THE YEAR AHEAD

THE MID-YEAR UPDATE: AN EVENTFUL FIRST HALF.

What More to Expect in 2014 (And Beyond)

July 2014

This article was written prior to the print of second quarter US GDP, except for the first expectation.

What an eventful first six and a half months of a year. One could have written a new set of expectations for the rest of the year every month. The culmination of new highs on the S&P, a decline in interest rates and a maelstrom of geopolitical events calls for a more specific review and a new set of expectations for the remainder of the year and beyond. As we get closer to the end of Quantitative Easing (QE), it is worth taking a close look at what has changed and whether one's exposures to various asset classes should change accordingly.

We have transcribed the expectations text from the January "What to Expect in 2014..." *Perspective* and added a review of the comments as well as a fresh look at what one can likely expect from here. We close with some more specific suggestions on investments. The original comments from January are in italics, which may encourage some not to read them. That's not the objective, but if it makes it more difficult to see the expectations that may not come to pass, that's okay, too.

US SEES ANOTHER 4% QUARTER IN GDP GROWTH

The GDP grew by 4% in 3rd quarter of 2013, and it's likely that the 4th quarter registers similar gains, once final numbers get reported. This economic growth, plus a 1% drop in the unemployment rate, suggests that there is finally some recognition that the Federal Reserve's actions really did produce some stimulus. This could lead to self-sustaining growth in the US economy in 2014, with at least one more 4% quarter this year. Less noise from the politicians in Washington adds to business confidence and, ultimately, capital expenditures and, most likely, an extended credit cycle.

In spite of some nervous thoughts, even on my part, we did print a 4% second quarter and the second half of 2013 was revised up providing more consistency between what was happening on the labor front and

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the reported numbers. Inventory accumulation helped to hit the 4% number. The first quarter was also revised "up". The US is running ahead of most of the rest of the world in terms of its recovery from the Great Recession. Trade balances reflect that, with export growth down and import growth up, which in turn has a negative impact on reported GDP. This is in spite of these numbers being an indication of strength of the US economy relative to its trading partners. The first quarter was substantially worse than the preliminary estimates with the weather, but also trade balances and a strange fall in the Health Care Services estimate of that segment's contribution to GDP. This didn't totally compute with what we were seeing in the individual statistics, but the revisions to past numbers including the first quarter, plus the inventory building did produce a 4% number. While activity in the housing markets (or lack thereof) bears watching, it does look like we are on a path to higher employment and will most likely see a 1% drop in the unemployment rate for the full year—maybe more. We are at 5.2% for the 25+ group already. The unemployment is concentrated in the under 25s. The focus of the Fed on bringing down the unemployment rate and raising a demographically-challenged participation rate will likely cause a tightening of major segments of the labor market, wage increases and ultimately a higher inflation rate. We can't ignore the impact of the workers who are part-time for economic reasons, which could reduce the slope of wage increases. Ultimately though, rates will have to rise. Investors should be well into adjusting portfolios to deal with that. Betting on an extended credit cycle and lower duration make more sense than taking a chance on rates staying low.

FEDERAL RESERVE TAKES ACTION FASTER THAN EXPECTED

Economic growth and job creation become more apparent, with forecasts for a decline in the unemployment rate possibly approaching 6% before the end of the year. The Federal Reserve begins making noise about speeding up tapering and hints at reducing the time the federal funds rate would remain anchored at its current level. This is in spite of limited evidence, at least early in the year, that the inflation rate is still approaching the targeted 2% level. This ultimately has a dampening effect on the markets.

We just talked about the employment rate. While tapering appears to be on a very predictable path, we are hearing some noise from some Fed governors about the timing on an increase in the Fed Funds rate. We are certainly hearing from the pundits after the last employment reports. The inflation rate is creeping up. This is certainly beginning to cause some volatility (from a very low level) in the stock market. Unless there is an escalation geopolitically, odds are the stock market will ultimately follow earnings up, in spite of the noise about rates. However, I would rather make my bet on Alpha managers including those who can generate Alpha on both the long and short side in this environment.

TECHNOLOGY KEEPS INFLATION LOW, RISK OF DEFLATION LOOMS

We begin seeing some academic work showing that an acceleration of the technological revolution and pundits will credit this for keeping inflation low. The low inflation picture is reinforced at the headline level by energy supplies expanding within the US, from Iraq and, ultimately, Iran. As other countries embrace fracking, the potential for even more supply keeps downside pressure on energy prices.

I haven't seen any real academic work that has dealt with the potential causes of deflation since Daniel Alpert's book, *The Age of Oversupply,* written last year. The year isn't over. However, we are seeing some early signs of inflation as discussed above. As Moore's Law marches on, technology will ultimately have a major impact on prices and productivity as well as employment. In the near term, I believe we will see increased competition among all the names in the social media sphere as market share battles heat up. Technology is working its way into all other aspects of service and manufacturing businesses globally. We will begin seeing industry disruptors changing supply chains, introducing new business models and truly making use of Big Data. Sustainable business models may prove harder to achieve without the capital and the willingness to cannibalize an existing business. I am waiting for the first real analytical report that shows that those companies returning capital to their shareholders may be setting themselves up for their own long-term demise.

The energy picture has been somewhat muddled by the major intrusion of geopolitical events in the Middle East as well as Russia's expensive engagement with activities in Ukraine and elsewhere in the former SSRs. Russia will need to do what it can to keep energy prices up, including involvement in the Middle East or elsewhere. Witness the latest idea of creating a BRIC OPEC along with a BRIC IMF. This is truly a "Rise of the Rest." It is interesting that we haven't seen more of a spike in energy prices. The slowness of global economic growth is a factor, but the level of technological activity and drilling activity in the energy sector as well as continued non-carbon based activity is likely to keep energy prices lower than they might otherwise be. Still, this is a sector that offers interesting investment opportunities from the well to the wheel and beyond—whether MLPs, E&Ps, Integrateds and other peripheral participants. Again, active management will likely make a difference.

BAD WEATHER, DROUGHTS AND ASIAN ECONOMIC GROWTH CAUSE COMMODITIES PRICES TO RISE

The negative elements on inflation, which are not sufficient to cause major concerns, come via erratic supply in soft commodities from continuation of regional droughts, combined with weather abnormalities, which are increasingly blamed on climate change. As we get into the latter part of the year, the improving developed market economies, combined with growth in Asia, put some upward pressure on hard commodities. Investors must decide whether to invest in the extraction companies that have suffered from low prices, or directly into the commodities themselves.

Weather has had an impact on soft commodity prices and should continue to provide an occasional surprise. This does affect discretionary consumption and actually had an impact on trade balances as we did have an uptick in food-related imports in the first quarter. We will likely see a modest pickup in hard commodity demand in the emerging markets while geopolitical events will also affect prices. From the investment side, the volatility and some extended trends will likely make commodity trading, itself, a more interesting segment of the investing universe.

WEAK JAPANESE YEN SPARKS CURRENCY WAR

The positive change in US trade balances from lower imports of energy, combined with rising energy exports, adds more than a percentage point to US GDP and reinforces the case for a strong dollar relative to almost every other currency except possibly the Chinese yuan. Asia shows growing signs of a currency war fueled by the impact of further weakening of the Japanese yen, which has begun to seriously affect the export trade of its Asian competitors. While this tends to push up inflation rates in many of the Asian countries, the developed markets benefit from lower prices on many imported goods, further softening their inflation rates.

Well, we haven't seen the positive change in trade balances nor as significant a step up in energy exports. Trade balances have actually reduced GDP growth. We also haven't yet seen the significant weakening of the yen that was anticipated. A true currency war has not yet developed. And, it is hard to separate the decline in China's trade activity from actual policy decisions on currencies to say there is a trade war. In retrospect, it would appear best to leave currency pronouncements to the investment experts who spend their full time trying to determine relative movements among major and minor currencies. It has not been that easy for these folks during this period of global QE.

Our view is that, as QE in the US ends, the opportunity for anticipating currency moves will increase, with the dollar experiencing relative strength from growth, rates rising and a tenuous global geopolitical environment.

US CORPORATIONS BRING BUSINESS BACK HOME

The impact of the currency wars raises questions about the stability of some of the emerging markets, particularly in Asia. There are also concerns about the pace of wage increases in these once-attractive locations for outsourcing. Manufacturing and some service corporations begin making different strategic decisions on the best places to locate manufacturing and processing centers. The decisions are reinforced by a growing belief that technological advances will continue to allow capital to substitute for labor, or at least keep pressure on wages. More business activities find their way back into the developed countries of the world. China moves cautiously in the same direction, taking advantage of its own technological progress. It begins marketing itself as a technological leader as opposed to a low-cost labor market. This is not easy as China, at the same time, continues to push toward a more consumer-oriented society. Incomes have to rise and, politically, the population needs to be kept content. It will not be a smooth year for China.

We have seen new facilities being built in the US by US companies and non-US companies. The availability of cheaper energy and feedstock is a factor. Brand names are a factor. The rule of law, the continued turmoil geopolitically, the ability to substitute capital for labor, and cheaper energy make the US a competitive environment, which we expect to continue for some time. It is not a smooth transition for China. However, China has many tools at its disposal to deal with its issues. No doubt the noise will get louder, particularly around overbuilding and credit issues. While there is a slim possibility of an implosion, the major short-term effect will be the drag of China's slower growth on global growth. I think the biggest surprise would be how quickly China does get its economic act together which could influence activity in the whole Asian sphere. China also wants to control its own destiny geopolitically, and will continue to flex its muscles within the Asia and beyond.

INDIA FALTERS

Coming elections in India point to a possible loss of leadership for the Congress party. Combined with continued economic difficulties and some strife associated with the potential leadership change, the country moves further down the path of being even less attractive for foreign direct investment. It loses another year to the relative growth of its Asian neighbors, and finds itself participating in the currency wars as a possible way to salvage elements of growth.

The defeat for the Congress party was staggering with the BJP gaining a majority in Parliament and Narendra Modi as prime minister having more degrees of freedom than any leader in India in a long time. The actions of India's central banker, Raghuram Rajan, raising rates to fight inflation and stemming the fall in the Rupee, probably helped the BJP more than the Congress party and was in contrast to my expectation that India would join the currency wars. As it became apparent that there would be a change, foreign investors returned to the Indian stock and bond markets. India has been one of the best performing markets in the world year to date. As an economy, India continues to have major challenges, but the general expectation is that Modi will make a difference. This will take time and will not be a one-way positive ride. It will be interesting to watch India become a second engine of real growth in Asia, which will likely continue to offer interesting investment opportunities—not without volatility. Near term energy problems could escalate into internal unrest. We will be watching how Modi handles this issue and others that may arise, e.g., Pakistani/Indian relations.

SOUTH AMERICA HAS FEW BRIGHT SPOTS, ARGENTINA RESTRUCTURES DEBT

With the exception of Chile, Colombia, Mexico and Panama, the rest of Central and South America flounders. The US begins to pay more attention to its southern neighbors. Out of desperation, Argentina reaches a settlement on its outstanding debt and begins to focus on building its energy sector with help from outside sources. A return to policies of its former president, Carlos Menem, becomes a more likely political outcome.

Argentina would appear to be on a path toward restructuring its debt and looking to build its energy sector, although neither is a certainty, given court-driven deadlines for payments.

The US has made some efforts to change some of its relationships with neighbors to the south. Relative to other geopolitical turmoil this will be a slow process. I am of the view that for non-US market exposure outside of Asia one can find interesting opportunities in the Americas, ranging from Canada to Tierra del Fuego.

US ENERGY BOOM AFFECTS GEOPOLITICS IN MIDDLE EAST

The changing energy picture outside the Middle East, combined with likely increased production out of Iraq and, ultimately, Iran, result in a change in the relative importance of Saudi Arabia and, to some extent, Israel. This could produce some progress in the Palestinian situation, and in the relationships between Saudi Arabia and the rest of the Middle East, and possibly Asia, as the US becomes an even smaller market for its oil and an export competitor. On the other hand, it raises the risk of further turmoil in the region as the power picture changes, and attempts are made to preserve the old order in a possibly military fashion.

The only statement above that is operative thus far is the last sentence. It is surprising that the turmoil in the Middle East and Russia's activities have not caused a more significant rise in oil prices to date. Supply and demand appear to be overruling geopolitics. That could shift. The energy picture is changing, and the turmoil simply reinforces the need for energy independence, which can come from new sources of supply through new technology, i.e., fracking and non-hydrocarbon-based developments. This is not a one-year change. It does reinforce, in our view, that the energy sector remains an important part of any investment portfolio. As said earlier, opportunities exist across the investment spectrum from well to wheel. This should not be pursued through passive investment vehicles, but through active managers with real expertise in the energy sector.

SO CAN WE TRANSLATE WHAT THIS ALL MEANS FOR THE MARKETS?

Some of you may notice that this is the same title for the latter part of this *Perspectives* as that written in January. That is intentional. Much of what was written at the beginning of the year regarding translating some observations into investment action remains valid. I would urge a re-reading of the sections that follow that heading.

We are no longer in markets where simply letting Beta work will produce decent risk-adjusted returns. While volatility over the last six months has remained low, as one can see, exogenous shocks to the system can lead to a change in the characteristics of the markets, which may have a more lasting impact. With QE ending and dispersion among performance widening, exogenous incidents such as those we have experienced most recently can accelerate a return to a more "normal" investment environment.

In the short term, the flight to safety and concerns about growth have pushed treasury yields to new lows. We are not in the camp that interest rates will remain low forever as we have discussed above. These declines in yields provide investors with an opportunity to adjust portfolios within the fixed income space to prepare for rates ultimately rising. We discussed this in an earlier *Perspectives* piece written in April and recently updated. The full piece provides some interesting history on the fixed income markets. I hate to sound like a broken record, but it is worth repeating some of the steps that can be taken to potentially offset, and even take advantage of, a rising rate environment.

The most obvious is to move a portion of a fixed income portfolio into cash and wait for rates to adjust. The problem with that option is the difficulty in timing the market and getting zero return while one waits. However, if one can do without the income, and will be prepared to reenter the markets at a later time, this is an option. It is an extreme option, in our view, given the alternatives that exist today. A better option would be to reallocate to investment managers with income-oriented portfolios that don't correlate to conventional fixed income indices but provide a yield and maybe some principal return. We have seen institutional investors making these shifts more so than individual investors.

The strategies include investing in income-producing assets such as Master Limited Partnerships (MLPs) or Real Estate Investment Trusts (REITs) that are offering decent yields now and also mitigate the risks of inflation, as cash flows could increase with an improving economy, resulting in higher distributions. But using MLPs and REITs as hedges against rising rates requires skill and understanding of each vehicle. Not every one of these vehicles will behave the same in a rising rate or an inflationary environment. I would look carefully at how a specific manager is addressing either of these two asset classes and what their views are on the impact of rising rates.

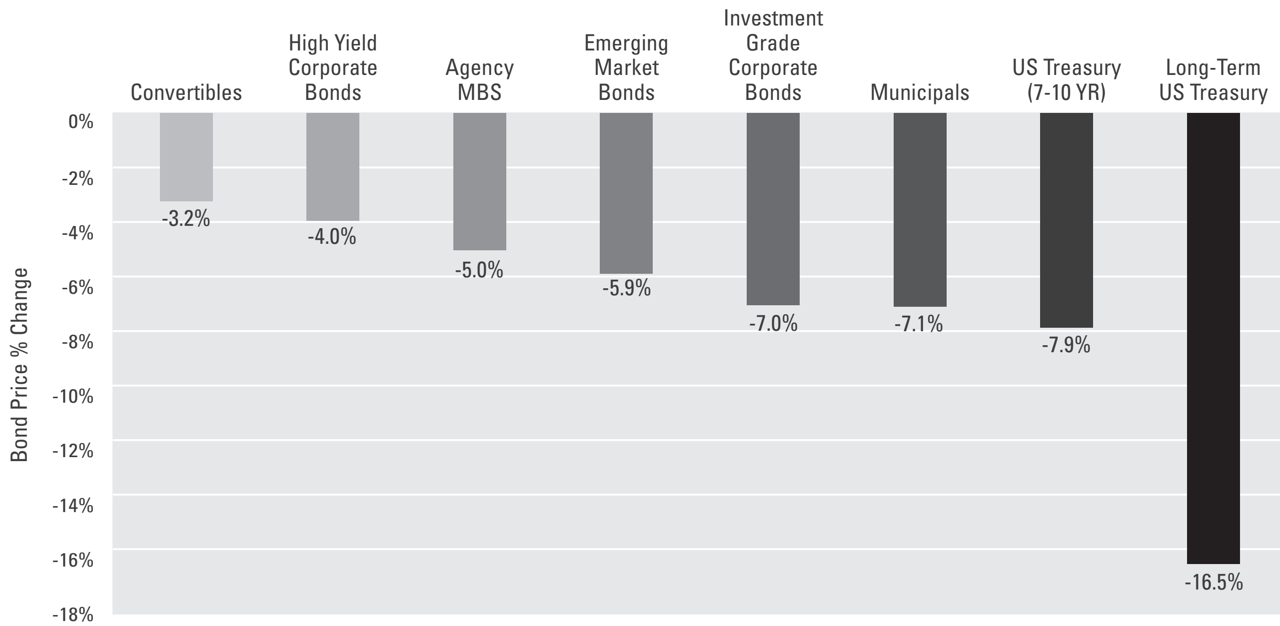
For those who can forego immediate liquidity, there are non-conventional lending portfolios, which contain a substantial amount of higher yielding, floating rate securities that will typically benefit from rising rates. (I discussed this in a CIO Perspective on the Illiquidity Premium, which describes the appeal of investing in higher-yielding, private portfolios, recognizing that liquidity is an issue.)

There are also liquid fixed income long/short funds with hedged positions that seek to provide downside protection if rates rise. There are now several managers who have been running hedged fixed income portfolios for some time—to produce yield in the current environment with risk characteristics that provide a dampening of what could happen to a portfolio when rates move. Each of these portfolios, whether involving one manager or several, has its own risk and return characteristics and differs from conventional bond portfolios. But like conventional bond portfolios, they do provide daily pricing and liquidity.

Historically, in a rising rate environment, different yield vehicles carry different degrees of risk. The table below provides a comparison of risk relative to a one percent increase in rates. Our suggestion is at this stage in the fixed income markets one should be moving holdings to the left, lowering duration.

1% RISE IN INTEREST RATES COULD MATERIALLY IMPACT BOND PRICES

Bond Price % Change after 1% Interest Rate Increase | As of June 30, 2014



Past performance is not indicative of future results. This analysis is based on the impact of bond duration. The potential for higher yield comes with greater risk. Fixed income securities are subject to various risks including, but not limited to, market risk as well as credit risk, which is heightened for high yield and emerging market bonds. When interest rates rise, bond prices typically fall and the sensitivity to interest rates is directly correlated to duration. It is important to note that Treasury Bonds are backed by the full faith and credit of the U.S. Government as to the timely payment of principal and interest, and municipal securities offer a tax benefit.

The following are used as benchmarks to represent each asset class: Convertibles: Barclays U.S. Convertibles Composite Index; Investment Grade Corporate Bonds: Barclays US Corporate Index; High Yield Corporate Bonds: Barclays US High Yield Index; Treasury (7-10 YR): Barclays US Treasuries Index, 7-10 Yr.; Emerging Market Bonds: Barclays EM USD Aggregate Index; Agency MBS: Barclays US MBS, Coupon Stock; Municipals: Barclays Municipal Bond Index; Long US Treasuries: Barclays US Treasuries Index, Long. Benchmarks used for general market comparisons and do not represent the performance of any fund. Source: Barclays.

The US equity market is not cheap, but stocks should at least follow earnings. And the flow of funds from outside the US, as much tied to the view of a strong dollar, will reinforce an upward bias to the markets. As indicated above, we do expect to see greater dispersion in sector and individual stock performance. This is a time for active managers, both long only and long/short managers to do well. We would refer readers to some recent blog posts, "It's a Country Picker's Market," "The Story of the Market," and "Something's Got to Give" for more thoughts.

As we return to a more "normal" market with its inherent risks, alternative investments with lower correlation to the traditional markets may have a place in the portfolio. The end of QE may remove an element that clearly has affected volatility, and, some would say, artificially propelled the performance in equities and fixed income.

I have suggested above that, in the coming environment, active managers, including managers of long/short equity and fixed income—generators of Alpha—will do well, particularly on a risk-adjusted basis. This is a move away from Beta. We have seen some interesting investment decisions by some of our clients to re-introduce managed futures and global macro managers to their portfolio mix. It would appear that this is primarily a defensive measure against a major turn in the markets, but also with a sense that these strategies can perform well in a more "normal" environment, particularly if volatility picks up. We will be publishing a paper on the topic of managed futures and global macro investing, "Three Reasons for Managed Futures and Macro...Now" that is worth reading.

FINAL THOUGHTS

It is always interesting to go through the exercise of comparing one's expectations at a point in time to what has actually occurred and resetting those views. There is an inherent bias in these views at any point in time, influenced by most recent events. Much as we all try to overcome this bias, it does exist. It often makes it difficult to adjust one's portfolio while certain strategies continue to work. Does one really want to move away from the Beta play in the equity markets? As interest rates have declined, the chorus grows that they will stay lower longer. And, why would one consider these uncorrelated managed futures and macro strategies that have really not made a contribution to performance until very recently? So, what does one do differently now and why?

The why on the equity side has to do with the strong belief that, with the end of QE and the requirement and likelihood of the economy standing on its own, we will see more dispersion in results among companies. We are also approaching an important mid-term election, which could introduce some additional unintended consequences into the course of governance. Finally, the geopolitical picture has added some further elements of uncertainty into an already muddied picture. While our general view is modestly positive on the equity front, we would want to see a shift to more active managers, which would include long/short managers and event-driven managers. This would involve a review of current equity holdings to move away from benchmark-hugging strategies with an element of risk-mitigation. We would not necessarily reduce exposure to the equity markets, but would look to reduce risk or find managers who have demonstrated an ability to generate alpha.

In fixed income, we are concerned that rates will rise exposing some fixed income strategies to principal risk. We are less concerned about credit risk—yet. Investors should look for strategies with lower duration and lower correlation to interest rate movements. This could include some equity strategies such as MLPs or REITs as well.

While we are seeing some current holders of managed futures and global macro strategies reducing their exposure as they approach break even, those who are taking a first or fresh look at these strategies are beginning to include them in a diversified portfolio. As QE ends and economies around the world proceed at different paces, uncorrelated strategies could hold their own with the overall market and provide positive return in case of an event reinforcing some weakness in the internals of the markets.

In the January *Perspectives* on What to Expect, I included some longer term expectations, which, of course, remain valid since the longer term hasn't come yet. I would urge you to read those. As I stated in that piece, the general march of human progress is positive. We are coming to the end of the experiment that may have gotten us through these past five years in better shape than we might have been. It certainly has been a great period for the traditional equity and fixed income strategies in the US. This may be "The End of the Beginning or the Beginning of the End" (worth a read). Whichever it is, the portfolio adjustments we are suggesting, which involve taking some risk off the table, would seem appropriate.

RISKS AND IMPORTANT CONSIDERATIONS

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