INVESTMENT OUTLOOK

GREATER VOLATILITY IN MARKETS AHEAD?

What Investors Should [Can] Do.

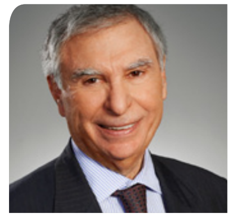
January 2014

Actions by the Federal Reserve and other central banks, economic recoveries, the Volcker Rule, and changes in bank capital rules dictated by Basel III will combine to increase volatility in equity and fixed income markets globally.

The pace of economic growth and continued stimulus from most central banks should keep borrowing costs low in the US and even bring those costs down in Europe. Meanwhile, rates will likely rise on longer maturity government and high grade bonds. This will create opportunities in less conventional lending markets. Investors in traditional fixed income and equity holdings should maintain exposure to these significant asset classes, but consider reducing their risk by changing the mix of managers.

EQUITIES

We believe we are entering a stock picker's market, one that rewards manager skill. If we are correct, a shift to active managers would benefit investors. By definition, active managers' securities positions typically deviate significantly by name and weighting from securities in the indices against which they are measured. In a stock picker's market, securities no longer move in lockstep. As *Figure 1* shows, almost all market sectors posted stellar gains in 2013 (telecommunications and utilities were the exceptions). This sharp rise and the fact that multiples have expanded faster than earnings, *(See Figure 2)* makes it



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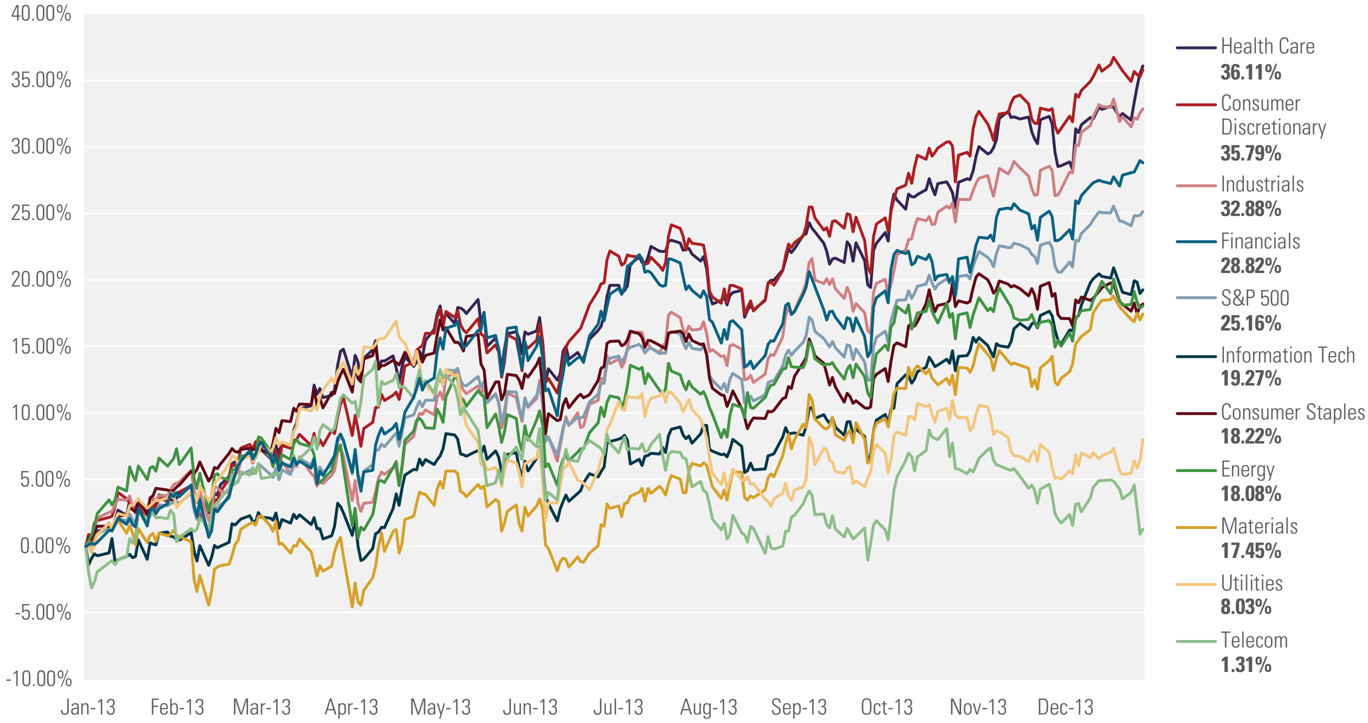
Jack Rivkin has had a long and varied career in the investment industry encompassing private and public equity, investment policy and management. He is known as a keen observer of investment and business strategy, with over 46 years of investment research and asset class expertise. He is a respected thought leader and has held senior roles in the investment industry including Chief Investment Officer and Head of Private Asset Management at Neuberger Berman and Director of Global Research and head of the Worldwide Equities Division of Lehman Brothers Inc. Following his time at Lehman Brothers, he was a Vice Chairman and Director of Global Research at Smith Barney (ultimately a subsidiary of Citigroup), and an Executive Vice President with Citigroup Investments making direct investments and leading an investment team. Jack is the co-author of "Risk & Reward—Venture Capital and the Making of America's Great Industries," Random House, 1987. He is a regular guest on various media including CNBC and Bloomberg. He is the principal subject in a series of Harvard Business School cases describing his experience as Director of Research and Head of Equities at Lehman Brothers. He has served as a director of a number of private and public companies and the New York Society of Security Analysts.

Jack earned his Professional Engineering degree from the Colorado School of Mines and his MBA from the Harvard Graduate School of Business Administration.

FIGURE 1.

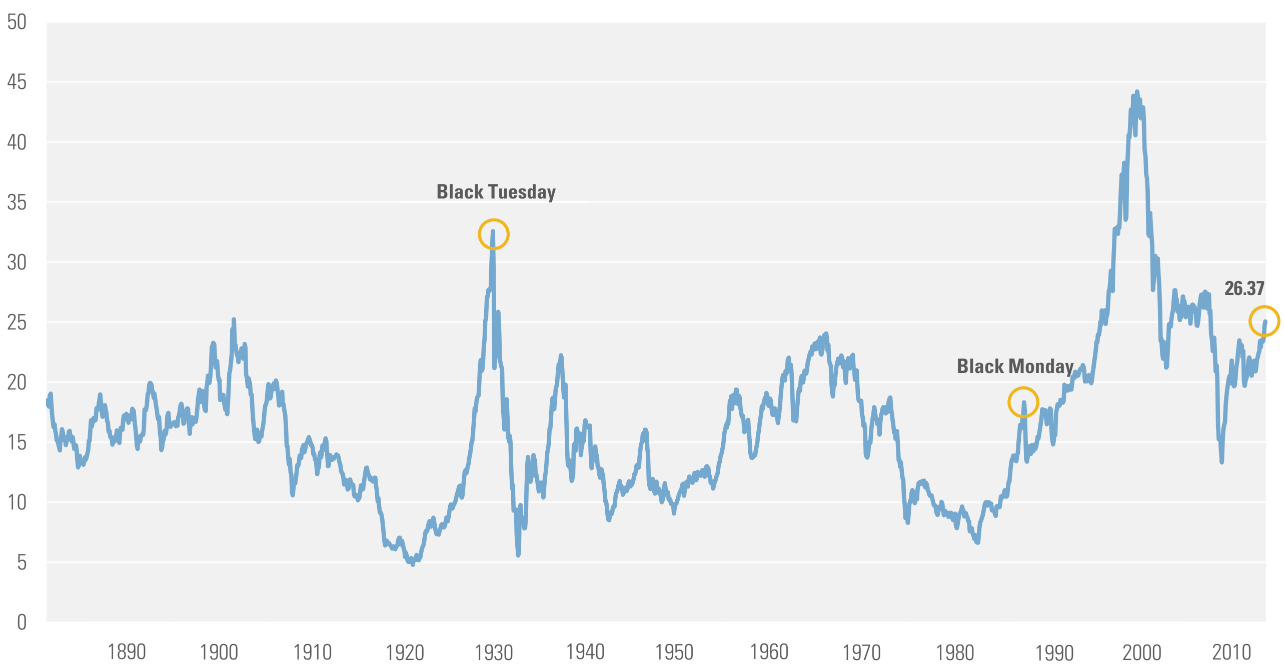
US EQUITIES PERFORMANCE BY SECTOR | 1 Year*



**As of 1/10/14. Source: Altegris. Data Source: Bloomberg. Indices: Health Care: AMEX Select Sector SPIDER – Healthcare Index (IXV); Consumer Discretionary: AMEX Consumer Select Spider Index (IXY); Industrials: AMEX Industrial Select Sector Index (IXI); Financials: AMEX Select Sector SPIDER – Financial Index (IXM); Information Tech: AMEX Select Sector SPIDER – Technology Index (IXT); Consumer Staples: AMEX Consumer Staples SPIDER Index (IXR); Energy: AMEX Select Sector SPIDER – Energy Index (IXE); Materials: AMEX Materials Select Sector Index; (IXB) Utilities: AMEX Utilities Select SPIDER Index (IXU) Telecom: S&P 500 Telecommunication Services Index (S5TELS).*

FIGURE 2.

SHILLER PE RATIO FOR THE S&P 500 | January 1881 – December 2013



Source: multpl.com/shiller-pe. Data source: http://www.econ.yale.edu/~shiller/data.htm. Price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio (CAPE Ratio), Shiller PE Ratio, or PE 10. Indices: US Stocks: S&P 500 Index.

more than likely that some sectors and specific stocks will lag or even see corrections, if only temporarily. This should set the stage for managers who focus more narrowly. Among that group are managers of hedge funds and other alternatives whose strategies include shorting and other hedging techniques. They should find the market in 2014 more to their liking.

FIXED INCOME

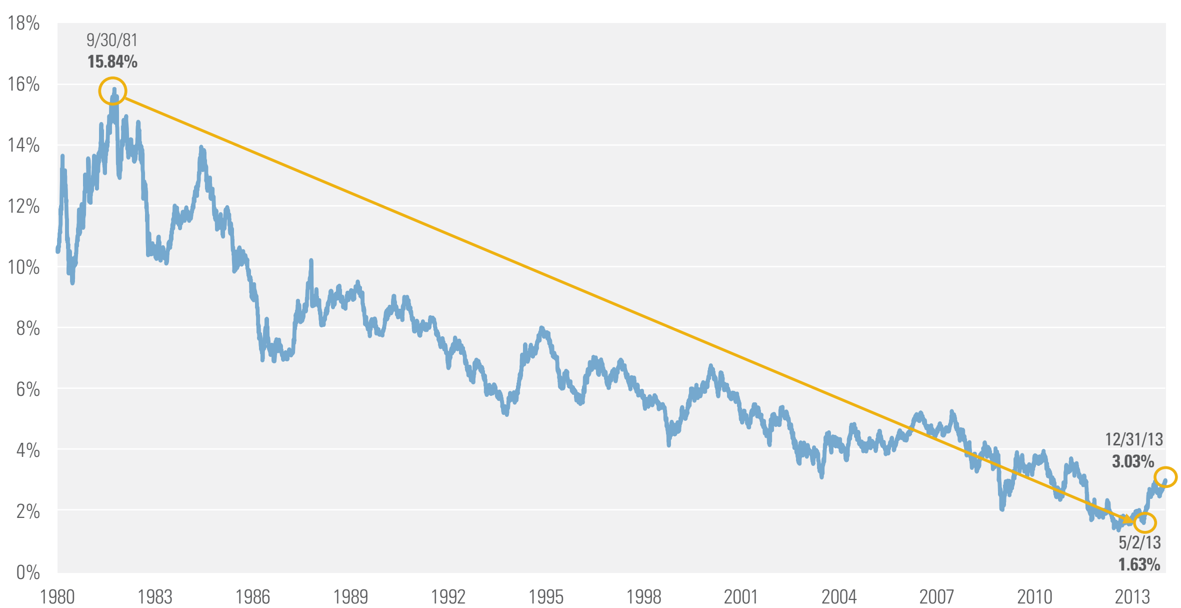
It's a similar story for the fixed income sector. In effect, 2014 could be a bond picker's market. After a 30-year run, the bull market in bonds appears to be over, as *Figure 3* showing the decline in interest rates indicates. Rates could fall even further, but that scenario is unlikely in a growing economy. The easy gains have been made. Just as a stock picker's market favors active equity fund managers, a low-interest rate environment can favor active managers of fixed income portfolios. Those who have the skill to identify non-conventional fixed income opportunities, who understand the credit cycle, and who can capitalize on the new lending restrictions placed on banks should be able to generate yield at lower risk. Long/short fixed income managers who can take advantage of relative credit disparities and/or changes in the yield curve, potentially have an even greater opportunity to outperform in 2014.

FINAL THOUGHTS: MOVING INTO 2014

2013 was a watershed year. The S&P 500 Index soared 29.6%, setting a record high. It was the stock market's best year since 1997. While the economy expanded modestly, the pace of the recovery appears to be quickening, if preliminary economic statistics hold true. Anticipating slow but steady gains, the Federal Reserve announced in December that it would begin reducing the pace of Quantitative Easing (QE) by $10 billion, beginning in January. Should that pattern continue, the Fed would end QE during the third quarter of 2014. The Fed also announced that it would likely keep the federal funds rate at the current level, at least until unemployment falls below 6.5%. While short term rates have been, and may continue to be, anchored by Fed action, the rate on 10-year US Treasury notes has already risen from a 2013 low of 1.63% on May 2 to 3.03% on the last day of the year. The 30-year US Treasury bond moved from 2.82% to 3.97% across the same time period. If one had held these instruments at their lowest yield, by year end, the total return would have been a negative 9.47% and a negative 18.25%, respectively. Two trends seem likely to continue. Longer maturity rates will most likely rise over the course of 2014 and the equity markets will likely post some positive gains but with greater volatility. We see merit in adjusting fixed income portfolios now to mitigate the risk of rising long-date rates and to take advantage of what could be an extended positive credit environment. We also favor adjusting equity portfolios toward active managers, and in particular, managers who can invest both long and short.

FIGURE 3.

10-YEAR US TREASURY YIELD | January 1980–December 2013



Past performance is not indicative of future results. Source: Bloomberg

10-year Treasury note: 2% due 2/15/2023; 30-year Treasury bond: 3.125% due 2/15/2043. Source: Altegris, Bloomberg.

INDEX DEFINITIONS

An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

US Stocks. The S&P 500 is an Index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market value weighted index, each stock's weight is proportionate to its market value.

RISKS AND IMPORTANT CONSIDERATIONS

The views and opinions expressed are for informational purposes only. These views are based on economic conditions as of the date of writing and may change at any time as conditions warrant. Any forecasted results may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. The information provided does not take into account the specific objectives, financial situation, or particular needs of any specific person.

Past performance is not indicative of future results. There is no guarantee that any investment will achieve its objectives, generate profits or avoid losses. It is important to note that every asset class is subject to various risks that affect their performance in different market cycles. Equity securities are subject to market risk or loss due to adverse company news or general economic decline; bonds and fixed income securities are subject to credit risk, default risk, income risk, and interest rate risk; when interest rates rise, bond prices typically fall; foreign investments may be more volatile due to currency fluctuations, as well as adverse economic, social and political factors. Alternative investments that utilize complex strategies are also subject to market risk, liquidity risk, regulatory restrictions, and volatility due to speculative trading and use of leverage.

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