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NORMALIZATION HAS BEGUN
INVESTMENT STRATEGY
SEPTEMBER 30TH, 2013

SUMMARY

Outlook for Growth, Inflation, & Interest Rates:

During the past several years the US has experienced subpar economic growth, i.e. less than 3% annually, and has also had exceptionally low inflation and therefore, the lowest interest rates in postwar history. During 2014, we would expect to see at last, normalized growth, continued favorable inflation, and interest rates that begin to look normal, i.e. 3% growth or more, 2% inflation, ten year US Treasury yields at 3%-4%, and mortgage rates at 4.5%-5.5%.

Stable growth in China and improving growth in Europe should help US exports while housing, auto sales, and state spending should all contribute to growth here. The drag on economic growth from higher taxes and the sequester will ease permitting reported growth to rise to 3% or more.

As growth strengthens more convincingly, we would expect the market place to sell bonds, particularly US Treasuries, in anticipation of the Federal Reserve's normalization of interest rates. But, while the financial markets may decline, we don't expect much change in housing demand except for a brief period. Rising rates may hurt prices but not overall demand? House-hold formation is occurring at about 1.5 million households per year while new housing starts are growing at the rate of less than 1 million. Tight bank lending standards have caused much of this gap, but they are clearly easing, and thus we would expect continued growth in housing which has been a mainstay of this recovery.

Financial Markets Reaction to Normalization:

We have already seen the financial markets reaction to the planned ending of the Quantitative Easing III program. And while the Federal Reserve has pledged not to raise short term rates until 2015, the market place will do so sooner! Thus, we may see a 10% correction in the S&P 500, and are maintaining 15%-25% cash levels to take advantage of it. Foreign stock markets, highly correlated with the US market, will also have difficulties but Europe may have somewhat less as the European Central Bank's current policies may insulate them from Fed policy.

Other Risks and Opportunities:

The ideologically divided Congress will raise the debt ceiling in the end, but not without some grandstanding. Since the government has enough money to run itself until mid-October, we would not expect a resolution until that time. In the meantime, Congress may shut the govern- ment down until the last minute. We would not be surprised to see Obama care or part of it postponed for six months since even the Federal government isn't ready?

In the meantime, there are positive opportunities in Iran with its new, very intelligent leadership, and Syria seems to be following a tight time frame for removing its chemical weapons reducing uncertainty there. India, Brazil, and China would now seem to offer good opportunities.

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Growth in the US has been hampered in 2013, by tax increases as well as the sequester: the former held growth back by 1% and the latter by 0.5%. Next year, we won't have the drag of the former, but will have a slightly greater drag from the sequester. The net result, however, will be an overall reduction in drag. Growth will continue to be supported by new jobs, housing, and automobile sales. Some of the job growth will come from state and local government hiring, and we may finally see further expansion of spending on infrastructure by the states as their incomes improve. We can also expect better exports as growth in Europe and China slowly improves.

As the second largest economy in the world, China's growth rate, with government approval, has declined from its breakneck pace of 10%+ to 7%+, as it becomes more difficult to grow by so much, and as the government restrains economic activity to avoid inflation. But one can see the government steadily making changes to upgrade its infrastructure, both physical and financial, to bring the economy into the modern world. For the foreseeable future, we would expect China's growth rate to remain a moderate 7%-8% annually.

To our surprise, Europe too has finally shown signs of life, and would appear to be coming out of its recession. Nonetheless, Italy has yet to deal with its labor problems that make it uncompeti-tive, and Spain's banks still have much more to reserve for their real estate loans. It is not so much the sovereign debt of Spain that is problematic, but rather the indebtedness of some of its fifty provinces, and the need ultimately to recapitalize its banking system. Greece will probably require another "in Zone" voluntary debt restructuring. When the next recession arrives, it may be that both Spain and Italy will require in-zone restructuring. These are shoes yet to drop!

The gradual normalization of global growth will bring a market (as opposed to Fed) driven rise in interest rates. In postponing the start of "tapering" (remember the Fed has been purchasing US Government and mortgage backed securities to the tune of more than $1 trillion annually), the Fed has simply postponed the inevitable. We expect "the taper" to start before year end, perhaps as soon as October, if only because the market place has accepted the need to do so, and because the Fed will be purchasing close to 100% of the government's newly issued securities. This is not necessarily a good thing.

But as we see evidence of stronger growth, we would expect further market driven rises in longer term interest rates even if inflation doesn't immediately pick up. Mortgage rates will rise as well – depending on the amount of Fed purchases – and with investors fearful of a turn down in the housing market, housing stocks may suffer.

But while the market may decline, we don't expect much change in housing demand, except possibly for a very brief period. While the recent increase in interest rates (long treasury bonds) by 1% (a 60% plus increase) did cause a sharp decrease in refinancing, the housing market continued to grow. We believe household formation is occurring at the rate of 1.5 million house-holds per year, but new housing starts are increasing at the rate of less than 1 million per year. To some degree the differential is being caused by bankers who have such tight lending standards that relatively few have been able to get mortgages. Those conditions are beginning to ease and should continue in the coming year. The rise in interest rates will have the impact of slowing the increase in housing prices, but not necessarily the availability of loans. On the contrary, mort-gage lending will become somewhat more attractive to lenders as interest rates rise.

Since most corporations have refinanced their balance sheets at this point a rise in interest rates will have relatively little impact on their operational costs.

Financial Markets React to Normalization:

The market place seems very fearful of not only the ending of Quantitative Easing III, but also the increase in interest rates arising from the normalization of interest rates. We attribute most of the 20% increase in the S&P 500 to the Central Bank's supply of funds to the market that have not gone into the economy! Short term rates are close to zero percent. Normalization means raising them to at least 2% (i.e. equal to the rate of inflation), and they have averaged a full percentage point above inflation in the post war period! We would suggest that normalization should not result in an extended decline in the stock market, but because many will equate the normalization with the increase in interest rates that the Federal Reserve does when it fears rising inflation, we **may well see a 10% correction**.

Foreign stock markets are highly correlated with the US market, and the recent rise in interest rates here resulted in a temporary "risk off" trade, i.e. investors sold emerging markets, such as China and India. Rising rates are thus a threat to foreign market stock prices too.

Furthermore, since the US government bond market represents more than 50% of the global sovereign bond market, a rise in rates here usually translates to higher interest rates abroad. Because of the policies of the European Central Bank, the connection between interest rates in the US and those of Europe may be somewhat attenuated, and therefore, rate increases here may have less effect on the bond markets of Spain and Italy than would otherwise be the case. Other-wise, we could have another round of Euro-zone financial crises as a result of events in the US!

Other Risks & Opportunities:

We suspect we are seeing the beginnings of a rapprochement between Iran and the West. Iran has the population, natural resources, many places of historic interest, and industries that could lead the leadership to view economic development and supremacy as the key to leadership in the region as well as the key balance in the scale of power between Shiites (Iran, Iraq, Syria, etc.) versus the Sunni's (Saudi Arabia et alia). In the short term, this bodes well for a nuclear agreement that frees Iran from its current economic isolation. It won't happen overnight, but there is evidence for support in Iran of such ideas.

The US Congress, ideologically divided, will raise the debt ceiling and produce a continuing budget resolution, but not without some grandstanding along the way that may even shut down the government for a few days – leading to temporary indigestion in financial markets. A continuing resolution (short term budget agreement) probably isn't critical until about mid-October. We would not be surprised to see some postponement of "Obama Care" simply because the government isn't ready to implement its provisions on October 1st.

Having done that, however, we are not at all certain Congress will come to grips with the long term structure and amount of US debt, leaving the US very vulnerable to the next recession.

The Syrian Civil War will continue probably without an airstrike from the US. The Organization for the Prohibition of Chemical Weapons (OPCW) along with the UN will supervise the removal and destruction of chemical arms. If an airstrike does occur, oil stocks rise while the broader stock markets decline. Syria is subject to a tight time frame, and seems to be following it.

Market Valuations:

Earnings for the S&P 500 were expected to be about $112 at the beginning of the year, are now at $107 and change, and as we have said since the end of last year, we think they will end up around $105-$106. Ordinarily, this could mean that we have seen the highs in the S&P for the year already. However, since investors are anticipating $122 next year for the Index (we expect ca. $114), we could see a repeat of this year, as earnings expectations decline next year throughout the course of the year. At 1680, the S&P 500 is 13.8 to 14.7 times next year's earnings. At 15 times the market is fairly valued.

We also note that several emerging markets, India, Brazil and China are at or close to their lows especially when currency and market levels are considered in the first two. These countries are in the midst of recessions or major slowdowns, and thus represent relatively good entry points for at least some representation in portfolios.

What to Do:

Maintain Cash: Cash levels of 15%-25% to provide dry powder as the economy normalizes next year is desirable.

Add to Emerging Market Positions Gingerly: Substantial gains are possible in many emerging markets as the global economy strengthens, notwithstanding their greater volatility.

Take Initial Positions in some of the world's most dynamic industries, e.g. 3D Printing.

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