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THIRD QUARTER 2014 INVESTMENT ADVISORY REPORT

The Bull Market in Complacency Pauses – A Correction or Cycle Top?

Often when markets diverge, it's described as a "tale of two markets". The Third Quarter just ended was not so much one tale of two markets as much as several tales of many markets! Concerning the broader macro view, we've consistently looked to the US dollar (USD) as our primary barometer of global reflation vs. deflation. We've been favorably inclined towards USD strength, believing that years of Fed induced capital outflows from the US and into foreign and emerging markets (EM) were peaking, and in fact beginning to reverse. Our portfolios performance was therefore enhanced by reducing/underweighting exposure to EM. However, we have exposure to developed Europe, and in particular Spain. We failed to appreciate the depth of the deflationary impulse on that sector and that exposure detracted, as the MSCI Europe Index declined by nearly 7% in Q III (see Index data below).[1] We feel that there is good value in many of these markets, and would not be sellers at this point.

Spain (and Ireland) in particular, has undertaken many structural reforms (see the note below for a synopsis of many of the reforms undertaken or in progress[2]). The Economist notes that, "By making wages and prices more flexible, they allow countries like Spain and Portugal that have lost competitiveness to regain it even though they can no longer devalue against their euro-zone trading partners. They also hold out the promise of higher growth…"[3] We primarily employ the iShares MSCI Spain ETF (EWP) for our exposure. Timing, it is said, is everything, and there are certainly valid concerns regarding a separation of Catalonia and European growth in general, but we like the risk reward tradeoff here, EWP is currently yielding nearly 3%, and we will be looking to increase our allocation.

Many of our portfolios have held long USD (and short Japanese Yen) positons. These have done well and we believe this is a secular trend and want to increase exposure on any weakness. However, a flip side of this (along with the unwind/transition of the investment led boom in the Chinese economy) has been a dramatic decline in commodity prices, and in oil in particular.

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

[2] http://www.thespanisheconomy.com/portal/site/tse/menuitem.efbc5feeac2b3957b88f9b10026041a0/?vgnextoid=38ce7e7b61b7f310VgnVCM1000002006140aRCRD

[3] http://www.economist.com/news/finance-and-economics/21601008-some-signs-improvement-must-try-harder-patchy-progress

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Our exposure to energy and gold were negatives. We will not be looking to add to this exposure, and might look to reduce energy exposure as we suspect that this too will prove to be more of a secular story than is currently appreciated.

Finally, we continue to believe there's a high probability that small cap stocks have put in a cyclical top, and remain underweight that space. In some senses, this doesn't square with our strong USD, US centric theme. However, according to the Wall Street Journal, the trailing 12 month (ttm) price to earnings (P/E) ratio for small cap stocks, as measured by the Russell 2000 index, is 70.08! This contrasts with a ttm P/E ratio of 18.60 for the S&P 500 and 23.05 for the Nasdaq 100.[4] We could speculate as to reasons behind the recent small company underperformance, however, after many years of outperformance, we feel that a 70.08 P/E is bubble like territory, and there's relatively little value left in that space. We continue to like the mid-cap area, and while there has certainly been technical damage done to that sector, there's good odds that this area will be a market leader coming out of the current correction. Mid-sized company revenues tend to be more domestically driven which allows us to express our theme of stronger US growth vs. weaker overseas activity.

Regarding the current correction, our last report, entitled "Ripple in Still Water", discussed the relentless compression of market volatility. Born of a new found faith that the central banks (and especially the US Fed) had gotten it just right, were in control, and had managed to ease us away from the brink of financial collapse, comforted investors fueled a broad based bull market in stocks, risk assets in general, and for complacency in particular! The markets' favored measure of "fear" – the Volatility Index, or the VIX – was plumbing multi-year lows and has in fact become a tradable asset class in and of itself.

For the past few years (from the end of June 2012 through now), the VIX has traded in a well-defined range between around 22 on the top end and 12 on the bottom. During this past summer, reflecting extreme levels of newfound complacency, the VIX broke decisively below this range. It traded down close to 10 in June and July, and was the reason we focused on that topic in our last report. As of the close of trading on October 15th, the VIX traded as high as 31.06, intraday, before settling back to close at 25.27.[5]

It should be noted that levels around 50 have historically been associated with extreme levels of fear – e.g. the VIX traded up to 48 in August of 2011 as the US debt was downgraded to AA+, and it traded up to 48.20 in May of 2010 as Greece threatened to default on its debt and exit the Eurozone.[6] (See chart below).[7] White knuckled, bar the windows panic, such as that experienced in the crash of 1987 and the financial crisis of 2008 has seen the VIX spike to levels of 172.79 and 89.53 respectively.[8] Nevertheless, readings over 20 tend to be followed by periods of increased volatility, that's where we now reside.

[4] http://online.wsj.com/mdc/public/page/2_3021-peyield.html
[5] http://finance.yahoo.com/q/hp?s=%5EVIX+Historical+Prices
[6] Ibid. # 5
[7] https://research.stlouisfed.org/fred2/graph/fredgraph.png?g=ORI
[8] Op.cit. # 5

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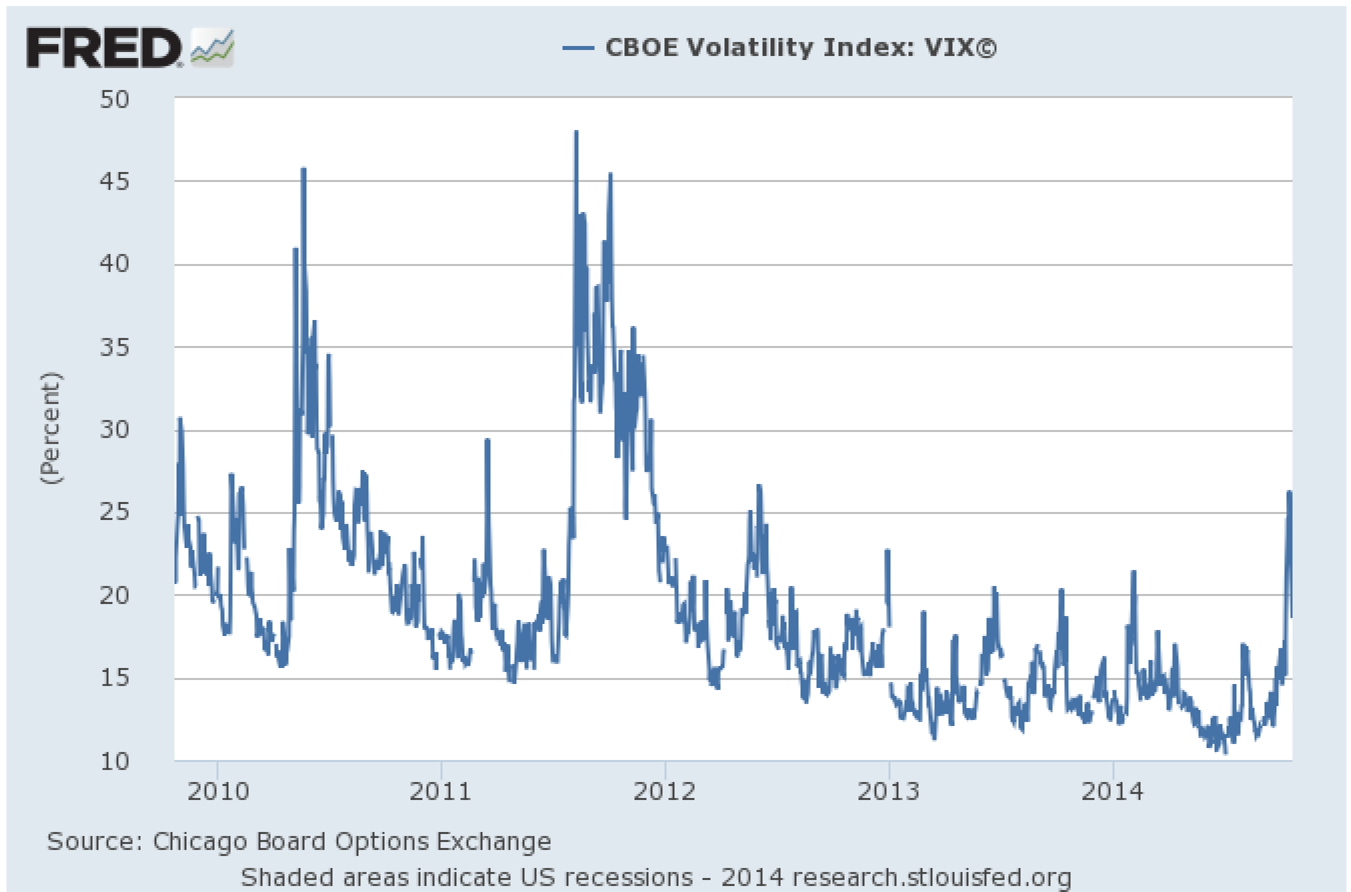

So where does that leave us going forward? Odds favor increased volatility ahead for a variety of reasons. Mid Term elections are looming; the Federal Open Market Committee meets at the end of October; there will be elections in Brazil and geopolitical tensions/events seem an almost certainty. Or, perhaps this is just payback for the calm seas we've all grown accustomed to of late and a reminder that investing in risk assets such as equities, entails risk and volatility. But we feel the broader macro environment remains, on balance, positive.

On the negative side, Europe is clearly a concern. In a world where the balance sheets of most major central banks are expanding (see charts below), the balance sheet of the European Central Bank (ECB) is contracting dramatically. This has led to a virtual collapse of longer term interest rates in the Eurozone. According to Bloomberg, while 10-year US Treasury rates hover around 2 ¼%, the equivalent 10-year yields in Germany are 0.89%, 1.3% in France, and 2.16% in Spain![9]

[9] http://www.bloomberg.com/markets/rates-bonds/

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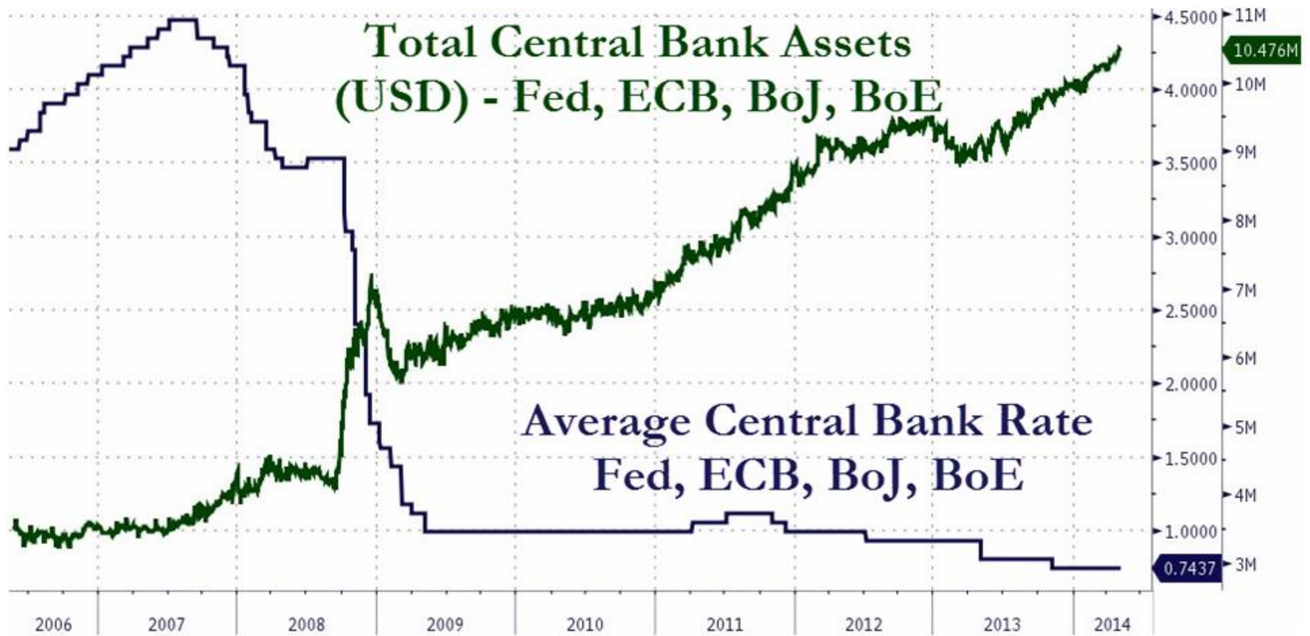

[11]

[10] http://soberlook.com/2013/11/ecb-contemplating-new-ltro-with-twist.html

[11] http://www.resilience.org/stories/2014-06-10/central-banks-balance-sheets-interest-rates-and-the-oil-price

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Germany appears to be sinking into recession and France is becoming the new Greece in terms of its fiscal house. Investor's Business Daily recently reported that "German industrial production slid 4% in August, its worst showing in nearly six years, the government said Tuesday. That followed a 5.7% plunge in manufacturing orders in August, reported Monday, and a spate of surveys showing sentiment at multi-year lows. Those reports suggest Germany's Q2 GDP dip was not just a one-time event."[12] The ECB has still shown little intention of offering help. In their meeting in early October, they announced some de minimis easing measures, but in an article entitled "Challenges Deepen for Central Bankers", the Financial Times reported that "Mario Draghi (ed. note, the president of the ECB) set no precise figure for its asset-backed securities and covered bonds purchases, and indicated the ECB was no nearer full-blown QE, which is opposed by at least some on its governing council."[13] And, they continue, "The ECB was not the only central bank in a spot of trouble. Bleak data on Japanese industrial production prompted reports that the Bank of Japan could halve its growth forecast for this fiscal year, currently at 1%"[14]

However, the positive flip side of this is the downward pull it is having on global interest rates and on US interest rates in particular. According to the St. Louis Fed, 30 year fixed mortgages just broke below 4% - still above the 3.4% levels seen at the lows in 2013, but well below the 5% levels seen in 2010 and 2011.[15] This could be stimulative for a whole swath of the domestic economy, from housing, to capital expenditures, to corporate financing and consumer debt service.

The other great worry, also discussed at length in past reports, is China. As seen in the below charts, the balance sheet of the People's Bank of China (PBOC) is also shrinking dramatically. Nevertheless, total private credit is still surging as the PBOC walks a fine line of rebalancing their economy away from investment centric growth (i.e. they've already built enough roads and housing to satisfy demand for many years to come, and have arguably created a bubble in this sector that must now be deflated) and towards more consumption and government spending on social capital.

[12] "German Output Dive Raises the Risk of European Recession"; Investor's Business Daily; Oct. 8, 2014; pg.1
[13] "Challenges Deepen for central Bankers"; Financial Times; Oct. 4/5; pg. 13
[14] Ibid. # 13
[15] https://research.stlouisfed.org/fred2/graph/?g=NUh

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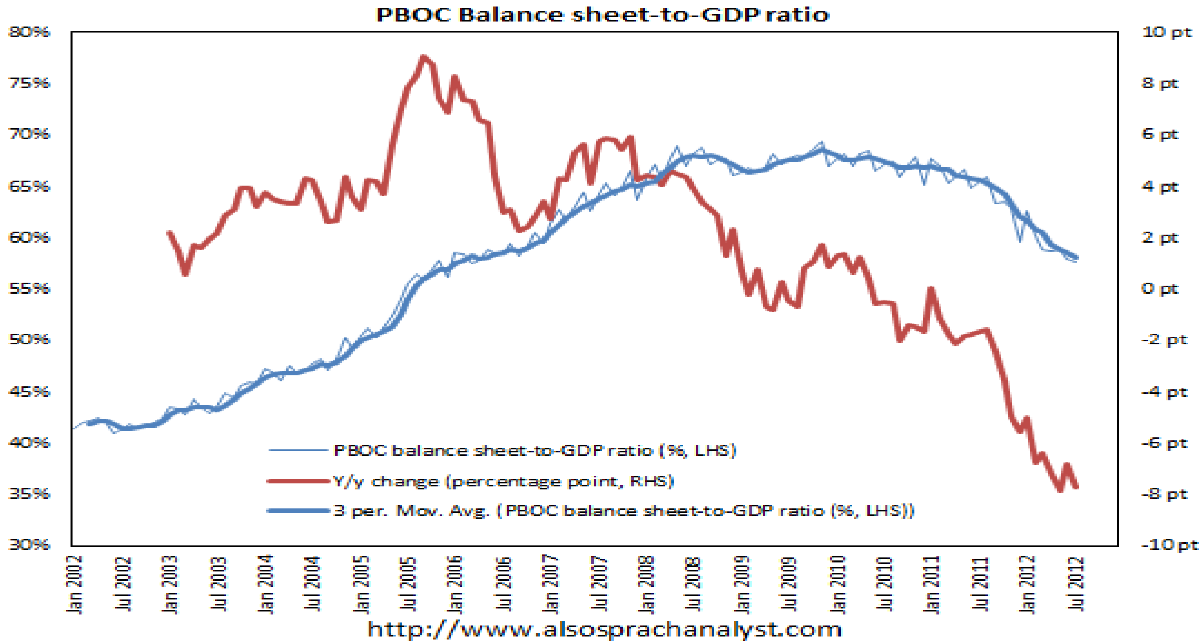

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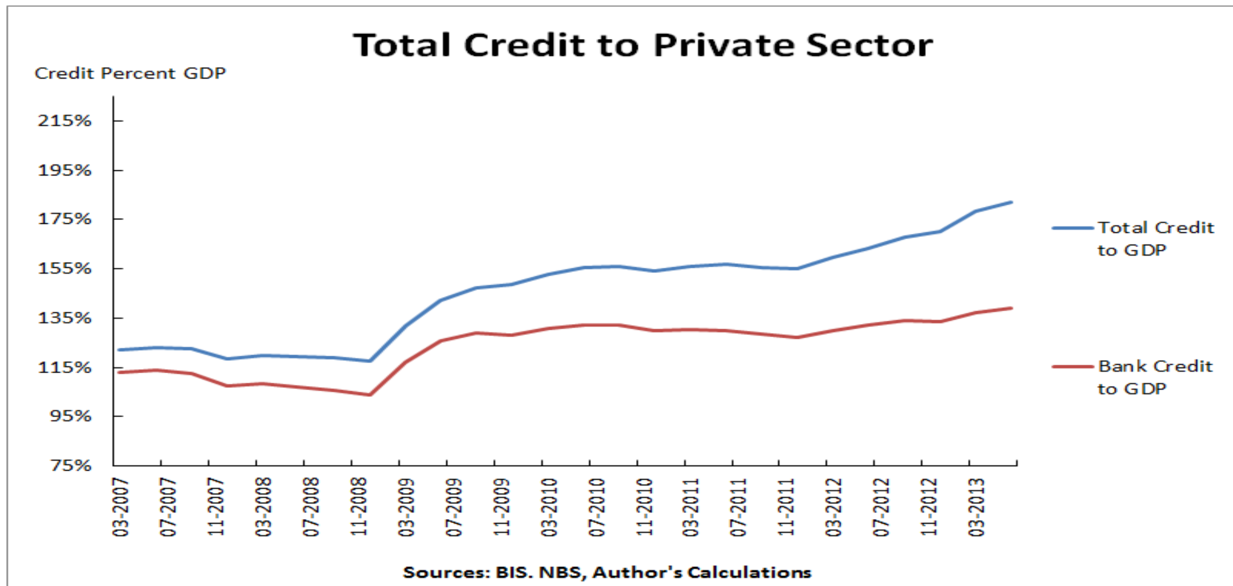

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[16] http://www.macrobusiness.com.au/2012/09/china-is-winning-the-race-to-print/

[17] http://blogs.piie.com/china/?p=3119

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Bloomberg reported that "China's broadest measure of new credit rose to a three-month high in September as the central bank's targeted measures to boost liquidity helped spur lending… While holding off from broad cuts to interest rates or the overall level banks need to keep as reserves, the central bank has sought to bolster lending to targeted areas and reportedly injected 500 billion yuan into the largest lenders last month. Weighed by a property slump, the economy probably expanded 7.2 percent in the third quarter, the slowest in more than five years, based on the median estimate in a Bloomberg survey."[18]

If the Chinese do not, or cannot manage an orderly rebalancing of their economy and do indeed encounter a financial collapse, this would clearly be a major negative to global markets and economies. Michael Pettis recently wrote a piece entitled "What does a "good" Chinese adjustment look like?" It provides an excellent overview of the unfolding process, attendant risks, and potential outcomes. He posits a scenario whereby China experiences neither a soft nor a hard landing, but rather a lengthy gradual rebalancing, or a "long landing".[19]

We will be watching this process most closely of all, because the outcome profoundly informs our overall investment thesis. In particular, the Chinese slowdown/transition has taken the wind out of demand for the entire commodity complex, and also means that capital will be flowing away from China and back towards the US. Thus, ***the positive flip side to China's woes are lower commodity prices which drives lower inflation, and capital inflows back to the US which strengthens the dollar and also gives the Fed cover to back away from its Quantitative Easing and zero-interest rate monetary policies***.

According to the FT, "Commodity prices have dropped to their lowest level since the global financial crisis…The Total Return Bloomberg Commodities index…fell to a fresh five-year low of 118.2 points…The index has dropped more than 12 percent since the end of June as commodities from crude oil to soyabeans and nickel and gold have fallen in the face of soft economic data from China – the world's leading consumer of raw materials – and the prospect of a record grain harvest in the US."[20]

And, according to a release from the Agency France-Presse reporting on a recent survey from the Boston Consulting Group, "In the third annual survey of US-based senior executives at manufacturing companies with annual sales of at least $1 billion, the number of respondents who said their companies were currently reshoring to the US from China increased 20 percent from a year ago."[21] Much of the increase was due to continuing upward pressure on Chinese wage costs, but in addition, "More than 70 percent cited better access to skilled labor as a reason to move production to the US, more than four times as many who cited it for moving production away from the US. For goods that would be sold in the US, nearly 80 percent gave

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[18] http://www.bloomberg.com/news/2014-10-16/china-credit-growth-rebounds-as-pboc-s-targeted-easing-kicks-in.html

[19] http://blog.mpettis.com/2014/09/what-does-a-good-chinese-adjustment-look-like/

[20] "Raw Materials Prices Hit Five-Year Low"; Financial Times; September 23, 2014; pg. 22

[21] http://finance.yahoo.com/news/manufacturing-moving-china-us-survey-065217238--finance.html

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shorter supply chains and reduced shipping costs as a motive for reshoring. In addition, 71 percent said it was easier to do business in the world's largest economy and about 75 percent said the move provided local control over manufacturing processes and improved quality and yield."[22]

So, while there are plenty of negative headlines to occupy our attention currently, there's an abundance of profoundly positive events – at least for the US domestic economy and markets – that receive far less attention and exposure in the media. We recognize that the current bull market is an aging one. Participation is not as broadly based as it once was – a phenomenon starkly displayed by the underperformance in the Russell 2000 Index (smaller company stocks) many of which individually are clearly already in their own bear market. Nevertheless, for the reasons outlined above, we remain overall positive on the US equity markets – although less so on the small caps. We are neutral on Europe (it is ridiculously inexpensive, but could remain that way for quite some time), and are minimizing our exposure to China and the Developing markets in general.

Longer term, we continue to believe that there will be a price to be paid for the central bankers largess, and the pathetic lack of responsible fiscal action by legislators (at least in the US and Europe, while the story of China's unwind has yet to be completed).

In the meanwhile, we hope you've been enjoying the arrival of the autumn colors here in the Northeast, and will abundantly avail yourselves of fresh apples, pumpkin pie and turkey.

Warm regards,

Jason Waxler

Information has been obtained from sources believed to be reliable and are subject to change without notification. The information presented is provided for informational purposes only and not to be construed as a recommendation or solicitation. Investors must make their own determination as to appropriateness of an investment or strategy based on their specific investment objectives, financial status and risk tolerance. Past performance is not an indication of future results. Investments involve risk and the possible loss of principal.

[22] Ibid; #21

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Katonah Capital Group, LLC

	Total Return	
Index	**Third Quarter 2014**	**Year-to-Date**
DJIA	1.87%	4.60%
S&P 500	1.13	8.34
Nasdaq Composite	1.93	7.59
S&P MidCap 400	-3.98	3.22
Russell 2000	-7.36	-4.41

Index	Third Quarter 2014	Year-to-Date
Barclays U.S. Aggregate Bond Index	0.17%	4.10%
Credit Suisse High Yield Index	-1.94	3.50
Barclays Municipal Bond Index	1.49	7.58
J.P. Morgan Emerging Markets Bond Index Global Diversified	-0.59	8.02

	Total Return	
MSCI Index	**Third Quarter 2014**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	-5.83%	-0.99%
All Country World ex-U.S.A	-5.19	0.39
Europe	-6.98	-1.44
Japan	-2.19	-1.36
All Country Asia ex-Japan	-1.54	4.93
EM (Emerging Markets)	-3.36	2.75

	Total Return	
MSCI Index	**Third Quarter 2014**	**Year-to-Date**
Emerging Markets (EM) Index	-3.36%	2.75%
Asia Index	-1.41	5.89
Europe, Middle East, Africa (EMEA) Index	-7.79	5.95
Latin American Index	-5.44	0.85

[23]

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

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