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FOURTH QUARTER 2013 INVESTMENT ADVISORY REPORT and 2014 OUTLOOK

Forget the Secular Bull/Bear Debate…Welcome to the "New Normal" of Secular Mediocrity

Our longtime readers and clients know that our investment approach is primarily driven by tactical allocation. We search out sectors that we feel offer exceptional value or unreasonable risk and we overweight or underweight accordingly. We believe in the risk mitigation attainable through diversification, and it is hard to envision a scenario where we would be 100% exposed to any one asset or sector.

Well, 2013 will be inscribed in the annals of investing history as a year where diversification was basically a good hedge against returns. Equities were the only game in town – and even then, it had to be equities in the so called "developed" markets such as the U.S., Europe, or Japan. Bonds, REITs, emerging markets, commodities, emerging market debt – all traditional asset class mainstays of diversified portfolios – dramatically underperformed at best, and at worst suffered declines for the year.

A large (and probably unquantifiable) driver of the strength in the stock market has, of course, been the stated Federal Reserve Bank policy of inflating asset prices in an attempt to boost consumption. This is an artificial situation; creating artificially priced risk assets and for us, does not make for a compelling longer term investment thesis. Whether their policies were (or will ultimately be) successful or whether organic economic cycles are at play, is a debate in and of itself. Whatever the case, there has been marked improvement in the real economy and as the year progressed we adjusted portfolios accordingly.

There are several secular changes informing our allocations currently. Perhaps most significant is a longer term unwind of the Emerging Markets and the effects of that global rebalancing. We accept that Emerging Markets are cheap on a historical basis, however, much of that "historical data sample" is the result of years of massive Central Bank induced liquidity flows – particularly after the Y2K nonevent, and the collapse of the NASDAQ bubble in 2000. These flows in large part found their way offshore. They were driven largely by Foreign Direct Investment (FDI) of U.S. companies looking to expand abroad, and increased exports from these countries to satisfy our consumption demand at home (also fueled by the last Fed induced bubble). This phenomena was years in the making, and will very likely be a long slow unwind – driven by the secular deleveraging in the developed world, and cyclical deleveraging occurring in China.

We've consistently referenced the U.S. dollar as our preferred barometer of the global reflation / deflation battle. We've felt the forces of deflation were dominant; were US$ friendly; and represented wealth flowing out of emerging economies. Simultaneously this manifested in the collapse of gold, commodities and raw materials in general, and was to the profit detriment of large multinational companies whose revenue was dependent on overseas sales and demand. This is starkly depicted below in the chart of the US$ vs. the Turkish Lira. These same trends can be found in charts of the Indian Rupee, South African Rand, Indonesian Rupiah, and many others.

Within this overview, there are two major macro events we're following currently. The first is the progress of the recovery in the developed economies – and in the U.S. in particular. Second, is the progress of the slowdown unfolding in China, and the consequent global reallocation of resources.

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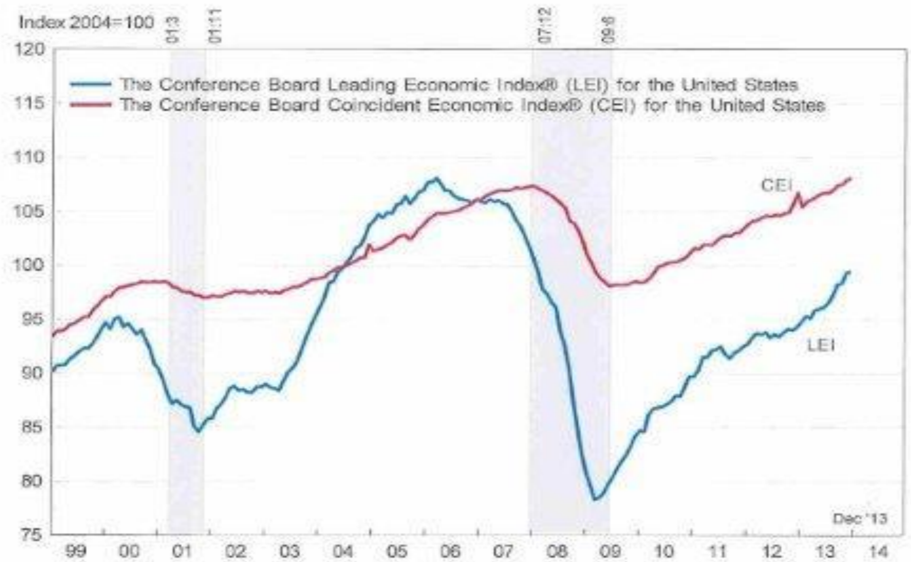
[1] http://www.exchangerates.org.uk/USD-TRY-exchange-rate-history.html

In many respects, there are elements of a classical economic recovery at play in the developed economies. The Conference Board is a global independent think tank that does extensive research on economies and business cycles. They've developed a set of indicators that track the path of economic cycles as they unfold. There are 3 sets of indicators: Leading (LEI), Coincident (CEI) and Lagging (LEI). The LEI are comprised of 10 indicators that track data concerning emerging labor conditions (e.g. average weekly hours worked, initial claims for

unemployment insurance), housing, consumer sentiment, financial conditions (credit spreads, stock market performance), and so on. These tend to turn up in advance of an economic recovery, or "lead" the recovery. As the chart below shows, these indicators have been trending straight up since 2009 (coincident with the bottoming of the stock market); however, 2013 was truly the "year of the LEI", because every indicator in the series was up for the year. The increase accelerated in the last 6 months of the year, and individual component contribution was broader.

So far so good. The next stage is for the Coincident indicators to kick in. These indicators are concerned with the health and pace of actual economic growth. They focus on data related to payroll growth and hiring, GDP, corporate earnings and industrial production. The chart below also shows the strong uptrend in this series as well. There's been huge debate over whether stocks are overvalued or not, based on their future earnings potential. The key question is what price "multiple" should be assigned to these earnings and the coincident indicators are where the rubber hits the road in this debate. Our view is that it is not the multiple itself that's of primary concern to us, but the macro forces driving the multiples. We believe that in a low inflation environment, multiples (and consequently stock prices) can continue to trend higher. Inflation lives in the realm of the Lagging indicators, and this will certainly be a major area to monitor going forward, but we think it's a 2015 – 2016 story, at best.

The Conference Board Leading Economic Index® (LEI) for the U.S. Increased in December



Latest LEI Trough March 2009, Latest CEI Trough June 2009
Shaded areas represent recessions as determined by the National Bureau of Economic Research.
Source: The Conference Board

Summary Table of Composite Economic Indexes

	2013 Oct	Nov	Dec	6-month Jun to Dec
Leading index	98.3 r	99.3 r	99.4 p	
Percent Change	0.1 r	1.0 r	0.1 p	3.4
Diffusion	65.0	70.0	55.0	70.0
Coincident Index	107.5 r	107.9 r	108.1 p	
Percent Change	0.1 r	0.4	0.2 p	1.3
Diffusion	75.0	100.0	100.0	100.0
Lagging Index	120.8 r	120.8 r	121.2 p	
Percent Change	0.3	0.0	0.3 p	1.6
Diffusion	64.3	50.0	64.3	64.3

n.a. Not available p Preliminary r Revised
Indexes equal 100 in 2004
Source: The Conference Board

The next release is scheduled for February 20, 2014, Thursday at 10 A.M. ET

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Of far greater concern to us at this point is the Coincident Indicator that measures the growth of capital expenditures of non-financial corporations. We've devoted many past pages of these reports exploring the role and consequences of debt and leverage on the economy. We've discussed, ad nauseam, our concerns regarding our country's excessive consumption, financed by too much debt, and not enough savings, along with our astonished dismay that the

[2] https://www.conference-board.org/pdf_free/press/PressPDF_5073_1390470619.pdf

Government's policy response to this has been to encourage even more debt fueled consumption at the expense of savings and investment. There's nothing wrong with utilization of debt, per se, but the ultimate use of that debt – i.e. to finance consumption vs. financing investment – is of enormous import.

On the government level, there are basically four possible outcomes for addressing debt (and we are assuming here that debt has an actual maturity date upon which the principal must be repaid – as opposed to some unfunded promise intended to last, in full faith and credit, for perpetuity). Spending can be cut (austerity); Debt can be reduced (either paid off, restructured, or defaulted on); Wealth can be redistributed (thus bailing out the debtors at the expense of the lenders); or the government can print money. All of these options can occur simultaneously, but transpire in conjunction with income growth and productivity growth (see note below).[3] Assuming some positive rate of interest, income must grow at a similar (or greater) rate. Otherwise, the debt will grow faster than income and eventually force default. But, without growth in productivity it's very hard, in the aggregate, for incomes (or GDP's) to grow.

And this is where capital spending becomes so crucial, because this can increase productivity, and incomes, (and ultimately help support higher stock multiples and prices). So far, the jury is very much still out. A lot of attention recently has been focused on the large amount of cash balances sitting idly on corporate balance sheets. This is part of a longer term trend, but appears to be accelerating, and is becoming more and more concentrated in larger and larger companies. In a study published this past summer by the Federal Reserve Bank of St. Louis, authors Juan Sanchez and Emircan Yurdagül "… analyzed data on publicly traded U.S. firms to shed light on the increasing trend in their cash holdings. By 2011, U.S. firms were holding four times as much cash as they were holding in 1995. Perhaps even more striking, the cash-to-asset ratio more than doubled between 2000 and 2010".[4] Much of this cash has found its way into stock buybacks. According to a Wall Street Journal blog site, "Moneybeat", "U.S. companies continue to buy back stock and pay out dividends at a blistering pace …Stock buybacks among S&P 500 companies jumped to $128.2 billion in the third quarter, the highest level since the fourth quarter of 2007, according to S&P Dow Jones Indices. Buybacks rose 8.6% from a quarter ago and 24% from a year earlier."[5]

This is not the "productivity enhancing" long-run profit maximizing deployment of cash that we'd hope to see at this point in the cycle. As Henny Sender relates in a recent FT article:

> "The Fed's policy means that companies have an incentive to engage in share buybacks and dividend issuance (preferably with borrowed money) rather than

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[3] (This can be all rather nuanced, but I would direct my readers to a piece put out by hedge fund manager, Ray Dalio, through EconomicPrinciples.org. It lays out a fascinating template through which to understand the economy and its financial and debt cycles. Dalio does not offer answers, but he lays out the scenarios that could result in a "beautiful deleveraging" vs. an "ugly deleveraging")

[4] Why Are U.S. Firms Holding So Much Cash? An Exploration of Cross-Sectional Variation; Juan M. Sanchez and Emircan Yurdagul; FRB St. Louis Review; July/August 2013; pg. 323

[5] http://blogs.wsj.com/moneybeat/2013/12/23/the-buyback-dividend-bonanza-picks-up-steam/

> investing in their operations. Since the trough, such activity is up almost 200 percent, according to data from Citigroup.
>
> All this means that the disconnect between financial asset prices (especially share prices) and the real economy remains as wide as ever.
>
> For a snapshot of what the world looks like today consider the better than expected earnings of AP Moller-Maersk, the shipping company, which is a proxy for world trade. Its operations today are all about taking out capacity, not placing orders to add capacity, its earnings a reflection of vigorous cost cutting rather than real growth."[6]

In one sense, the reduction in capacity can be a good thing. To the extent that the capacity is old and depreciated, this paves the way for investment in newer, more productive equipment. However, as mentioned, evidence of such activity is still inconclusive. In fact, there's data indicating that the situation is even more precarious than described above by Sender. The FT also reports that:

> "The pool of unspent cash that has built up since the start of the financial crisis is being held by an increasingly concentrated pool of companies that will be crucial to hopes of a pick-up in investment to stimulate the global economy.
>
> **About a third of the world's *biggest* non-financial companies** (emph. added) are sitting on most of a $2.8tn gross cash pile, according to a study by advisory firm Deloitte, with the polarization between hoarders and spenders widening since the financial crisis.
>
> This will have a big influence on whether 2014 will see a revival in capital expenditure…"[7]

Sadly, at the time of this writing, the "revival" appears tenuous. The FT further reports that:

> "Capital spending by US companies is expected to grow this year at its slowest pace for four years, in a sign of caution over the outlook for global demand.
>
> Total capital expenditure by the non-financial companies in the S&P 500 index is forecast to rise by only 1.2 per cent in the 12 months to October…In aggregate, analysts' forecasts indicated the **slowest growth in capital spending by the *largest* US companies** (emph. added) since it declined in 2010, in the aftermath of the recession of 2007-09."[8]

[6] "Fed Easing Fuels Growth in Wealth Over Real Economy"; Financial Times, 11/19/2013; pg. 22

[7] "Concentrated Cash Pile Puts Recovery in Hands of the Few"; Anousha Sakoui; Financial Times, 1/22/2014, pg. 1

[8] "US Capital Spending Set to Slow to Four-Year Low in Sign of Caution"; Ed Crooks; Financial Times; 1/24/14; pg. 1.

Note, however, the lines above emphasized in bold. The data is all focused on large multinational corporations. These are exactly the sector most vulnerable to a slowdown in global demand. Data on smaller companies is harder to come by, but these companies tend to derive more of their earnings domestically and profit greatly from the benign inflation environment which lowers their input costs. As the chart below shows, smaller cap stocks (as represented by the Russell 2000 / blue line) have outperformed their larger counterparts for years now, and the trend shows no sign of abatement.[9]

In terms of our U.S. domestic economy, we will be following future capital expenditure plans closely. Without its resurgence, productivity cannot grow, the earnings gains borne on the back of cost cutting or share buy-backs will eventually run its course, along with the support it has provided for stock prices and multiples. At this point, we remain "cautiously optimistic" that capital expenditures will begin to accelerate, driven by outmoded existing capacity and pent up demand for productivity enhancement. We remain biased towards smaller companies and to developed markets and continue to be overweight there.

Regarding the emerging markets (EM), their readjustment is the mirror opposite of our problems at home. Ironically, the EM, and China in particular, have saved too much, invested too much, and domestically are consuming too little. As described above concerning the case in the developed economies, this does not have to be a "bad thing". The problem lies, as always, in the employment and buildup of debt to drive these activities. Much of the

[9] http://investorplace.com/2014/01/small-caps-stock-russell-2000/#.UuLkrNIo7RZ

investment has been financed by credit which has resulted in an excess in investment that mirrors our excess of consumption. Anecdotally, we hear of the "ghost towns", empty highways and bridges to nowhere in China. This deleveraging has the potential to be every bit as destabilizing for the emerging economies as that occurring here and in Europe. We are monitoring it closely, and as stated, continue to underweight that area.

How this global rebalancing evolves and progresses will determine whether the deleveraging will be a more benign "beautiful" deleveraging, or an "ugly" one replete with global and domestic political unrest, social turmoil and economic distress. Our best guess for now is, unfortunately, that we make some of the hard changes (not as a result of any brilliant political leadership, but rather through the relentless, intractable forces of the market itself). Although bumpy and not without challenges, we avoid a major collapse, but also fail to achieve the full greatness that this country is capable of, that it has achieved in the past and that it has the wherewithal to attain in the future.. The result will be a "muddling through" into the "new normal" of a secular mediocrity.

Meanwhile, we're positioned with higher thermostats and many more layers here in the Northeast, as we continue to be buffeted by Polar Vortexes. We hope you're all safe and warm as we begin this New Year.

Regards,

Jason Waxler

T.Rowe Price Fourth Quarter 2013 Market Wrap-Up

	Total Return	
Index[1]	**Fourth Quarter 2013**	**Year-to-Date**
DJIA	10.22%	29.65%
S&P 500	10.51	32.39
Nasdaq Composite	10.74	38.32
S&P MidCap 400	8.33	33.50
Russell 2000	8.72	38.82

Index[1]	Fourth Quarter 2013	Year-to-Date
Barclays Capital U.S. Aggregate Bond Index	-0.14%	-2.02%
Credit Suisse High Yield Index	3.45	7.53
Barclays Capital Municipal Bond Index	0.32	-2.55
Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index	-0.72	-3.08
J.P. Morgan Emerging Markets Index Plus	0.64	-8.31
Barclays U.S. Mortgage Backed Securities Index	-0.42	-1.41

	Total Return	
MSCI Index[1]	**Fourth Quarter 2013**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	5.75%	23.29%
All Country World ex-U.S.	4.81	15.78
Europe	7.92	25.96
Japan	2.31	27.35
All Country Asia Ex-Japan	3.42	3.33
EM (Emerging Markets)	1.86	-2.27

	Total Return	
MSCI Index[1]	**Fourth Quarter 2013**	**Year-to-Date**
Emerging Markets (EM)	1.86%	-2.27%
EM—Asia	3.66	2.31
EM—Europe, Middle East, and Africa (EMEA)	0.26	-4.62
EM—Latin America	-2.27	-13.15