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

THIRD QUARTER 2013 INVESTMENT ADVISORY REPORT

"THERE'S SOMETHING HAPPENING HERE"

(- Buffalo Springfield)

In their 1966 song, "For What It's Worth", the Buffalo Springfield wrote "There's something happening here; what it is ain't exactly clear". The lyrics certainly apply to the economic and political landscape of today. However, there are some major macro-trends that seem to be emerging and are becoming "very clear". They will have enormous effect on the performance on investment assets going forward.

Of the many tectonic shifts unfolding, perhaps the most potent (and most strongly resisted, counterintuitive, and least understood) is the shift of growth away from the "developing" economies (think India, China, Turkey, Brazil…) and towards the "advanced" or "developed" countries – most prominently the US, and developed Europe and the UK. According to a Financial Times report, as recently as this past April, the International Monetary Fund (IMF) was talking about "a 'three-speed recovery' with ***emerging economies set fair and growing rapidly***, the US and Japan doing reasonably, and Europe still mired in crisis [emph. added]…[However, just] last week, IMF managing director Christine Lagarde had to reverse those views in a speech acknowledging that "'in many of the advanced economies… we are finally seeing signs of hope', while 'momentum is slowing' in countries such as China, India and Brazil."[1]

The author goes on to report that "Confidence has turned everywhere, with business and consumer surveys showing higher orders and increased production. The US motor industry has been revving faster on the back of improved household finances and a stronger housing market, but rapid recovery has been held back by this year's sharp tightening of fiscal policy."[2] Another FT report cites the results of the recent Brookings Institution "Tiger Index" (Tracking Indexes for the Global Economic Recovery) which indicates that "Surging business confidence in rich countries has put the global economy 'back on track' to resume a steady recovery…The improvement in outlook has come as a surprise over the summer…"[3]

Many of our clients – particularly on the East coast – might be wondering "what recovery?", and on the face of it (and in terms of national aggregate data), the sentiment is understandable. Assessing the past five years since the onset of the financial crisis, Martin Wolf observes that:

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[1] Confidence Takes Welcome Turn; Chris Giles; FT Special Report; 10/11/2013; pg.1
[2] Op. cit. #1.
[3] Global Economy 'Back On Track'; Chris Giles; Financial Times, 10/7/2013; pg.2

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> "The four most important central banks – the Federal Reserve, the European Central Bank, the Bank of Japan and the Bank of England – all have short-term interest rates of half a per cent, or less. These rates have remained extremely low for four years, or more. The Bank of Japan's rates have remained ultra-low since the mid-1990's.
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> Since the crisis began, the Fed's balance sheet has grown fourfold and is still growing, at a rate of $85 bn a month. The supposedly conservative ECB has promised to buy the bonds of troubled governments, if necessary, through the 'outright monetary transactions' programme announced in the summer of 2012. The Bank of Japan has launched a huge programme of balance-sheet expansion under its new governor, Haruhiko Kuroda.
>
> What then has all this monetary activism bought? Disappointment. Of the six largest high-income economies, ***only two – the US and Germany – were bigger in the second quarter of 2013 than at their pre-crisis peaks five years before*** (emph. added): the US economy was 5 per cent bigger, Germany's 2 per cent. The French economy was back to its starting point while the UK's was some 3 per cent smaller. Crisis-hit Italy's economy had shrunk by 9 per cent."[4]

This is not particularly headline breaking news, but there are two phenomena "happening here" neither of which are "exactly clear", but we think both merit further discussion. First, there are the "unintended consequences" resulting from the Central Bank's grand monetary experiment. One such consequence was aptly articulated by Randall Forsyth of Barron's:

> "What has emerged has been a bear market in fear. That would seem to be the reasonable result of the Xanax provided by the Federal Reserve in what has been popularly called the Bernanke Put, which is the successor to the Greenspan Put. That's the widely held perception that the monetary authorities will always provide a safety net to the markets in the event of a plunge. A put option provides the buyer with the right to sell something at a predetermined price; in other words, it's an insurance policy. And, as with insurance, the put buyer pays a premium for that protection, commensurate with the risk. ***In the case of the Fed, this put protection is being provided free of charge*** (emph. added). The monetary authorities' idea is to encourage risk-taking in order to spur economic growth and employment.
>
> The reality is that the perception of reduced risk has fed into the financial markets more than the real economy has. Investors have less incentive to pay up for protection in the options market, which keeps a cap on implied volatilities. As a result, the VIX remains subdued. ***And the putative wall of worry for the bulls to climb is actually no more than waist-high*** (emph. added)"[5]

This same phenomenon was portrayed by Henny Sender in a FT article. "Every time hedge funds and other investors have positioned themselves defensively, cutting back on risk in the

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[4] Sound and Fury But Signifying Nothing Yet; Martin Wolf; Financial Times, 10/11/2013; pg.2

[5] The Risk Beyond the Beltway; Randall Forsyth; Barron's; 10/14/13; pg.8

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face of uncertainties, they have regretted their prudent stance. They, like Chuck Prince, the hapless former chief executive of Citibank, have concluded that while the music is still playing they might as well keep dancing to the tune of easy money - which means staying long US equities."[6]

All this highlights the disdain in which most investors hold the current stock market rally. They're long, but are uncomfortable because they know there's risk out there somewhere, despite the "Xanax provided by the Federal Reserve". In a contrarian sense, we find this potentially bullish for stocks. We agree that there's definitely risk in the markets – in fact, it's the same risk (or perhaps its offspring) that created the NASDAQ bubble in 1999-2000, and the housing/financial bubble in 2007-2008. However, we believe that the risk today currently resides on the balance sheet of the Federal Reserve Bank, and unlike the two prior events, this one will manifest primarily in the bond market.

The team at Marketfield Asset Management states;"The unmistakable aura of hope that defines the early stages of all significant bear markets pervades the bond market at the current time, with the reliance on the Bernanke led FRB as unshakable (and we assume as ill placed) as the equity market's belief in the protection of the Greenspan led FRB in 2000 and 2001."[7] And, in a later report, they continue; "There is little evidence that some of the more concentrated [bond] portfolios have been moderated during the recent stabilizing, in fact the quarterly allocation period actually suggests that a modest re-building of long positions took place in recent weeks. This would be consistent with the early stages of all major bear markets, whereby the initial break comes as a complete surprise and once its ferocity is extinguished is greeted as something of a buying opportunity."[8]

One area of potential concern is the arcane Repurchase Agreement (Repo) market. In an article concerning the US Budget and Debt impasse, Gillian Tett explains that; "The issue at stake is the $2 tn tri-party repurchasing market, where financial institutions raise cash for short-term needs, by pledging securities (such as those T-bills) as collateral….although this Achilles' heel spooks market cognoscenti, most Tea Party supporters have no idea the repo world even exists. Voters know what a crashing stock market looks like; tri-party repo deals are a mystery…there is no lender of last resort and no neutral third-party exchange or clearing platform to complete deals swiftly if a party fails or a security defaults. Instead, clearing is concentrated in the hands of two private-sector players: Bank of New York and JPMorgan."[9] This sounds unnervingly similar to the tiny subprime mortgage market that became the tail that brought down the entire dog.

To be sure, the US bond market itself, is much more than a tail wagging a dog – it is an integral part of the entire global financial markets. Furthermore, the process of valuing any financial asset ultimately requires the use of some "discount rate" in order to obtain the present value of future cash flows and asset prices. Typically, that discount rate is based on current bond yields –which as we've discussed at length, have themselves been artificially

[6] Markets Carry on Dancing to the Tune of Easy Money; Henny Sender; Financial Times; 10/12-10/13/2013; pg.14

[7] The Weekly Speculator; Marketfield Asset Management; 10/3/2013; pg.2

[8] The Weekly Speculator; Marketfield Asset Management; 10/10/2013; pg.2.

[9] US Debt Impasse exposes Achilles' Heel of Finance; Gillian Tett; Financial Times; 10/11/2013; pg.22

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distorted by Fed actions. At some point, they will normalize, potentially wreaking havoc upon the valuation of all risk assets, including most certainly the stock market. The question remains then; are there economic fundamentals that exist to support stock valuations, beyond the "cleanest dirty shirt" phenomena whereby equities only look good relative to (artificially created) zero interest rate alternatives? ***The real risk is that the Fed loses control of the bond market – a process that might be evolving currently – at which point we'll know with much greater certainty how much valuations have been floating on a liquidity induced sugar high vs. how much they're being driven by economic fundamentals.*** We believe it's a combination of both.

This brings us to the second point in Martin Wolf's article above, that's not exactly "clear", or at least not fully appreciated, and this is his comment that [the economies of]…"the US and Germany were [now] bigger in the second quarter of 2013 than [they were] at their pre-crisis peaks five years before". There are signs that the economy is healing – on its own and despite the farcical sideshow unfolding in Washington. Further, as noted, this healing seems to be centered in the "developed" economies of the US and the UK and Europe. In a recent speech given by William Dudley in September, following a Fed meeting, and as reported by the FT, Dudley noted that "'The underlying fundamentals supporting business investment are also good…Profit margins have been high and cash flows strong for some time. Credit availability has been gradually improving.'"[10] The article further notes that, "According to the latest data, household debt is back down to its 2003 pre-bubble level relative to the size of the economy. The net worth of households is hitting new highs…The housing sector is recovering. All across the US, the excess of houses built during the bubble seems to have been absorbed, and the number of homes in foreclosure is in rapid decline."[11] And, in a recent white paper, Richard Bernstein comments; "Earnings surprise data strongly suggest that analysts refuse to believe that the global sea change is underway. For more than a year, the majority of emerging market companies have (sic) produced negative earnings surprises. 56% of emerging market companies and 53% of BRIC (Brazil, Russia, India, and China) companies produced negative earnings surprises in the latest reporting period."[12]

As mentioned at the top of this report, this good news seems to have bypassed many observers – and particularly those living on the East coast. We will explore this in greater depth in future reports, but essentially the perception is true. The growth on the two coasts during the '90's and 2000's were largely driven by the housing boom. During that time, the economies in the nation's center basically languished (think the "Rust Belt"). Today, however, that's all changing and evolving as growth is spreading south to north from Mexico, through the southern and central US, and up to Canada. The national ***average*** unemployment rate is 7.3%, but it's 6.4% In Texas, 5.3% in Oklahoma, 5.9% in Kansas, 5.1% in Minnesota, 3.8% in South Dakota, and 3.0% in North Dakota.[13] Much of this is, of course, tied to energy, but many of these states have low/no state taxes, no unions, and are experiencing a real resurgence in manufacturing and production.

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[10] US Forecasts for Next Year Points to Significant Headway at Last; Robin Harding; Financial Times, 10/11/2013; pg.3

[11] Op. Cit. # 10.

[12] The Global Sea Change Continues; Richard Bernstein; Richard Bernstein Advisors; 9/26/13; pg.2

[13] Department of Labor data as aggregated by Google search

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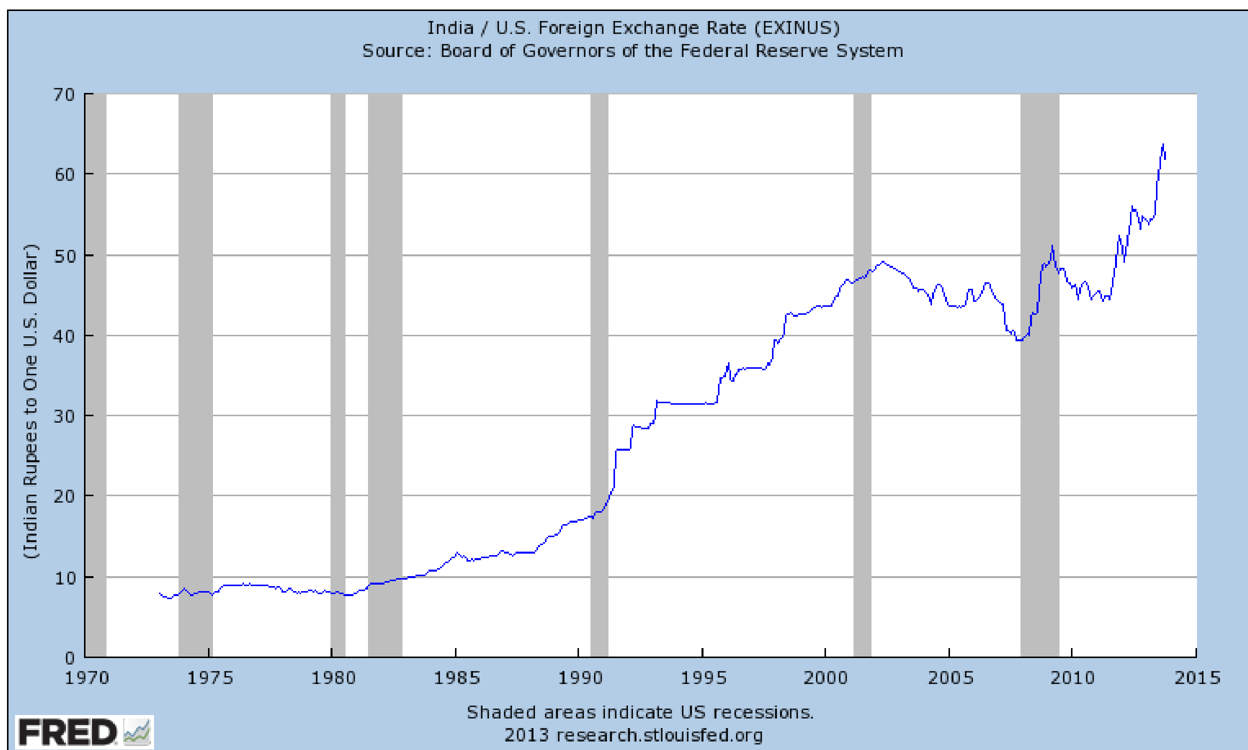
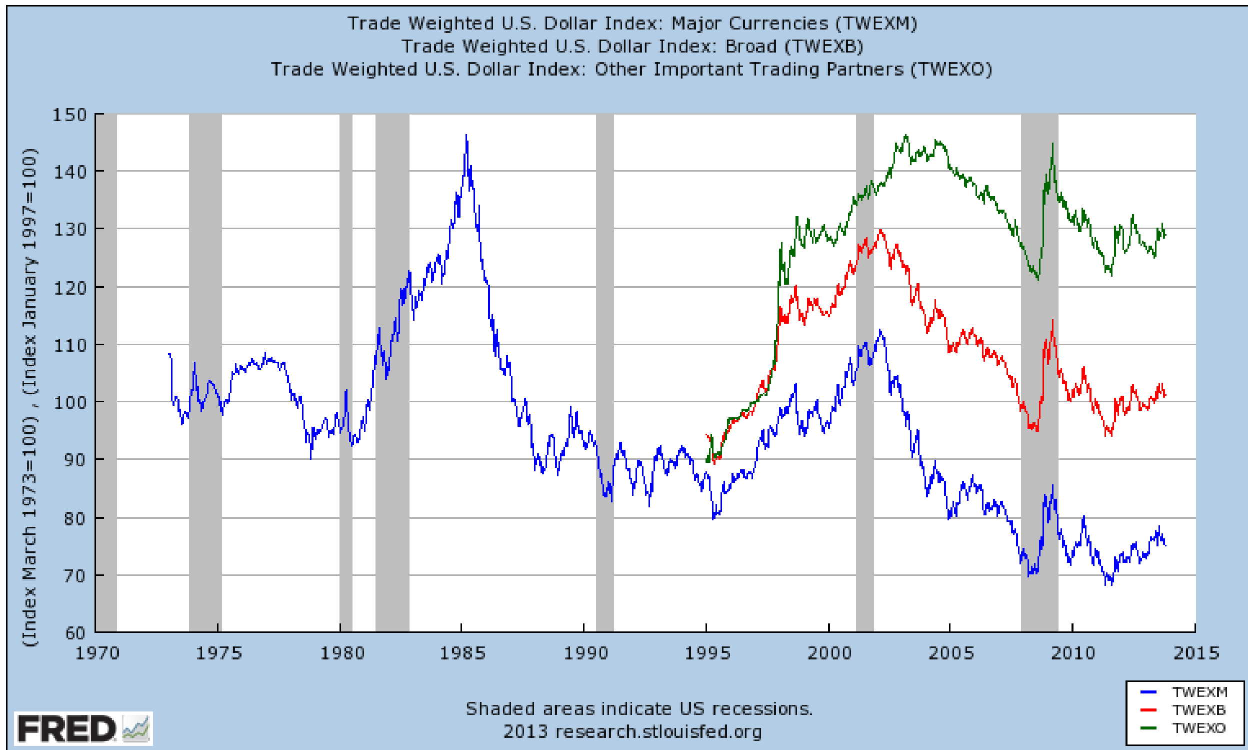
As always, one of our favorite market indicators remains the US dollar (USD). It has been an excellent barometer of global capital flows, the ongoing battle between deflation and reflation, and the unfolding rebalancing of global economic growth. The charts below depict the capital outflows from the emerging/BRIC economies and into the US. The first chart is of the USD vs. the Indian Rupee (INR). The depreciation of the INR particularly after 2011, is striking. (Ed. note; more rupees per USD equates to a weaker rupee). Interestingly, a chart of the USD vs. gold would convey the same macro trend. The next chart, however, paints a slightly different picture. The series in blue is of the USD vs. other major currencies (e.g. the Euro and the Yen). This data displays the recent dollar strength (seen after the global shocks of '08 and 2011), but also clearly shows the overall longer term decline of the dollar. The green series graphs the USD vs. "other important trading partners". It shows the recent relative strength of the USD vs. our major trading partners, as capital flows back into the US. These capital flows are closely correlated with the recent manufacturing resurgence and energy independence in the US.

The scenario outlined above supports our current allocation strategies. Going forward, we will be reducing our bond and emerging market exposure even further, and will be increasing equity exposure – particularly to companies deriving their income from the US and other developed economies. This also would imply a tendency towards smaller and mid-sized companies, and an aversion to large cap multinationals.



[14]

[14] http://research.stlouisfed.org/fred2/series/EXINUS?cid=95



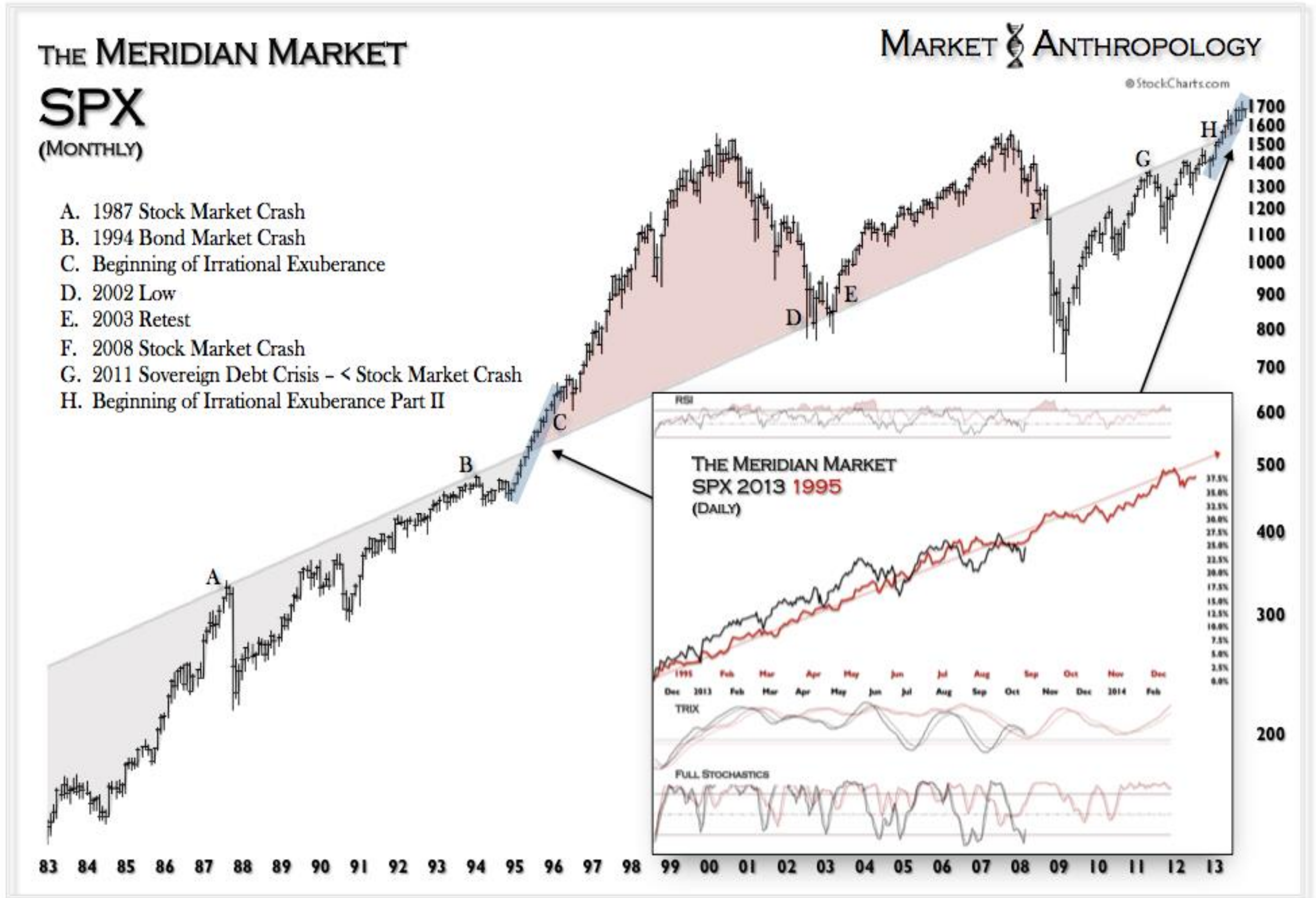
[15]

Finally, we leave you with the below chart from Erik Swarts at Market Anthropology who puts out ever thought provoking charts and commentary. The ramifications of this particular chart, should it prove prescient, are astounding. It could mean that we're in the process of exiting the roughly 15 year secular bear market for equities. It could also mean that we're about to embark on another equity mania similar to the NASDAQ market in the late nineties, or the "nifty-fifty" market of the mid 1970's.

Sincerely,

Jason Waxler

[15] http://research.stlouisfed.org/fred2/graph/?id=TWEXMMTH,TWEXBMTH,TWEXOMTH,#


The Meridian Market
SPX
(Monthly)
Market Anthropology
©StockCharts.com
A. 1987 Stock Market Crash
B. 1994 Bond Market Crash
C. Beginning of Irrational Exuberance
D. 2002 Low
E. 2003 Retest
F. 2008 Stock Market Crash
G. 2011 Sovereign Debt Crisis – < Stock Market Crash
H. Beginning of Irrational Exuberance Part II
A
B
C
D
E
F
G
H
1700
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1200
1100
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900
800
700
600
500
400
300
200
83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13
RSI
The Meridian Market
SPX 2013 1995
(Daily)
TRIX
Full Stochastics

	Total Return	
Index[1]	Third Quarter 2013	Year-to-Date
DJIA	2.12%	17.64%
S&P 500	5.24	19.79
Nasdaq Composite	10.82	24.90
S&P MidCap 400	7.54	23.23
Russell 2000	10.21	27.69

Index[1]	Third Quarter 2013	Year-to-Date
Barclays Capital U.S. Aggregate Bond Index	0.57%	-1.89%
Credit Suisse High Yield Index	2.39	3.94
Barclays Capital Municipal Bond Index	-0.19	-2.87
Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index	4.38	-2.38
J.P. Morgan Emerging Markets Index Plus	0.51	-8.89

	Total Return	
MSCI Index[1]	Third Quarter 2013	Year-to-Date
EAFE (Europe, Australasia, Far East)	11.61%	16.59%
All Country World ex-U.S.	10.17	10.47
Europe	13.66	16.71
Japan	6.71	24.47
All Country Asia Ex-Japan	5.86	-0.08
EM (Emerging Markets)	5.90	-4.05

	Total Return	
MSCI Index[1]	Third Quarter 2013	Year-to-Date
Emerging Markets (EM)	5.90%	-4.05%
EM—Asia	5.48	-1.30
EM—Europe, Middle East, and Africa (EMEA)	9.45	-4.87
EM—Latin America	4.14	-11.14

[16]

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

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