Q3 2013 Quarterly Outlook

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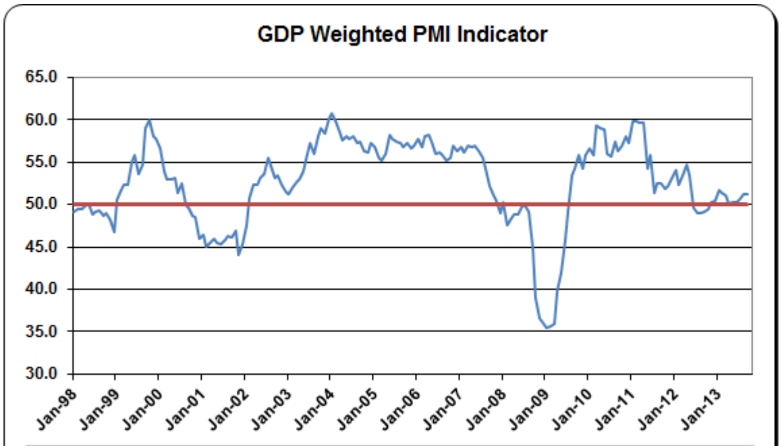
It's been a good year. Let's not be too greedy here….

The 30,000 Foot View

The big picture story is looking more and more confusing as the year progresses. There are so many converging market dynamics at present. Let's take a step back and look at the economy from the 30,000 foot view to see if we can get a better grasp of broad trends in order to help eliminate some of the noise that might distract our broader strategic perspective.

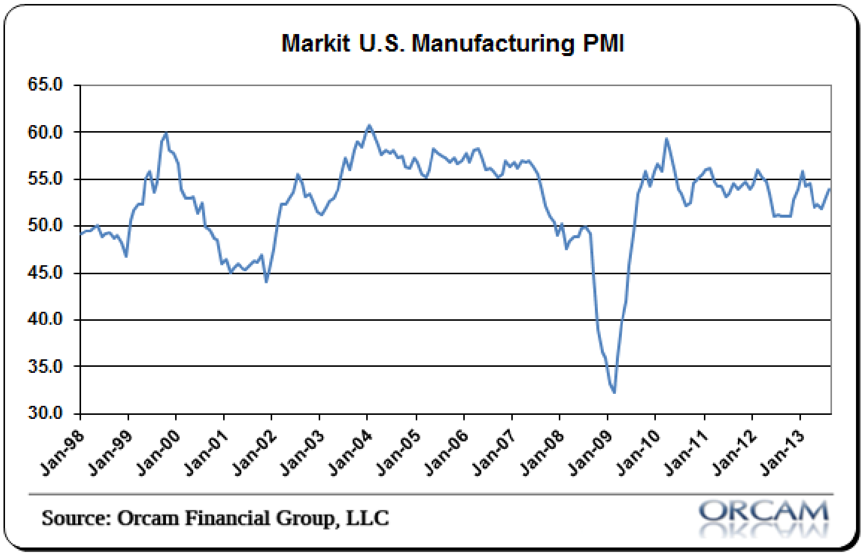
The global economy is weak. There's no denying that the recovery since 2009 has stagnated to some degree. The GDP weighted PMI has slowed to 51.2 which is just barely consistent with growth. More importantly, the trend is clearly moving lower. But the news might not be all bad from here. If we look at the components of the index we can see some signs of improve-



Source: Orcam Financial Group, LLC

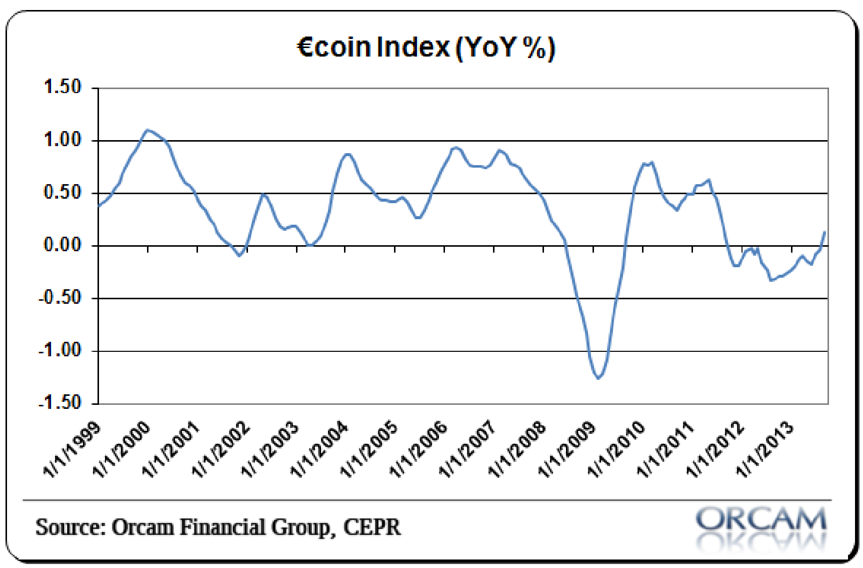
"Failure to prepare is preparing to fail."
-Coach John Wooden

ment. In the USA the PMI has remained resilient in the low 50's. The latest Flash reading from Markit, at 52.8, is consistent with sluggish growth. But the news from abroad is potentially improving. The latest reading from the Eurozone came in at 51.1 which is just shy of a 27 month high. Europe has been a particularly weak performer during the recovery so this could be signs of better times in one of the world's most important economic regions.



Source: Orcam Financial Group, LLC

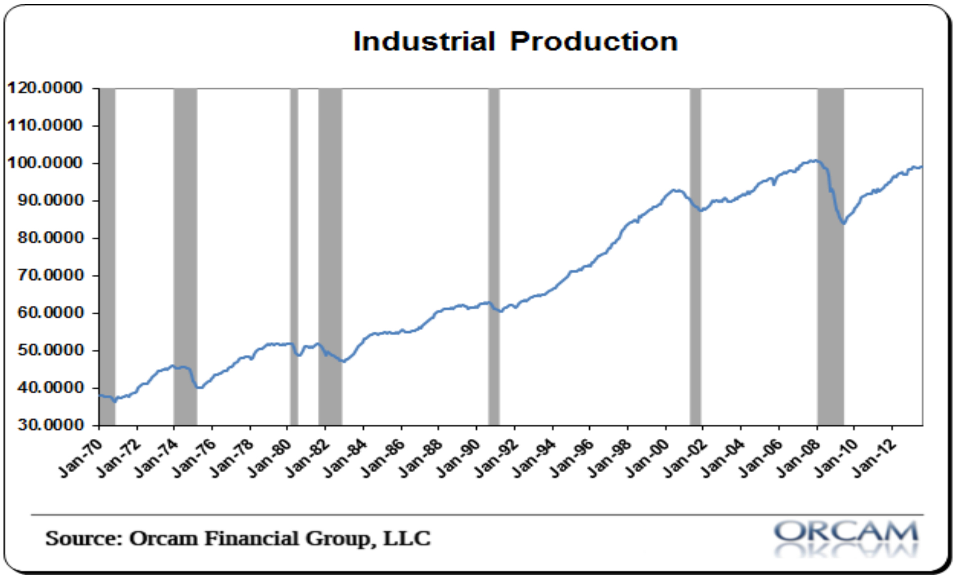
This story of improvement has also been confirmed in the EuroCoin index which is now at its best levels since August of 2011. I don't think the Euro crisis is completely over yet, but much of the painful adjustment has taken place via deflation. This has had a devastating impact on the peripheral economies, but perhaps the most painful deflation is now behind us. I would expect a muddle through to continue here, but marginal improvement and even muddle through is better than crippling deflation.

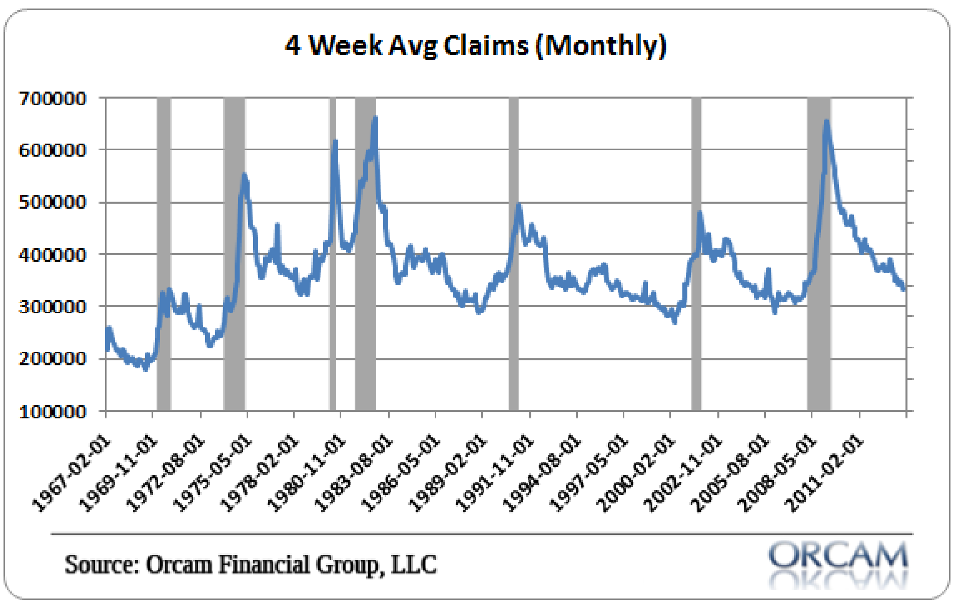


Source: Orcam Financial Group, CEPR

Unfortunately, the Chinese PMI came in at 50.2 for September so the story remains rather mixed. If the global economic stool has three key legs (China, the USA and Europe) then all three legs still look pretty wobbly.

If we turn our focus squarely on the USA, things look like they're muddling along. But mudding is better than contracting. The last few months have shown some signs of life in the economy. Notable improvement has been seen in jobless claims which just hit a post-recession low as well as industrial production which is just shy of a post-recession high. These are hugely important macro indicators that clearly show the economy is slowly growing. It's worth noting that both of these indices turn south prior to recessions. Growth in industrial production is ALWAYS negative inside of a recession and claims ALWAYS spike prior to recessions. The current lows in claims and new highs industrial production clearly show that the US economy is currently growing.

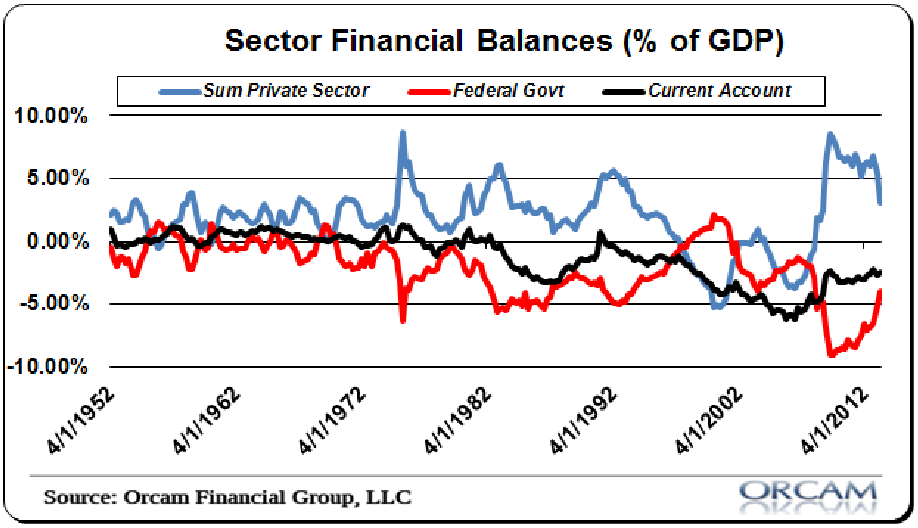




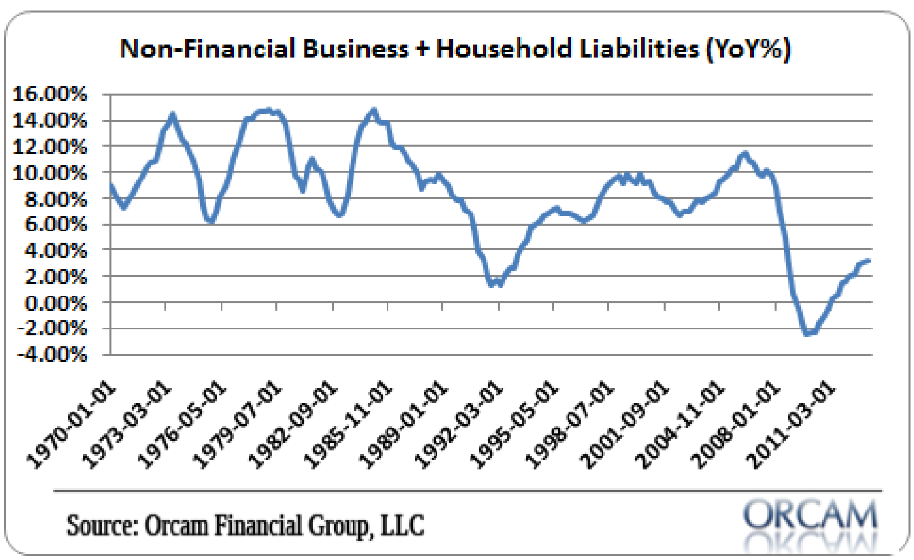
But will it last? In order to answer that question it is useful to look into the Z.1 crystal ball. That's the Fed's Flow of Funds report for those of you who aren't up to snuff on your economic nerdology.

Now, I would normally update you on the Fed's Flow of Funds report in a separate and more detailed report, but given the timing here with the release just a few days ago I figured I'd consolidate the two into this one report.

The latest Flow of Funds report showed some dramatic changes going on in the US economy.   Using a 3 sector view of the economy we can begin to see the substantial impact of the decline in the US government's budget deficit. I like to describe the government's deficit as "asset printing" because it results in the creation of a net financial asset for the private sector in the form of US government bonds. That is, a deficit is the redistribution of bank deposits from one party (the bond buyer) to another (the recipient of government spending) and the issuance of a bond to the bond buyer. This bond has no corresponding private sector liability (because it is a government liability) so the private sector balance sheet improves as a result.



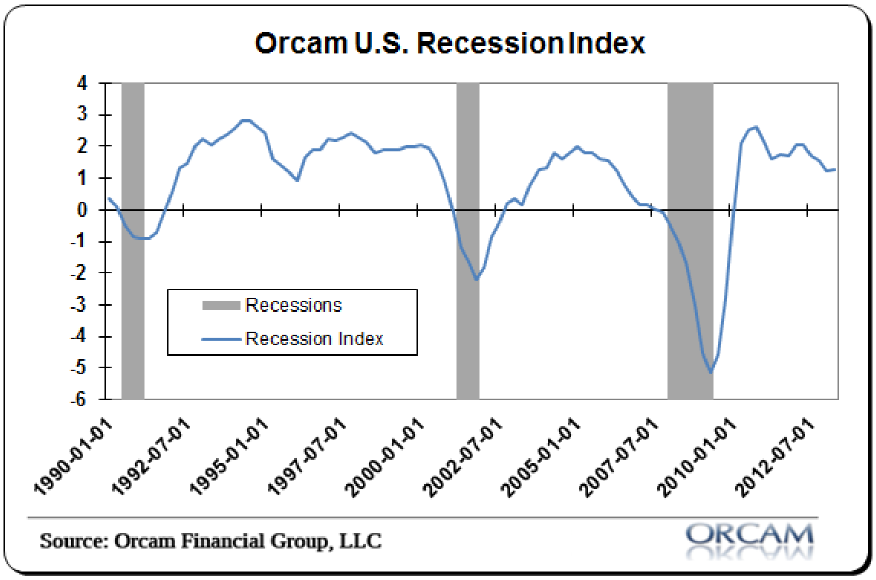
But in order to really understand what's going on in the economy the 3 sector view is not sufficient. We have to dive deeper into the private sector itself because this is where the real economic action occurs. Now, in a credit based monetary system we pretty much always need someone to be expanding their balance sheet in order to sustain growth. That's why understanding the de-leveraging of the private sector was so important in recent years. If the government had not expanded its balance sheet the US economy would look a lot more like Greece today because ALL THREE key sectors would be contracting balance sheets. So, the question now is—if the government is no longer expanding its balance sheet at the rate it has been then whose balance sheet is going to take up the slack? Well, we're beginning to see the private sector carry that burden.



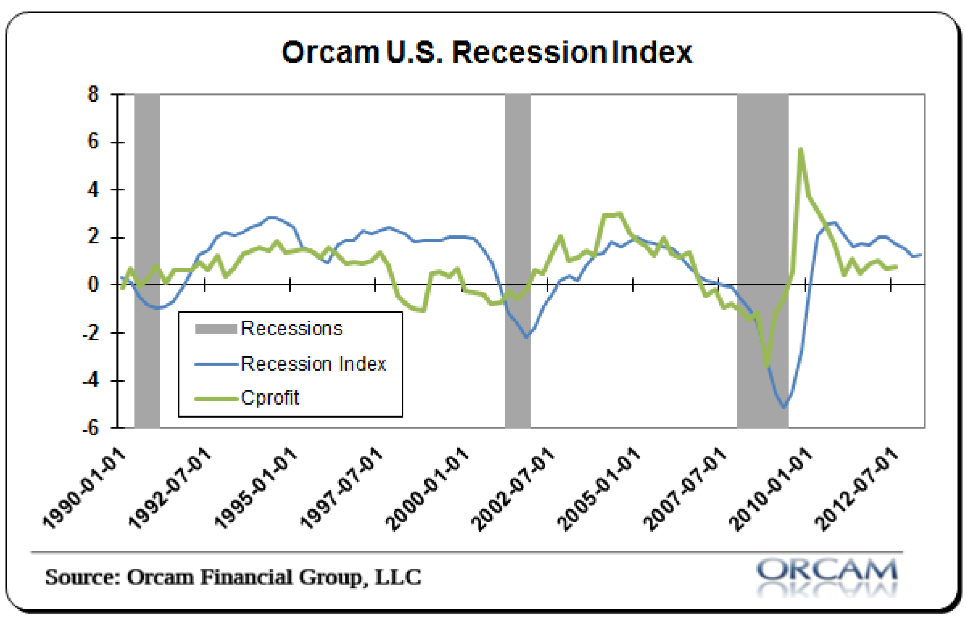
Household debt has continued to stagnate in recent quarters, but the big change has come from the corporate sector. In the last 4 quarters we've seen a steady increase in issuance of corporate liabilities.

This is hugely important. The chart on the previous page shows the total year over year change in household and non-financial corporate business liabilities. That huge decline in the 2008-12 period was utterly devastating for the private sector. Had the government not expanded its balance sheet when it did we almost certainly would have experienced a much deeper and longer recession.

This is good news for now. And it's all being confirmed by the Orcam U.S. Recession Index which gives me a good deal of confidence about the big picture view going into the end of the year. Things aren't looking great, but they could sure be a lot worse considering the unusual environment we've been in for the last 5 years. And the decline in the government's deficit, while alarming, is actually not all bad since much of it appears to be occurring as a result of private sector improvement (higher tax receipts) and not just government imposed austerity in tandem with a private sector de-leveraging. What we're seeing in the USA is actually a sequential improvement and increasing health in the private sector's balance sheet. Let's hope it continues.



This brings us to the markets. If economic growth has been so weak then why are markets continuing to rally? This has been at least partially the results of improving fundamentals. Remember, even modest growth can coincide with profit growth. As I've shown before, the recession index correlates highly with year over year profit growth. And the logic behind this is rather simple. Corporate profits are driven by 4 primary factors—net corporate investment, net exports, household saving (or dissaving) and government deficits. In other words, the key drivers of GDP correlate to the key drivers of corporate profits. This is why the largest market declines tend to occur within



recessions. It's when the macro picture is deteriorating that businesses suffer the most. Of course, the stock market does not always perfectly reflect the state of corporate America. So while we're seeing relatively meager revenue growth (just 3-4% at present) and profit growth that has slowed into a similar range we're still seeing multiple expansion. 12 month operating earnings put the P/E ratio of the S&P 500 at about 17 at present. That's up sharply from the 2011 low of 13. Theoretically, there's no telling how high or low this multiple can expand and contract because that's nothing more than a folly in trying to predict how much investors are willing to pay for the S&P 500 at a certain level of earnings. If you're like me, you don't know where future earnings are headed precisely and you don't know where future prices are headed so the idea of relying too heavily on P/E ratios is silly. But that at least puts some of the price action in the right perspective.

What Could Go Wrong?

We seem to be in a sort of holding pattern where the economy isn't strong, but it's not contracting either. In some ways it's been a goldilocks environment for the equity market and corporate profits. Not too hot and not too cold. But risks remain and we should be aware of the potential pitfalls. Below are the 2 biggest risks I see in the coming quarter:

1) The end of the taper. QE has clearly had a powerful psychological impact on market participants and the mere mention of the end of QE sends yields higher. Interestingly, stocks have actually been rather immune to the taper talk in recent months, but bond markets have reacted violently. The end of the taper is a big risk to fixed income markets. We have to be aware of duration risk and exposure to government bonds.

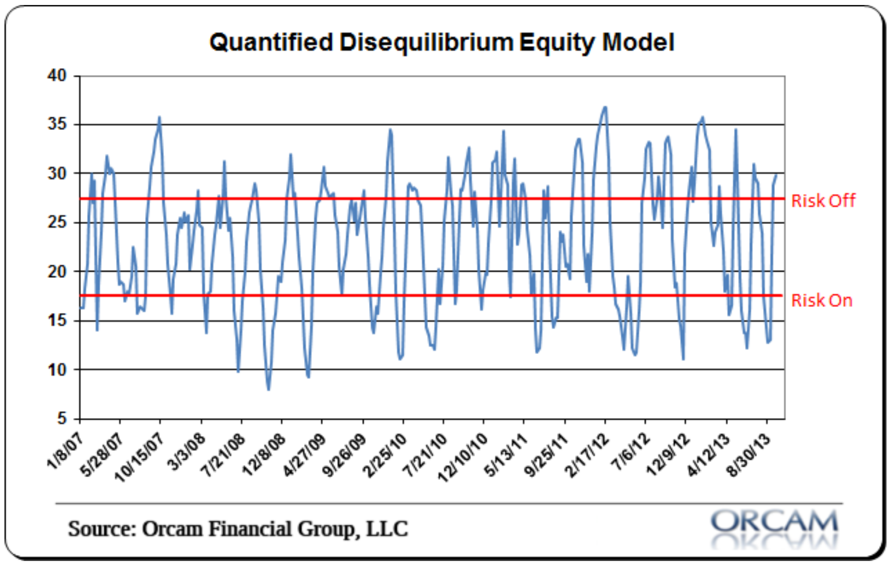
I would keep duration short and ensure you're well diversified across different types of bonds. The taper rumors also had a big impact on emerging market stocks. I would be highly selective about how you go about exposing your portfolio to emerging market equities in the coming quarters as the markets are likely to continue being skittish about the potential taper effect here. Developed economies are definitely superior for equity exposure.

2) The Continuing Euro Crisis. We have to be very careful when we discuss Europe. There are, in my opinion, two Europes at present. There is the periphery and the core. The core has benefitted from the Euro construct while the peripheral countries should continue to suffer from it. Many peripheral countries have seen huge equity market rallies in recent months as many assume the Euro crisis has passed. This is not the case in my view. The Euro is structurally flawed and markets like Spain, Italy & Greece should be sold relative to safer core countries like Germany.

The Equity Market View

The big picture perspective leaves me bullish, but I hesitate to get overly greedy given how good the equity market has been to us this year. I still think we should approach the investment landscape with a core bullish position in equities. On the other hand, we do have to realize that the S&P 500 is up 17.89% year to date.

The QD model has turned back to a risk off reading so I am more cautious entering this quarter. I think that's fairly prudent given the big rally in equities and the potential for a rather unexciting Q3 earnings season. If we're lucky we'll see the market take a nice dip in October or November so we can buy into year-end, but frankly, given that our goal is ultimately all about protecting against purchasing power loss and the risk of permanent loss we really can't be too unhappy with the way the year has unfolded. Maybe it's better to be on the cautious side as the year closes out.



The Fixed Income View

Given the more cautious view around equities I am increasingly bullish on fixed income relative to equities. I think that the Fed has capped rates for 2013 and I think the taper is likely off the table until Janet Yellen takes over. I don't think Ben Bernanke wants to start an exit phase and then hand over that mess to a new Fed Chief. Instead, I think he'll leave the mess entirely to her so she can deal with it as she pleases. And given some of Yellen's recent comments I think that she's unlikely to taper in early 2013, but we'll cross that bridge later in the year.

That said, I think the fixed income markets look increasingly attractive. But we do need to be mindful of where we allocate capital. If you're going to jump into fixed income here, the Ishares Aggregate is not a bad way to gain exposure in Q4 if you're bearish on interest rates and bullish on bond prices. If you want to be more aggressive I think TIPS are a fine way to approach the longer end of the Treasury curve.

Summing It Up

To me, understanding the 30,000 foot view is crucial in portfolio construction and risk management. I don't expect to be able to precisely forecast the next recession, but I believe we can design models that show when the odds of recession are a high probability event. And knowing that all of the 30%+ declines in market history occur within these environments gives us the potential ability to implement risk management structures that reduce our exposure to massive downside risks. This isn't about forecasting or pretending to have a crystal ball. It's about creating a process that increases the odds of sidestepping potentially catastrophic environments. For the duration of this business cycle the Recession Index has been remarkably good at keeping us out of harms way while keeping us in the game when things turned up. Despite persistent headwinds, this year has been no different. At present, this index continues to point us towards a low risk macro environment. I'd say the odds of a recession and therefore a substantial market decline are low at present.

But the big picture is only a part of the battle. Portfolio construction is about process and not prophecy. And that's why I emphasize the use of a tactical hedge at times. In many ways, we're hedging against our own stupidity. I'd love a 18% return every year, but no one needs that from their portfolio and those who reach for it rarely achieve it consistently or are usually just playing a loser's game where they think the rewards have been justified by what are usually extremely high risks. So maybe the name of the game to start Q4 is to know when to fold 'em. It's been a good run, let's get up, walk around and see if we feel refreshed a bit later in the quarter before we decide to sit back down at the equity table….

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