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If All the Economists Were Laid End to End, They'd Never Reach a Conclusion.

- George Bernard Shaw

The Second Quarter of 2013 was perhaps most notable for the headlines trumpeting the stock market indexes march to new highs (see benchmark index return data on page 10). However, this masked the underlying turmoil endemic to the latter part of the quarter, and the reality that ***nearly every other asset class declined,*** making for a truly "interesting" period**.** Emerging Market stocks, commodities and precious metals, currencies, bonds (especially emerging market and TIPS bonds) all registered losses. June, in particular saw a spike in volatility, as the markets reacted to the first possible hints from Federal Reserve chairman Ben Bernanke that the Fed's accommodative monetary policy might be soon ending. It was, in fact, the worst month for the bond market in 20 years (see below for more on this). This proved especially challenging for us because our accounts are primarily "balanced portfolios" comprised of diversified asset classes. While we tactically overweight sectors, it's unlikely that we would ever be 100% exposed to any one single asset category. The good news is that much of the volatility has since subsided and many declining sectors have since stabilized and reversed. Our thinking on positioning going forward is explored in more detail below.

The redoubtable Gillian Tett of the Financial Times recently penned an article highlighting the disparities apparent between the "bulls" and the "bears". I'm quoting rather liberally, but her commentary brilliantly captures the diverging sentiments – both sides of which are equally defensible. She begins by describing the reaction of the chief economist of a global European bank who had just attended a design conference in the US;

> "…It left him reeling. Over in Europe, as he says, corrosive pessimism has become so deeply ingrained it is barely even noticed any more; gloom is the new norm, particularly in the dismal science of economics.
>
> Not so in the US design community. 'the most striking thing for me was the contrast between the optimism of the tech crowd and the prevailing pessimism of many economists about productivity growth in general, and technology in particular,' ".

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Ms. Tett experienced the same dichotomy while attending the Aspen Ideas Festival in Colorado. She relates;

> "…the zeitgeist was striking. In sharp contrast to Europe – and to earlier Aspen gatherings – nobody was talking about banks or financial regulation. Nor was there much backward-looking debate about the 2008 crisis, or recriminations about the credit bubble. Instead, the focus was forward –looking. There was obsessive interest in technology and big data. There was strong interest in educational reform and medicine. And there was extensive debate about the nature of the American political system, geopolitics and the state of the energy sector.
>
> Not all the discussion was optimistic. Men such as Eric Cantor, House majority leader, decried the lack of bipartisan dialogue. Jack Lew, Treasury secretary, warned that sequestration was undermining growth. Hedge fund luminaries muttered that central banks were creating more market bubbles. US diplomats, military officials and Middle East leaders warned about instability in Syria, Egypt and Iran. Men such as David Rubenstein, head of Carlyle, and Bob Rubin, former Treasury secretary, noted the debilitating impact of high US unemployment and political gridlock.
>
> But what was equally noticeable was that every note of gloom was offset by a flash of cheer. Thus, delegates heard Eric Lander, a Harvard professor, declare that a dramatic decline in the cost of human genome research is sparking medical breakthroughs. They also were told how the revolution in shale gas was cutting energy prices and sucking US manufacturing back 'onshore'. They listened as Andy McCaffee, a MIT professor, predicted that technology would continue to double in power every 18 months for the next few years, and as Dick Costello, Twitter chief executive, explained how social media was helping to fuel a striking – and unexpected – renaissance in quality television." [1]

So, which perspective is correct? Taking our cue from the title of this report, we'd definitively conclude that they're both right! There are certainly encouraging signs in the economic data:

- "The Conference Board said its **leading index rose 0.1% last month** [May] after rising a revised 0.8% in April, first reported as 0.6%...(This) **suggests the U.S. recovery will continue through most of the second half of 2013."**[2]

- **"Business conditions for mid-Atlantic manufacturers rebounded this month [June] to their highest level since April 2011**… The Philadelphia Fed's index of general business activity within the factory sector jumped to 12.5, from -5.2 in May."[3]

[1] "Stop Worrying and Breathe the Zeitgeist in America"; Gillian Tett, Financial Times, 7/5/13, pg. 20.
[2] http://news.morningstar.com/all/dow-jones/economic-news/201306201045/000539/us-may-leading-indicators-rose-01.aspx

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- **"The number of homebuyers purchasing previously owned homes surged in May to the highest level since late 2009** as prices rose, inventories remained tight and sales closed at a brisk pace, offering the latest signs of a strengthening housing recovery. Existing-home sales rose 4.2% in May from a month earlier to a seasonally adjusted annual rate of 5.18 million... That is the highest figure since November 2009, when a tax credit was expiring, and was 12.9% above the same month a year earlier."[4]

- **"The Dallas Fed said its general business activity index jumped to 6.5 in June."[5]**

- **"Total orders for durable goods**--those built to last longer than three years, from televisions to earth movers--**rose by 3.6%** to a seasonally adjusted $231 billion in May from the prior month, the Commerce Department said Tuesday. That matched the increase in **April, which was revised higher from initial estimates, and also exceeded economists' expectations of a 3.2% rise**."[6]

- **"U.S. consumer confidence jumped in June to a five-year high thanks to a better view on job prospects."[7]**

You get the point. I could go on, but the last item concerning "a better view on job prospects" really does strain credulity, and is worthy of further exploration. In fact, there is anecdotal evidence of job creation. To date, most of the growth appears to exist in what David Darst of Morgan Stanley calls the "eat, drink and get sick" sectors – i.e. restaurants, bars and health care; all of which tend to be lower paying/minimal benefit jobs. Of greater interest is the growth in more skilled manufacturing jobs, and here the data is mixed. According to Department of Labor reporting, total manufacturing employment as of June, 2013 was 11.964 million, barely changed from June 2012 at 11.935 million, and well below June 2007 levels of 13.9 million. (See chart below)[8].

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[3] http://news.morningstar.com/all/dow-jones/economic-news/201306201043/000536/philadelphia-fed-june-business-index-rebounds-to-125-from-52-in-may.aspx

[4] http://news.morningstar.com/all/dow-jones/economic-news/201306201025/000520/us-existing-home-sales-surge-42-in-may.aspx

[5] http://news.morningstar.com/all/dow-jones/economic-news/201306241125/000241/business-activity-increases-among-texas-area-manufacturers.aspx

[6] http://news.morningstar.com/all/dow-jones/economic-news/201306250915/000190/us-durable-goods-orders-up-36-in-may.aspx

[7] http://news.morningstar.com/all/dow-jones/economic-news/201306251129/000296/update-june-us-consumer-confidence-rises-to-five-year-high.aspx

[8] http://data.bls.gov/timeseries/CES3000000001?data_tool=XGtable

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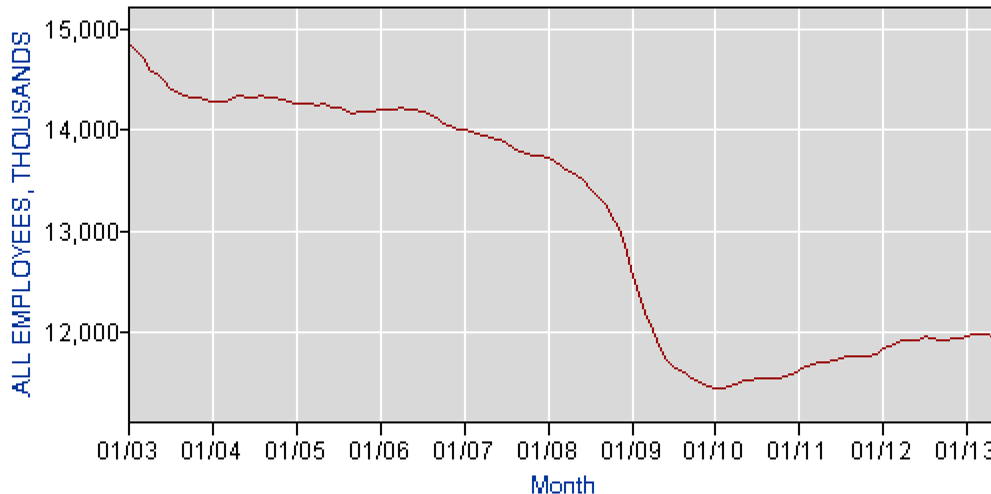

Nevertheless, since the trough in 2010, the trend is upward (albeit at a glacial pace). Samsung is proceeding with its plans for a $4 billion expansion of its chip manufacturing plant in Austin Texas, where it employs 2,500 workers – including a 200 person engineer research and design center – and growing.[9] American Axle & Manufacturing Holdings, Inc. employs 1,500 workers at its 800,000 sq. ft. plant in Michigan, and announced that it will be adding 400 new employees by year end.[10] In Portland, Tennessee, Tsubakimoto Chain Co. is adding 70 employees as part of a $1.9 million plant expansion, and Chrysler Group is adding 1,250 employees in Indiana to support a $374 million investment to manufacture fuel-saving transmissions.[11] The story of growth in the shale, hydraulic fracturing and energy sector is well known. Thus, perhaps the Gillian Tett's optimists have it right. Is the spirit endemic to this country rising above the existing morass to usher in a new cycle of growth?

Long time followers of this newsletter might be wondering if I've momentarily lost my senses (or perhaps inadvertently found them). And we are in the midst of a heat wave which could certainly be taking its toll. The excerpt below should assuage any such fears. Yes, there is clearly organic growth occurring, encouraged by the Fed's monetary policies and natural pent up demand that's been involuntarily waiting to be sated. This has all been supportive of the equities markets here in the US, and is creating nascent headwinds for bonds. In the near to intermediate term, we see nothing interfering with this trend. The longer picture, however, also remains unchanged in our opinion. The equally redoubtable Marc Faber, editor of the

[9] http://www.bloomberg.com/news/2012-12-13/samsung-to-proceed-with-4-billion-austin-plant-expansion.html

[10] http://www.bloomberg.com/news/2013-03-13/workweek-tying-longest-since-wwii-spurs-hiring-at-u-s-factories.html

[11] Op. Cit. # 10

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Gloom, Boom & Doom Report, recently shared a letter written to him by another market observer, Ramsey Su;

> "Sooner or later, we have to face reality the way the Irish, the Icelanders, the Greeks and most recently the Cypriots all did. Our standard of living is too high and unsustainable. It is higher than our income. We are consuming non-essentials while underfunding essentials such as education, retirement, healthcare and reserves.
>
> **Our standard of living is not only underfunded, it is borrowed.** Every component of our future is borrowed, with very little to show for (it). The house is borrowed. The cars are leased. The education is financed by $1 trillion in student loans. Medicare today is debt to future generations. Social Security is underfunded. Public pension plans are underfunded. Households are borrowing from their 401k plans to survive. Most tragic of all, our Government is operating only because of funding from the Federal Reserve. I often wonder when is (sic) Bernanke going to buy more Treasuries than total tax receipts. Maybe we do not have to pay tax anymore and just let Bernanke print/finance the Federal Government."[12]

Famed hedge fund manager Stanley Druckenmiller has recently voiced similar concerns. "…he sees an even bigger reason for concern because of the government's massive unfunded liabilities. He also sees trouble with what he calls its trickle-down monetary policy. The Federal Reserve's decision to hold interest rates near zero and buy $85 billion of assets a month is pumping up the stock market, all with the hope that rich people will spend those gains, and that money will trickle sown to the rest of the country. While stocks may continue to rise for a while because companies are buying back shares and retail investors are coming back to the market in search of returns, the gains probably won't last…***'The chances of this being a new bull market like 1982 aren't high because we're not attacking the crux of the problem, which is too much leverage and too much debt…I don't know the timing of when the markets will respond to this, but it will happen***' [emph. added)."[13]

Yes, of course. ***There has never been a recorded instance in history when public debt was "cured" by the issuance of more debt***. But for now, the pendulum seems to be swinging our way. The growth, while subdued, is real. Of particular interest, is the dichotomy unfolding between the North-South corridor through mid-America, vs. the West and Northeast coastal regions. These latter regions boomed during the heydays of Silicon Valley and Wall Street, and were then artificially kept afloat by the Fed-induced housing boom. It's been estimated that this misallocation of capital created 3.4 million housing related jobs – many of which disappeared after the 2008 crash and will not be returning.[14] The Midwest / rust belt never really participated in that growth but now is in the midst of a resurgence – driven in no small part by technological advances (and new reserve discoveries) in shale energy extraction – which is encompassing the regions from Mexico, all the way up through Canada.

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[12] The Gloom, Boom & Doom Report; May 2013 Report, April 29, 1013; pg.18

[13] http://www.investmentnews.com/article/20130301/FREE/130309999&template=printart

[14] http://www.fanniemae.com/resources/file/research/datanotes/pdf/housing-insights-0513.pdf

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If correct, this assessment flies in the face of the conventional view that once the Federal Reserve begins its "tapering" (i.e. withdraws the liquidity they've been providing through their various "quantitative easing" [QE] programs), the economy and financial markets will implode. This is a view also shared by the Fed itself. Their recent suggestions that QE might not last in perpetuity wrought havoc in the markets and prompted immediate retractions and soothing pronouncements that nothing had changed and all was still well. As the FT reported; "US fixed income investors have suffered their worst first half of a year since the great bear market of 1994 with the Federal Reserve looking to step back from its open ended support of asset prices." [15]

The signals being given by the equity and bond markets right now are unambiguous – the uptrend in equities (while arguably overextended in the shorter term) remains strong, while the lows in interest rates, for the next several decades, are probably behind us. However, the causes behind these trends – a nascent US led economic recovery or another Fed induced asset bubble – are less clear, and the outcomes could not be more different. We've long maintained that perhaps the most important market signal to follow has been that of the strength of the U.S. Dollar (US$) relative to other currencies and commodities. This has been our favored barometer of the battle playing out between global "reflation" vs. deflation.

As referenced in past reports, we've felt that the US$ has had an underlying "bid" to it and that this strength reflected deflationary forces sweeping the global financial markets. This view allowed us to reduce our long held overweight's in precious metals and commodities. However, one phenomenon that we were admittedly late in fully appreciating was the effect this deflation was having in the emerging market space. In past reports, we've quoted work by longtime currency observer George Magnus. In a recent FT article aptly entitled "China's Ponzi Credit Boom Faces Up to the Crunch", he presciently observed; "Two previous US dollar bull markets acted as catalysts to bring down Latin America in the 1980's and Asia in the late 1990's. Another one would also have ubiquitous effects, especially on emerging markets, which have been the principal beneficiaries of risk capital."[16] (As an interesting, but fully related aside, the headline of a story in the adjoining column reads; "Copper Hits Three-Year Low as Liquidity Fears Prompt Sell-Off"[17]).

Magnus's article was primarily focused on the financial and economic challenges currently confronting China. This unfolding saga would comprise an entire report, in and of itself. Economist Martin Wolf recently wrote an article entitled "Risks of a Hard Landing for China", where he dissects and summarizes the incredible complexities inherent in "managing" a slowdown in China's GDP. He states;

> "None of this is to argue that China cannot continue its catch-up growth, in the medium to longer term. The point is, instead, that the structure of an economy

[15] Bond Investors Suffer Worst First Half Since 1994 Rout; Michael Mackenzie and Dan McCrum, Financial Times, June 29/June 30 2013; pg. 14

[16] China's Ponzi Credit Boom Faces Up to the Crunch; George Magnus, Financial Times, Tuesday, June 25, 2013; pg.22

[17] Op. Cit. # 16

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> growing at 6 per cent will, inevitably, be quite different from that of one growing at 10 per cent*. **One must not think of such an adjustment as proportional*** (emph. added)… [It] would mean a different distribution of income. …It would also necessitate a different structure of production, with relatively fast growth of services and relatively slow growth of manufacturing (ed. note: the difficulties in effecting these changes cannot be overstated because the manufacturing enterprises are owned by the "state" – i.e. concentrated amongst a small circle of powerful "princelings" of the communist party).
>
> The New Chinese government is, in effect, now engaged in the task of redesigning the jumbo jet, as it comes into land, with half of the engines working poorly. The market is most unlikely to deliver such a huge change smoothly."[18]

As significant as the resolution of China's slowdown is to the global economies, they are, as Magnus correctly points out, only a part of the phenomena affecting the entire emerging market region. In a recent FT article, referencing a study published by the Standard and Poor's rating agency, they write;

> "Money has gushed out of emerging markets since the Fed warned that it planned to scale back its quantitative easing programme this year and end it in 2014, sending stock markets and bonds in developing countries tumbling.
>
> Markets have stabilised after a fierce sell-off in May and June, and clawed back some of their losses. But despite the recovery, the FTSE Emerging Markets index is down more than 14 per cent since its early May peak, and dollar borrowing costs are about 1.5 percentage points more expensive.
>
> Although developing countries are in much better economic and financial shape than during crises in the 1980's and 1990's, some analysts are concerned that if the sell-off resumes it could deepen into what economists call a "sudden stop" in capital flows – freezing vulnerable countries out of debt markets.
>
> 'Observers always hope that it will be gradual, but history shows that reversals tend to be abrupt, and that has often led to balance of payments crises,' Mr. Kraemer [author of the S&P study] said."[19]

So, despite all the angst and concern about the effects on the US domestic economy of the inevitable reversal of the Fed's policies, ***it might actually be the Emerging Markets of Asia, Latin America and Eastern Europe (including the European periphery) that actually feel the brunt of the painful adjustment***. The charts below depict the abruptness of the adjustment. The first one is a one year chart of the Indian Rupee and the next one is the Brazilian Real (*note: more Reals per 1 US$ mean a stronger dollar*). [20]

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[18] Risks of a Hard Landing for China; Martin Wolf, Financial Times, Wednesday, July 3, 2013; pg. 9

[19] Emerging Europe at Risk from QE Sell-Off; Robin Wigglesworth; Financial Times, Friday, July 5, 2013; pg. 13

[20] http://www.advfn.com/p.php?pid=qkchart&symbol=FX%3AUSDBRL

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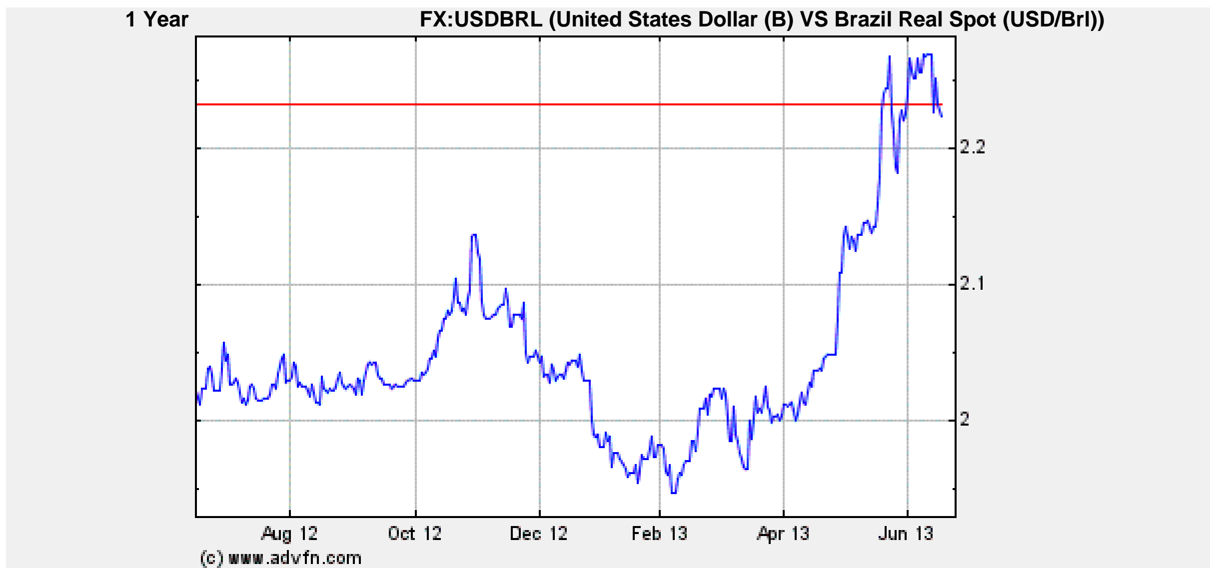
They're nearly identical, and could be from any number of emerging market countries. These countries were the beneficiaries of capital inflows for the better part of the past decade – compliments of the largesse of the Federal Reserve Bank of the United States. It will be enshrined in the annals of history as one of the great examples of "unintended consequences" resulting from the actions of public policy-makers, and as the source of one of the great misallocations of capital.



We have been expecting the strong dollar phenomenon to be a longer, intermediate term event. However, according to Yahoo Finance[21], the newly released July BofA Merrill Lynch Fund Manager Survey contains some striking results. In December of 2012, a net 65% of

[21] http://finance.yahoo.com/news/bofa-merrill-lynch-fund-manager-130500539.html;_ylt=A2KJ2PZpQOhR5T0AphbQtDMD

respondents expected ***stronger Chinese GDP*** data in 2013. That number has completely reversed with an identical number now expecting a weakening. ***Over half consider a "hard landing" in China to be their most feared "tail risk".***

A net 44% of the managers believe that, amongst all regions, the global emerging markets (GEM) offer the weakest potential for corporate earnings. This was the most negative reading ever recorded in the survey. A net 18% of them are underweight GEM equities and 26% plan to underweight this space over the next year – whereas just 2 months ago they held net overweight exposures. But what really caught our attention was the poll result showing that a ***net 83% were now bullish on the dollar vs. other currencies.*** From a contrarian perspective, one must consider if perhaps the adjustments are further along than we'd thought, and the markets have already begun discounting the next cycle. For now, though, we still feel that the capital outflows are the reversal of many years of inflows. They will not be reversed easily or imminently, and the GEM remain in the throes of a pervasive bear cycle (complete with the attendant, often spectacular, counter-trend rallies). Our equity exposure continues to be underweight emerging markets, and is tilted towards domestic, economically cyclical companies (a theme that remains to be validated). We're finding slightly more value now in bonds, but not much. Commodities and basic materials are still moribund (albeit oversold and roundly despised now). We remain overweight Japan, and we'll persist in our monitoring of the currency "barometers" as we observe the unwinding of these capital flows and participate as investors.

Stay cool, and enjoy your summer.

Best regards,

Jason Waxler

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	Total Return[1]	
Index[2]	Second Quarter 2013	Year-to-Date
DJIA	2.92%	15.20%
S&P 500	2.91	13.82
Nasdaq Composite	4.15	12.71
S&P MidCap 400	1.00	14.59
Russell 2000	3.08	15.86

Index[1]	Second Quarter 2013	Year-to-Date
Barclays Capital U.S. Aggregate Bond Index	-2.32%	-2.44%
Credit Suisse High Yield Index	-1.38	1.52
Barclays Capital Municipal Bond Index	-2.97	-2.69
Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index	-3.08	-6.48
J.P. Morgan Emerging Markets Index Plus	-6.26	-9.36

	Total Return	
MSCI Index[1]	Second Quarter 2013	Year-to-Date
EAFE (Europe, Australasia, Far East)	-0.73%	4.47%
All Country World ex-U.S.	-2.90	0.27
Europe	-0.14	2.69
Japan	4.42	16.64
All Country Asia Ex-Japan	-5.21	-5.61
EM (Emerging Markets)	-7.95	-9.40

	Total Return	
MSCI Index[1]	Second Quarter 2013	Year-to-Date
Emerging Markets (EM)	-7.95%	-9.40%
EM—Asia	-5.21	-6.43
EM—Europe, Middle East, and Africa (EMEA)	-8.10	-13.09
EM—Latin America	-15.45	-14.67

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