Katonah Capital Group, LLC
Jason Waxler
Principal
Jason@KatonahCapitalGroup.com
80 Business Park Drive, Suite 304
Armonk, NY 10504
Phone: (914)-219-5880
Fax: (914)-273-6806

SECOND QUARTER 2014 INVESTMENT ADVISORY REPORT

~ Ripple in Still Water, When There is No Pebble Tossed, Nor Wind to Blow[1]

Complacency has become a popular buzzword in the media recently. Despite the breakup of Ukraine and Russia's standoff with the West; the Israeli/Palestinian conflict; the turmoil in Iraq and the Sunni/Shia divide that threatens to destabilize the entire region; the ramifications for both of these issues on energy prices and the recent spike in oil; stagnant wages; structural unemployment and sluggish economic growth; issues of income inequality…none of these seem to be of any concern to the financial markets as the Dow Jones Industrial index and the S&P 500 continue to print new all-time highs[2].

Markets are widely assumed to be efficient, at least in the "long run" (however that may be defined!). Market prices, so the theory goes, are an aggregation of all the data publicly available at any point in time and, as such, provide valuable information about the economy and our world. If that is indeed the case, then the markets can only be loudly ringing the message that "all's well in paradise"!

This glaring dichotomy has been a source of concern to many market observers, including the Federal Reserve. In their recently released Federal Open Market Committee (FOMC) Minutes, they state that "Broad stock price indexes rose over the intermeeting period, apparently boosted by a more optimistic assessment of near-term economic prospects and likely supported by continued low interest rates…The VIX (ed. note; see below for further discussion of the VIX), an index of option-implied volatility for one-month returns on the S&P 500 index, continued to decline and ended the period near its historical lows. Measures of uncertainty in other financial markets also declined; results from the Desk's primary dealer survey suggested this development might have reflected low realized volatilities…***and complacency on the part of market participants about potential risks*** (emph. added)."[3]

---

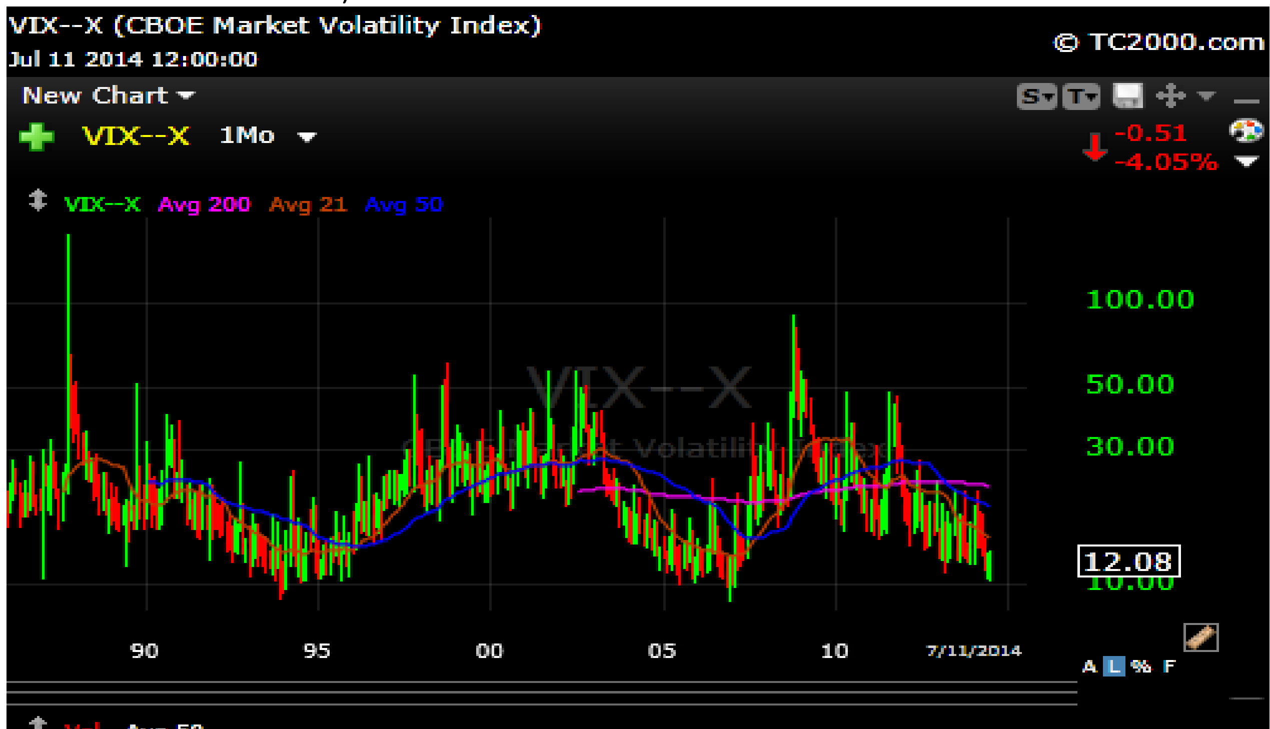
[1] Jerry Garcia, Robert Hunter; London, 1970; Copyright: Ice Nine Publishing Co. Inc.
[2] http://finance.yahoo.com/echarts?s=%5EGSPC+Interactive#symbol=%5EGSPC;range=my
[3] http://www.federalreserve.gov/monetarypolicy/fomcminutes20140618.htm

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

In fact, methods exist that actually measure complacency and its antithesis, fear. "Market volatility" is one such metric. It lends itself well to statistical quantification, and volatility is a key factor used in the pricing of all options securities (for a good introductory article on options and the models used to price them, see note[4] below). When options traders buy and sell puts and calls on underlying securities, what they're primarily "trading" is volatility (vol) – i.e. they are buying or selling "vol". Determining the value of volatility is such a fundamental component of security pricing and risk assessment that large markets have developed to trade vol.

Probably the best known such market is the VIX, or the CBOE Volatility Index. According to Investopedia, VIX is "The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options…The VIX is a widely used measure of market risk and is often referred to as the 'investor fear gauge'. "[5]

The two charts below show historical price data for the VIX (the data is presented logarithmically, so the absolute values of the price moves are greater than depicted in the graph). The top chart uses monthly price bars and spans almost 30 years of data. Note the huge spike in the 1987 crash, the elevated levels during the NASDAQ bubble of '98 through 2002, and the peaks marking the financial crash of '08, the European crisis in the spring of 2010 and the downgrading of the US debt in the spring of 2011. These were all times of intense fear and of course, with the certainty of hindsight, were great opportunities to buy stocks (or most risk assets for that matter).



[4] http://optionalpha.com/stock-options-and-the-7-factors-that-determine-their-pricing-and-value-10383.html
[5] http://www.investopedia.com/terms/v/vix.asp

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

However, also note the periods of low VIX prices around January of 1987 and June of 1989 (prior to the '89 "mini-crash"). Almost anytime during the 1990's was a good time to buy stocks, but the Fed raised interest rates in 1994 (causing one of the worst bond market routs ever). This was preceded by another period of historically low volatility. The 1-month change in the S&P 500, from the start of the tightening, was - 3.0%, and the 12-month change was - 2.3%.[6] And, in December of 2006, vol traded well below 9.0 – a particularly unfortunate period to be loading up on almost any risk assets. The VIX is currently at historically low levels, however, it can easily go lower or (remember that each data bar is a one month period) stay down here for many more months, if not years.

Finally, the bottom chart is a weekly chart that shows more recent history – roughly the past 6 years, and each bar is one week's worth of data. It clearly depicts the "fear peak" after the '08 financial crisis, and the gradual but steady erosion of this fear as the cycle evolves inexorably towards complacency.

It should also be noted that while the discussion above has focused on the VIX, which is a measure of broad stock market volatility, there are many other measures of volatility and they're all telling the same story. According to a recent Barron's column, (the) "Euro's implied volatility recently touched its low since the currency's inception in 2000… (and) the implied volatility of crude oil is also pinned to its long-term floor."[7] A Marketfield Asset Management research report states; "The VXO Index probed new intraday lows not only for this move, but

---

[6] http://www.businessinsider.com/history-of-federal-reserve-tightening-2013-1?op=1

[7] Barron's, The Striking Price; July 14, 2014; pg. M 11

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

also to the lowest in 28 years, since January 3, 1986…this collapse in volatility to new lows coincided with the quarter-end and half-end allocation window and may indicate capitulation by put buyers and long volatility players (ed. note; the VXO measures the volatility of the OEX index, which is an index of the largest 100 S&P stocks, such as Apple, Exxon, Microsoft, General Electric…)."[8]

Indeed, a recent front page lead story in the Financial Times (FT) trumpeted "*Volatility 'Extinguished' by Moves from Central Banks*". In addition to also corroborating the new lows in currency and oil volatility cited above, it also notes that the volatility of Citigroup's "economic surprises" index for the largest economies had also recently hit a record low.[9] The article quotes several leading economists and money managers and their comments give voice to a universal skepticism and unease:

- George Magnus, economic adviser to UBS – "…there (is) a resemblance to the so-called Great Moderation period leading up to 2007. 'The previous Great Moderation ended in great volatility; this one may well do so too' he warned in a note."
- Russ Koesterich, global chief investment strategist at BlackRock – "The VIX tells you investors are very complacent and not worried about exogenous shock or geopolitical risk…Eventually there will be a storm, but the VIX does not tell you anything about the timing of that storm."
- Matt Cobon, fund Manager at Threadneedle Investments – "The market seems to have bought into this, hook, line and sinker, that rates will remain low forever… It feels as if we're a few data points away from testing some of these underlying expectations."[10]

Of greatest interest to us, is the recent admonition delivered by the Bank for International Settlements (BIS). The BIS is known as the central banker to the Central Banks (e.g. they are the central bank to the US Federal Reserve). They generally fly well below the radar, but are the source of some of the best statistical data available concerning global capital flows amongst financial institutions. According to its website, "The Bank for International Settlements was established in 1930. It is the world's oldest international financial institution and remains the principal centre for international central bank cooperation".[11] "The mission of the Bank … is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks."[12]

---

[8] The Weekly Speculator; MarketField Asset Management; July 3, 2017; pg. 6.
[9] "Volatility 'Extinguished' by Moves from Central Banks"; Financial Times; June 10, 2014; pg.1
[10] Ibid. # 9
[11] http://www.bis.org/about/history.htm
[12] http://www.bis.org/about/index.htm?l=2

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

They tend to be early in their assessments and warnings – for example, they were warning as early as 2003 that dangerous imbalances were being created in the financial system (a warning that was dismissed by the Fed). In an article entitled "*BIS Hints at Calm before New Financial Storm*", the FT writes that the BIS "…has repeatedly cautioned its members that their response to the financial crisis – to slash interest rates to record lows and embark on mass bond buying – risks sowing the seeds of the next crisis, if it is not accompanied by structural economic reforms by governments." They quote, "'The risk of normalizing too late and too gradually should not be underestimated…A vicious circle can develop. In the end, it may be markets that react first, if participants start to see central banks as being behind the curve.' "[13] The FT further reports; " 'Good policy is less a question of seeking to pump up growth at all costs than of removing the obstacles that hold it back,' the BIS argued, saying the upturn in the global economy was a precious opportunity for reform…Global markets are 'under the spell' of central banks and their unprecedented monetary policy settings…"[14]

To be sure, while levels of volatility and asset values are clearly correlated, they are not the same, and there are significant differences that exist. As fund manager Axel Merk writes, "We can always argue about equity valuations. Sometimes, as in the late 1990s, we need a new paradigm to justify them. But it appears pretty clear that 'quantitative easing' and its variants throughout the world have compressed volatility."[15] Still, there are solid arguments to be made that the current low volatility levels are actually a bullish portent – at least for equities. Barron's cited SunTrust's Keith Lerner who noted that "since 1990, the VIX has traded below 12 for a good portion of time during two periods when stocks posted solid returns." (Of course, one of those periods was from 2004 through 2007 which saw a 23% rise in the S&P 500 and it's highly debatable whether that 23% was justified given the aftermath that ensued). Nevertheless, the point is valid and, "'By themselves, low VIX readings have not necessarily been a bad omen for equities,' Lerner says."[16] There are several differences that should be noted.

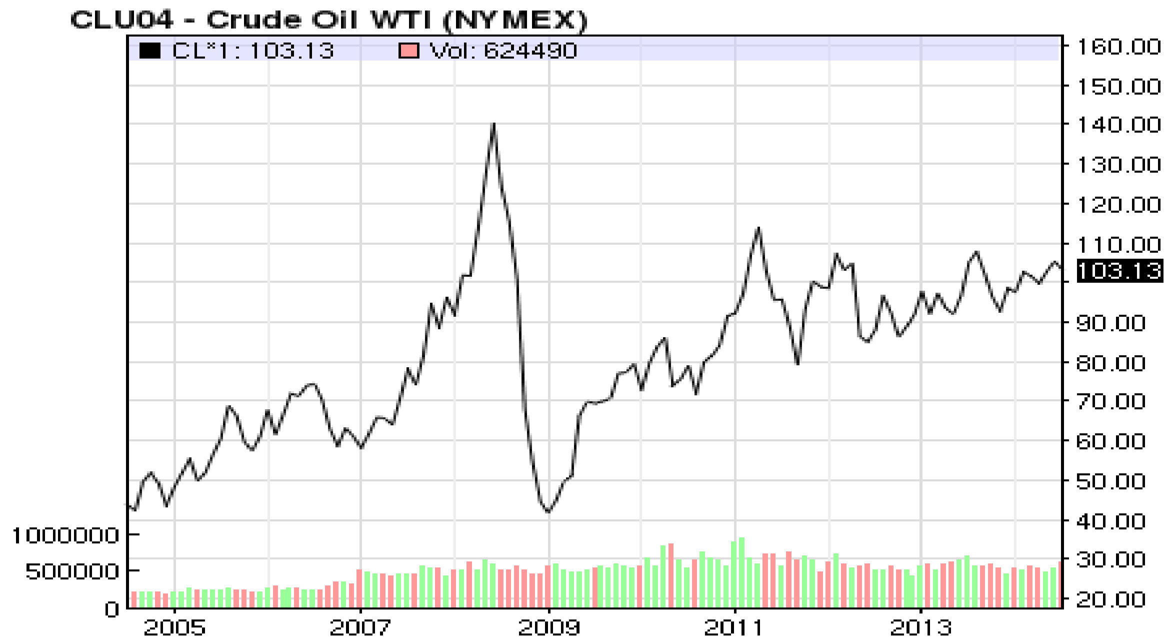
First, while volatility was at these same low levels in 2007, the economy today is nothing like that of 2007. In 2007, the economy was peaking. One can dispute the strength of the current uptrend, but as discussed in past quarterly reports, the trend is up – at least as measured by the Conference Board's Leading Economic Index series, as well as regional Fed reports and Institute for Supply Management (ISM) "Reports on Business". This growth serves to dampen business cycle volatility.

Further, the significance of the low levels of global inflation – both in terms of wage pressures as well as "non-core" food and energy commodity prices – cannot be over emphasized. Oil and energy prices are good proxies for commodity inflation. As the chart below depicts, they've pretty much traded sideways, basically between $85 - $105, for the past three years.[17]

---

[13] "BIS Hints at Calm before New Financial Storm"; Financial Times; June 30, 2014; pg. 2
[14] " 'Euphoric' Capital Markets are out of Step with Financial Reality, Warns BIS"; op. cit. #13; pg. 1
[15] "The Missing Fear Factor Will Return to Haunt Yellen"; Axel Merk; Financial Times; July 10, 2014; pg. 18
[16] Barron's; Market Week column; June 2, 2014; pg. M!
[17] http://www.nasdaq.com/markets/crude-oil.aspx?timeframe=3y

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.



Despite the turmoil and supply disruption in the Middle East, there has been an increase in North American supply to offset this. Of greater import, however, is the unfolding slowdown in China, which in the past decade has replaced the US as the global "price-setter" for commodities. As George Magnus has observed, "Optimists insist (China) is going through an 'adjustment' similar to previous property downturns. But a more sober view is that because of overbuilding and leverage nurtured by shadow banking, this downturn is more serious and systemic. China is probably in the first stage of a denouement of the property-and construction investment-led growth model of the past 15 years. Financial markets are having trouble pricing the implications."[18]

If Magnus is correct – and we're strongly sympathetic to his views – then the consequences for US equities and our domestic economy are actually quite benign. This type of environment would allow earnings multiples to continue to expand, and would allow US consumers to gradually regain purchasing power. We would argue that as important as the central bank monetary policies have been in damping volatility, subdued inflation/disinflation has been equally important. So, conversely, a resurgent Chinese economy would be a worst case scenario. That would reignite global inflationary pressures thus highlighting and exacerbating global imbalances.

Nevertheless, as Axel Merk notes, "Alan Greenspan suggested home prices could not fall; Ben Bernanke suggested the subprime mortgage market problems were contained; and Janet Yellen argues complacency in the market is not a problem. The current Federal Reserve chair, just like her predecessor, might well live to regret those words."[19]

---

[18] "End of China's Property Boom has Barely Begun"; Financial Times; July 8, 2014; pg.22

[19] Op. Cit. # 15

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

What is most concerning to us is not the low levels of volatility per se, but rather the fact that "volatility" in and of itself has become an "asset class" and as such, large positions are being established on either side of this "trade". The evolution of this trade was discussed in a recent FT article, and in particular, they discuss the role of major bond fund company PIMCO.

> "Unlike smaller fixed income funds that might just buy and sell bonds, the $230bn Pimco Total Return fund is a clever user of derivatives trading strategies, Mr. Gross went on to explain, and Pimco is one of the biggest sellers of insurance against market volatility…
>
> 'Sounds dangerous and is sometimes,' Mr. Gross said. 'Obviously, the volatility has to be underwritten properly and priced appropriately. It doesn't pay to write flood insurance before a flood, but over time it has been a very respectable structural template alpha generator,'
>
> In fact, so many different kinds of investors are now 'selling volatility' that BlackRock's Dennis Stattman worried at the same conference that it had become a 'crowded trade'. Sceptics worry these new performers might be selling flood insurance on the cheap, just before a deluge. (Ed. note; count us strongly in that skeptic's camp)…
>
> Both (stock and bond volatility indexes) are close to historic lows, and traders are in the middle of a vigorous debate about why. The economic recovery and central bank support for markets suggest big swings may be unlikely. But some traders think vol may be priced too low for technical reasons, too, such as the retrenchment of bank trading desks and resulting illiquidity, of an imbalance between supply and demand.
>
> According to Maneesh Deshpande, head of equity derivatives strategy at Barclays, the demand for protection from volatility has soared, but the supply from people selling insurance has soared even more.
>
> 'Premium has declined to the levels prevalent in the 2004-06 period, so we call it the 'old normal' – but with a twist,' Mr. Deshpande said. The twist is that a host of new performers are in the market trading a host of new volatility products. More than a half-dozen exchange-traded products allow hedge funds and retail investors to short the VIX. Trading in options is buoyant, with open interest near a record level.
>
> The attraction of selling vol is that, over several decades, payouts have been less than the money investors have taken in through premiums. The volatility implied by the price of options has never been fully realized in the actual, subsequent movement of the stock or bond markets.
>
> Howard Tai, analyst at Aite Group, says in a world of low returns, it is an attractive strategy for some investors. Pension funds have joined the sellers, attracted to the premium income at a time when bonds are yielding a pittance. ***The question is how many will be carried out if vol spikes and their losses are more than they can afford. 'if***

there is a flare up that causes volatility to jump, you will have a scramble at that point as sellers will need to buy it back,' says Mr. Tai (ed. note; emph. added)"[20]

Our readers know that our approach to investing focuses foremost on risk analysis. As such, we've long felt that the same risk that caused the booms and busts in the NASDQ during 1998-2002, and in the subprime/housing/financial markets during 2008 is alive and well and currently resides on the balance sheet of the Federal Reserve. The trillion dollar question remains how and when that unwind manifests. In 2008 its immediate and collateral effects were focused primarily through the housing complex and through the collapse of the enormous leverage that had built up in that market. Today, housing is not nearly as leveraged. However, when the price of any commodity is artificially subsidized, it always leads to overproduction of that commodity. With short term interest rates held at zero (and – at least for the time being – longer term rates artificially dragged down as well), few things have been artificially subsidized as bond prices. The industry has risen admirably to the occasion. According to the FT, Corporate bond sales have risen to the highest level in five years. They report that "Some of the largest companies, such as Verizon, Walmart, Bayer, Cisco and Petrobras, as well as banks including Wells Fargo, Bank of America and BNP Paribas have together sold more than $1.8tn in new bonds in the six months to the end of June, according to Standard & Poor's data. This is the highest total for the first half of a year since 2009."[21]

According to data from the BIS, total outstanding bond issues as of year-end 2013, was roughly $85 trillion.[22] (This far exceeds the size of the stock market. For reference, the total market capitalization of the global equity markets was $64 trillion as of year-end 2013.)[23] Thus, a plausible eventual outcome might be a shock to the bond market, triggered by a blow up in the volatility derivatives markets. The equities markets would not be immune to such an outcome, but nevertheless, in terms of risk – particularly overleverage, oversupply, and stretched valuations – we continue to find the bond market offering very little value relative to equities.

Further, the stock market in general, is beginning to show signs of its age. The large and mega-cap stocks continue to perform well, as the Dow Jones Industrials have made a series of new highs all year.[24] However, this has served to mask underlying deterioration and an actual correction in the smaller stocks as represented by the Russell 2000 Index (IWM). According to data from Yahoo Finance, this Index began failing back in March, after peaking at 119.76. On July 1st, it basically formed a double top (closed at 120.02) before failing and dropping sharply. We feel that the multi-year outperformance of this sector may be ending, and are reducing exposure accordingly. There is also a strong probability that this underlying deterioration will eventually pull down the "generals" – i.e. drag the Dow and S&P 500 into their own correction. We will use the cash raised from the small caps as a buffer and, hopefully, volatility reducer.

[20] "Pimco Takes Starring Role in "Vol" Sale"; Financial Times; June 28/June 29; pg. 12
[21] "Corporate Bond Sales at Five-Year High"; Financial Times; July 11, 2014; pg. 22
[22] http://www.bis.org/statistics/r_qa1406_hanx18.pdf
[23] http://www.world-exchanges.org/files/2013_WFE_Market_Highlights.pdf
[24] http://finance.yahoo.com/echarts?s=%5EDJI+Interactive#symbol=%5EDJI;range=1y

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

It should be noted that as this report was being written, we've witnessed a major unravelling of the Middle East, along with the downing of a Malaysian commercial airliner flying over the Ukraine. This caused a roughly 30% one day spike in the VIX[25], which has since promptly given most of those gains back.

Nevertheless, we try to stay focused on the longer term which we feel still favors equities. Of late, some of the former highfliers from the NASDAQ heyday have been acting very well, after roughly 15 years of trading essentially sideways. These include names such as Intel, Cisco, Applied Materials, as well as some of the Basic Materials and Industrial names. We continue to believe that the longer trend in the equities markets remains up; that the US domestic economy will continue to slowly heal; and we're favoring economically cyclical names.

We fervently hope, as the summer heats up, that things can somehow cool down in the Middle East and the Ukraine, although a positive near term outcome is hard to envision. And, as the summer tends to slow things down a bit, we hope you find some time to relax and enjoy it.

Warm regards,

Jason Waxler

[25] http://finance.yahoo.com/echarts?s=%5EVIX+Interactive#symbol=%5EVIX;range=1m
[25] http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

Katonah Capital Group, LLC

	Total Return	
Index[1]	Second Quarter 2014	Year-to-Date
DJIA	2.83%	2.68%
S&P 500	5.23	7.14
Nasdaq Composite	4.98	5.54
S&P MidCap 400	4.33	7.50
Russell 2000	2.05	3.19

Index[1]	Second Quarter 2014	Year-to-Date
Barclays U.S. Aggregate Bond Index	2.04%	3.93%
Credit Suisse High Yield Index	2.41	5.55
Barclays Municipal Bond Index	2.59	6.00
Barclays Global Aggregate Ex-U.S. Dollar Government Bond Index	2.72	5.59
J.P. Morgan Emerging Markets Index Plus	4.76	8.66
Barclays U.S. Mortgage Backed Securities Index	2.41	4.03

	Total Return	
MSCI Index[1]	Second Quarter 2014	Year-to-Date
EAFE (Europe, Australasia, Far East)	4.34%	5.14%
All Country World ex-U.S.	5.25	5.89
Europe	3.65	5.95
Japan	6.69	0.85
All Country Asia Ex-Japan	7.30	6.57
EM (Emerging Markets)	6.71	6.32

	Total Return	
MSCI Index[1]	Second Quarter 2014	Year-to-Date
Emerging Markets (EM)	6.71%	6.32%
EM—Asia	7.27	7.02
EM—Europe, Middle East, and Africa (EMEA)	4.54	2.85
EM—Latin America	6.99	7.40

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.

26

[26] http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups

Registered Representative offering securities through American Portfolios Financial Services, Inc., member: FINRA and SIPC; Investment Advisor services offered through Income & Asset Advisory, Inc. an SEC registered Investment Advisor, d/b/a Katonah Capital Group, LLC. American Portfolios, Income & Asset Advisory Inc., and Katonah Capital Group, LLC are unaffiliated entities.