to raise rates remains a wait for Godot.

This seemingly endless "If, Then" struggle keeps us wary. You own companies that typically are able to grow whether economic growth is supportive or merely benign. These higher-quality businesses generate strong cash flows that management can use to either grow the business or return to shareholders. Valuation remains critical, as does a strong balance sheet. Some of your companies have the added feature that they should benefit from rising rates. Finally, since we are not being paid to take the risk of buying long-term bonds, we continue to keep maturities on bond portfolios fairly short while we wait for rates to rise – whenever that may be.

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