Macro Strategy & Research

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Q2 2013 Quarterly Outlook

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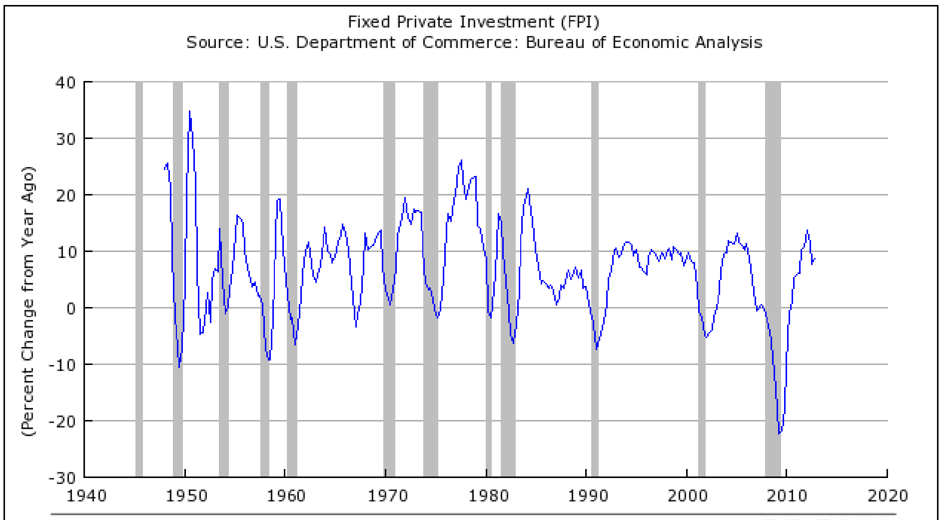
A world with greater certainty and clarity also brings in new and potentially dangerous risks.

The Strategic View

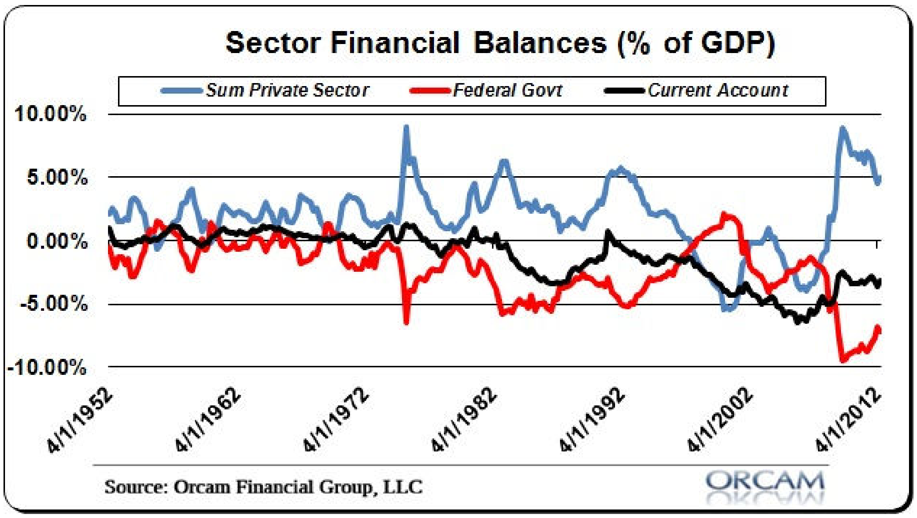
The most important driver of the US economy in recent years has been the impact of the de-leveraging cycle within the USA. When the housing bubble burst in the USA we had a massive collapse in private investment as the debt bubble impaired the private sector. This was nearly unprecedented and rendered the private sector incredibly fragile. The de-leveraging resulted in consumers saving more, spending less leading to too little income, too little revenue and thus too little private investment. We know from



Source: Orcam Financial Group, LLC

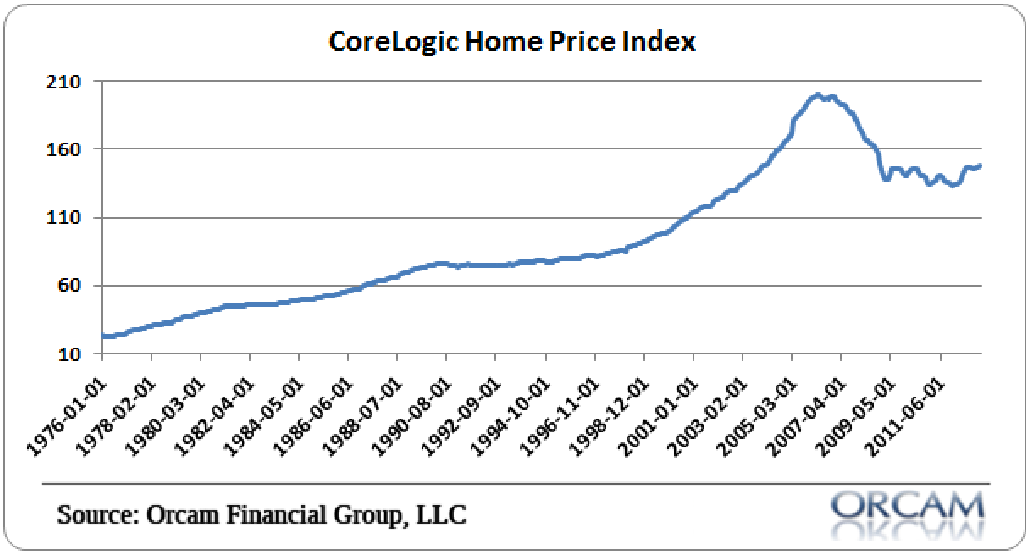
"Failure to prepare is preparing to fail."
-Coach John Wooden

sectoral balance accounting that national income (GDP) is derived from three primary sources—the foreign sector, the government sector and the private sector. As a nation that runs a current account deficit the USA essentially loses income to the foreign sector. And when the private sector collapsed after the housing bubble that left only one sector to pick up the slack. And boy did it ever. The government's spending package resulted in a substantial improvement in private sector balance sheets as income flowed through a stagnant economy and government bond issuance helped stabilize very weak debtor positions. The sharp decline in the red bar in the above chart shows the magnitude of the improvement in the private sector that resulted from the government's deficit position. Government spending is, by definition, additional income to the private sector and can be extremely helpful in generating growth when the private sector cannot sustain growth on its own (as occurred in 2008/9).

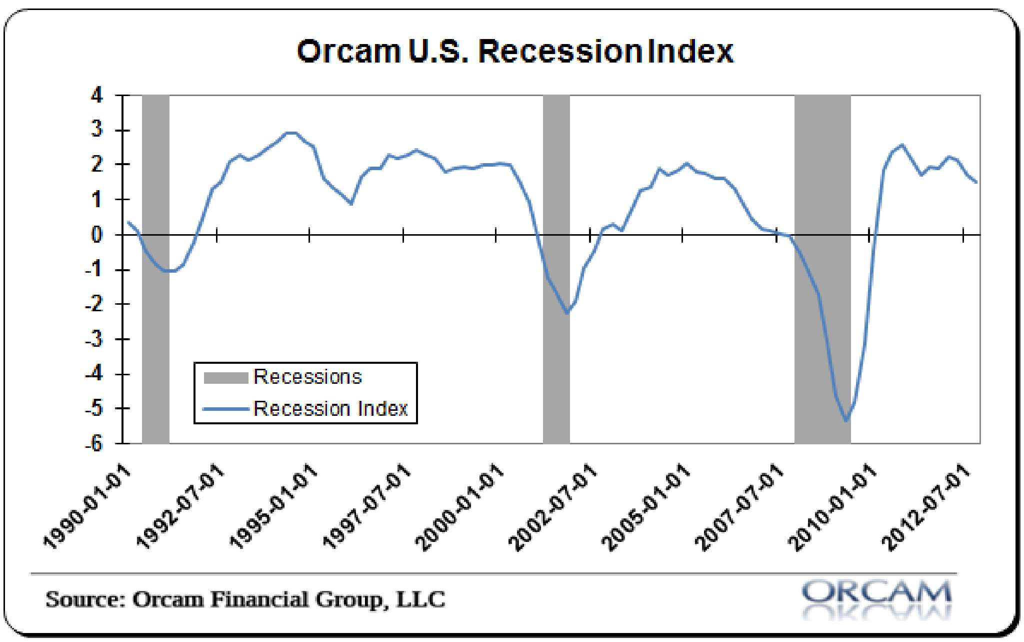


Although the trend has started to reverse it's also important to remain mindful of the improvement in private investment as seen on the previous page. It might be easier to think of the environment as an unhealthy person suffering a massive heart attack (the Great Recession) following a wild couple of years boozing (excessive debt accumulation). When the person suffered the heart attack he/she required external aid. His body was so unhealthy that it couldn't sustain itself. And the government acted like an artificial heart here. It pumped income through the system and helped bring the patient back to full health. Now the patient is close to full health and running around on his/her own (private investment has mostly recovered) so the need for government aid has been reduced. So the decline in the blue line is not terribly alarming since we're seeing more of an organic private sector recovery.

One of the keys to this improvement has been the real estate market. As I mentioned in the Q1 update, I am becoming increasingly bullish on US housing. The latest CoreLogic Home Price report showed a 10% increase in home prices year over year. That was the largest increase since 2007. This is a sign of serious improvement in the US economy.



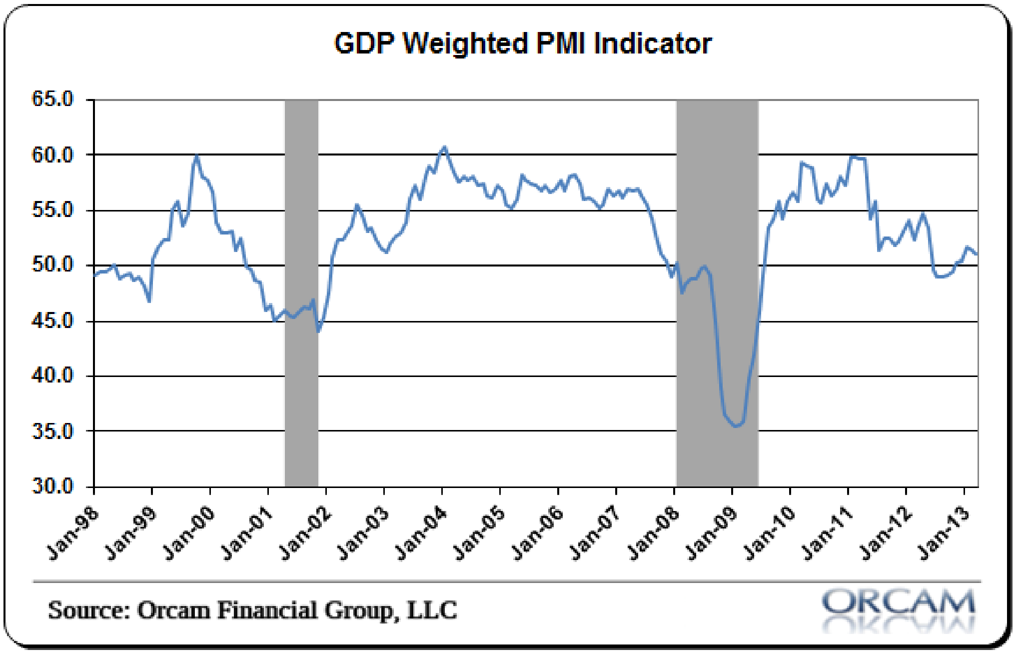
Not only is mortgage debt the most substantial piece of household debt, but housing is also a substantial driver of US economic growth. The improvement in housing shows that the de-leveraging cycle has started to improve significantly and also shows that private sector investment is beginning to improve.



There are other significant signs of improvement in the US economy, but these are best summed up in the Orcam US Recession Index. This summation index has been very accurate since the economic recovery began in 2009 and has kept us from turning bearish on a more cyclical sense. As I've described before, the worst capital destruction tends to occur inside of a recession so it's incredibly important to highlight the odds of a potential oncoming recession.

This leading index is still quite constructive and says there is no recession on the horizon in the USA.

From a more global perspective I would be a bit more cautious. I am not at all optimistic about economies in Europe given the continuing unworkable Euro currency. Although the GDP Weighted PMI Indicator has improved and continues to show growth (over 50) I do think you have to be much more careful abroad. The macro trends in the USA appear far more favorable at present when compared to Europe and most of Asia.



How to play it: All of this adds up to one succinct conclusion. I think you have to remain bullish on US equities as a core holding within the strategic component of a portfolio. Real estate and credit related industries should continue to perform well as the housing market improves and credit accumulation increases. Using our concept of a hierarchy of assets, equities should always play the most central role in a portfolio as they protect not only against purchasing power loss, but also against permanent loss (when used in an index format).

The Tactical View

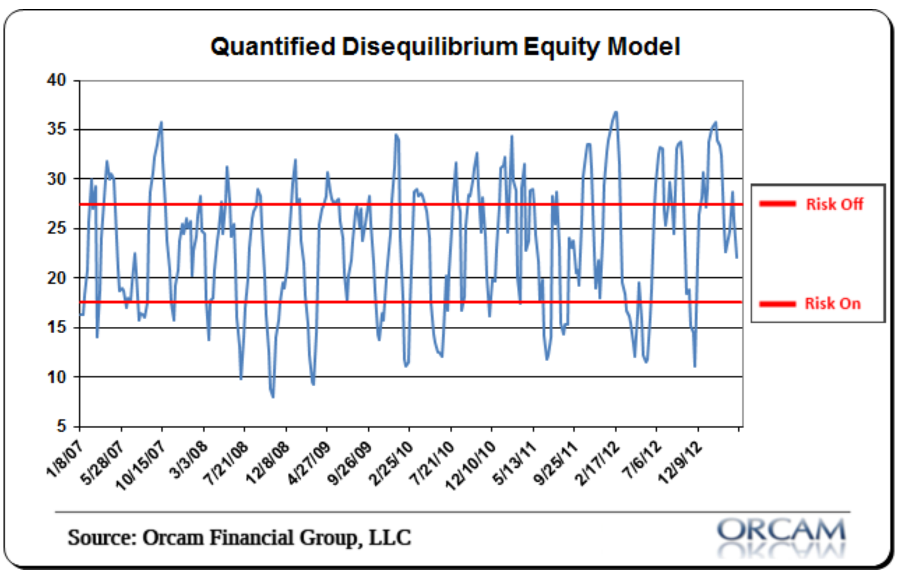
Although I am bullish from a strategic view of the equity market, I remain a tactical bear. I continue to think the equity markets have gotten a bit ahead of themselves in the near-term and that we're seeing excessive signs of complacency. The US equity market has an unusually persistent bullish feeling to it that creates a risky environment.

When thinking about the market from a tactical sense I prefer to think about the markets as though

I am utilizing an option with no expiration date. So, from a strategic sense I want to attach the core of my portfolio to an equity overweight with the option to exercise a put or call around that core piece. I've had a number of questions about this, but to keep things simple you might consider something like a 75/25 weighting in this view just for simplicity. I don't provide model portfolios through the research (though I might at some point) so for now it's easiest to think of the strategic/tactical weighting as described here within the equity weighting.

That said, I prefer to exercise this option at times when I feel as though the core is "running hot" or "running cold". When the equity market has rallied 10% in 3 months (a 40% annualized rate versus historical annual returns of 6.75%) I think that option should be exercised. That has obviously been wrong in recent months and I have zero excuses for this error, but it's all in keeping with the more general risk management based approach to the markets. The current "price compression" (pricing in long-term gain in a short timeframe) creates risk of a substantial washout at some point. I can't and won't guarantee that it will happen, but history proves that this time is not different and markets will once against act like markets (as in, not just going up every single day).

Of course, if you just want to "beat the market" you shouldn't subscribe to equity research. You should buy the S&P 500, leverage it up 20% and wake up when you get your margin call in years like 2008. I am just kidding of course. I don't think any of us should play the "beat the market" game. We are allocating our savings in a manner that is consistent with protecting against purchasing power loss and permanent loss while generating good risk adjusted returns. Of course, when there's no negative volatility (like this year) it's almost impossible to generate good risk adjusted returns when compared to an equity index, but that's not the historical norm so I think it's imprudent to let one quarter of market performance cloud our judgment and alter our methodology.



That said, the Orcam QD Model continues to paint a "risk off" picture. Although we've seen some improvement in the indicator there are still no definitive signs that point to a buy signal on the tactical side. In fact, I am still more inclined to remain bearish and add to short positions as a hedge to the bullish component of the strategic piece of the portfolio.

The Fixed Income View

Using my hierarchy of assets approach, it's important to understand the role of fixed income in a portfolio. When thinking about the role of various assets in a portfolio it's helpful to think of the actual issuer of that instrument. Fixed income, for instance, is an instrument that helps a corporation or entity raise capital in order to operate. It is not all that dissimilar from equity which also helps a corporation raise capital. It's just a different instrument designed to achieve the same thing (help that entity leverage its operations in some manner). Fixed income obviously pays a fixed interest rate and takes precedence in the liquidation proceeding so there are embedded advantages to owning these instruments. But the inherently greater safety also results in a reduced potential reward even though it is directly aligned with the goals of the issuing entity in the same manner that equity issuance is.

When I think of fixed income I think of it as being an asset that achieves the same goal as an equity portfolio, but does so in a slightly different and safer manner. In this regard, fixed income complements equity and doesn't compete with it. But, importantly, fixed income also cannot always protect you against purchasing power loss so most debt instruments will never score as highly on my hierarchy of assets as the equity piece.

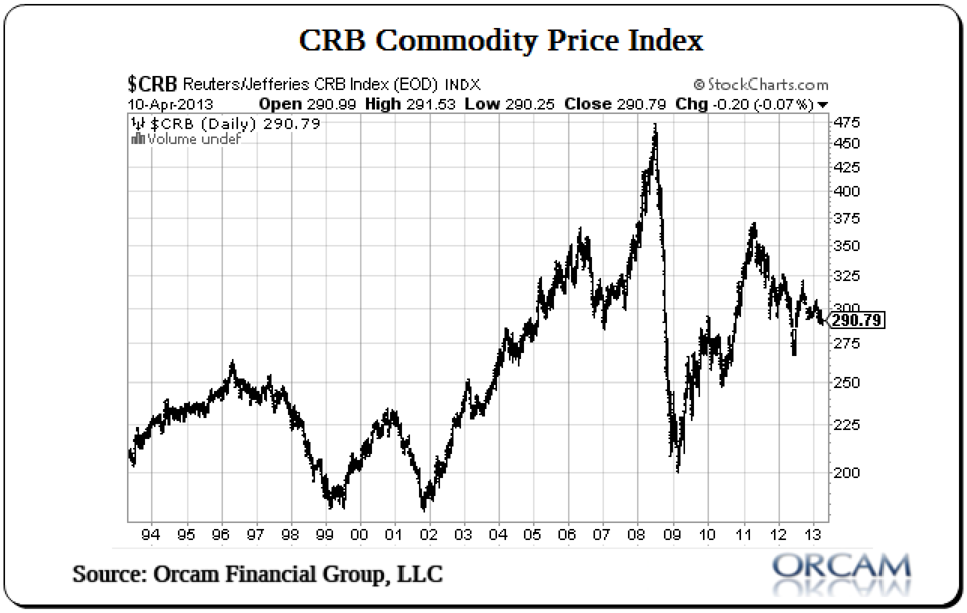
Unfortunately, most investors think of fixed income as being at odds with an equity component. As I've described above, I think this is a misconception and I believe that a fixed income component is a crucial piece of any properly constructed portfolio.

That said, the outlook for fixed income is little change in recent months. Corporate fixed income is inherently tied to the outlook for corporations and the low recession environment leads me to remain at least moderately bullish on corporate bonds. But I would focus primarily on TIPs, US government bonds and foreign bonds. A laddered bond portfolio is the ideal way to implement exposure to these instruments.

As I've mentioned briefly in past notes, this outlook is primarily based on very bullish Fed commentary. The Fed has been exceedingly clear that they will not raise rates before the unemployment rate hits 6.5%. We're still well above that range and I think that 2013 is a year in which we are highly unlikely to see such a rate. That could change in 2014 as we begin to creep towards the Fed's target, but I will keep you posted there. Given my rather cautious tactical equity view this component also serves as a nice piece in addition to using the equity hedge portion. If US equities were to tumble for whatever reason it's likely that a flight to quality would ensue via TIPS and US government bonds in particular.

Commodities, Gold and Bitcoin

As I described in the Q1 update, I am not fond of the idea of commodities as an asset class. In my view, commodities are a cost input in the corporate structure and not something that necessarily generates a profit. Yet Wall Street has built an entirely new sales product around the concept that commodities are a necessary component of asset allocation. I believe this is wrong. Commodities generate zero real return over long periods of history and even in recent history when they've soared in value, they've continued to generate meager returns. Over the last 20 years we've seen massive rallies in commodities at times yet the 20 year total return is just 39% or 1.65% per year. Even with two equity market collapses stocks have trounced commodities with a 6.5% average annual return over this same period.



Commodities, in my opinion, are not an asset class worthy of allocation and should not be used as such. If one is so inclined to gain exposure to commodities it is best to obtain exposure by purchasing firms whose operations involve the leveraging of these commodities for profit. Oil MLP's & REITs are examples of corporate exposure to entities that are not only income producing, but also directly tied to the productivity of a real asset.

Gold has lost some of its shine in recent months, but I don't think the macro picture has changed all that much for gold. The primary driver of gold prices is real interest rates as gold acts like a super duration risk-free instrument when inflation risk is high. With real rates remaining negative and inflation figures moving north I think the bull in gold is still charging. But be very careful with gold. There is an embedded faith put in gold as this is merely a simple commodity with a currency function. That currency function is entirely based on faith and perception and embeds a healthy premium in its price. Because of this there is very little protection against permanent loss. I would never allocate more than 5% or so to a gold holding.

I wanted to also make a brief comment about Bitcoin. If you're not familiar with Bitcoin then don't waste your time to research it. It is a recent monetary mania that has sprung out of the internet as an unregulated form of money for online purchases. Its value is unregulated, highly speculative, highly unstable and largely irrational. I can't imagine why any rational person would engage in such a market. In short, don't go near Bitcoin with a 20 foot pole.

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