THE YEAR AHEAD

WHAT TO EXPECT IN 2014 (AND BEYOND)

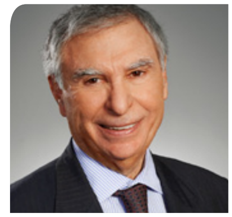
January 2014

Each year, I take Alfred Lord Tennyson's advice and "ring out the old, ring in the new" by creating a list of expectations about the markets. My list involves events that the average investor thinks have only a one-in-three-chance of happening, but which I believe have more than a 50% chance of occurring. If this approach sounds familiar, it should. It's modeled after Byron Wien's annual list of "surprises." Like his, my expectations are designed to provoke thought and discussion.

As I created my list, I made certain assumptions—that the economy would continue to improve, and depending on its robustness, that the Federal Reserve could be prompted to taper more quickly. I also think the energy sector will play an increasing role, and that Middle East economies, inflation, GDP growth, and geopolitical events will have supporting ones. Some of my expectations relate directly to the securities markets, and one is just a little piece of whimsy. Hopefully, you can figure out which one that is.

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.



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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.

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.

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.

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.

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.

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.

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.

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.

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.

NEWSPAPERS MAKE A COMEBACK?!

The fading newspaper industry surprises Wall Street with its earnings in the early part of the year, and benefits from contentious congressional races in the third and fourth quarters as well. The advertising related to Academy Award nominations and subsequent awards reaches new heights in print and social media. Studios advertise some small (but not cheap) movies to extremes to compete with some very high quality films and performances. We actually walked out of a couple of the most highly advertised ones. Aren't two-page spreads a little extreme? Unfortunately, the correlation between the advertising and the nominations and awards becomes very direct, leaving it up to the audiences to hopefully make their own decisions after the fact. The quality and audience continue to rise for television productions and the associated delivery mechanisms for these performances, leaving 3-D sequels and prequels to the movie industry. Can't wait for "Inside Llewyn Davis Today—in IMAX."

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

Maybe. History says the type of equity market we had in the US in 2013 is usually followed by a decent year. I don't think it is that simple.

We could see some re-allocation away from US equities by institutions whose US equity portfolios have been pushed above their target percentages. At the same time, if we are beginning to return to a more normal relationship between earnings yields and fixed income yields, traditional liquid debt doesn't look that attractive. It may mean that markets outside the US are more attractive—possibly Europe and some of the emerging markets, if the currency is hedged out. There are risk elements in the geopolitical situation. I think we will have to look harder for returns this year, and the risks are high enough that it makes sense to look for some less correlated investments. I wouldn't automatically reduce my equity exposure, but I might change the mix to reduce the risk. Last year was one in which US stocks were highly correlated with each other and active, long-only management, with some exceptions, did not necessarily add to performance nor reduce risk. It was a year of just letting Beta work.

An investor needs to look at whether the strong performance of the US equity markets has produced some imbalances in asset allocation relative to long term goals. It is not easy to allocate away from the best performing asset classes, but that is exactly what I would recommend. Within US allocations, there are ways to capture returns and, at the same time, take some risk off the table. I would be looking for active managers, who are deviating significantly in their holdings from the indices against which they are measured, and who can take advantage of the homogenization of values caused by the rising tide of the US equity markets. In addition, I would be looking at managers who can operate on both the long and short side of the markets. In retrospect, taking less risk last year by finding managers who were, by mandate, less correlated with the broad markets resulted in absolute returns that significantly lagged. As markets begin to adjust to a more "normal" environment, with less of a prop from central bank stimulus—and, ultimately, a tightening, the other side of this grand experiment—we may find ourselves in a more volatile period for the equity portion of corporate balance sheets. I would want to make sure my equity assets are with managers who focus more specifically on individual company fundamentals and, preferably, have the ability to play both sides of the market. On a risk-adjusted basis many of these types of managers did well last year, but risk turned out not to be an important consideration. Let's take what we were given last year, lock in some of the gains, and normalize the risk in our portfolios.

I have some other longer-term expectations, including a carryover from past years, which one of these days will actually come to pass. These have little to do with the markets over a one-year time frame, although these considerations will work their way into elements of performance in a slow, steady fashion. I include these as food for thought. As has been the case in each year since the millennium, 2014 will likely be more interesting than we anticipated.

CHINA

Contrary to normally quiet years during a transition of leadership, to some extent in reaction to elements of an "Asian Spring" in the region, China takes further steps in response to a more activist populace upset with corruption, the environment, and some areas of economic stress. Externally, this includes significant foreign acquisitions, as well as the opening of manufacturing and service facilities where there is a receptive government. At home, R&D is accelerated, particularly in alternative energy, space and IT processing. Subsidies for hydrocarbons are reduced and an explicit carbon tax is put in place.

EMPLOYMENT AND EDUCATION

As the US economy grows, corporations find it difficult to hire qualified people. Enlightened corporations become educational institutions, teaching skills and fundamentals to a work force that has been idle and undereducated by public schools. Corporations become much more vocal about creating paths to bring more immigrants into the US system, expanding visa programs and finding other mechanisms to add talented labor to the domestic pool. The tide shifts significantly on immigration issues. The skill match is aggravated by decisions on the part of some US corporations to bring business operations back home. Labor costs are rising elsewhere, and the elements of control, rule of law, productivity, available feedstock and relative safety lead to better economics for manufacturing and service operations.

TECHNOLOGY

Moore's Law, driven primarily by Intel driving down the nanometer scale and introducing other innovations, continues to march on. The use of Big Data becomes ubiquitous. This produces technological advances that enhance the opportunities in health care, manufacturing, extractive industries, media and services beyond even the imagination of some of the best speculative fiction writers. On balance, these advances are positive, but continue to raise concerns about the environment and quality of life, and opportunity for those at the lower end of the economic and educational spectrum.

HEALTHCARE

Breakthroughs in stem cell research, particularly led by work coming out of the New York Stem Cell Foundation, change the nature of disease management and eradication, and move general therapeutic advances away from animal models to direct testing on human cells. Targeted therapeutics driven by DNA analyses tied to narrower classes of patient recipients change the nature of drug and health delivery. It becomes apparent that the US FDA model is slowing the pace of US therapeutics development by the cost and time required to bring solutions to market. Much as financial services regulation was geared to the benefit of larger entities, it becomes clear that therapeutics development has been on the same path. Change occurs in response to other countries moving more rapidly to bring solutions to market.

HUMAN PROGRESS

Away from continual ups and downs in financial assets as the world works its way through the hangover from the 2008-2012 financial crises, the general march of human progress is positive. I hope to be around to observe it. Maybe the breakthroughs suggested in the previous expectation will help that.

ABOUT ALTEGRIS

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