ORCAM ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

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Q1 2014 Quarterly Outlook

Another year is in the books. As we head into 2014 this review and preview is intended to help you better understand where we might be headed and why. This outlook will contain some broader annual perspectives, but for all practical purposes this should be viewed as a quarterly outlook.

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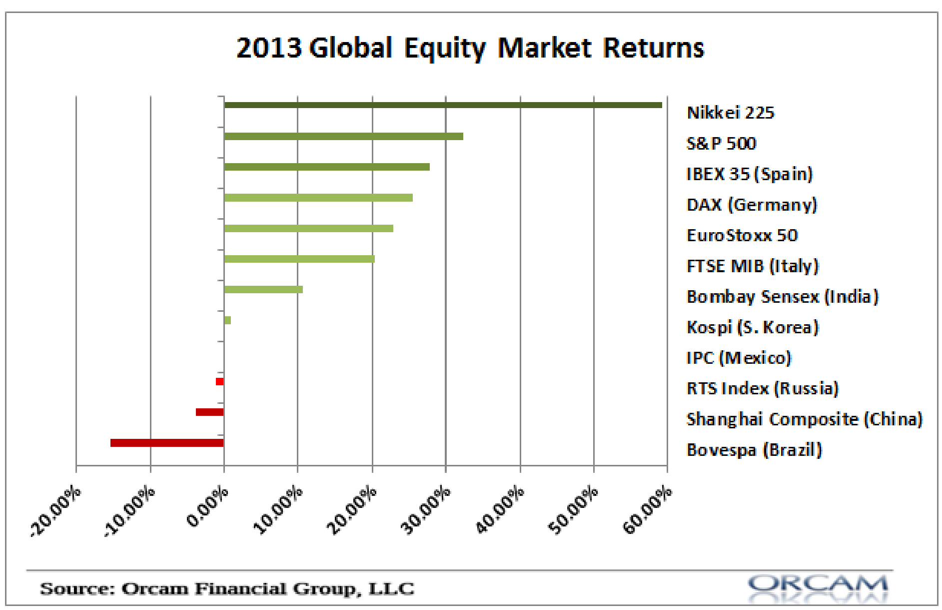
"Failure to prepare is preparing to fail."
-Coach John Wooden

The Year in Review

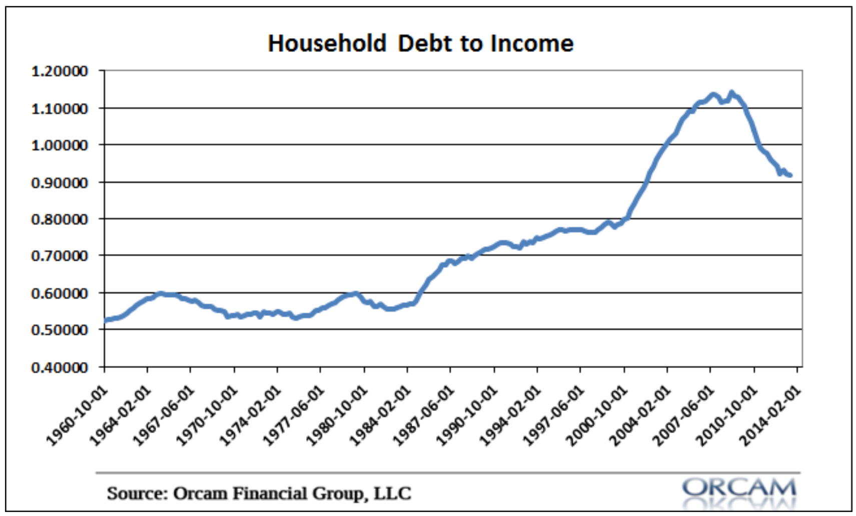
2013 was a wild year for the various asset classes and markets. We saw huge gains in some foreign equities like Japan and parts of Europe while the S&P 500 surged 32.3%. Meanwhile, US Treasury bonds got walloped (20 year+ bonds were down 14%), the aggregate bond index declined 2% and corporate bonds declined 2%. The big losers this year were Brazilian equities which fell 16% and commodities which suffered wide ranging losses. Gold and silver were especially hard hit with losses of –36% for silver and losses of –28% for gold.

On the strategy front the big losers were recent winners with risk parity funds getting hit by the bond losses, bond funds like PIMCO Total Return generating negative returns and hedge funds generating just a 9% total return. A 60/40 balanced fund generated a respectable 17.3%.



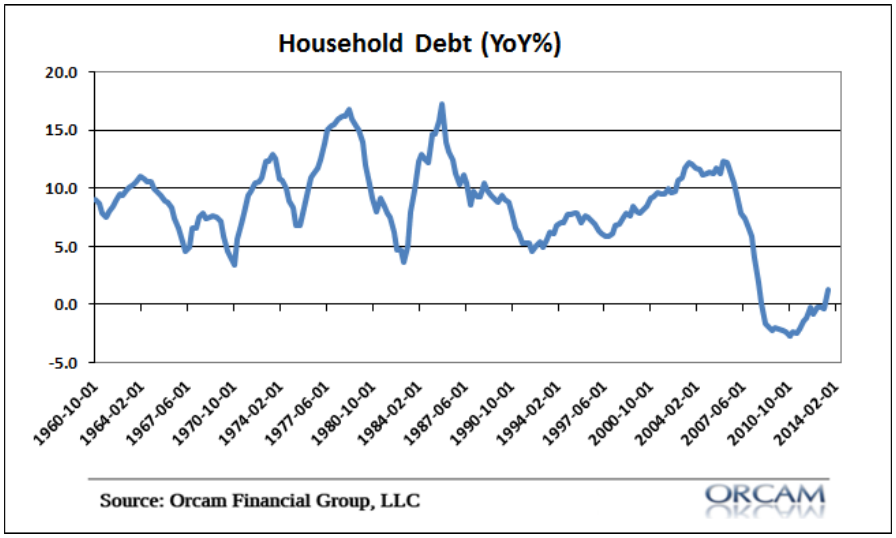
Where Have we Been?

In order to understand where we might be going it's important to first understand where we've been. The global economy has been through a remarkably traumatic experience since the earlier part of the 2000's. Global demand for credit and real estate in particular drove large credit bubbles in many economies and set the table for the most significant credit crisis in modern economic times. Household debt to income ratios surged to previously unforeseen levels. When the incomes and assets supporting this debt structure began to slow or turn negative this created the catalyst for a massive credit crisis which rippled through the global economy and the global banking system.



The economy has made enormous progress since the crisis, however. After peaking at a ratio of almost 1.15 the household debt to income ratio has declined to 2003 levels of 0.92. This has been due to a multitude of factors. The primary contributor has been private sector healing via the corporate sector. While the household sector remained burdened by the credit crisis the corporate sector's balance sheet remained relatively strong and private investment recovered sharply despite the crisis. This was aided in large part by the government's budget deficit (which contributed net financial assets and a flow of income to the private sector thereby helping balance sheet improvement) as well as the extraordinary measures by the Federal Reserve.

In Q3 2013 we saw the first year over year gain in household debt since the crisis began. This officially marks the end of the household de-leveraging cycle and means that we are moving into a period of much more normalized economic activity. As you can see in the figure to the right the credit cycle is an important driver of the typical business cycle. After all, we reside in a credit based monetary system so debt accumulation is a perfectly normal and healthy part of a normal cycle. You'll notice though that we generally see much higher levels of debt accumulation so while we're moving into a more normalized business cycle we are still not quite 100% back to full health. That said, the recent improvement in credit trends and the economy show that we are definitely making progress and headed in the right direction. This is hugely important for understanding where the economy is headed in the coming years. It means the economy will begin behaving differently, policy will be altered and assets will therefore respond accordingly.

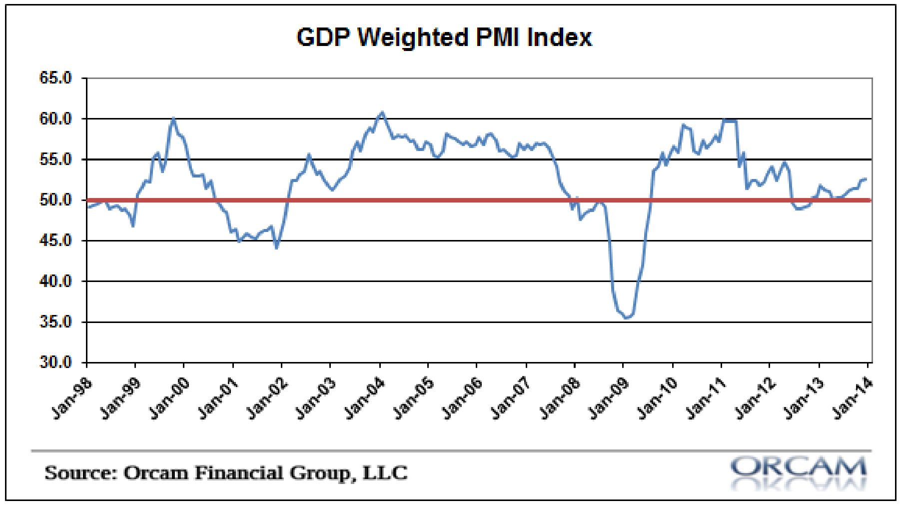


Where are we Headed?

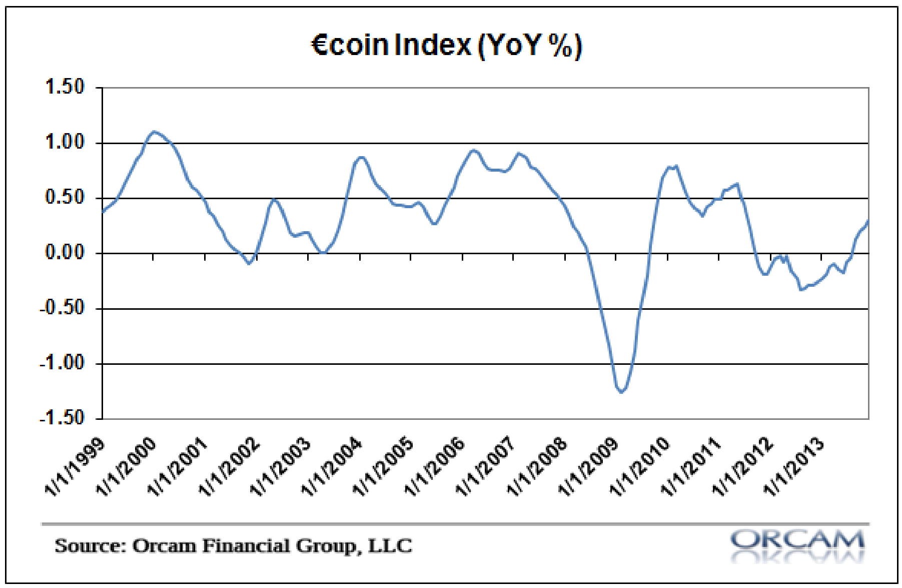
The big picture has improved dramatically over the last few years, but the past doesn't necessarily tell us a whole lot about where we're headed. In order to better understand what might unfold in 2014 it helps to begin deciphering the current state of the global economy and what some potential outcomes could be over the coming quarter.

The latest update on global PMI's showed a mixed picture, but some signs of continued optimism. PMI in Europe hit a 52 week high of 52.7 in December, up from 51.6 in November. The USA posted strong manufacturing growth at 55, up from 54.7 in November. China was flat at 50.5, India was down marginally, Japan's resurgence continued and Brazil saw an uptick back into growth territory at

50.5. Overall, the GDP weighted PMI Index came in at 52.6 for the month of December. That was the highest reading since May of 2012. The biggest positive in this data is the data out of Europe where we're beginning to see some modestly positive economic news.



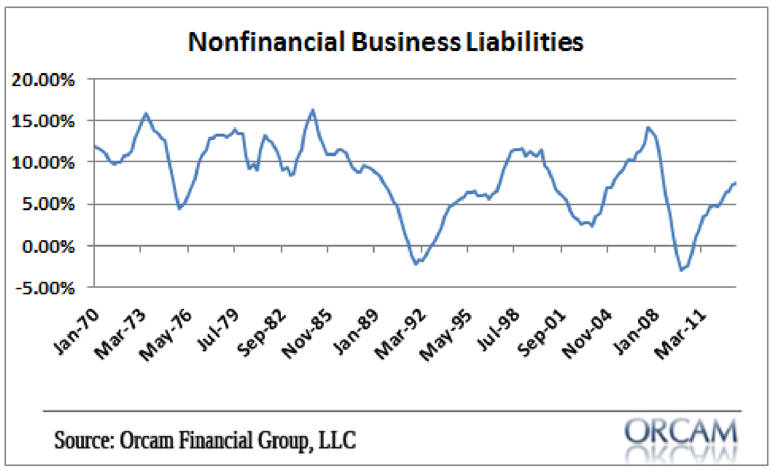
In addition to better PMI readings from across Europe we have also seen improvement in the EuroCoin Index which has jumped to its highest reading since 2011. The deflation that has gripped some of Europe's peripheral countries has led to substantial improvement in rebalancing some of the trade imbalances across the region. Unfortunately, I think Europe's structurally deficient currency structure leaves it vulnerable to slow growth and downside. Europe appears much more "Japanese" than the USA does at present and with the exception of the German economy I would be hesitant to own assets across the region. Nonetheless, the recent improvement is a positive sign for the global economy.



The more interesting story, in my view, is Japan, where a massive currency devaluation has helped revive the economy in the last 12 months. "Abenomics" appears to have gained substantial footing there thanks to the currency devalution. That's despite the Bank of Japan's claims that they are not influencing the currency—a claim I find hard to believe given the dramatic decline in recent months. Nonetheless, the improvement has been substantial and the results are real—for now. I remain extremely cautious about Japan, however. I think the structural problems in Japan make for a very difficult long-term outlook. In particular, Japan is likely to continue seeing population declines in the coming decades. This makes for an extremely negative structural economic headwind. So while these short-term policy interventions might give the appearance of a new bull market, I am deeply skeptical. And given the fact that the last year's economic performance is, in large part, the result of what looks like currency intervention, I would not bet on the sustainability of the economic recovery even if these policies can be sustained for a few years at a time. The long-term headwinds are simply too problematic in my view. But again, we'll take the short-term gains as a global positive for now.

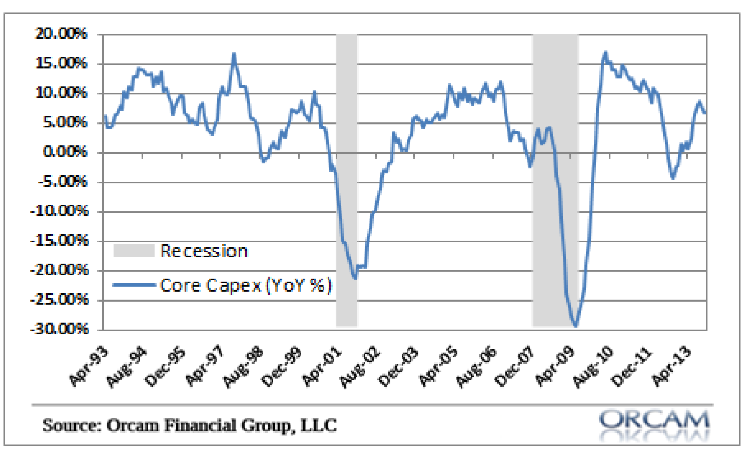
The US Economic Outlook

The US economy has been the engine behind the economic recovery in recent years. As China and Europe have stagnated the USA has actually begun to show some signs of real sustainable growth. In my view, this is all part of the healing process from the credit collapse. As private balance sheets have healed we've seen a slow and steady improvement in the broader economy. In my view, that healing is likely to continue into 2014 and certainly into Q1 2014.

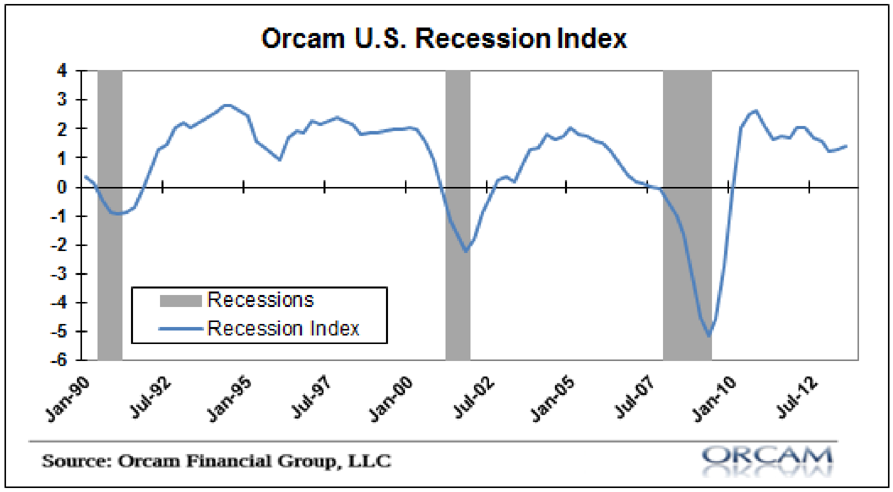


As the household sector in the USA deleveraged the business sector and government sector leveraged themselves up. This eased the burden on the overall economy as spending continued despite the deleveraging household sector.

In the last few quarters we've begun to see real sustainable signs of business spending and investment. Core capital expenditures, one of the best leading economic indicators, has ticked up to over 6.8% year over year. Businesses remain extremely healthy and have provided a substantial lift to the US economy when it was most needed. And most importantly, this is a sign that the recovery is becoming increasingly sustainable as the private sector is generating real organic growth with time and not relying so much on government policies and government intervention.



The broadest index I aggregate, the Orcam US Recession Index, has remained in positive territory heading into 2014. This index has led each of the last three recessions by at least a quarter and at present is showing no signs of recession risk. The latest reading at 1.42 is consistent with modest US economic growth. Overall, I maintain an optimistic broader perspective of the US economy heading into Q1 2014.

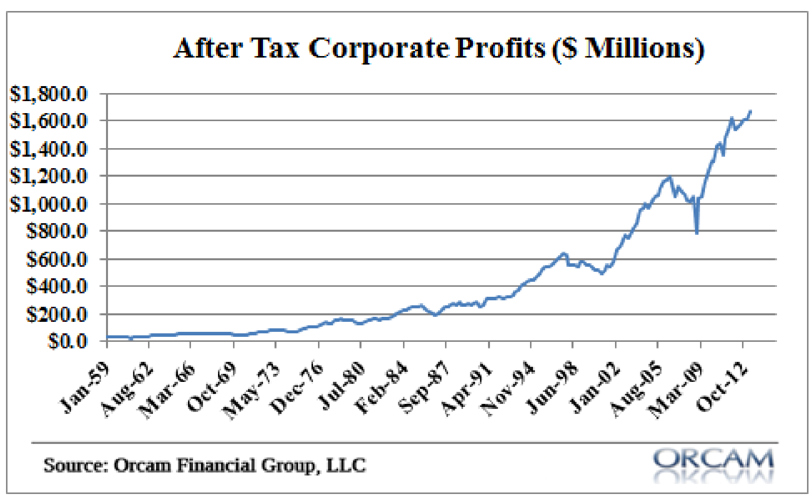


The Corporate Profits Outlook

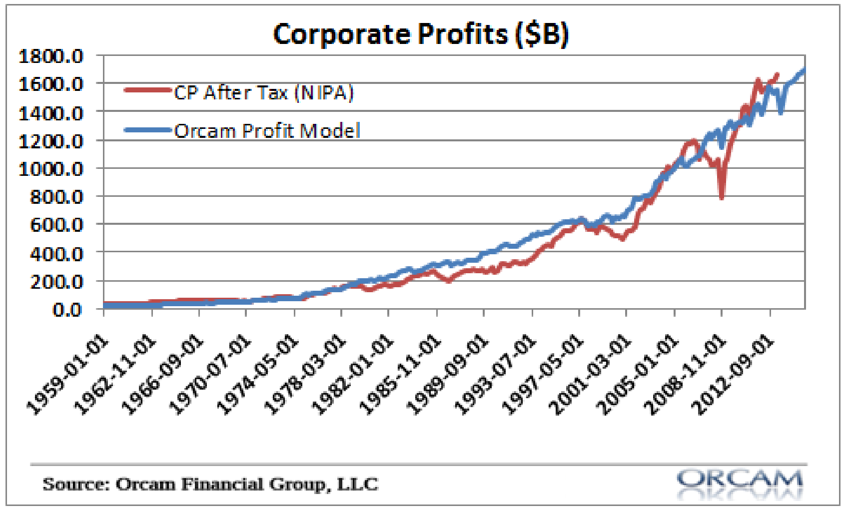
Of course, the economy and the markets don't always perfectly correlate. In fact, the market cycle tends to lead the economic cycle so we will have to rely on not only understanding the economic cycle, but we have to better gauge the drivers of the market cycle. Of the fundamental drivers we have to consider none is more important than corporate profits. After all, most of the instruments we allocate our savings to rely on the ability of the underlying entities to generate income. So the profit cycle is at the heart of the forces driving the market cycle.

Corporate profits have boomed in recent years so while there has been a good deal of chatter about how the Fed is "manipulating" a false market boom, there's actually been a real fundamental driver behind all of this. But how sustainable is the recent boom in corporate profits? If we dig down into the macro drivers behind this boom we can begin to gauge where profits might be headed in the coming years. As I've noted before, profits are a function of:

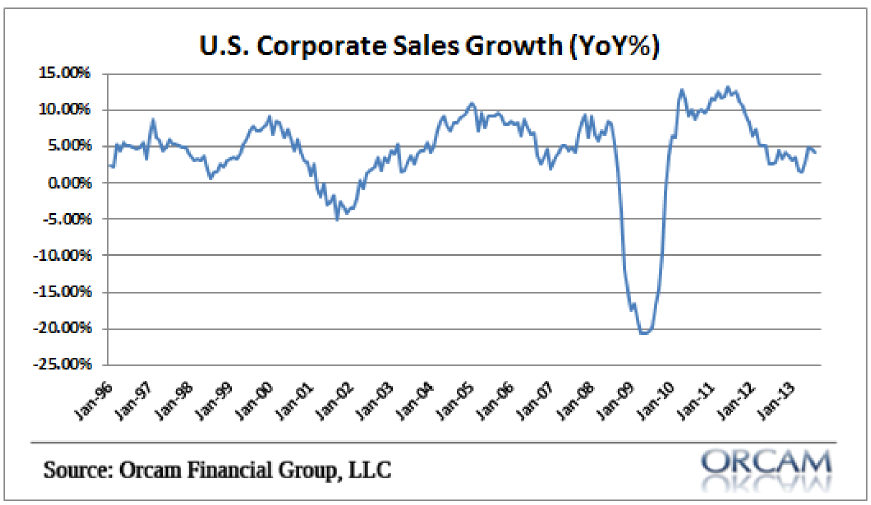
Investment – Household Savings – Government Savings – Foreign Savings + Dividends



Corporate profits came under some pressure in 2013 and I suspect we should see similar trends in 2014. In fact, there is the potential that we could see negative year over year profits growth in either Q1 or Q2 before seeing a second half resurgence in profits. If private investment and dividend growth remain somewhat robust (as I suspect they will) then the second half profits growth could be in the high single digits and could lead to average profits growth of 5-7% for the full year.



Corporate sales growth has also slowed substantially in the last few years, but remains in growth territory. The latest reading on revenues came in at 4% year over year. This is well shy of levels seen in 2010 & 2011, but still modest enough to maintain profit growth. I think we should continue to expect some convergence here where the slow profit growth and slow revenue growth meet in the middle single digits. Overall, revenues are the driver of profits and this paints a modestly positive picture heading into 2014.

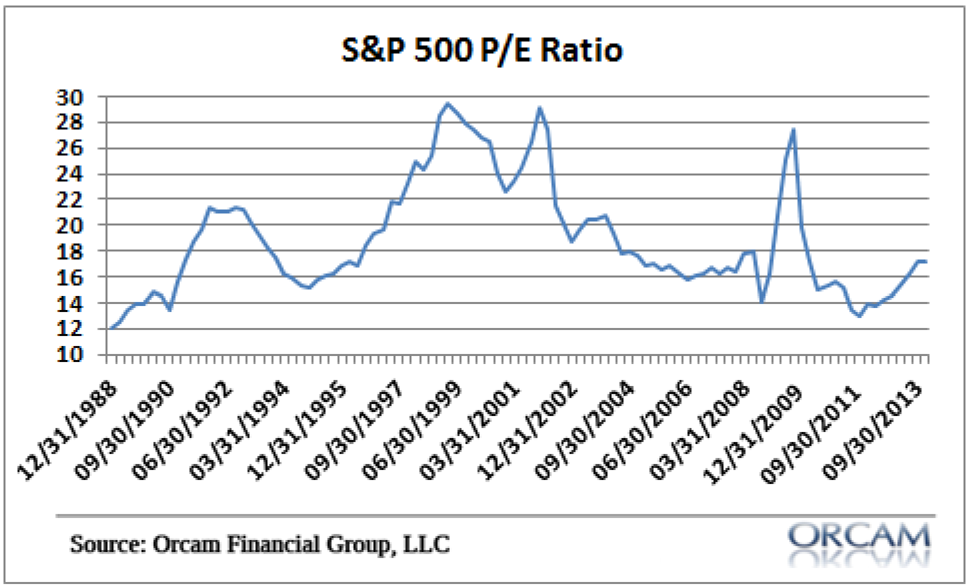


I will revisit this with each quarter, but for now the broader macro view remains somewhat constructive. Profits growth is profits growth even if we undergo some turbulence in the near-term. But we should consider the potential risk that markets begin to perceive this as a near-term negative while viewing this as a temporary headwind as opposed to a change in a cyclical trend.

The Equity Market Outlook

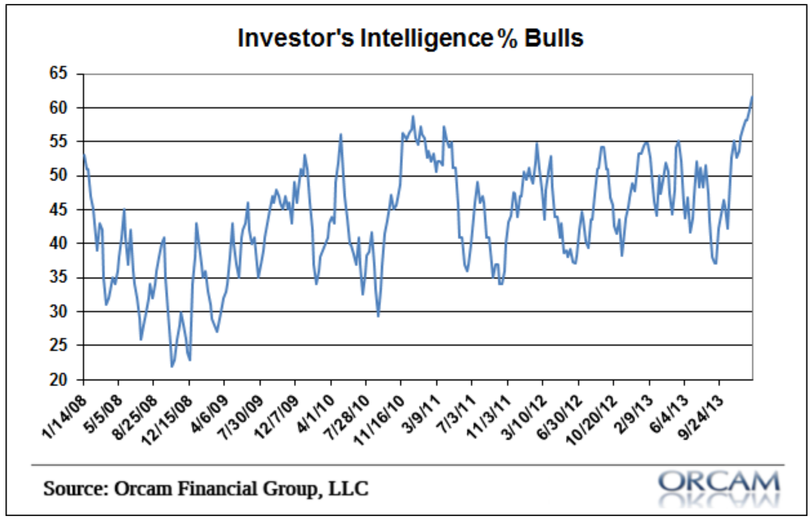
US equities remain my preferred vehicle for stock market allocations in Q1. Given the broadly positive macroeconomic trends I think it's prudent to maintain a strategically bullish cyclical perspective on the US stock market. Despite the enormous rally over the last few years there are still few signs of long-term structural risks that would make me extremely bearish on the cyclical view.

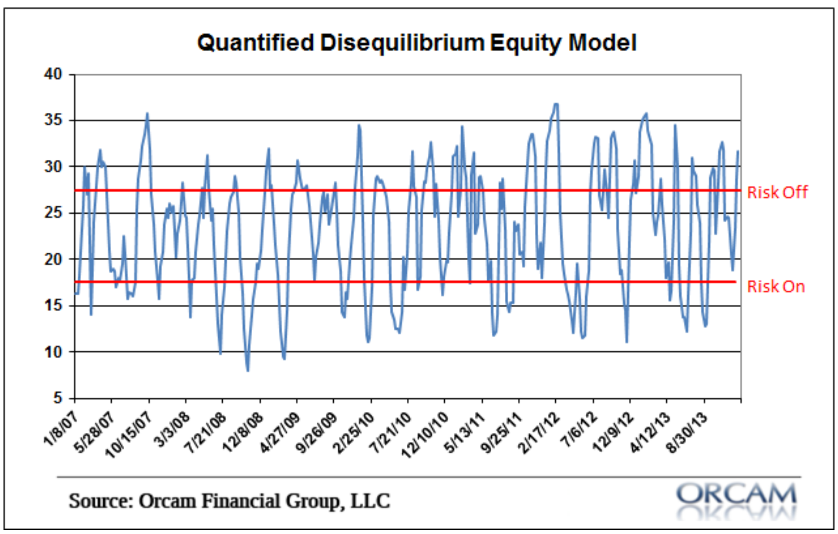
My tactical view remains cautious. Some sentiment indicators are at alarmingly elevated levels and there are definite signs of frothy perspectives in the market. The enormous rally in stocks in 2013 was largely due to behavioral factors as opposed to fundamental factors. While operating profits expanded just 3.7% on average per quarter in 2013 the S&P 500 returned over 32%. This was, in large part, due to multiple expansion and the expectation that profits will improve in 2014. As I noted previously, this isn't necessarily incorrect, but I do not think that such high levels of market growth are sustainable in the near-term.



Although the multiple expansion from recent years has not been wildly out of control, there is some considerable change in market psychology in recent months. The current P/E ratio of 17.1 is considerably higher than it was at the 2011 lows just under 13. That's certainly not an unreasonably expensive market, but investors should not expect the kind of growth in 2014 that we saw in 2013 given the strong likelihood for another modest year in profit growth. Otherwise, we would almost certainly begin to see relatively frothy market valuations which might drive sentiment in the other direction.

More importantly, near-term sentiment indicators have been raising some serious red flags. The CitiGroup Panic/Euphoria recently hit a 12 month high and the Investor's Intelligence Survey of portfolio managers hit its highest level since October 2007 just prior to the last cyclical bull market peak. In addition, the AAII Asset Allocation Survey showed a 7 year high for equity allocations. These are poor long-term indicators, but could be signs of some near-term froth. We appear to be seeing increasing signs that investors believe the recent gains in the stock market are something that are guaranteed to continue. A surprise in the pace of corporate profits in Q1 or Q2 could be just the thing to knock some of these permabulls off their rockers.





The unusual market environment from the last 12 months has led to some unusual activity in the QD Tactical Model. We haven't seen a strong buy signal since September of last year. This is another clear sign that sentiment is off the charts and buying the dip has become the modus operandi for all portfolio managers. I suspect that 2014 will bring some semblance of normalcy back to the markets and that the "one way market" will turn into something that resembles the typical rollercoaster ride we tend to see in equity markets.

Given the many near-term warning signs I would remain tactically cautious here on equities, but remember that our strategic perspective is still quite constructive. There is increasing downside risk, but given the lack of recession risk I do not place the odds of a tail risk event (high loss market event) as being all that high. Historically, the biggest market losses tend to occur inside of a recession after the economy has already started to show some signs of fragility and market psychology cracks.

I would remain particularly cautious about allocations to emerging market economies and undeveloped economies. The events from last May during the "Taper Tantrum" showed that emerging market equities are unusually susceptible to the potential for interest rate increases. If you're going to allocate to equities I would continue to adhere to the "high quality" story with developed economies like the USA and Germany leading the list of candidates.

The Fixed Income Market Outlook

The fixed income markets were incredibly turbulent in 2013. How turbulent?   If you owned 7-10 year US government bonds you generated a –6% total return in 2013.   Since 1928 there have been just 3 years that were worse than that. Since the Ishares Aggregate Bond Index was formed in 1981 there have been just 3 negative years. 2013 was the second worst total return over this period at –1.98%. This was a highly unusual year for fixed income. If you had told me at the beginning of 2013 that that rate of inflation would fall during the year and that economic growth would be relatively stagnant I would have been willing to bet you anything that bond prices would be broadly positive.

Of course, the Fed had different ideas and they proved a big disruption for bond fund portfolios. I think a lot of this has been mistaken as the markets view "tapering" as "tightening". I don't see it that way. I view the "tapering" as a modest shift in policy, but not necessarily a prelude to a rise in interest rates. In fact, if inflation remains low and economic growth disappoints we could very well see a halt in any "tapering" talk and a reversal in policy. That said, we have seen the potential impact of "tapering" and we have to consider the risk that the markets perceive tapering as tightening and that this could mean another tough year for long bonds.

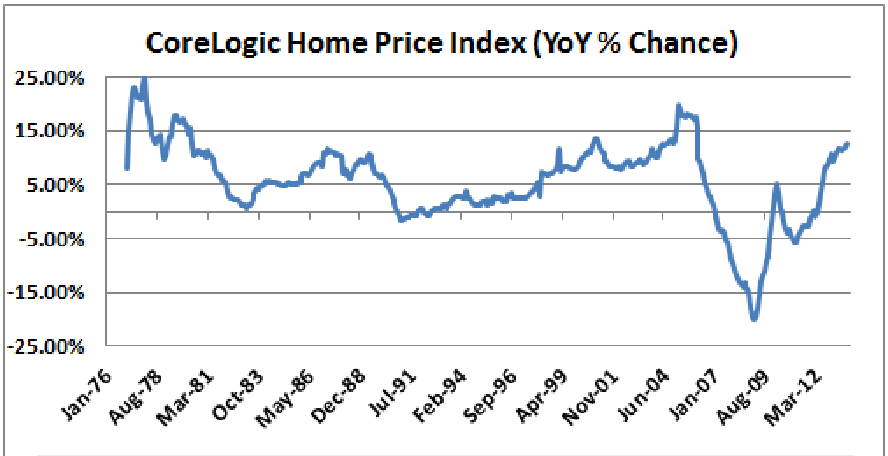
Source: Orcam Financial Group, LLC

In order to gauge the potential risk in fixed income markets let's consider a return to what market participants consider "normal". Over the last 10 years the 10 year note yield has commanded a 1.7% premium over core inflation. At present, that sits at about 1%. If bond investors command the average 1.7%

historical premium then we could be in for at least a 3%+ loss in US government bonds. That certainly isn't good, but we've seen a substantial change in the risks of owning US government bonds after the price re-set from 2013. That said, I would be hesitant about owning 20 year+ US government bonds in this environment as there remains the potential for economic upside surprises and continual "tapering" talk. If you're going to own fixed income instruments I would much prefer to own shorter duration instruments and a bond market aggregate like the Ishares aggregate (ticker: AGG).

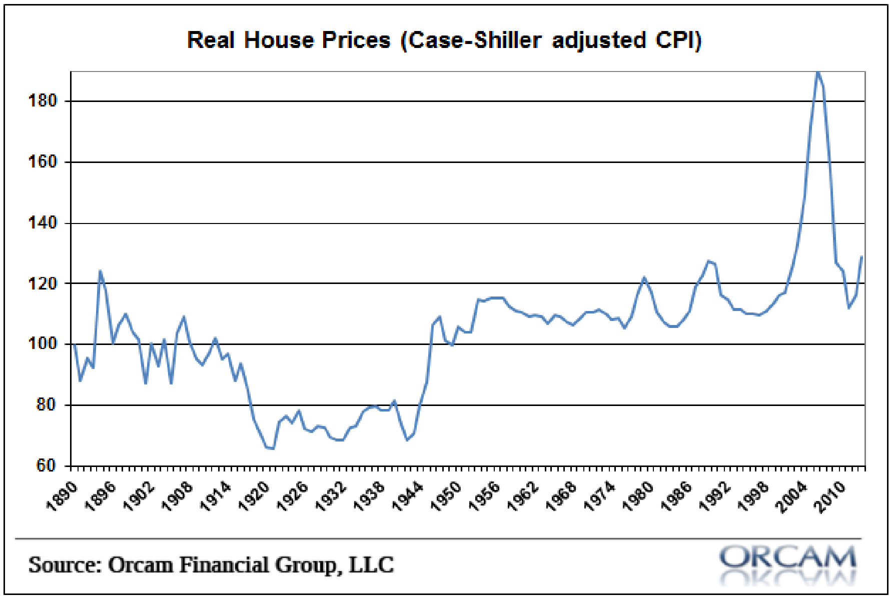
The Housing Market Outlook

Global housing markets made a big recovery in 2013. In fact, I think some markets made too much of a recovery. In the USA broad home price indices are up 12% year over year. Unfortunately, housing has turned into more of a speculative asset in recent decades as opposed to being a roof over one's head as it was once perceived. This has resulted in asset price volatility that makes the housing market look more like the stock market rollercoaster ride than what should be an asset class that correlates highly with income growth and inflation. These big price swings are good primarily for the people who benefit from speculating in housing prices. Unfortunately, they are entirely unsustainable as the underlying prices must, by definition, remain highly correlated to income growth and what people can actually afford to purchase (since housing is such a substantial component of the overall private sector balance sheet). So these 12% year over year changes are not sustainable and should not be viewed positively.



Source: Orcam Financial Group, LLC

That said, housing prices are far less expensive than they were in 2006, but are looking relatively expensive when compared to the historical average. In the post-war era US housing has sold at about 16% above the long-term inflation rate. The current rate of 29% puts the housing market at a 13% premium to its historical rate. So US housing has once again become expensive relative to history, but is still well off



the highs seen a few years ago. Given that, I would not be hesitant to purchase housing in the USA for a long-term investment and a place where one will actually consider living. On the other hand, if you're speculating you have to consider the potential that the market is now overvalued relative to historical trends and that you're essentially relying on a greater fool to bid prices up. Given the relatively stagnant income growth and the unlikely return to a "boom era" I would not expect another big speculative boom in housing. But I could of course be wrong given that housing seems to have become the new speculative asset class around the world. Just be mindful that you're speculating and not investing if your timeframe is short here.

Conclusion

On the whole, 2014 is shaping up to be another decent year for the global economy. My crystal ball can't see much past Q1, but I do think that there is vast improvement in macro trends that could sustain through the year. I see some potential near-term risks on the horizon, but nothing that would serve as a debilitating blow to the global economy at present. Overall, I think things look pretty good heading into Q1 and hopefully we'll see some fear and normalcy enter back into the equity markets so we can purchase at more attractive prices. That said, I would not get overly negative about the macro landscape. We're not in a boom, but we're certainly not in a bust and I don't see high risk of a bust in Q1.

Orcam Financial Group, LLC

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