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FOURTH QUARTER 2014 INVESTMENT ADVISORY REPORT

Will Summertime on Main Street Mean Winter for Wall Street?

The close of 2014 could not come fast enough for most portfolio managers; your author included. The quarter saw a marked uptick in volatility, after several years of relative stability (and a consequent rise in complacency). We discussed this in depth in previous Quarterly Reports (see the Q III 2014 Report entitled “The Bull Market in Complacency – A Correction or Cycle Top?” or Q II 2014 entitled “Ripple in Still Water”) and we examined the deep compression and reduction in volatility – particularly as measured by the CBOE “VIX Index”. Within a two week period, from the opening bell on October 1 through the intraday spike low on October 15, the Dow plunged by 1,185 points or nearly 7%, and the S&P 500 lost 150.78 points for a 7.65% decline. Smaller stocks, as measured by the Russell 2000 Index, had actually topped out nearly a month earlier on September 3 and its decline into the October 15 low was 11.24%. *Volatility during this latter time period exploded by 158%!¹*

Portfolio diversification during 2014 was your worst enemy, and Q IV was no exception as major asset sectors such as European and Emerging Market stocks, along with commodities and basic materials all saw losses and significantly detracted from performance. Diversified bonds added little, and cash added even less!

The stark irony is that the narrowly focused large cap U.S. indexes, such as the Dow Jones Industrial Index (Dow) or the S&P 500 Index (S&P), steadily advanced. These popularly followed indexes are widely covered by the press and are closely associated, in the minds of most investors, as actually being “the market”! The reality, of course couldn’t be more different. The Dow is an index comprised of 30 stocks, and the S&P 500 contains 500 individual stocks. However, according to the World Federation of Exchanges, a trade association, as of November 2014 there were 5,228 individual companies listed and trading on the two major exchanges in the US alone, and 44,215 companies trading on various exchanges worldwide.² As noted above, European and Emerging Market (EM) indexes both **lost** money last year. Vanguard

¹ <http://finance.yahoo.com/>

² <http://www.world-exchanges.org/statistics/monthly-reports>

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offers a fund called Vanguard Total World Stock ETF (VT) which is comprised of roughly 6,894 individual stocks domiciled in the Americas, Greater Europe and Greater Asia and thus is a good proxy for the global equity market. According to data from Morningstar, this fund lost 2.52% in Q III, was essentially flat for the fourth quarter, and gained only 3.67% for all of 2014³ – a far cry from the 11.4% and 7% gains logged by the S&P and the Dow respectively.⁴ And even these outcomes assume a portfolio that's **100% invested in equities**.

Of particular significance here – aside from the shameless attempt at justifying sub-S&P returns – is that the public is now clamoring for these S&P-like returns, and they're increasingly oblivious to the risk associated with equity investment. As one pundit observed, "I now know exactly how long eternity is...it's around 6 years...because after 2008, people said it would take an eternity for the public to come back to the stock market!"

In addition to the VIX, another useful barometer for measuring complacency (and fear) is the various Consumer Sentiment series. Using the University of Michigan series, Doug Short illustrates the correlation between the index, and U.S. GDP and recessions (see chart below).⁵ Data from the Conference Board's Consumer Confidence Index is broadly similar. But of greater interest here is that ***periods of high consumer confidence have been highly correlated with spikes in volatility***. Elevated confidence readings during the latter part of the '80's coincided with the volatility of the 1987 crash. Peak levels in 1997 and 1998 occurred prior to the Asian financial crisis, the collapse of the Russian Rouble and the subsequent Russian Government bond default, and the collapse of the hedge fund, Long Term Capital Management.⁶ The all-time high reading in 2000 preceded the collapse of the NASDAQ bubble, and of course, peak readings in 2007 preceded the 2008 financial crisis. As the chart shows, we're now at an 11 year high in Consumer Sentiment, and at levels which over the past 50 years have coincided with turbulence and market shocks.

³ <http://etfs.morningstar.com/quote?t=vt>

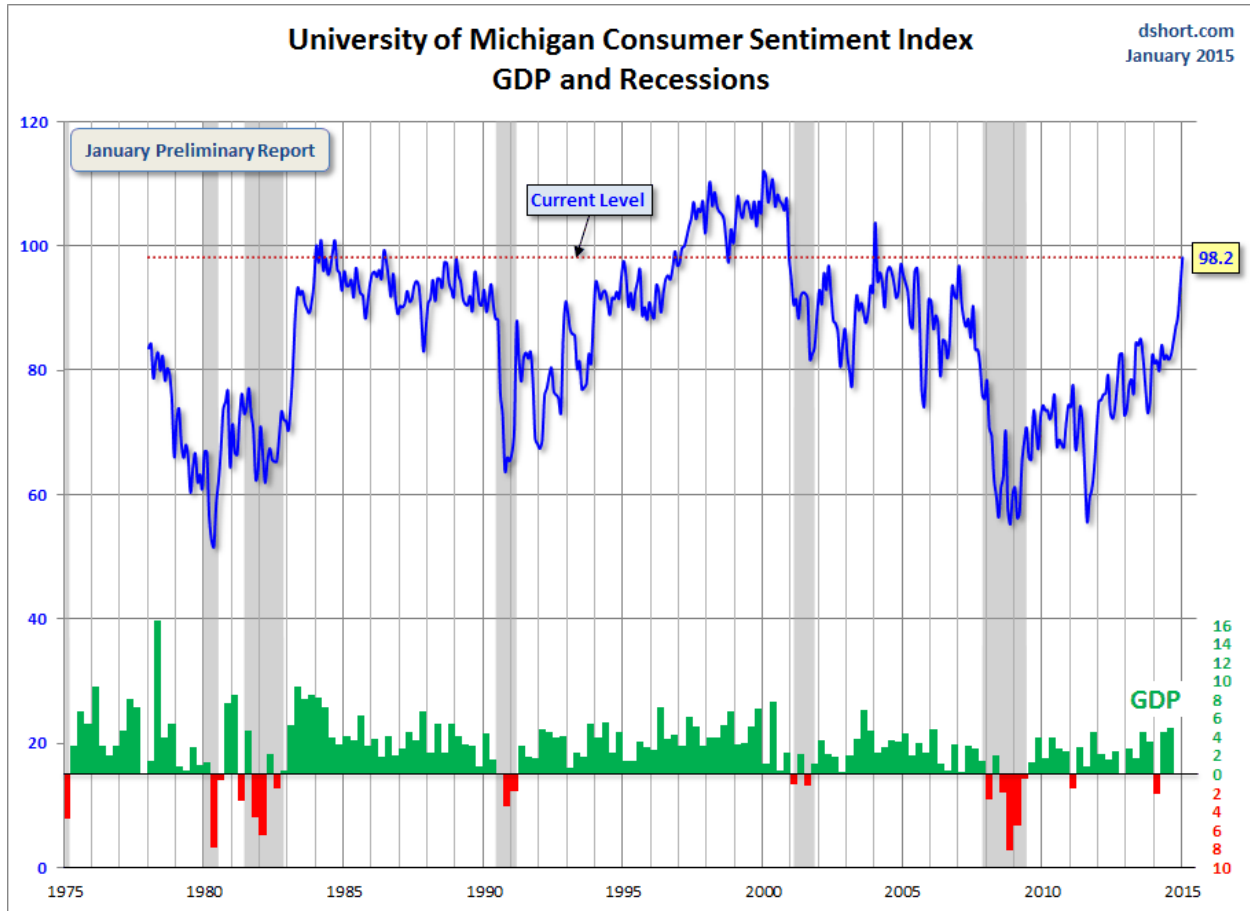
⁴ <http://abcnews.go.com/Business/wireStory/sp-500-index-ends-2014-gain-11-percent-27933614>

⁵ <http://www.advisorperspectives.com/dshort/updates/Michigan-Consumer-Sentiment-Index.php>

⁶ http://en.wikipedia.org/wiki/Long-Term_Capital_Management

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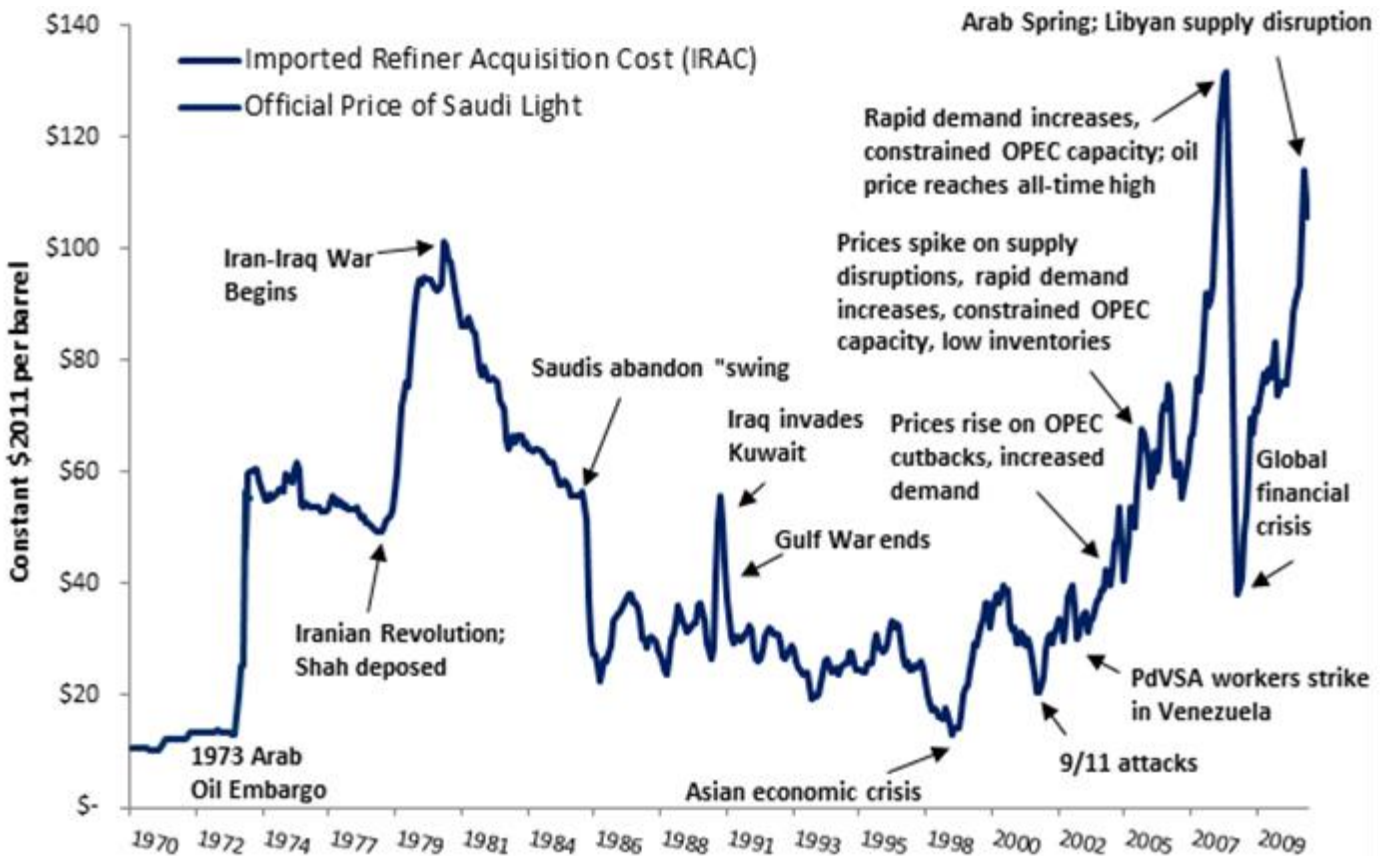
In addition to sentiment data, there are 3 other key macro factors that are all pointing towards increased volatility – the strong US dollar (USD), plunging energy prices, and slowing global growth. To be clear, the issue is not the absolute price levels of the dollar or commodity prices per se. Overall, a stronger USD and lower energy prices are a definite plus for our domestic economy, given that the vast majority of our GDP is driven by consumption and not exports. And, weaker commodity prices, on balance, are a net plus for growth globally. These two factors have been the foundation for our bullish outlook for US based economic growth and equity markets.

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The problem lies within the severity of the rates of change in these two variables – i.e. is this too much of a good thing? The next chart shows the strong correlation between oil prices and geopolitical shocks.⁷

Oil Price Volatility

The figure below conveys the relationship of oil price volatility and events in oil producing countries since 1970. C2ES created the figure by updating data available from DOE's website (<http://bit.ly/ntcraw>).



Note the broad but robust inverse correlation between levels of consumer sentiment, rapid changes in oil price trends, and geopolitical shocks. Sharp swings higher in oil prices are often associated with shocks to the US domestic economy – e.g. the '86 spike preceded the '87 market crash and the 1990 spike preceded the '91 recession (both periods associated with peak Confidence Sentiment). Rapidly falling prices are often associated with shocks to producing nations – e.g. the Mexican crisis in '94 and the Russian default in '98. While this chart barely covers 2011, we know that prices today are back down to levels last seen during the financial

⁷http://www.fhwa.dot.gov/environment/climate_change/mitigation/publications_and_tools/pev_action_plan/page08.cfm

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crisis of 2008 and are causing serious disruption to all oil (and commodity) producing economies. Many of these countries have significant USD denominated debt liabilities. This brings us to our next focus of macro concern – the US dollar.

The USD is another key piece in the puzzle here and sharp changes in the value of the dollar are also highly correlated with global instability. A weakening dollar is associated with inflation, US domestic weakness, and/or stagflation. A stronger USD (see chart below)⁸, however, has clearly been the hallmark of numerous global blowups.

Note the sharp run up in the USD beginning around 1980, as Paul Volker (the last real Fed chairman of my generation) was appointed as the new chairman of the Federal Reserve and embarked on a regime of aggressive monetary tightening in order to combat rampant inflation in the US. This led to the Latin American debt crisis in the early 1980's, along with two severe US recessions (but also coincided with sharply declining oil prices and eventually, rising US consumer confidence). By 1985, under pressure from major US exporters, the Plaza Accord was struck – an agreement between the US and the governments of France, Germany, Japan, and the United Kingdom, to depreciate the U.S. dollar.⁹ This led to a collapse of the USD to below the pre-Volker 1980 levels. By 1995, aided by Fed tightening moves, the USD began a 5 year ascent coinciding with a sharp plunge in oil prices (see Oil Volatility chart above). This all ushered in the above referenced Asian crisis and Russian Government default. With the popping of the NASDAQ dot.com bubble in 2000 and the economy sliding into recession, the Fed panicked and eased aggressively for an almost four year period, bringing the Fed Funds rate down from 6.5% to 1.0% by April 2004¹⁰. This caused the USD to relinquish over one third of its value. In June 2004 the Fed began to reverse course and by December 2006 rates had risen back up to 5¼%.¹¹ The USD bottomed and began a sharp ascent in the summer of 2008 – just in time to herald in the 2008 global financial crisis.

⁸ Board of Governors of the Federal Reserve System (US), *Trade Weighted U.S. Dollar Index: Major Currencies* [DTWEXM], retrieved from FRED, Federal Reserve Bank of St. Louis <https://research.stlouisfed.org/fred2/series/DTWEXM/>, January 25, 2015.

⁹ http://en.wikipedia.org/wiki/Plaza_Accord

¹⁰ <https://research.stlouisfed.org/fred2/series/FEDFUNDS>

¹¹ *Ibid.* # 10

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The chart below was created by John Mauldin in a recent edition of his always enlightening Advisor Perspectives¹². Of utmost interest is that the recent USD strength is causing it to break out above multi-year resistance levels as well as a **multi-decade downtrend line extending back to the 1985 Plaza Accord highs**. This brings us to the final piece of concern – **plunging oil prices and a strengthening dollar are all taking place after years of global debt build up (particularly foreign, USD denominated debt) and in the context of slowing global growth**.

¹² http://www.advisorperspectives.com/commentaries/mauldin_122214.php

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These two final charts show the astounding rise in the Money Supplies of many emerging economies and their associated correlation with each country's rates of inflation¹³ (note as an aside the stark contrast of the negative rates of money growth along with deflation in the Southern Eurozone countries) along with the surge in US dollar denominated debt issued to non-banks outside the US (i.e. foreign corporate debt)¹⁴.

The second chart, based on an independent report done by Hyun Song Shin, an economist with the Bank for International Settlements (BIS), and presented at a conference at the Brookings Institution, shows that after a brief pause during the 2008 financial crisis, ***non-bank offshore borrowers have accumulated over \$9 trillion in debt. According to Dr. Shin, roughly 80% of this debt is denominated in US dollars.*** Much of this debt went to finance commodity and energy infrastructure projects needed to satisfy insatiable Chinese demand for raw materials during its recent infrastructure boom. This growth is reflected in the chart measuring the astounding levels of double digit money supply growth in many of the emerging economies (EM).

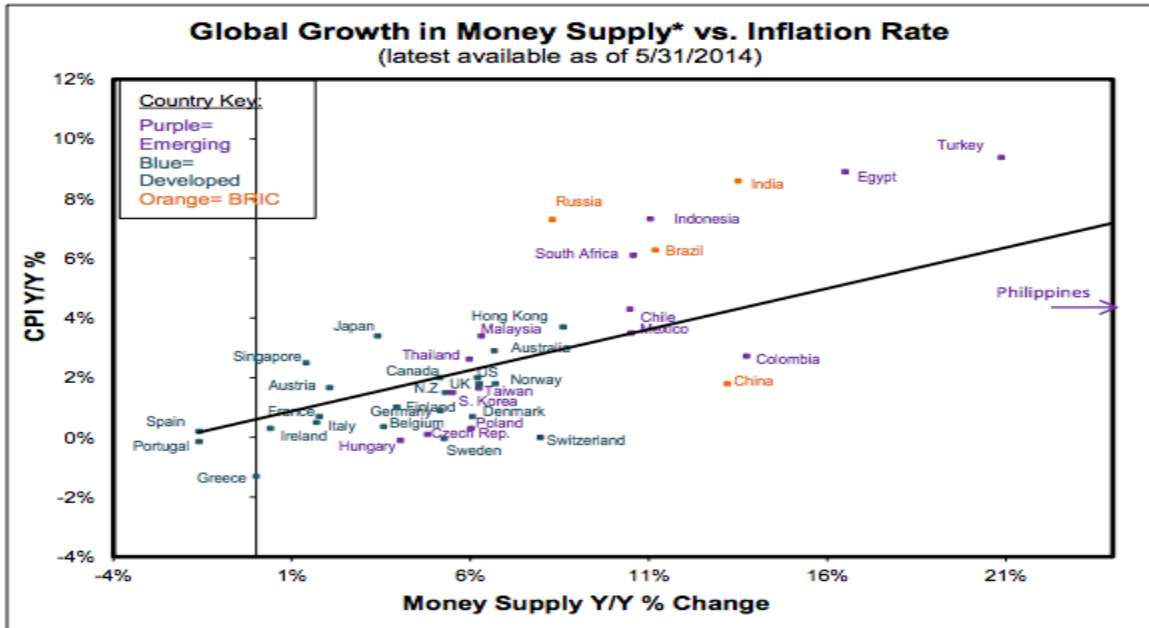
¹³ <http://thereformedbroker.com/2014/06/15/rich-bernstein-heres-where-the-inflation-is/>

¹⁴ http://www.brookings.edu/~media/Blogs/Up%20Front/2014/12/04%20financial%20stability%20risks/shin_presentation.pdf

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Chart 1:

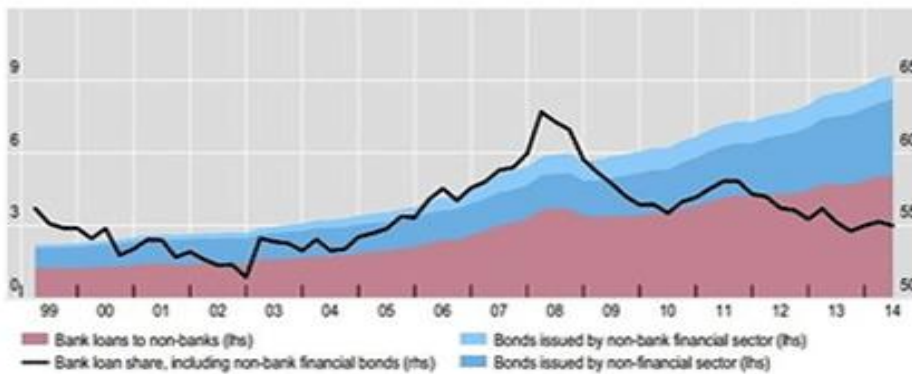


Source: Richard Bernstein Advisors LLC, Bloomberg *Money Supply defined as M2 (or M3, if M2 not available, or IMF Currency issued by Monetary Authority in National Currency, for EMU countries).

US dollar credit to non-banks outside the United States

Outstanding stocks (USD trillion)

Per cent



Notes: Bank loans include cross-border and locally extended loans to non-banks outside the United States. For China and Hong Kong SAR, locally extended loans are derived from national data on total local lending in foreign currencies on the assumption that 80% are denominated in US dollars. For other non-BIS reporting countries, local US dollar loans to non-banks are proxied by all BIS reporting banks' gross cross-border US dollar loans to banks in the country. Bonds issued by US national non-bank financial sector entities resident in the Cayman Islands have been excluded.
Sources: IMF, International Financial Statistics; Datastream; BIS international debt statistics and locational banking statistics by residence; authors' calculations.

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So, while on the surface, all seems well in the US and in our equity markets, global borrowing and outstanding overseas debt liabilities have surged. Most of this debt is USD denominated so a strengthening USD makes it more expensive for overseas borrowers (with weakening local currencies) to service that debt. In addition, contracting global growth makes it harder for these companies to generate the revenue needed to service debt, and particularly if the debt was issued to finance commodity and basic material production. Juxtaposed on all of this are levels of sentiment and complacency that have historically coincided with severe geopolitical and economic disruption. Unfortunately, this scenario, if it unfolds, is unpredictable and subject to any random event. Thus, while we continue to feel that the broader trend of the US equity markets remains up, and we're not looking for another 2008 event, we would not at all be surprised to encounter a 1997-1998 scenario which, as may be recalled, saw equity corrections of 20% magnitude – all preceding the 1999-2000 greatest bull market rise of all time. Our response is to maintain our minimal foreign exposure (both in Developed and Emerging Markets), maintain our overweight in US equities and begin increasing cash levels in most accounts. We're also exploring hedging options such as short equity and long volatility positions.

Hopefully, this retrenchment in our risk exposure will prove unnecessary. Global dislocations will work themselves out, winter Nor'easters will prove to be few and mild, and set the stage for spring and summertime on Main Street. For now, however, we remain braced for winter on Wall Street.

Regards,

Jason Waxler

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	Total Return	
Index	Fourth Quarter 2014	Year-to-Date
DJIA	5.20%	10.04%
S&P 500	4.93	13.69
Nasdaq Composite	5.40	13.40
S&P MidCap 400	6.35	9.77
Russell 2000	9.73	4.89

Index	Fourth Quarter 2014	Year-to-Date
Barclays U.S. Aggregate Bond Index	1.79%	5.97%
Credit Suisse High Yield Index	-1.59	1.86
Barclays Municipal Bond Index	1.37	9.05
Barclays Global Aggregate Ex-U.S. Dollar Government Bond Index	-2.99	-3.08
J.P. Morgan Emerging Markets Bond Index Global Diversified	-0.55	7.43
Barclays U.S. Mortgage Backed Securities Index	1.79	6.08

	Total Return	
MSCI Index	Fourth Quarter 2014	Year-to-Date
EAFE (Europe, Australasia, Far East)	-3.53%	-4.48%
All Country World ex-U.S.A	-3.81	-3.44
Europe	-4.30	-5.68
Japan	-2.40	-3.72
All Country Asia ex-Japan	0.17	5.11
EM (Emerging Markets)	-4.44	-1.82

	Total Return	
MSCI Index	Fourth Quarter 2014	Year-to-Date
Emerging Markets (EM) Index	-4.44%	-1.82%
Asia Index	-0.22	5.27
Europe, Middle East, Africa (EMEA) Index	-10.09	-14.74
Latin American Index	-13.38	-12.03

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

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