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FIRST QUARTER 2014 INVESTMENT ADVISORY REPORT

~ Down at the Crossroads

The First Quarter was a choppy affair for the broad equity indexes as they digested their outsized gains of 2013. After a sharp selloff during late January/early February – as Putin stirred up geopolitical tensions in the Ukraine – the S&P 500 churned its way to a roughly 1.8% gain, the NASDAQ eked out a 0.54% gain, and the Dow Industrials posted a small decline[1]. A key difference between the market action in this past quarter and that of 2013 was that diversification once again mattered. We have been, and remain underweight in our exposure to the Emerging Markets (EM) and all things bond and fixed income related. Nevertheless, we are still net long – primarily for diversification purposes – and this added to returns in the past quarters as both sectors rebounded sharply. Historically, however, some of the most vicious rallies tend to be "bear market rallies". Whether that's the case here, or a secular shift is occurring is still open to debate and will be explored below. Interest rates may remain subdued for a prolonged period, as global deflationary forces blanket fixed income markets. However, we still believe that the "unwind" that's occurred in the EM space is a longer term, secular story, analogous to the end of the NASDAQ tech boom in 2000; the Japanese boom around 1990; and the energy/commodity boom of the late '70's.

In last quarter's report, we outlined two areas of primary concern to us. First was the progress of the recovery in the "developed" economies (DV) and the US recovery in particular. We felt that the various "leading" economic indicators (LEI) as tracked by the Conference Board were all pointing towards future domestic growth – despite the very real and present deflationary headwinds. In fact, the latest release showed a 0.5% increase in the LEI in February. According to Ataman Ozyildirim, Economist at The Conference Board, "The U.S. LEI increased sharply in February, suggesting that any weather-related volatility will be short lived and the economy should continue to improve into the second half of the year"[2]

Further, the US Federal Reserve recently reported that "Industrial production increased 0.7 percent in March after having advanced 1.2 percent in February. The rise in February was higher than previously reported primarily because of stronger gains for durable goods manufacturing and for mining."[3] This is exactly where we'd hope to see growth as it's an encouraging harbinger of a long awaited resurgence in investment and capital expenditure

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[1] http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups See entire Q1 market data below.

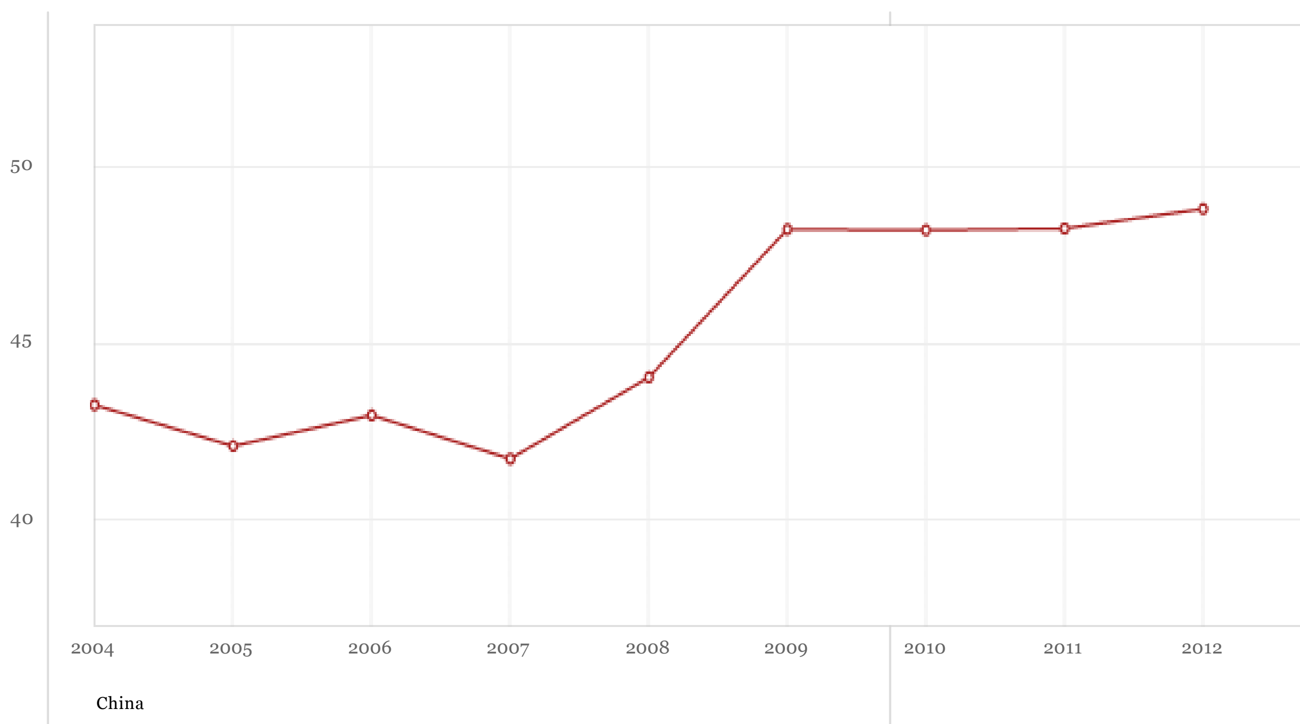
[2] https://www.conference-board.org/data/bcicountry.cfm?cid=1

[3] http://www.federalreserve.gov/RELEASES/G17/current/default.htm

(see the Q IV 2013 Report). And, the same release revealed that "Capacity Utilization for total industry increased in March to 79.2 percent, a rate that is 0.9 percentage point below its long-run (1972–2013) average but 1.2 percentage points higher than a year prior."[4] This is significant because an 80% utilization rate historically has been the level at which companies had to increase hiring as well as capital expenditures thus further fostering economic recovery. This would support the "gradually rising interest rate theme"; absorb additional slack in the labor markets; and be a tailwind for domestically derived corporate profits.

Despite this encouraging progress, there's no shortage of headwinds to report – from Russia's incursion into Crimea and the Ukraine; elections going on in the Middle East; the deflating of an incipient biotech and "social media" bubble in the US NASDAQ market; to the record low yields on sovereign debt in Europe (particularly the periphery countries like Greece, Spain and Portugal); the specter of deflation in the Euro area in general, and the expectations raised by the ECB of imminent QE to counter this deflation.

Of greatest import to us though, is the (in our opinion) secular unwinding of the economic growth and capital inflows in the EM countries and the unfolding slowdown in China in particular. In a very real sense, the attempts of the DV world to reflate and China's efforts to cool down their growth are two opposing parts of the same picture. Chinese growth was fueled by massive domestic capital infrastructure investment – i.e. overinvestment and/or malinvestment – to historically unprecedented levels totaling nearly 50% of GDP (see chart below, particularly as they flooded their own economy with liquidity in response to the 2008 financial crisis)[5]!

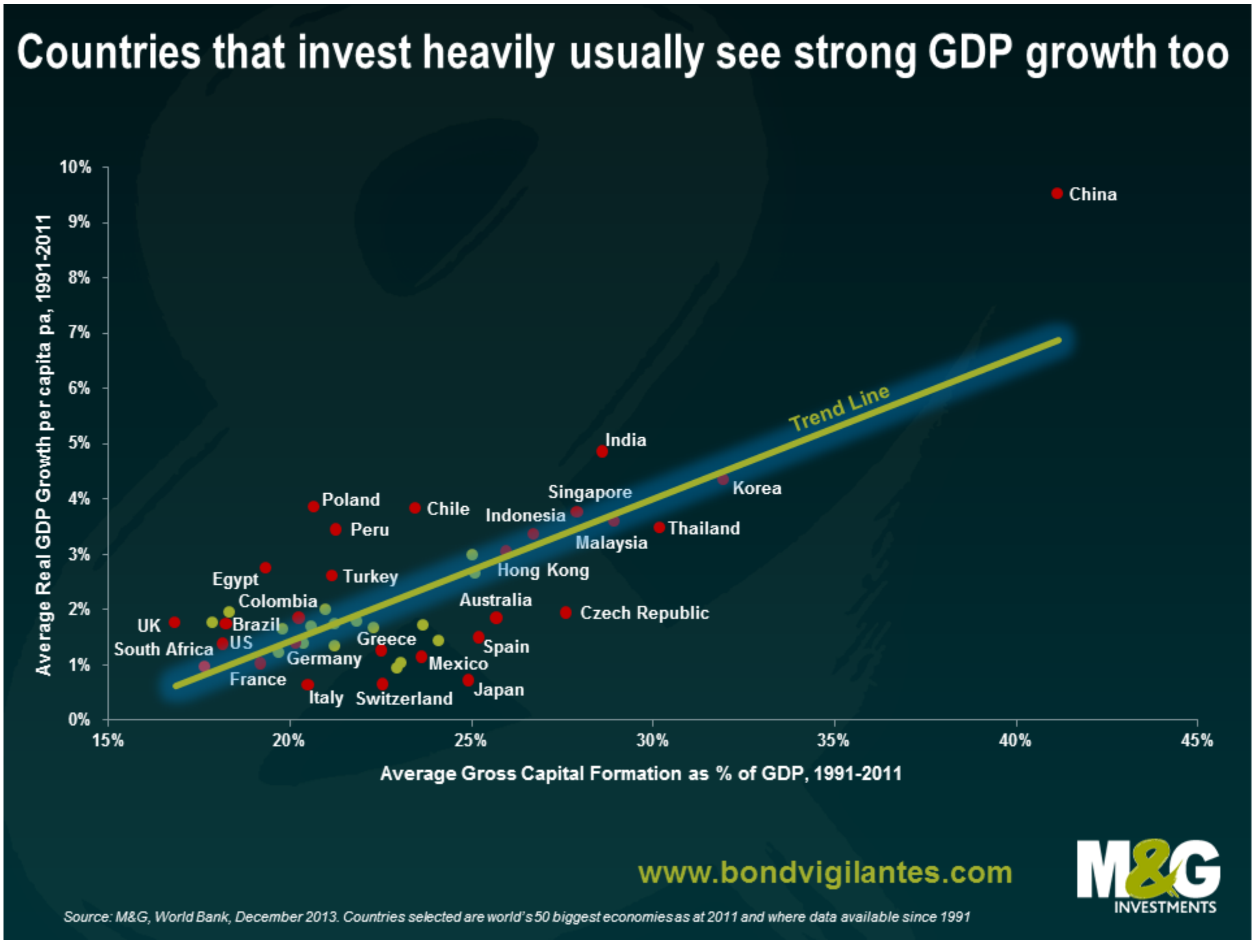


[4] Ibid. #3.

[5] http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS/countries/CN?display=graph

In 1990, at the peak of its investment bubble, Japan's Fixed Capital Investment as a percentage of its GDP rose to "only" 32.53%, and some two decades later, they're still trying to shake that off[6].

Other measures equally depict the enormity of the bubble that exists now in China. The chart below is from a recent post by Mike Riddell entitled "China's investment/GDP ratio soars to a totally unsustainable 54.4%. Be Afraid"[7]. China's domestic investment has clearly been "off the charts".

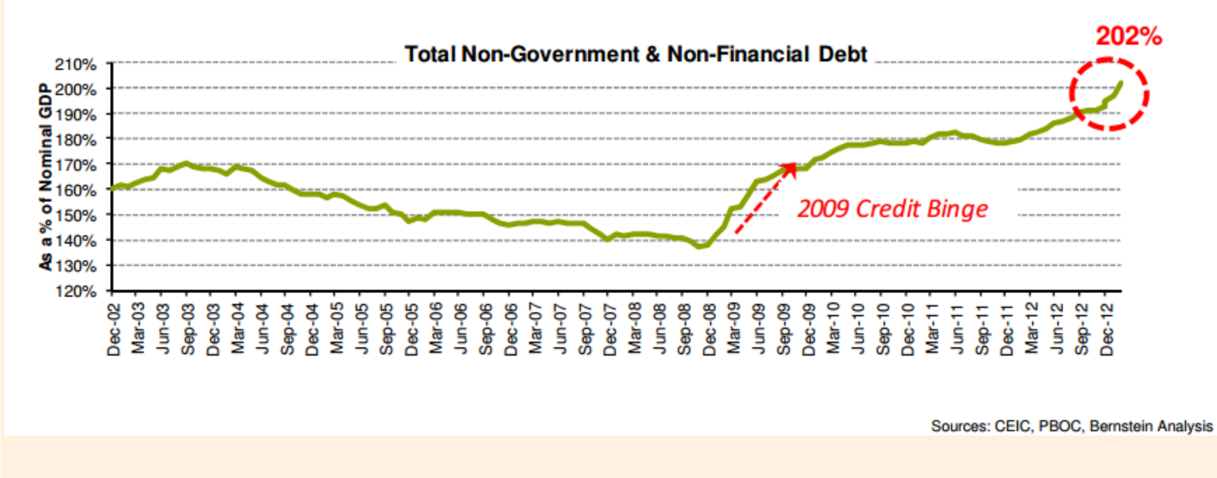


Some might argue that this is actually a good thing that will generate future growth. As always, one needs to "follow the credit" that fueled this growth. Total credit is a nebulous measure, at best. As with the "sub-prime" and "derivatives" portion of the US credit system that existed (and still exists) in the US during the run up to the bursting of the housing bubble in 2008 – much of which was "off balance sheet" financing - China also has it's "official" banking sector along with its "shadow" financial sector. The nuances are beyond the scope of

[6] http://www.economywatch.com/economic-statistics/Japan/Investment_Percentage_of_GDP/

[7] http://www.bondvigilantes.com/blog/2014/01/24/chinas-investmentgdp-ratio-soars-to-a-totally-unsustainable-54-4-be-afraid/

this report, but the graph below, from the Financial Times blog site starkly depicts the explosion in credit[8].



The Chinese Central Bank, the PBOC (which, not without some small bit of irony, stands for the *Peoples Bank* of China), is well aware of the looming bubble and the attendant consequences. Various measures taken by the PBOC to reverse things were not effective. This prompted them to resort to some serious old fashioned credit tightening including a sharp increase in interest rates. In an article titled "*Beijing's Crackdown on Credit Intensifies*", the Financial Times reports; "Chinese financial institutions slashed the supply of credit by $90bn in the first quarter, underlining the scale of Beijing's crackdown on its vast shadow finance system and fueling fears of a 'hard landing' for the world's second-largest economy….Data released…showed total social financing, the widest official measure, fell by Rmb560bn ($90bn) or 9 percent year-on-year to Rmb5.6tn in the first quarter"[9].

The policy is evidenced by the below chart depicting the SHIBOR (Shanghai Interbank Offering Rate – the overnight bank lending rate, analogous to LIBOR in Europe or the Fed funds rate in the US)[10]. The results have been predictable, and this past March, China announced its first domestic corporate bond default in recent history when Shanghai Chaori Solar was only able to service a tiny fraction of their interest obligations[11]. More have since followed.

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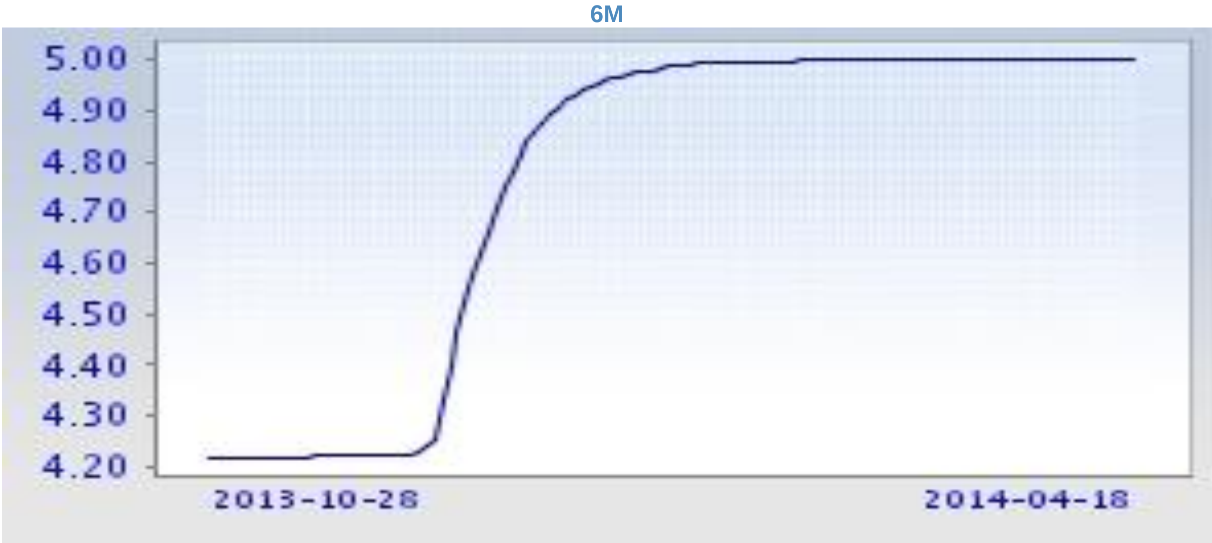
[8] http://ftalphaville.ft.com/2013/04/17/1463992/chinas-credit-to-gdp-ratio-updated-and-why-it-matters/

[9] "*Beijing's Crackdown on Credit Intensifies*"; Financial Times USA, 4/16/2014, pg. 1

[10] http://www.shibor.org/shibor/web/ShiborJPG_e.jsp

[11] *"Corporate Bond Default is China's First Since 1990";* Financial Times USA, March 8/March 9 2014, pg. 12

Daily SHIBOR Rates



According to the FT article, "China has not seen a single outright default of a domestic corporate bond since it established a nascent bond market in the early 1990s"[12]. Some feel this is a long-term positive development in that corporate default is a reality of any mature market. However, the article continues; "Some analysts have suggested the default could be China's 'Bear Stearns moment', prompting investors to reassess the risks of investing in Chinese corporate debt and causing a run on the entire sector ending in a Lehman Brothers-like crash"[13].

Barron's recently reported that "In the past three months, Chinese banking stocks have dropped 20%. The majority of them now trade at about five times this year's expected earnings and well below book value, levels that suggest investors are pricing in the possibility of a financial crisis and nonperforming loan ratios of 6.5% to 8%....In the aftermath of the financial crisis, Beijing primed its economy by getting banks to lend over $3 trillion. A lot of that went into real estate and projects like solar-panel manufacturing, two oversupplied segments. 'Banks are not making adequate provisions for bad or doubtful loans, so few people are taking them seriously,' says Patricia Cheng analyst for CLSA in Hong Kong."[14]

The ramifications of this unwind extends beyond the mainland Chinese banks. According to a Reuters report,

> "Foreign bank claims on China hit $1 trillion last year, up from nearly zero 10 years ago, and the biggest portion was provided by Hong Kong, Bank of International Settlements data shows….In just a few years, Hong Kong banks have ramped up lending to China from near zero to $430 billion, fuelling concerns about their credit exposure to the mainland at a time when sliding economic growth and defaults are

[12] Op. Cit. # 11
[13] Ibid. # 12
[14] *"China's Banks Priced for Crisis"*; Barron's, March 24, 2014, pg. M7

> making investors nervous…. The $430 billion in loans outstanding represents ***165 percent of Hong Kong's GDP*** (emph. added), BIS figures show.
>
> There is no breakdown of the type of loans behind the $430 billion figure. But Stephen Long, managing director of financial institutions at Moody's Investor Services, said "a substantial part" is in lower-risk categories such as trade finance. This would include loans to Hong Kong blue-chip companies operating on the mainland or loans supported by guarantees from Chinese banks.
>
> Stock and credit analysts also say a big chunk of the loans has ended up in China's property and financial sectors, as well as industries with surplus production capacity, such as steel - all areas where regulators are trying to control lending."[15]

Given the current stance of the PBOC, the deflating of China's credit bubble is not in debate. What is highly unknown is the effect it will have on China's near and long term economic growth rate. Much of the analysis is focused on whether China will experience a "hard" or a "soft" landing. Our contention is that, as the world's second largest economy and single largest contributor to economic growth, ***any*** "landing" at all will have profound impact on global growth. On the same page as the above mentioned FT article on China's first corporate bond default (see footnote 11) is an article on copper prices. Copper, a key industrial component across a wide swath of products and industries, is often referred to as "Dr. Copper" because it is a barometer of the health of manufacturing growth. The FT article reports that "Copper dropped to a seven-month low in heavy volume after a bond default in China added to growing concerns about slowing economic growth and demand from the world's biggest consumer of the metal."[16]

A Bloomberg article states "China Slowdown Seen Worst for Norway as Oil Key to Growth". Norway's Prime Minister, Erna Solberg "warned that Scandinavia's richest nation may face a 'hard landing'", and Hilde Bjoernland, an economics professor at the BI Norwegian Business School said " 'If China is in a bubble, that would be bad for everyone but even worse for the Norwegian economy because reduced demand from China would bring down oil prices' "[17].

Russia too, might find a drop in oil prices to be mildly inconvenient, as would all of the OPEC nations from Saudi Arabia and the Gulf States, to Nigeria, Venezuela and Brazil. According to the World Trade Organization, China was the 3rd largest importer of goods from Canada (at $19b in 2012) as well as from the EU ($185b in 2012).[18]

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[15] http://www.reuters.com/article/2014/03/25/hongkong-banks-china-idUSL4N0MM1FF20140325

[16] *"Growth Concerns Send Copper Prices to Seven-Month Low"*; Op. Cit. # 11

[17] http://www.bloomberg.com/news/2014-03-21/china-slowdown-seen-worst-for-norway-as-oil-key-to-growth-1-.html

[18] http://www.wto.org/english/res_e/statis_e/statis_bis_e.htm?solution=WTO&path=/Dashboards/MAPS&file=Map.wcdf&bookmarkState={%22impl%22:%22client%22,%22params%22:{%22langParam%22:%22en%22}}

Regardless of the reported "official" data, we expect the slowdown to have broader repercussions than currently appreciated in the markets.[19] The Economic Times recently reported "…China's central bank announced that the broadly measured money supply grew 12.1 per cent in March, compared with a year earlier. That would be a brisk pace for most countries, but it was the ***slowest in China since comparable record-keeping began in 1997*** (emph. added)…. At first glance, it seems extraordinary that anyone in China would have trouble finding credit, given how much money is already sloshing around the country. China's broadly measured money supply passed that of the US in August 2009, and has been soaring ever since. China now has two-thirds more money than the United States, swirling through an economy that is a little over half the size of the US economy."[20]

As the redoubtable George Magnus, former Chief economist at UBS, so aptly explains;

> "Investors have a lot to worry about without cause to fret about China, but now they have that too…
>
> The incidence of financial distress is rising and becoming more visible. The recent drop in the renminbi and sharp fall in copper and iron ore prices are the latest high-profile manifestations of China's changing outlook. These are not random developments or bad luck, ***but connected parts of a complex economic transformation with deflationary consequences for the world economy and skittish financial markets*** (emph. add.)….
>
> Slowing economic growth, chronic overcapacity and rising debt service problems in key industries are becoming more common, raising the risk of chain defaults involving suppliers and purchasers. Overcapacity recently prompted a senior executive in the Chinese Iron and Steel Association, Li Xinchuang, to say the problem was so severe it was 'probably beyond anyone's imagination'.
>
> In an industry survey by the State Council, 71 per cent of respondents said overcapacity in iron and steel, aluminium, cement, coal, solar panels and shipbuilding was 'relatively or very' serious…
>
> The transmission effects of lower prices into emerging markets and the global economy are most likely to prove disruptive, even if the positive real income effects for consumers eventually win out.
>
> China's economic transformation is happening regardless. Its leaders have choices only about how to manage it, and when to accommodate what is likely to be a painful adjustment. ***Sage advice would be to grin and bear it now, so as to avoid harsher***

[19] For an excellent synopsis of this, see the FT article "*Do China's Q1 GDP Numbers Gloss Reality?*"; http://blogs.ft.com/beyond-brics/2014/04/16/do-chinas-q1-gdp-numbers-gloss-reality/#

[20] http://articles.economictimes.indiatimes.com/2014-04-17/news/49214522_1_china-economist-global-economic-growth-credit-squeeze

> ***outcomes later. But the political willingness and capacity to do so is unpredictable*** (emph. add.)…"[21]

Sage advice, indeed, and equally applicable to US policy makers who've ignored it for the better part of the past two and a half decades. Meanwhile, winter seems to have finally given in. Crocuses are out, and let's hope the springtime growth is prologue to a thawing economy and opportunity for society. We feel, at least for the near term, that this will be the case and we therefore are maintaining our overweight exposure to DV equities, and underweight to fixed income and EM assets. However, at 5 plus years (from March of '09), this is by anyone's count an aging bull market. We will be faithfully watching the internal participation of the broader market to warn of a transition to the inevitable next cyclical downturn. As of this writing though, aside from elevated margin levels and a deterioration in the number of stocks making 52 week new highs, signs of deterioration in the longer term trend remain sparse.

Warm regards,

Jason Waxler

[21] *"Signs of China's Financial Distress Become all too Visible"*; Financial Times USA, March 20, 2014, pg. 20

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	Total Return	
Index[1]	**First Quarter 2014**	**Year-to-Date**
DJIA	-0.15%	-0.15%
S&P 500	1.81	1.81
Nasdaq Composite	0.54	0.54
S&P MidCap 400	3.04	3.04
Russell 2000	1.12	1.12

Index[1]	**First Quarter 2014**	**Year-to-Date**
Barclays Capital U.S. Aggregate Bond Index	1.84%	1.84%
Credit Suisse High Yield Index	3.07	3.07
Barclays Capital Municipal Bond Index	3.32	3.32
Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index	2.79	2.79
J.P. Morgan Emerging Markets Index Plus	3.73	3.73
Barclays U.S. Mortgage Backed Securities Index	1.59	1.59

	Total Return	
MSCI Index[1]	**First Quarter 2014**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	0.77%	0.77%
All Country World ex-U.S.	0.61	0.61
Europe	2.21	2.21
Japan	-5.47	-5.47
All Country Asia Ex-Japan	-0.68	-0.68
EM (Emerging Markets)	-0.37	-0.37

	Total Return	
MSCI Index[1]	**First Quarter 2014**	**Year-to-Date**
Emerging Markets (EM)	-0.37%	-0.37%
EM—Asia	-0.24	-0.24
EM—Europe, Middle East, and Africa (EMEA)	-1.62	-1.62
EM—Latin America	0.39	0.39