VIRGINIA GLOBAL Asset Management, LLC

409 Yarmouth Street, Norfolk, VA 23510
P 757.962.7976 www.virginiaglobal.com

MUDDLING THROUGH
INVESTMENT STRATEGY
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Once again the US leads the global economic recovery, growing at 4.6% in real terms during the past quarter and probably 3% for the rest of the year for total growth in 2014 of only 2%+ given the negative first quarter. Historically 3% is only an average rate of growth and in that sense it is unspectacular today. However:

European real growth will do well to do more than 1% this year, as Europe's various economies struggle to recover from recession. Debt levels are burdensome both in amount and in that there is little inflation to eat away at the real cost of this debt. Japan, too, is likely to grow about 1% going forward, despite efforts by the government to increase its growth rate.

We see Chinese growth as only a little bit better than Europe's. Real GDP growth in China looks like 7.5% but when one considers the growth rate needed simply to handle the new entrants to the work force, Chinese real growth is more like the equivalent of 1.5% in the US or Europe. But it is nowhere close to the 10%-14% annual growth rates that we witnessed in the second half of the prior economic cycle.

Finally, we note that much of Latin America is in recession – both Brazil and Argentina are in serious difficulty with high inflation, interest rates, and slow growth. Yesterday, Brazil's central bank slashed its economic growth forecast for 2014 from 1.6% to 0.7% setting up an environment for Marina Silva, who still is lagging in the polls, to upset Dilma Rousseff in next month's Presidential election. We are impressed with Ms. Silva's capabilities.

In short, the US is doing well to be growing at 3%, particularly given the global headwinds facing it! That relatively superior position is reflected in its stock market which remains close to its all-time high. Furthermore, we mentioned in our last Investment Strategy (June 30, 2014) that the divergence in monetary policy between the Fed on the one side and the ECB and Bank of Japan on the other side will put downward pressure on the Euro and Yen relative to the dollar. Over the quarter both the Euro and the Yen depreciated by about 8% versus the dollar. Going forward we expect the divergence to continue and the dollar to strengthen a bit more but we are not yet concerned about any significant economic or earnings implications. It is important to understand that even though US Dollar Index, which is often presented in media, has risen by almost 8% over the quarter it is only made up of six developed countries currencies, with the Euro and Yen accounting for 71% of the Index. Instead, the Broad Trade Weighted Dollar Index, which we prefer to follow, has appreciated by less than 4%. It consists of 26 currencies and is reset every year to reflect US actual trade weights with other countries (its total weight of the Euro and Yen is 23.8%).

We think the US economy has normalized: employment is growing steadily and we expect the unemployment rate to reach below 6% by year end. Consumer spending appears to be growing about 2%-3% and inflation remains modest at 1.5%. For the near term the trade deficit should improve as oil imports decline and business re-shores to the US the production units it had put off shore. The end of the Federal Reserve's quantitative easing in this October is another indication that the Fed believes the economy has normalized. Given the headwinds it faces, however, we rather expect the US to continue growing at only 2.5%-3% - which is a down shift from our prior expectations.

Market sentiment clearly suggests expectations that the Federal Reserve will only raise rates very gradually. The futures market for Fed Funds suggests that the Fed's first rate increase will come in June of 2015, and rates will be 0.77% by the end of 2015, and 1.84% by end of 2016 versus the average Federal Open Market Committee (FOMC) estimate of 1.22% and 2.68% by the end of 2015 and 2016, respectively. We believe the market is more dovish than the Fed since it realizes that the Fed throughout this recovery has overestimated growth and because the two main hawks on the committee, Fisher and Plosser, won't be voting members next year. Therefore, since the market is already pricing in the Fed to be more dovish than what it is currently outlining, we don't expect any Fed induced P/E expansion over the next year or so. A P/E expansion would instead have to come from a brighter geo-political outlook.

That is not our base case scenario. Instead, Putin seems set on exerting control over Ukraine and holding it within the Russian orbit of primary influence, and at a minimum maintaining a frozen conflict with Russian influence remaining over eastern Ukraine. He already managed to delay the implementation of the trade treaty between the European Union and the Ukraine until 2016. We expect Putin's threats to be increased as winter arrives, and the threat of higher prices for the gas Russia supplies to Europe causes Europe to waffle at increasing sanctions. Both the higher fuel prices and additional sanctions could tip Europe back into recession. The threat of either or both of these would have adverse effects on stock markets world-wide.

We have two key perceptions of Mr. Putin: he thinks he has the upper hand in the conflict with Ukraine and secondly, that he believes appearing to be strong to his countrymen is more important than the state of the economy in terms of his political power. He wants to regain control over Ukraine at a minimal cost to his personal power, and only after that, to his country as a whole.

We do not perceive ISIS as a threat to the US economy and its stock market unless the US begins investing in its fight with them to the tune of several hundred billion of off budget expenses to carry the fight to foreign shores with troops.

Finally, we remain disturbed by the lack of progress in Italy towards labor reform. Only yesterday, Prime Minister Renzi finally overcame the opposition within his own party to ease the labor market rigidity by eliminating current job protection measures. Unfortunately, no labor reform proposal has yet been presented to the parliament and no legislation is expected to pass until the back half of next year. These reforms are key to bringing competitiveness to the Italian economy, and given its debt levels, and the slow growth in Europe, we can foresee its financial situation worsening raising the ugly specter again of an Italian default, Mario Draghi and the ECB notwithstanding.

What To Do:

We continue to maintain portfolio cash levels because of the uncertain geo-political environment. And we are careful with adding to our international positions since we expect the dollar may strengthen some more and certainly outperform other currencies in the event of a geo-political shock. Having said that, with the Renminbi being pegged to the dollar we will maintain our modest position in China as it continues to restructure its economy before beginning a major expansion several years from now. A potential drag on the Chinese economy going forward may be the policy makers' attempt to rein the shadow banking industry which according to some measures has quadrupled from 2010 through 2013. Offsetting that headwind is China's turn to relaxing mortgage standards and its broad effort to make it easier for foreign financial institutions to expand in the country. For example, going forward the required down payment for second-home mortgages will be reduced from 60% to 30% and foreign banks will be allowed to have more than one branch in each city. We will probably expand our allocation to Brazil because it will begin to leave its recession behind sometime next year. This month alone the Bovespa Index declined by about 20% in US dollar terms.

And in the US we will reduce some of our exposure to certain cyclicals, and increase others as well as orient ourselves to more income producing securities as another way of lowering the risk in portfolios. If we get a P/E expansion even these shares will do well. The bottom line is that while we can expect some significant volatility, in the end we will muddle through!

David R. Kenerson, Jr.
Niklas K. Oskarsson