THE YEAR AHEAD

WHAT MORE TO EXPECT IN 2015 (AND BEYOND)

Separating Signal from Noise

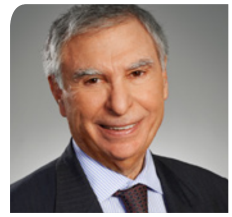
March 2015

Schizophrenia: A Fast, Furious, and Volatile Start to the Year

The pace of change since "What to Expect in 2015..." was published December 23rd has been quite dramatic. Normally, we would wait to review our expectations until mid-year. However, some of what we expected is resulting in a different mix of winners and losers in the equity and fixed income markets and is happening at a faster pace, while other expectations appear less likely to come to pass in the manner predicted. We still believe what is happening requires a very fresh look at portfolios and, in particular, the risk profile represented as we move into the post QE era in the United States. What we have done below is take the major headings in our "What to Expect..." *Perspectives* and provide a current view. What is written here is best put into perspective by a review of what was said in December. It is worth noting that the S&P500 closed at 2082 on the day our piece was published and closed last Friday, March 20, at 2108. The 10-year yield was at 2.26% and closed Friday at 1.93%, a sharp decline in response to the Fed's release and Chairperson Yellen's rather dovish comments. One could say, if one had been asleep over this period, (s)he didn't miss much. However, on 31 of the 60 trading days (52%) to last Friday, the S&P has experienced more than a 1% spread between its high and low those days. This 52% compares to 31% over the full year 2014. In addition, the mix of individual securities in the equity markets that produced the index values and the spreads of specific credits in the fixed income markets are quite different from those 60 trading days ago. Past performers have not necessarily been the securities to own in this new environment. We expect this to continue. Let's proceed with the review.

UNITED STATES: GROWTH CONTINUES AND THE US DEFINES ITS OWN ECONOMIC PATH

Growth is continuing, but the number for the first quarter will likely be below the low end of our expected range of annualized growth. Weather was a factor, but other variables are at work. The trade deficit looks like it will be wider in spite of the lower cost of imported oil, as foreign demand for US goods disappoints while the reverse—US demand for foreign goods—increases. Inventory levels are high which



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could affect industrial production (and maybe imports) and jobs. However, the jobs momentum seems to continue. We discussed this in a very recent blog in some detail. The February seasonally adjusted number at 295,000 was way above most estimates. In the most recent JOLTS report, job openings in January at five million were the highest since 2001. We do have a skills mismatch. In the just released Beige Book, almost every region reported difficulty in hiring because of a skill mismatch as well as some wage pressure. This included, in some instances, jobs outside of those requiring specialized skills. Maybe Walmart's increase in its minimum wage was an indication of this phenomenon. Other retailers seem to be following WMT's lead.

Interestingly, the South has the highest number of job openings. Possibly, this ferocious northeastern winter will ultimately alter that gap. Fallout in the energy industry may also reduce the gap. Quits remained at a high level, which should ultimately show up in wages—a lagging indicator. While most of the pundits get it, the general public still doesn't realize that the US has a very dynamic labor situation. We are at five million people being hired each month. We tend to look at the relatively small spread between the hires and the quits, terminations and retirements.

In the meantime, the rhetoric from Fed members, for the most part, seems to point toward a desire to start getting rates rising possibly by mid-year. It is not clear that the numbers in the first quarter will be additional reinforcement. And the "dot" forecast from the Fed members points to a lower rate of growth. While "patient" came out of the language almost every other indication was slightly more circumspect about the path of growth, employment and inflation. I did not expect "patient" to come out of the statement, given the near-term economic outlook. However, the word had taken on a very specific definition, and its removal has given the Fed more degrees of freedom, but with an unusual dovish bias in the new language. If the Fed does start raising the funds rate in June or July, the surprise could be that the increase is not the expected 25 basis points, but maybe half that, indicating that the Fed will be data driven and will take its time pushing up the rates. The opposite looming surprise could be an increase in commodity prices as Europe, as well as some other parts of the world, begin to show signs of growth. That could very quickly change the inflation picture. China remains the swing factor on commodities, although one cannot ignore India. Thus far, China still seems on a path to disappoint economically. See the comments below in the section on China for more on this topic. We could see a short-term pop in commodity prices, most likely not including oil. However, if oil stays low, the breakeven on other extraction industries can change significantly as energy is a big part of the costs. If variable costs fall enough to provide a positive contribution at low prices, extraction and smelting will continue and hold prices down for longer than one might think. It doesn't preclude a short-term rise sufficient enough to get the Central Banks more concerned than they are presently about inflation vs. deflation.

With continued volatility, the markets have, on balance, responded positively since the Fed announcement, certainly with some schizophrenia. It is interesting most recently, though, that the bond and stock markets in the US have become somewhat less correlated. The earnings likely won't ultimately support the equity side of that equation. Multiples will have to expand to meet most market forecasters' expectations. Stocks most likely will track earnings, which are likely to be flat at best this year—maybe a little better than that if the energy sector is excluded. On the fixed income side, with the European economy and some others showing some signs of life, the flow of funds to the long end of the US Treasury spectrum, which was based on a strong dollar and a substantial spread, may have shifted to the corporate markets in Europe and elsewhere. The yield curve may not get as flat as we originally expected. It is possible the US Treasury has missed its window to increase the average maturity on its liabilities at low rates. In the short run, at today's rates, issuing short maturities holds down the deficit, but if rates start to rise, that can go away very quickly. Other countries are locking in very low long rates. The US is taking a big risk with our money by not doing the same.

Given all of the above, if one is making decisions based on the precise timing of the funds rate rising, they are not investing. They are trading. We will likely continue to have a different set of winners and losers in equities and bonds over the next few years. I wouldn't try to be too cute on timing and would be spending my time finding active managers in both sectors who are fundamentally focused and can be nimble in their securities' picks both long and short. That wasn't of much help on the stock side and, with some exceptions, on the bond side during the period of US QE. That is over.

THE REST OF THE AMERICAS—A MIXED PICTURE OFFERS OPPORTUNITIES

I'm having difficulty finding the "opportunities" part of the mixed picture. If anything, things look a bit worse across the board from Canada to Tierra del Fuego. Commodity prices are important to almost all the countries above and below the US. The opportunities remain dependent on those prices and the lack thereof increases the uncertainties politically.

Canada has to deal with the impact of lower oil prices and an expensive housing market.

Venezuela continues to be a disaster with a "leader" looking for all distractions to what is really going on in the economy. We may be looking at some form of relief measures from the global community for the populace when the distractions run out. This will affect **Cuba** as well.

Brazil is experiencing the internal reactions—demonstrations—to the state of the economy and the Petrobras issue. Weak economy.

The rest of the countries are, for the most part, tied to commodities with **Argentina** having its own issues away from the economy. It does not appear that there will be a settlement of Argentina's outstanding debt obligations under Kirchner's watch. Reserves could last, just barely, until there is a change at the top. At that point things could get worse.

EUROPE—ECONOMICALLY BETTER, BUT POLITICALLY WORSE

From "What to Expect...:" "Also aided by lower energy prices, the European economies show some new signs of life while the politics get more dismal."

We are all watching Greece as a bad outcome there can set up a cascade for some of the other PIIGS. The first kick of the can down the road doesn't look like it was far enough. This is happening while there are some signs of life in Europe. What is impressive is the direct engagement of the leaders of the various countries in reaching resolution. This gives some indication of the importance of a good resolution combined with just a different approach to dealing with a serious problem. The solutions are clearly in the hands of the ultimate leaders, not without input and noise from the other elements of government. The buck (or euro), though, clearly goes to and rests for decision-making at the top. If the euro weakens (gets to par or below with the dollar) there is a chance that there is no Grexit and the potential domino effect that creates. I am somewhat optimistic on what can happen in the European economies, led by Eastern Europe. And, by the way, what is going on there has happened thus far without QE. It is not clear, though, that all of the elements in Europe will come together to support a sustained rebound there. Selectively, this can be an interesting market opportunity ranging from corporate success driven by a lower euro to accidents producing some distressed debt opportunities.

JAPAN—ABENOMICS CONTINUE WITH THE YEN WEAKENING FURTHER

Well, the yen hasn't weakened much further, yet. In fact, it has been a relatively strong currency just by almost keeping pace with the dollar. It has been volatile, as has the market, which is now starting to strengthen. This seems to be close to the only path open to Abe, but, again, a leader who appears to have control over his destiny. It is just not totally clear what that destiny really is. We are seeing a turn in the trade balances. And, the Toyota wage increase is interesting. Toyota's sales are improving with the lower yen helping. While corporations in Japan tend to respond more to urgings from the government than elsewhere in the world, they will not do something that is truly detrimental to the company. This may indicate something more fundamental in the Japanese labor situation and maybe the economy. An interesting market if one hedges the currency.

CHINA—GROWTH DISAPPOINTS, CURRENCY STAYS STRONG, AND THE ECONOMIC TRANSITION ACCELERATES

Nothing in China happens in three months. To me, China's actions are consistent with the path described in December. Domestic growth will disappoint. However, much as the trade balances will hurt US GDP, China's lack of imports with a weaker economy (combined with a lower cost of imported commodities including oil), while exports continue, will produce trade balances that will push up GDP results. I still believe China is in a transition to a more internal, technology-driven economy. In addition, China also wants its currency to become a member of the reserve currency family. Thus, the currency is likely to keep pace with the dollar, unless the domestic economy really tanks. I don't think that will happen, but some who know the country in great detail believe otherwise. I believe that China has many levers it can pull to avoid a hard landing as it works its way through this transition. It won't be totally smooth. An indication of serious troubles would be if the yuan was allowed to weaken significantly against the dollar. The yuan was at 6.23 to the dollar when we published our "What to Expect..." *Perspective*. It closed last Friday, March 20th, at 6.21. Again, if one had gone to sleep...

INDIA—BREATHING ROOM FOR REFORM AND INDIA JOINS THE CURRENCY WARS

There is still breathing room for reform, but imbalances in the economy will make consensus in the world's largest democracy more difficult than the honeymoon atmosphere right after Modi's election. India is joining the currency wars because it can. The internal and external Hindu/Muslim conflict could escalate. The new budget is a step, as is the change in corporate tax rates. Direct cash transfers in the subsidy area are a step toward eliminating corruption. Turning the country into a real country as opposed to a federation of states by replacing border taxes with a national goods and services tax is a very big step. Land reform may produce some political backlash. Let's hope it all works. An attractive market away from the currency, although that is also being worked on. Could India become the fastest growing large economy in the world, replacing China? Very possible. It won't be smooth though.

RUSSIA—THE FINANCIAL SITUATION PRODUCES A DIFFERENT PATH LEADING TOWARD REGIME CHANGE

I'm sticking with the case spelled out in December. The uncertainties in the Ukraine are an indication of the weakness in Russia's current situation. Expect volatile actions from Putin. The Nemtsov assassination bears watching. The key is Putin's popularity rankings within the country and how long the political/financial elite are prepared to tolerate an anti-west stance which is not to their benefit. Putin has created a leadership vacuum underneath him, but he can't control everyone. Stay tuned.

IRAN—A SETTLEMENT SOONER THAN THE DEADLINE. OIL PRICES MAKE A DIFFERENCE

The noises support this. Netanyahu's visit to the US Congress was not helpful. If, in fact, he disclosed information to Congressional leaders that could only have come from some espionage, that will make things worse. Many variables at work here, but oil prices do make a difference, regarding the internal politics of the situation. Deadlines may not be precisely met, but oil prices and sanctions will make a difference.

OIL—PRICES STAY LOW WITH GENERALLY POSITIVE, BUT VOLATILE EFFECTS

As I said in a media appearance several weeks ago, energy is the most interesting sector because there are choices. That is still the case on the long and short side. When I published "What to Expect...," WTI was at $56.78/bbl and Brent was at $59.07. WTI, while having been quite volatile, was at $46.00 on Friday the 20th and Brent was at $53.88. I expect we will continue to see volatile movements in the price and every move will get reflected in some fashion in the market. The dollar is a factor of course.

Events in the Middle East can always have an effect.

It is amazing how much activity (or reduction of activity) has occurred in the US oil market. We seem to be the swing factor. It will be interesting to see the reaction in the public sphere when it becomes apparent the US is the determinant of whether prices rise or fall. I do believe we will still see low oil prices for quite some time. There is no reason for OPEC (Saudi Arabia) to take actions to raise prices this soon, unless the message is hold off on more production because we can take the prices down any time we want. Not even sure if that is true. In the meantime there are transactions within the oil patch. An interesting example was the sale of Lucas Energy after it couldn't meet its financial obligations. The purchaser is all excited because it can now drill five new wells in the Eagle Ford, which wouldn't have happened otherwise. Oil assets will end up in stronger hands and production will likely continue. I expect prices to bounce around, but these levels do not necessarily make the whole oil patch suddenly attractive. It makes for interesting news and some interesting investment entry points, but I wouldn't count on a recovery to previous levels in any reasonable investment time frame.

US POLITICS—A WILD CARD THAT INCREASES VOLATILITY AND UNCERTAINTY IN THE MARKETS

There is more evidence every day that Washington, particularly Congress, will be a wild card to watch. The noise around the new trade agreements and the threatened shut-down of Homeland Security, "Audit the Fed," are just small examples of what could happen and affect future growth and the creditworthiness of the US. It is hard to predict what will come out of Congress, but this is a factor. This is a backdrop that adds to uncertainty.

CYBER ATTACKS—THEY CONTINUE. AN INVESTMENT OPPORTUNITY, BUT ADDED GEOPOLITICAL RISK.

This is becoming an everyday topic.

CONSUMPTION—CHANGING EATING HABITS AFFECT STOCK PRICES

This is still one of my favorite expectations. I believe we are seeing one of those, on the margin, tipping points that will continue to have ramifications on some of the major names in the fast food and soft drink/snack industry and, possibly, Big Food as well. It will be a scramble for these companies to keep pace with changing habits. Combined with the international aspect of their businesses they are unlikely to get any relief from currency translations for a while. There will be management changes, á la McDonalds, but this requires strategic thinking, not tactical.

OTHER TAIL RISKS—NEED TO BE CONSIDERED IN PORTFOLIO CONSTRUCTION

Below are a repeat of some lower odds expectations, but still sufficient enough to require some thought about their impact on the markets and to consider some form of tail-risk protection.

1) A Putin-led Russia maintaining and acting on an anti-west stance

2) A terrorist attack in the west

3) An unexpected financial accident beyond those indicated above

4) Something unusual in the Middle East most likely involving Israel in what would be viewed as an independent offensive action

5) OPEC or some other factor (see above) pushes oil prices up

6) A runaway US equity market on the upside with multiple expansion against a backdrop of low interest rates and "the best game in town" syndrome. It has happened before. Fed action or, more so, inaction could produce this.

The combination of the end of QE, lower oil prices, different patterns of growth including a rise in the wage outlook leads to a different and much more diverse set of winners and losers in the markets. We may be entering a more absolute return world where the traditional equity and fixed income investments, overall, experience low rates of return. This truly may be the time when active managers do well, certainly on a risk-adjusted basis. There are major tail risks from primarily geopolitical actions. We believe it is prudent to spend a few basis points in most portfolios as a buffer against tail risk, both positive and negative. We also believe that a fresh look at one's portfolio, moving away from what may have worked over the period of QE, is important. Recent past performance may truly not be indicative of this coming year's results. We expect that allocations related to risk mitigation will become more important, and at the same time provide decent returns. Please pay attention.

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