ORCAM | ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

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Q1 2013 Quarterly Outlook

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This is the time of year when market strategists and economists are all clamoring to publish their full year outlooks. At Orcam you will never read an annual outlook because I don't believe in annual outlooks. Markets and economies are complex dynamical systems. They evolve and adapt. Sometimes with great speed. Anyone who tells you what this system will look like in 12 months is not being completely honest with you. There are millions of variables that go into that equation. Far too many for anyone to understand well enough to accurately predict. What is moderately predictable is the near future (or the ***very*** *long-term). That's why I provide strategic and tactical asset class perspectives. You will never hear me tell you that I know where markets will be in a year. I will, however, try to gauge, with some level of reasoning and understanding, where the markets will be in 1 (tactical), 2 or even 3 months (strategic) from now.*

"Failure to prepare is preparing to fail."
-Coach John Wooden

10 Questions for 2013

This is an extended, updated and more detailed version of what some of you may have seen on Pragmatic Capitalism.

1) **What Will Happen With US Fiscal Policy?**

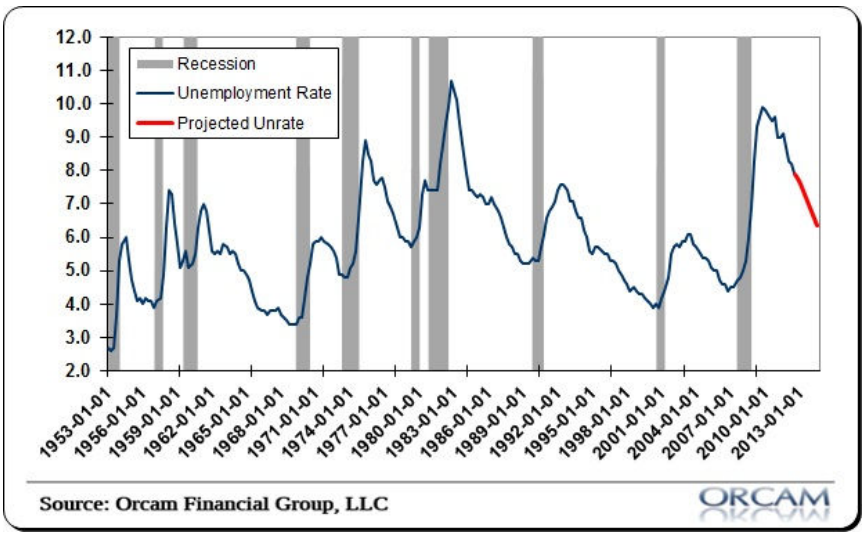
The fiscal cliff has been resolved and the cut to spending in 2013 looks like it will be substantially less than a worst case scenario. Total cuts to the 2013 deficit are likely to total about $225B out of a potential $575B in cuts. I estimate the hit to 2013 GDP to be about 1.3%. That's not insignificant, but it's important to note that the budget deficit will still come close to $1 trillion in 2013.

With a private sector that is still de-leveraging and unable to run with the baton since the damage of the credit crisis the government's spending is essentially keeping the economy from cratering. Government deficits (whether through tax cuts or spending increases) have bolstered the private sector during this period of de-leveraging and allowed private balance sheets to heal without bringing the economy to a complete halt. For now, the cliff deal looks like a moderately positive outcome when compared to the potential worst case scenario.

Downside risk: The US government could still torpedo 2013 growth if the debt ceiling or sequestration debate results in more severe cuts.

2) What Will Happen with US Monetary Policy?

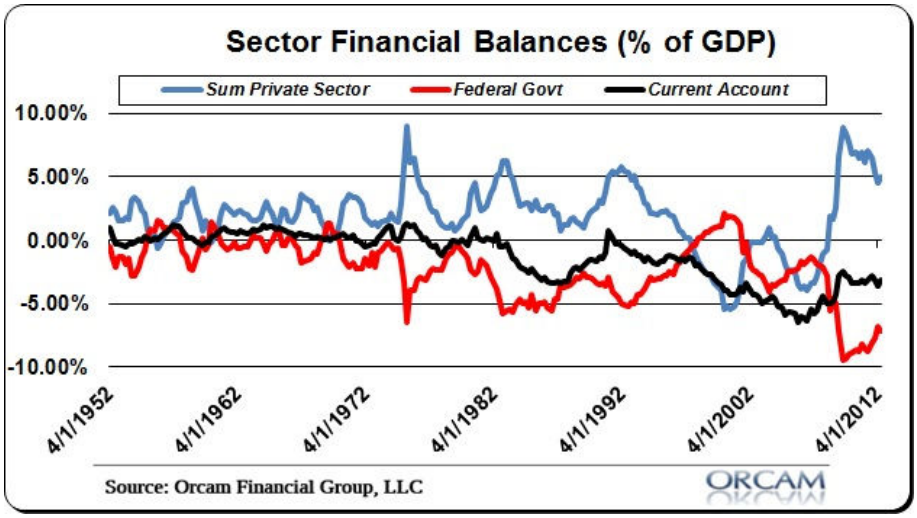
The Fed has been pretty clear that they'll remain accommodative through 2015. The recent change in communication and timing made it clear that they'll be on hold until the unemployment rate drops below 6.5%. Even in a best case scenario the unemployment rate likely won't hit 6.5% until the middle of 2014 so it looks like we're in accommodation mode for the duration of 2013.



Downside risk: Ben Bernanke is likely to step down in 2014. Could he become less accommodative later in the year in order to create flexibility for a smoother transition? Or could policy take an unexpected turn due to the uncertainty that is likely to develop in the market surrounding this event? There's no way of knowing.

3) Is the US Economy Headed into a Recession?

I've been pretty vocal over the last 18 months since the ECRI came out with their recession call. I said the US economy would **not** enter a new recession in late 2011 or 2012. The thinking was relatively simple. Because the US economy remained in a balance sheet recession you had to throw all the past historical data out. None of the models applied to what we are going through. What did apply was understanding how the US economy was de-leveraging and that meant the private sector was too weak to sustain growth on its own. That meant we needed the public sector to pick up the slack. You've probably seen this chart (or some version of it) a million times from me:

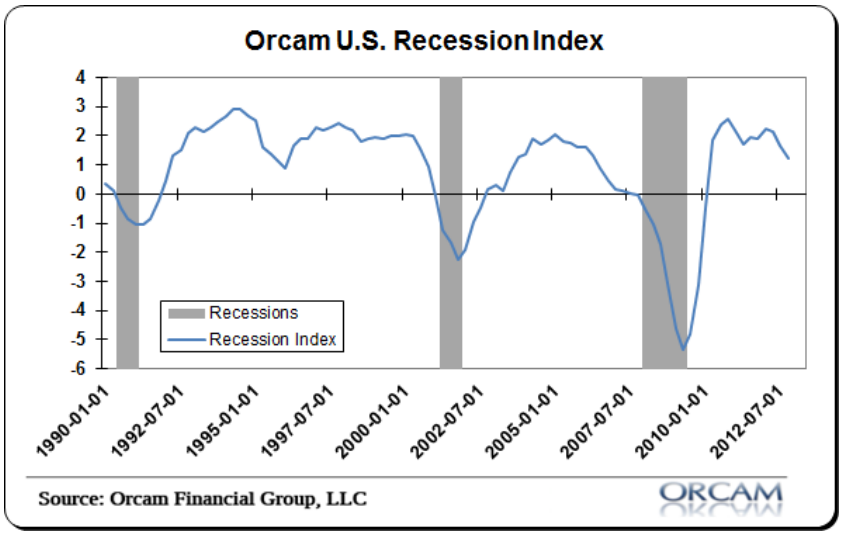


What happened to the US economy was an unprecedented collapse in private investment. Normally, the private sector alone can bring us out of a recession. But this was no ordinary recession. Private investment cratered over 20%. This was beyond unusual. It meant the private sector was flat on its back. And more importantly it meant that the huge public deficit was supporting incomes, driving revenues, and generating an economic "flow" where there wasn't one.

It's kind of like the office building called the US economy was burning down and the indoor sprinkler system stopped working. A balance sheet recession isn't merely a contained one office fire. It has the potential to wreck the building. So, what was needed was an outside flow. That arrived in the form of government spending. It not only put the fire out, but saved the building from collapsing.

The response to the fiscal cliff has been relatively sane. The spending hits will cause the most pain in Q1, but should begin to have a reduced impact assuming no big changes in policy going forward.

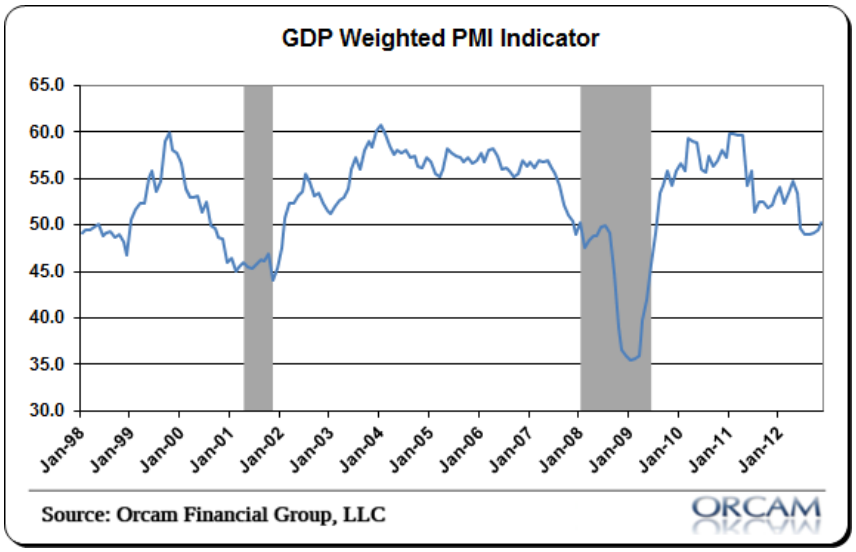
The Orcam US Recession Index is still modestly constructive. The index has historically turned negative prior to US recessions so the current positive readings point to a modest growth environment. We know that the worst market declines tend to occur within recessions so this is a bullish longer-term indication.



Downside Risk: Debt ceiling and sequestration talks turn the US more austere.

4) Is Global Growth Going to Slow?

Global growth appears to be stabilizing. The USA has maintained a muddle through environment, Europe has been mired in recession and Asia has stumbled a bit in late 2012. But that third leg of the stool (Asia) appears to be turning a corner. This has been apparent in global PMI data where the GDP weighted PMI is turning positive for the first time since early 2012. I think global GDP should stabilize further in 2012 largely on the back of a stabilizing Chinese economy.



Downside risk: The Chinese government fails to act in front of a still very fragile economic environment.

5) Is the Euro Crisis Over?

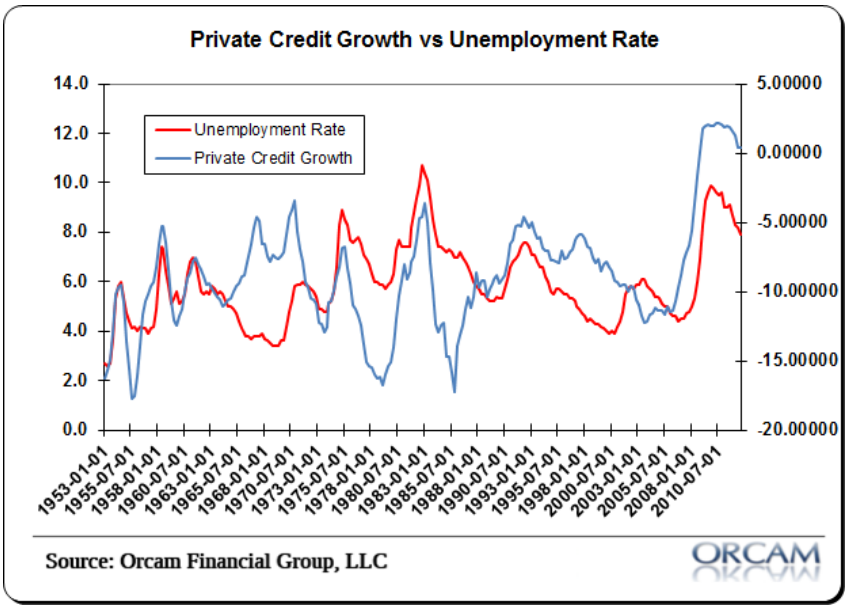
The Euro crisis never ended. As I've explained before, this remains a currency crisis and not a banking crisis. The problem in Europe is that the Euro remains unworkable. The single currency system has locked its users into a fixed exchange rate regime without a fiscal rebalancing mechanism. In other words, unlike the USA (which is almost perfectly analogous to Europe's union) there is no central treasury to rebalance any imbalances. Most people aren't aware of the fact that the USA is actually a huge fiscal transfer union. The wealthy states pay more into a system that redistributes funds to weaker states. This helps eliminate the solvency concerns and trade imbalances that naturally develop in any fixed exchange rate system.

Europe has no such arrangement so the only rebalancing mechanism is through painful austerity and time. The result is depression in many regions. Unfortunately, there hasn't been any permanent fix to this problem. Instead, the ECB has implemented a series of measures that help reduce the solvency risk at the national level which brings private bond buyers back to the market, but this is far from a permanent fix to the underlying economic problems in the region. The Euro crisis remains one of the primary risks to the global economy.

Downside risk: The big risk is civil unrest which leads to potential defections and defaults. The citizens of Europe are unlikely to put up with depressionary economics forever.

6) Where is US Employment Headed?

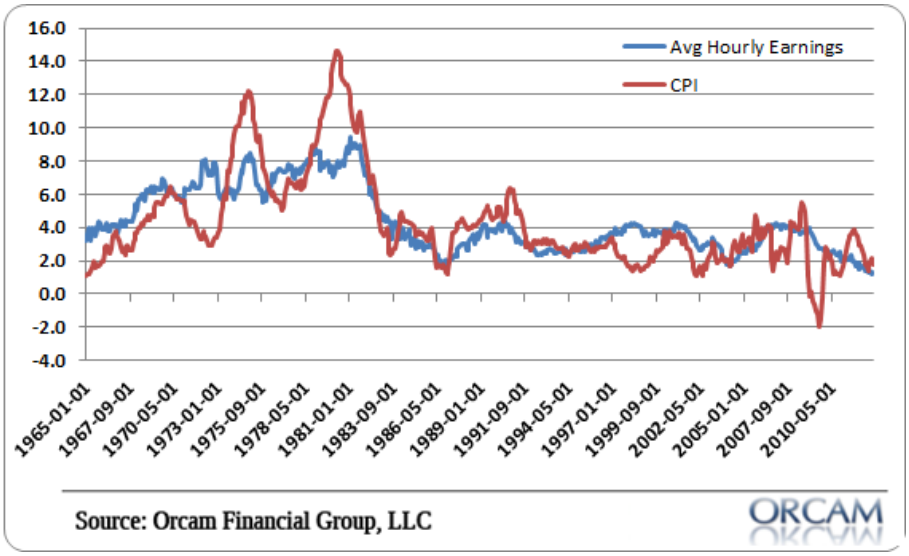
Last year I said we were making "baby steps" in the right direction on the employment front. Understanding the balance sheet recession has been all about understanding the growth of private credit. As the lifeblood of our monetary system private credit tends to correlate with the unemployment rate and rate of hiring. The one positive trend we've seen on the employment front is the beginning of gains in private credit accumulation. As you can see in the chart below, private credit (inverted) is beginning to turn the corner. The process is slow and remains incredibly fragile, but it's moving in the right direction. I don't think it's unreasonable to assume that the unemployment rate will drop below 7% this year for the first time since the crisis flared up.



Downside risk: Again, it's all about the cliff and austerity. Austerity would hurt private balance sheets and likely cause a freeze in credit accumulation and hiring.

7) Will High Inflation Finally Arrive in 2013?

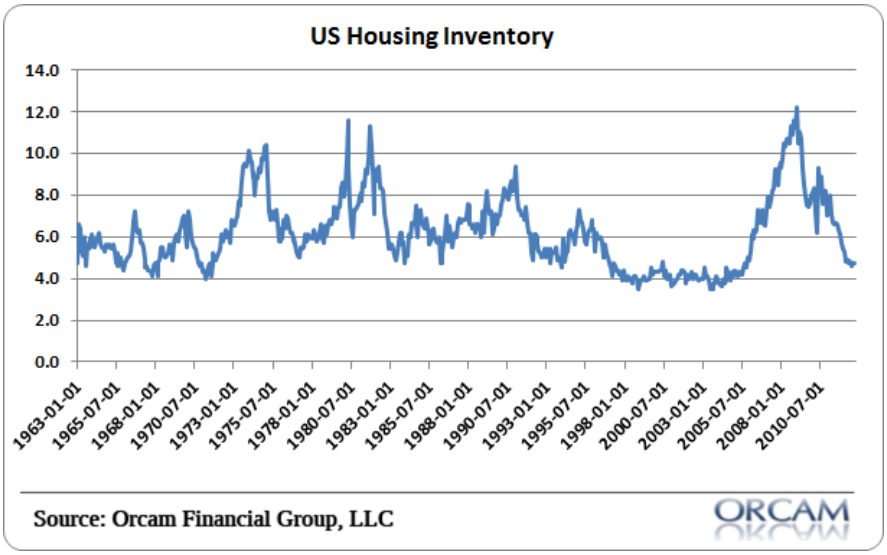
In 2012 I expected disinflation leading to a level where the Fed would feel comfortable intervening with QE3 around the middle of the year. I've been lucky predicting inflation in recent years. Looking forward, we're likely to see many competing forces on the inflation front in 2013. Oil prices are still very high, credit trends are improving, government spending remains high and yet hourly earnings are still near rock bottom. Ultimately, I think the two primary drivers will be credit trends and hourly earnings. Continuing weak demand for credit and virtually zero earnings power on the labor front will continue to suppress inflation. So, I see positive inflation, but low inflation in early 2013.



Downside risk: Or should I say "upside risk"? It is definitely oil prices. A repeat of something like 2008 cannot be ruled out. Particularly with the volatility in the Middle East. This would cause an enormous shock to consumer spending and while it might lead to temporary price increases it would ultimately result in recession.

9) Should You Buy a House in 2013?

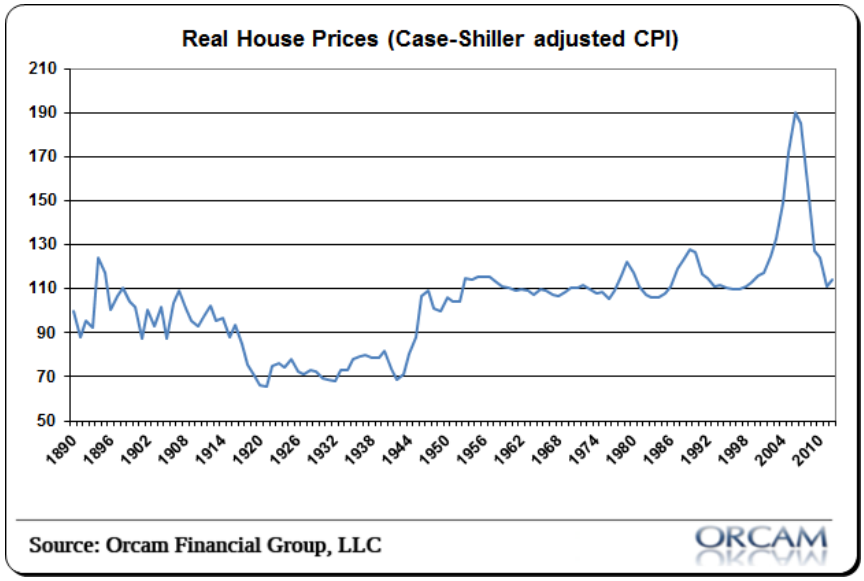
5 years ago I was a big housing bear. I wouldn't say that I've done a 180 here, but I've definitely become much more constructive on housing in recent years. The keys in the housing market has been sizable declines in inventory, vast improvements in affordability, improving price to rent ratios and substantial price declines across the nation. I still think we're in the midst of a post-bubble "workout". Like most bubbles, it's highly unusual for prices to bounce back quickly. Instead, we're likely to see a flat-lining in prices.



It is important to note that inventories have declined substantially in the USA. Shadow inventories remain relatively high, but the reduced foreclosure rate should bolster this from having a negative impact in the coming year. As you can see in the charts here we've experienced massive adjustments in both prices and supply. As demand slowly crawls back that should continue to stabilize prices.

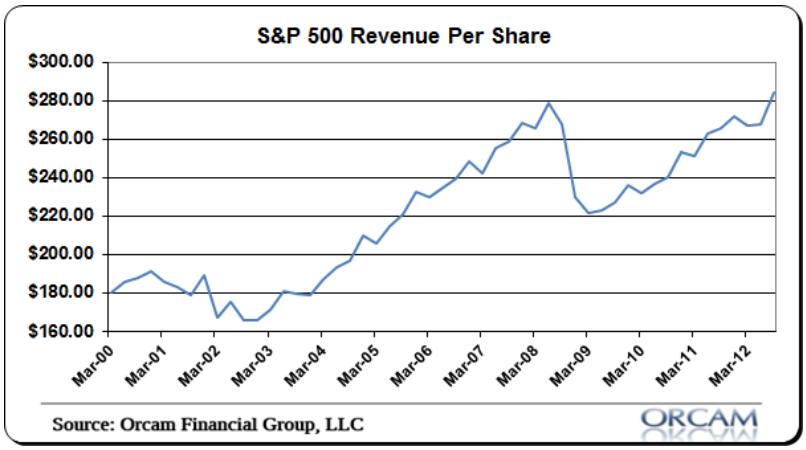
Despite the many calls for recovery this year, I still don't see a big recovery in housing. That said, I also don't see great downside in prices. We've already had a massive decline in real house prices so I think we're most likely to see moderate gains at best in 2013. If you're looking to buy a home in 2013 and you're looking to live in that house then I think the downside risks are fairly limited.

Downside risk: if the US government were to move to a more austere position we could see a substantial decline in consumer spending which would ripple through the housing market.

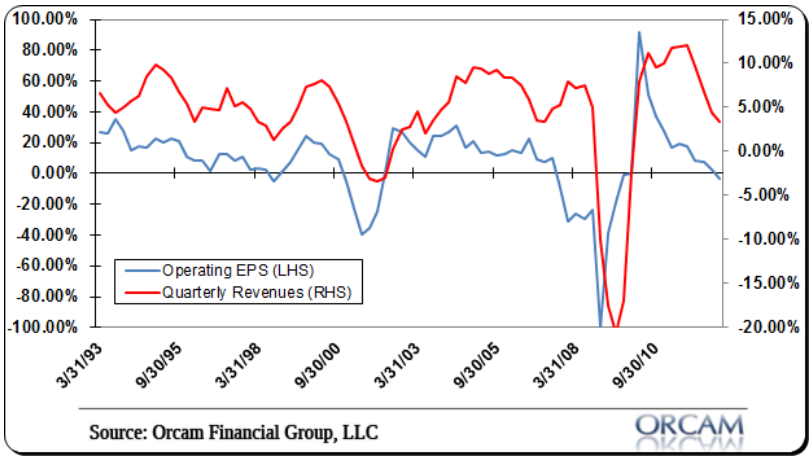


10) What Will Happen to Corporate Profits in 2013?

Last year I predicted that corporate profits were likely to come under pressure for the first time since 2009. As Q3 operating earnings come in at just 1% I think that has become a reality. There are a lot of moving parts here, but the likelihood of slow corporate profit growth is likely to continue into 2013. Revenues are slowing into the low single digits, corporate profit margins are high and profits have soared on the back of the large budget deficit. I think the risk to all of this is to the downside. I am much more concerned about a profits recession in 2013 than an economic recession.



Revenues have slowed quite a bit in the last few quarters to a pace in the low single digits even though revenues per share are hitting an all-time high. By far, I would say the more concerning of these trends is the rate of growth. With corporate margins near all-time highs and the pace of revenue growth slowing we're likely to see corporate profits grow at a more modest level. The days of double digit earnings growth in this expansion could very well be behind us. Look for earnings in the coming quarters to remain in the low single digit growth range.



Downside risk: Again, understanding the Kalecki equation shows us that corporate profits have benefited enormously from the large budget deficit. If the debt ceiling negotiations in February turn negative and result in a substantial decline in the budget in 2013 we should expect a profits recession.

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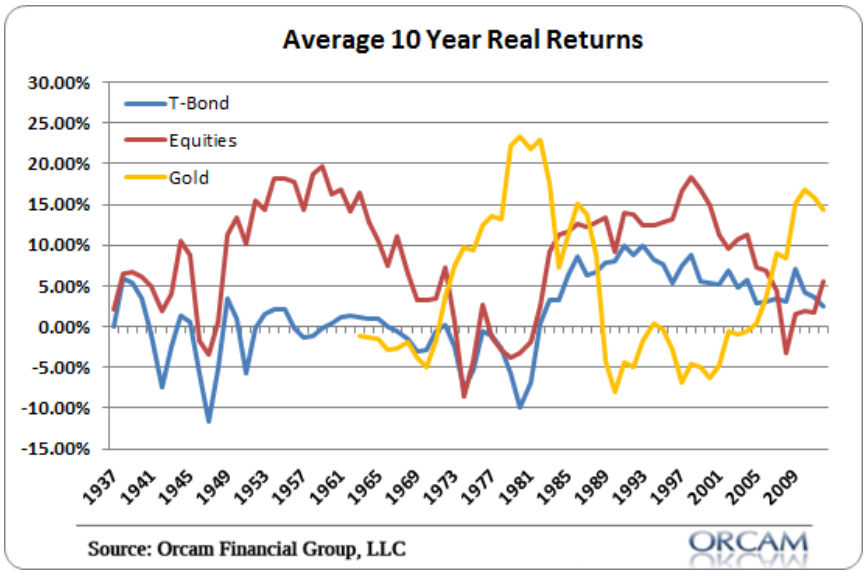
Asset Class Outlook

I'd like to start this quarterly outlook with a 30,000 foot view of the investment landscape. I like to think of various asset classes in what I call a "hierarchy of assets". In order to protect one's portfolio from the risk of permanent loss and the risk of purchasing power loss you must understand the various assets that can help you achieve this. At the core of the hierarchy of assets is the equity class because this is the asset that can achieve not only the greatest purchasing power protection, but also the greatest protection against permanent loss. Through its high correlation with national output, equity is essentially the foundational holding given its relationship to economic output. After all, corporations are the cornerstone of national output so it only makes sense that this asset class is the core piece. All other asset classes are subordinate and are designed in a way that help serve the equity piece in some manner. Fixed income, for instance, is a less expensive form of capital raising for a corporation that helps it achieve a similar goal to equity. It is, in essence, a safer holding for the owner due to its structure. Most commodities are inputs in the goods or services that corporations sell.

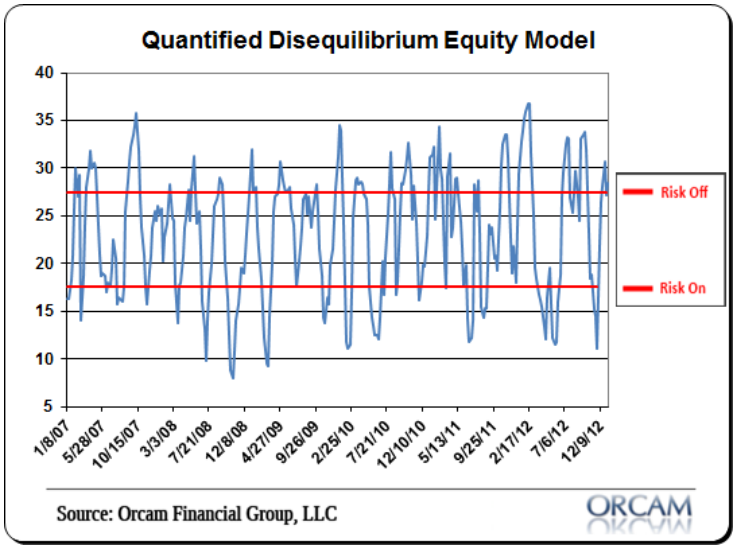
All of these assets serve a purpose in the role of portfolio construction, but all assets are not created equal. There is a distinct difference in the way these assets help achieve the two aforementioned goals. I have neither the time nor the space here to elaborate on these matters, but I did want to briefly discuss three of these asset classes—equities, government bonds and gold— since they are three of the more abundant assets that are presently held and discussed in the mainstream.



The chart at the right shows the average 10 year real returns for each asset class. As you can see, the returns have deviated quite substantially with time. This is not surprising given their differing roles in the hierarchy. But I think a brief historical review will provide some clarity to a very long-term view of the assets. In particular, I think these returns are notable when put into the context of mean reversion. The real returns show a volatile story, but one that is quite cyclical. The notable takeaway from this is that bonds and gold

have substantially outperformed their historical returns on a 10 year basis. This is one reason why I often caution people about the very popular "lazy portfolio" or "permanent portfolio" approach. A simple review of historical returns combined with a mean reversion view will lead one to believe that the next ten years are not likely to be as favorable for gold and bonds as the last 10 years have been. Equities appear far more favorable and make even more sense when considered in the hierarchy of assets.

Obviously, I don't know your personal investment perspective or strategy, but I hope this brief review provides some clarity to the very long-term view. Now for something more granular….



Equities—Based on the relatively constructive macro outlook for this quarter we remain constructive from a strategic (3 month) perspective. The recession index continues to point to a modest growth environment which means that downside in the equity markets is likely to create buying opportunities. This view could change in February given the uncertainty around the debt ceiling discussions, but for now the equity market does not appear to have substantial headwinds that warrant bear market type sell-offs (20%+). As I've noted before, the most devastating capital destruction tends to occur within recessions so it's crucial to manage risks around a potential recessionary environment. For now I don't see the risks of recession as being particularly high.

On a tactical basis (1-2 months) the fiscal cliff debates injected a bit of excitement around the near-term readings. As I expected, the cliff debates were resolved and the markets were proven to be overreacting last week when I said the VIX was a clear sign of excessive downside protection in what was likely to be a non-event. Given the market's powerful move on the first few trading days of the year the near-term picture is now considerably less clear. My primary tactical model has moved into a risk off range which means that risks are higher than normal. I am now more inclined to sell into strength than to buy on weakness. Particularly given the 2.5% rally in one day—it's clear that the equity markets have priced in the impact of the cliff negotiations. Now the focus will turn to earnings season and the potential February problems in DC. For now, there doesn't appear to be a downside catalyst that could cause a steep sell-off, but I do think we're entering a near-term environment where more caution is likely warranted.

Fixed Income— An interesting divergence has developed in fixed income markets where corporate bonds have experienced an enormous rally as US government bonds have essentially moved sideways over the last year. I still think the Fed is dominating the discussion around fixed income and that the accommodative policy stance means there is not substantial downside in US government bonds as the Fed is likely to remain accommodative well into 2014. In other words, overnight interest rates will not be allowed to rise for another 12 months and that bodes well for US government bonds.

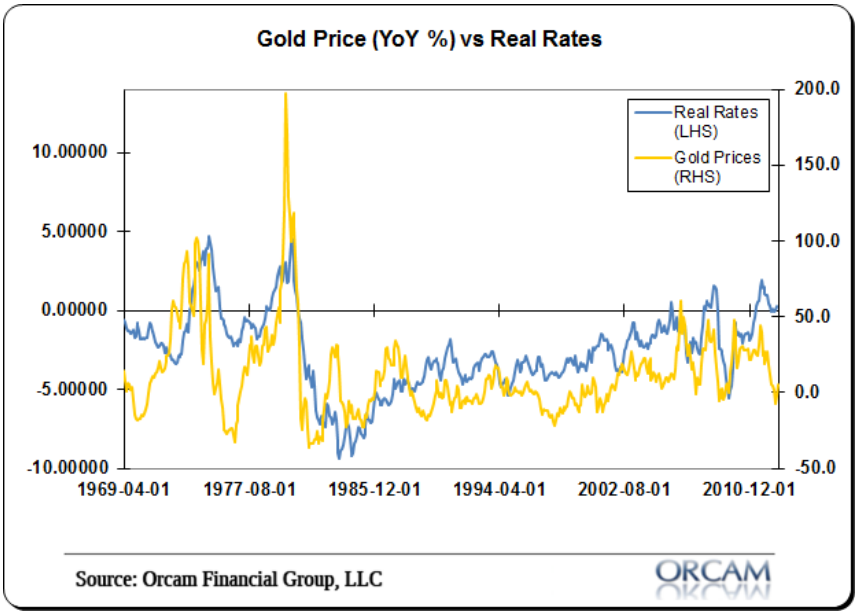
I am less constructive on corporate bonds where valuations have become frothy and largely driven by Fed policy. If you can ladder into a portfolio of corporate bonds you can substantially mitigate the risks in this asset class.

My two favorite asset classes in the fixed income space are international bonds and Treasury Inflation Protected Securities. I universally prefer to ladder into such portfolios, but I find that these asset classes are likely to mitigate the risk of the US Central Bank by diversifying outside of fixed income products that are largely driven by Fed policy. As I've mentioned earlier in this report, 2013 is likely to experience substantial uncertainty around 2014 Fed policy so while I am confident that the Fed will remain accommodative we can diversify out of this risk.

Commodities—Historical real returns in the commodity space are close to zero. It's unfortunate that the investment industry has jumped on the recent strength in some commodities to begin selling the idea of diversification through commodities. The historical evidence simply proves otherwise. As a non-income producing asset this asset class has historically served as an input or cost in corporate output. A corporation does not simply pass on the cost of the commodity input, but rather, leverages it to generate a profit. In other words, it is not the commodity that generates a profit, but the ingenuity of the corporation that generates a profit. "Investing" in commodities themselves is essentially a bet against ingenuity in that you're betting that the cost of this input will not be outperformed by the ability of a corporation to leverage this cost input. That makes very little sense in terms of portfolio construction. While it might prove correct in brief periods of time over the long-term it has proven a very poor bet. The better use of commodities is to bet on the corporations that actually leverage the real resources.

Gold—Gold is not your average commodity. Unlike most other commodities gold serves as a universal medium of exchange. In other words, gold is seen not only as a commodity, but also as a currency. This means that gold has an embedded "put" in its price that provides it with a unique asset class standing. However, gold is also not an income producing. In other words, it is not directly tied to national output and so scores poorly in our hierarchy of assets. But given its unusual standing as an asset class I am comfortable holding a small portion of gold in an attempt to benefit from its negative correlation with the

the other assets in the hierarchy (fixed income and equity in particular). I do not provide a tactical reading on gold prices, but I will say that I like gold from a strategic perspective primarily due to one reason—its strong inverse correlation to real interest rates. As you can see in the chart to the right real interest rates and the price of gold have a very high correlation. This has been researched in what is called the "Gibson Paradox". In essence, the thinking is that gold serves like a super long duration bond in a portfolio when real interest rates are negative because of the belief that future inflation is likely to be high. In other words, gold serves as the ultimate risk free asset when real rates are negative and governments are seen as behaving irrationally. Whether this is totally accurate is unimportant. It's the historical relationship that is most pertinent here. And from a strategic position it's clear that real rates will remain negative in Q1 which should support gold prices.



On the other hand, I would never be excessively overweight gold due to one simple fact. It cannot and will not ever serve as protection against permanent loss. This element of a currency "put" makes the price of gold extremely susceptible to changes in mere perception. An asset class that has this element of faith (as opposed to fundamentals) is always at risk of substantial downside. So, we cannot discount the potential that even negative real interest rates cannot always protect gold from substantial price declines. Therefore, you can think of gold as serving a purpose given the negative real interest rate environment, but always being an "underweight" in our hierarchy of assets. I generally never advise more than a 5-10% weighting in gold.

Conclusion—In sum, Q1 2013 is setting up to be a modestly positive quarter. There are many converging currents that currently point to a modestly positive economic environment, but a more difficult corporate profits environment. As always, I will keep you updated with regular changes in my equity market view from a tactical positioning and any changes in the strategic views.

I hope 2013 is a prosperous year for us all and that we learn and grow together as the year progresses.

Orcam Financial Group, LLC

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