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FINALLY!
INVESTMENT STRATEGY
DECEMBER 31ST, 2013

Improving Global and Domestic Growth Outlook:

Our basic view that the world is in global recovery mode has not changed since last September. Most forecasters are now expecting global growth to accelerate to 3.5% in 2014 from slightly below 3% this year. Furthermore, we are encouraged to see that the Global Purchasing Managers Index, one of our favorite global coincident indicators which covers 89% of the global manufacturing sector, recently reached a 31 month high.

The stock market's rise through December 31st, reflects expectations of a normal 3% real economic growth in the United States for the coming year, a forecast with which we would agree. Domestic growth, via exports, should benefit from the strong global growth but also from the easing fiscal drag. We expect the total fiscal drag to decline from around 1.5% of GDP this year to around 0.3% in 2014. Another domestic tailwind going forward is the wealth effect from household's real estate assets. Based on the Federal Reserve's quarterly household balance sheet update, we expect the positive impact to be around 0.6% to 1.2% of GDP next year which is roughly twice of what it was this year. In such an environment, cyclical and commodity stocks such as those we have in our portfolios tend to do well as demand finally begins to soak up excess capacity. It would also suggest a higher risk tolerance for investors, suggesting that money flows may be away from the US rather than towards it as it was this year. With a solid US market, peripheral markets can flourish.

We expect continuing improvement in US employment rising from an average rate of about 182,000 new jobs per month this year to something on the order of 225,000-250,000 jobs per month next year – which in turn will bring the unemployment rate down to close to 6%. Housing too should continue its recovery as banks increase their mortgage lending which is becoming more profitable as the yield curve rises (i.e. interest rates increase). Further, the National Association of Homebuilders Builders Market Index which looks at, for example, traffic of prospective buyers is indicating strong housing starts for next six months.

Growth in the Eurozone may improve by 1% in 2014 to around 1%, and we expect Chinese growth to stay at around 7.5% for the third consecutive year and Japanese growth to slow slightly to around 1.6% from close to 2% in 2013 due to the sales tax hike from 5% to 8% that takes effect on April 1, 2014. Anticipating higher purchase costs, Japanese consumers have accelerated their spending and the future loss of these purchases may not be fully cushioned by the additional $53 billion of stimulus spending.

Main Concerns and Risks:

Our concern remains that the market place, upon receiving confirmation of its growth expectations, may become overly concerned about rising interest rates. It is the potential for rising inflation as demand increases that could drive interest rates upward through market forces earlier than any action by the Federal Reserve.

Therefore we agree with those, such as Goldman Sachs who perceive a 2:1 chance of a 10% correction during the year. Such a correction would wipe out one third of the S&P 500 Index's gain this year. The Federal Reserve has indicated that it does not expect to start raising short term interest rates until mid-year 2015. If this event is anticipated 6-9 months earlier by the market place – such a correction should occur between September and year end. However, if we are working from the 2nd derivative so to speak, where the market anticipates the market's "anticipation," we could see such a correction any time this year. Moreover, we believe the Fed will continue to reduce its long term asset purchases by $10 billion per FOMC meeting and thus end the quantitative easing program by the fourth quarter of 2014.

We expect the FOMC to be more hawkish going forward. Of the 12-voting members, about half will be replaced in early 2014. As usual, four regional Reserve Bank Presidents will be replaced with Presidents from other regions. This time the incoming Presidents are in total more hawkish than the outgoing. Furthermore, there is currently a vacant Board of Governor seat and another opens when Yellen takes over for Bernanke on February 1, 2014. Both of the departing Governors are dovish and President Obama will nominate their replacements. We expect him to continue to make balanced nominations to raise the probability that they are confirmed by the Senate, which thereby further raises the hawkishness of the FOMC.

We continue to be concerned over the longer term about government debt levels in the US which now exceed 100% of GDP. The recent agreement in Congress over the budget does remove some of the fiscal drag from the sequestration (the FY 2014 sequester was cut in half or by $45 billion and the FY 2015 was cut by one quarter or by $18 billion) – which improves the economic growth outlook for next year. However, the debt to GDP ratio may only decline marginally over the next couple of years - raising a nasty specter for the US when interest rates rise here, because we have more debt upon which to pay increasing amounts of interest.

Finally, we continue to be concerned about Europe and the Middle East. As the European economy improves and fears of a Euro zone breakup subside, we expect European politicians to drag their feet when it comes to European wide banking reform. A few important steps still have to be taken in developing a banking union. First, the ECB is scheduled to take over as a single supervisor overseeing 85% of Eurozone bank assets in November 2014. In the lead up, the ECB has begun to review the quality of the assets held by 128 banks in 18 countries, probably culminating in a stress test in 2014. (These stress tests tend to be performed once the banks can deliver acceptable results to avoid adding fears to the system which would undo other measures that the ECB or other institutions have already undertaken.) European decision makers are also working on a Single Resolution Mechanism and a Single Resolution Fund that will have the power to decide when to close a bank and who pays for shutting down the bank, respectively. Tentatively, the states have agreed to decide by March on the Resolution Fund – the most difficult issue – and to complete legislation by May which will become fully effective January 1st, 2015. We question whether this will be done in a timely fashion with potentially adverse consequences to the European and global financial markets.

While we are hopeful for resolution of the difficulties with Iran, one cannot be certain of the outcome, and in addition we are beginning to have concerns about the potential conflicts between the Shiite crescent (Iran, Iraq, Syria and some of Lebanon) versus the Sunni populations of Kuwait, Saudi Arabia, and the United Arab Emirates.

What to Do:

Given our reservations about the complacency of investors, we continue to maintain 25% cash (money market) positions or larger to provide dry powder in the event of a serious (10%) correction. In accounts where risk tolerances are less, we have larger cash positions.

Furthermore, given the expected increases in global demand, we continue to hold many of our cyclical commodity plays such as aluminum, steel, oil, and cement. These should do better in a stronger growth environment even if they may have greater volatility in a correction.

We are looking to expand our foreign exposures as US investors look abroad for higher earnings growth that is not reflected yet in higher prices in some of the emerging markets. Interestingly, while the US market rose more than 30% and most European markets rose more than 20%, all the BRIC's posted negative returns in US dollar terms for the year with Brazil faring worst with a 30% decline.

We will continue our acquisition of shares in China as the country continues through the reforms necessary to make its financial markets (securities, currency, and futures) more flexible and able to adjust automatically through market forces rather than by government fiat. Brazil too, in recession now, looks more attractive than it has in a while despite its inflation rate. Finally, we also think Japan, temporarily overvalued for the moment, is attractive longer term especially if one has hedged the currency.

Thus, for most of our portfolios it is "steady as she goes!"

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