ORCAM | ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

December 4, 2013

A 2014 Preview—Market Drivers

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Having a sound macro view of the world requires a 30,000 foot perspective. When we plan and construct portfolios we have to build this perspective into the way we begin to think about the markets and what the potential outcomes might be so we can plan accordingly. This matters whether you're a so-called "passive investor" or an "active investor". For instance, the so-called "passive investor" pretends to be pursuing a forecast free portfolio, but nothing could be further from the truth. Even the most passive John Bogle type investor is indeed making a macro forecast about the world. It just so happens that they bet on long-term growth and a bull market. And this happens to be a pretty good bet over long periods of time. But these "passive investors" are still making a forecast. Some might even call it a rather naïve one.

That said, when we look out on the horizon into 2014 it's helpful to begin formulating a 30,000 foot view of the potential market directions. I'll provide a more formal Q1 and 2014 preview later this month, but since we're at the point in the year where markets will begin planning and accounting for the new year it's helpful to begin piecing this puzzle together.

The Macro Drivers in 2014

There are several big trends that are likely to drive markets in 2014. Let's touch on each on briefly.

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Long story short—The 2014 Economy Might Rhyme with 2013, but the Markets Likely Won't.

The Dreaded Taper

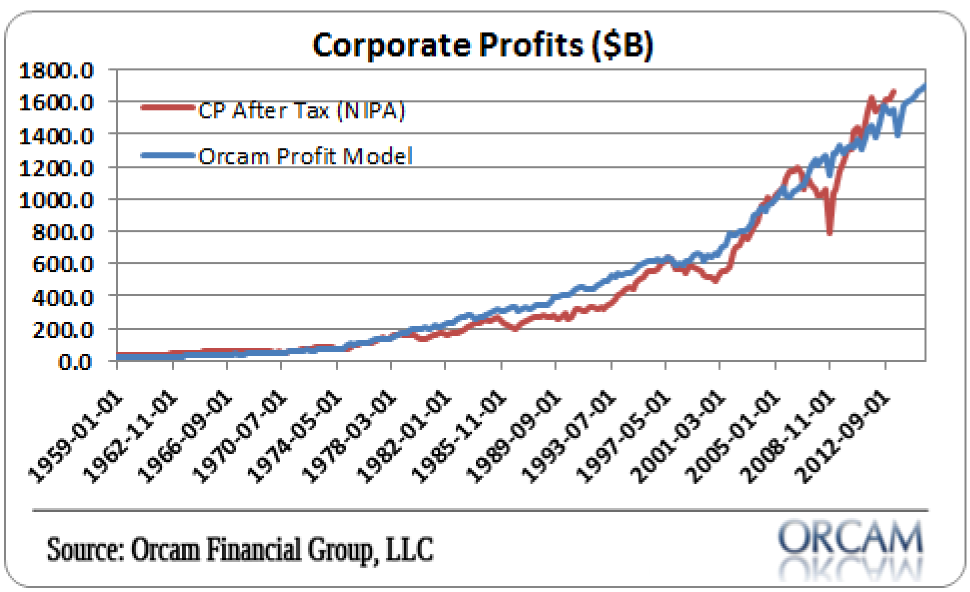
The biggest risk to financial assets in 2014 is the potential for Fed Tapering. What's nice about the tapering environment is that we actually got a brief glimpse of how markets might respond to the actual tapering. In May of 2013 when rumors of the taper began to swirl we saw dramatic market moves.

My baseline for tapering is late Q1, but I do think there's potential for this to be pushed back. Still, this creates potential risks in certain asset classes heading into the new year. Specifically, we saw particularly poor performance from emerging market equities, REITs, emerging market debt, corporate bonds and developed market debt. Interestingly, the asset class that was least hurt by the rumors of taper were domestic equities. In addition, volatility served as a good hedge as did many currencies including the Yen, Swiss Franc and the US Dollar.

As we begin to look into 2014 we have to recognize the high potential risk of a tapering at some point during Q1. This means interest rate sensitive instruments are likely to be abnormally volatile during this period.

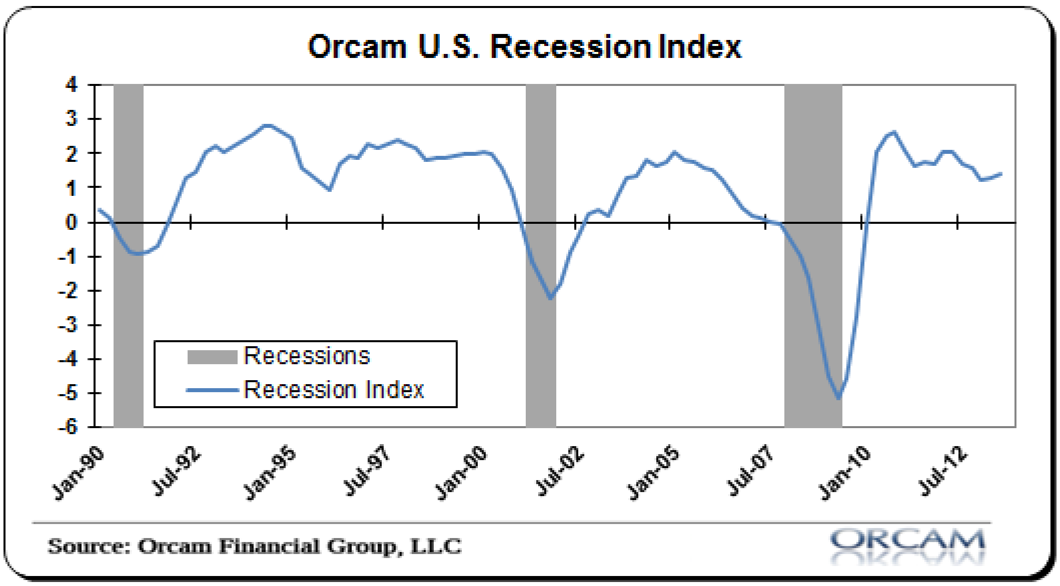
Weak Corporate Profits

Wall Street is calling for 10%+ earning growth next year. I don't see where it's going to come from. I am not negative on the economy in 2014, but I do think that double digit profit growth is a bit on the high side. We know from our macro work using the Profits Equation that corporate profits = Investment – Household Savings – Government Savings – Foreign Savings + Dividends. My corporate profits model suggests profits growth is likely to be in the low single digits to flat in 2014.



This is a reality that the markets are likely to wake up to at some point. You're not going to see perpetual 25%+ equity growth with a sluggish corporate profits picture. This means we're likely to see a much more muted year on the equity side of things. Unless of course the market responds irrationally and the market multiple continues to expand. But again, risk assets often become increasingly risky as they rise, not as they fall so that's something to be mindful of. Profits truly are the most important driver of equity growth and the weak reality of this picture is likely to be more fully digested this year.

Continued Soft Economic Growth



Many are talking about 2014 as though it's the year when the global economy returns to "normal". I don't fully agree. After all, any environment with zero interest rate policy, 7%+ unemployment and 2% growth is hardly "normal". Instead, I think we're still in the transition phase from a credit collapse moving on to a balance sheet healing process and hopefully a "normal" credit expansion in the coming years. In a lot of ways I actually think the overall economic environment in 2014 will rhyme with the 2013 environment. Growth is likely to muddle through again, but the game changer with regards to the markets is the Fed's tapering and the behavioral impact this is likely to have on investors.

In general, the Orcam Recession Index is still looking favorable so I don't think there's much reason to get too negative about the big picture, but I do think that those expecting 2014 to reflect the 25%+ equity performance of 2013 are likely to be in for a downside surprise.

Later in the month I'll provide a fuller picture of what's to come, but this should help to build a foundation for what the new year is likely to bring.

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