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FIRST QUARTER 2015 INVESTMENT ADVISORY REPORT

Wither the Dollar?

Despite many fits and starts, the first quarter finished as a non-event for US equities. According to Yahoo Finance, the Dow Jones Industrials lost -0.26% and the S&P 500 eked out a +0.44% gain. Only the NASDAQ showed any strength. Boosted by strong gains in biotech and certain technology shares, the NASDAQ Composite gained +3.4%, reaching a 15 year high of 5,042.14 on March 20th. Of note, the ***all-time high*** for the NASDAQ is 5.046.86 - last reached on March 9th, 2000, during the peak of the dot.com bubble.[1] The NASDAQ is the last of the major US indexes to reach new all-time highs. We believe it will soon pass that hurdle, and continue to like the biotech/healthcare and technology sectors.

Overseas markets regained their footing somewhat, after miserable performance in 2014. Japan contributed a 10.34% gain, offset partly by -9.5% losses in Latin America. Accounts holding individual equities saw solid gains in foreign shares such as Veolia Environment (VEOEY) and Volkswagen AG (VLKAY). During the past quarter we have increased our exposure to the "Developed" overseas markets (Europe and Japan) but continue to avoid the Emerging Market (EM) space. The EM markets have underperformed significantly relative to US stocks, and are arguably undervalued. However, as discussed below, we don't feel the risk/reward tradeoff is compelling – ***assuming the strong US dollar trend remains intact!***

The real action last quarter was in currencies and commodities. The US Dollar Index increased by nearly 10%,[2] and WTI Crude Oil declined by the same.[3] We cannot overemphasize the significance of these two related trends.

In our last report (see "Will Summertime on Main Street Mean Winter for Wall Street?"), we explored the historically high levels of Consumer Confidence, rapid changes in commodity prices (and in oil in particular), and rapid changes in the US Dollar (USD). We showed how in the past, these all correlated positively with spikes in market volatility. Past reports have focused on the extremely subdued levels of volatility the markets have experienced for the past two years. As the chart below of the CBOE VIX Index shows[4], the end of 2014 and early 2015 *has* shown signs of a pickup in volatility, (although nothing comparable to the surge witnessed during the 2008 financial crisis, let alone the spikes in 2010 caused by the turmoil in the Euro Zone, and the downgrading of the US debt in 2011).

[1] http://www.nasdaq.com/markets/nasdaq-composite
[2] http://www.tradingeconomics.com/united-states/currency
[3] https://www.quandl.com/data/DOE/RWTC-WTI-Crude-Oil-Spot-Price-Cushing-OK-FOB
[4] Worden Brothers TC2000 Charts

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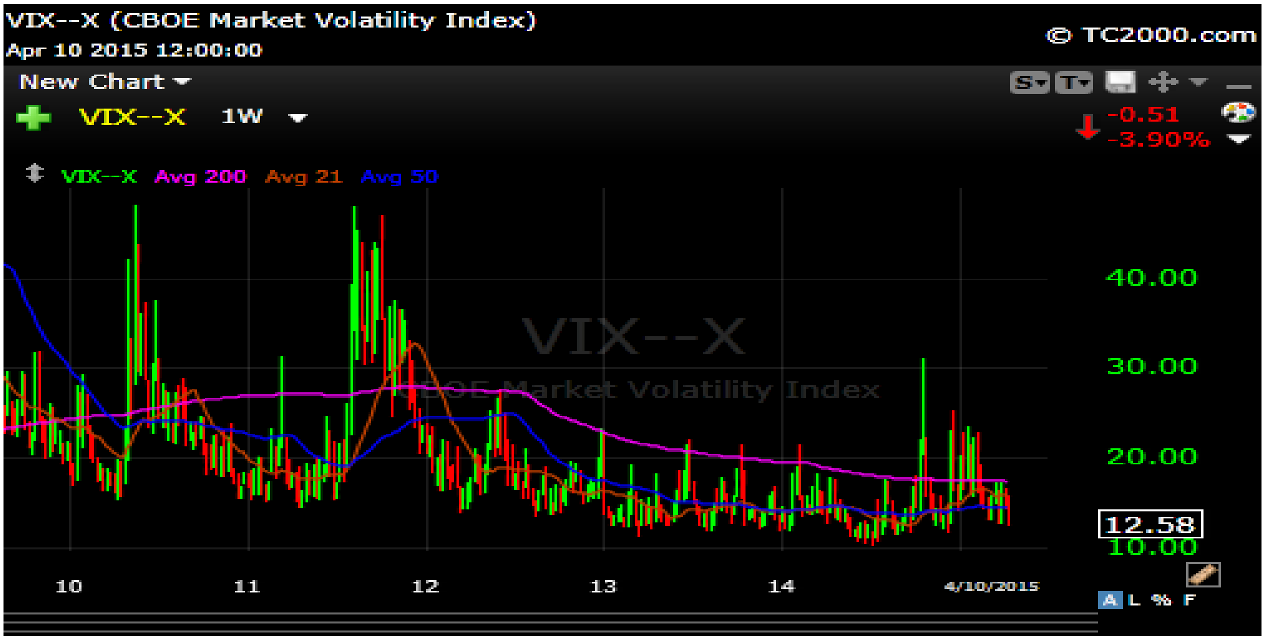

The recent spike and then gradual easing of the VIX coincides almost exactly with recent US dollar movement (see chart below). Note the sharp run up in the USD from October 2014 through March of this year, and then the more recent sideways trading range.[5] For the past few years we've been commenting on the USD as our preferred "barometer" of global reflation vs. deflation – a strengthening USD being associated with deflation and a global tightening of liquidity. ***Is this all about to change***?

Daily View

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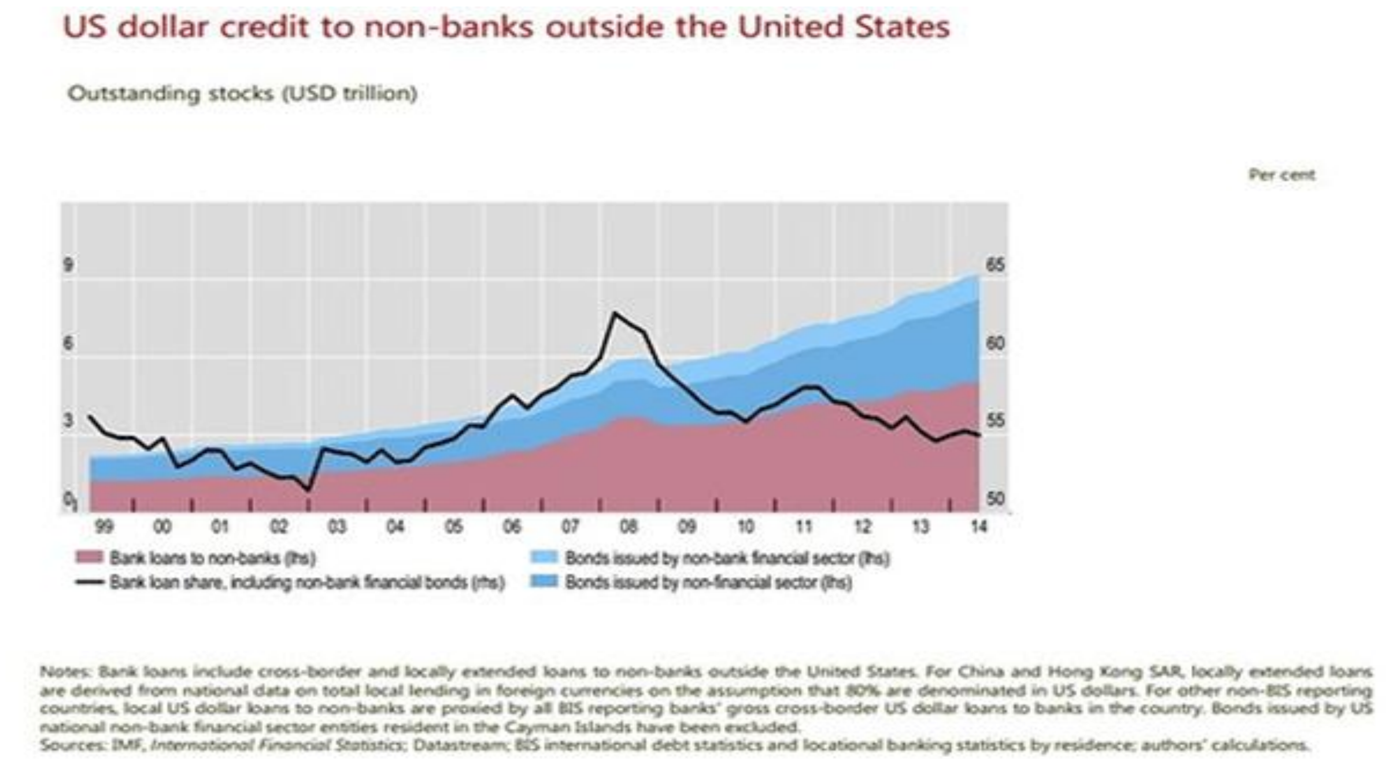
[5] http://stockcharts.com/freecharts/gallery.html?s=%24USD

Our ongoing assumption remains that the USD is in a secular uptrend. This means that global liquidity continues to contract, and the EM space remains at huge risk. Our primary focus at Katonah Capital Group has always been first and foremost an analysis of risk – i.e. what can "blow up" and permanently impair capital. Typically, to find areas of risk, one needs to look no farther than excessive buildup of debt which inevitably leads to misallocated capital (i.e. bad, overleveraged investments). In last quarters report, we explored the surge in EM debt (mostly USD denominated) caught in the crosscurrents of a sharply appreciating USD. The concepts were well illustrated by the two charts below: the first by John Mauldin (see "*The US Dollar is One 'Flight Away from an Earth-Shaking Rally*")[6] and the second 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, which shows that after a brief pause during the 2008 financial crisis, ***non-bank offshore borrowers have accumulated over $9 trillion in debt*** (ed. note: i.e. primarily EM corporate borrowing). According to Dr. Shin, roughly 80% of this debt is denominated in US dollars.[7]

There is an old saw in trading and investing that says "the trend is your friend". This is a powerful, time honored precept that's ignored at one's own peril. The three trends depicted below – 1) the USD breaking out to the upside; 2) the inexorable growth of global debt; and 3) the marked increase, seen since 2008, of the percentage of overall lending being originated by non-banks (i.e. the "shadow banking system", such as private equity, sovereign wealth funds, mutual funds, and so on) – all show no signs of abating or reversing.

[6] http://www.advisorperspectives.com/commentaries/mauldin_122214.php

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



Despite our admonition to always respect the primary trend, we're also continuously searching for what could go wrong with our hypotheses. In fact, some compelling arguments can be made for why the USD actually *has* seen its highs, and is in the process of topping out and ultimately resuming its multi-decade downtrend. In a well thought out article entitled "US Dollar: American Phoenix", written by Jawad Mian, and posted in a recent issue of Mauldin Economics' Outside the Box, Mian begins by listing several widely accepted beliefs *supporting* the USD.[8] First are perceptions of sustainable economic US growth. Second is the reality that longer term US interest rates are significantly higher than those of its major trading partners (and, in particular, Japanese and some European rates which are either near zero or ***below*** zero – for a good synopsis of this phenomenon of negative interest rates, see Bloomberg QuickTake[9]). Third is the gradual improvement of our external Current Account balances (trade in goods, services and capital flows), as shown in the below chart.[10] And, of course, there's the behavioral effect of future expectations being driven by past events. According to Mian, ***86% of hedge fund managers polled by AKSIA's Hedge Fund Manager Survey expected the USD to be the best performing currency in 2015***. [11] This alone is at the very least cause for concern about the near term trend in the USD.

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[8] http://www.mauldineconomics.com/outsidethebox/us-dollar-american-phoenix
[9] http://www.bloombergview.com/quicktake/negative-interest-rates
[10] http://www.bea.gov/newsreleases/international/transactions/trans_annual_large.gif
[11] Op. Cit. # 8

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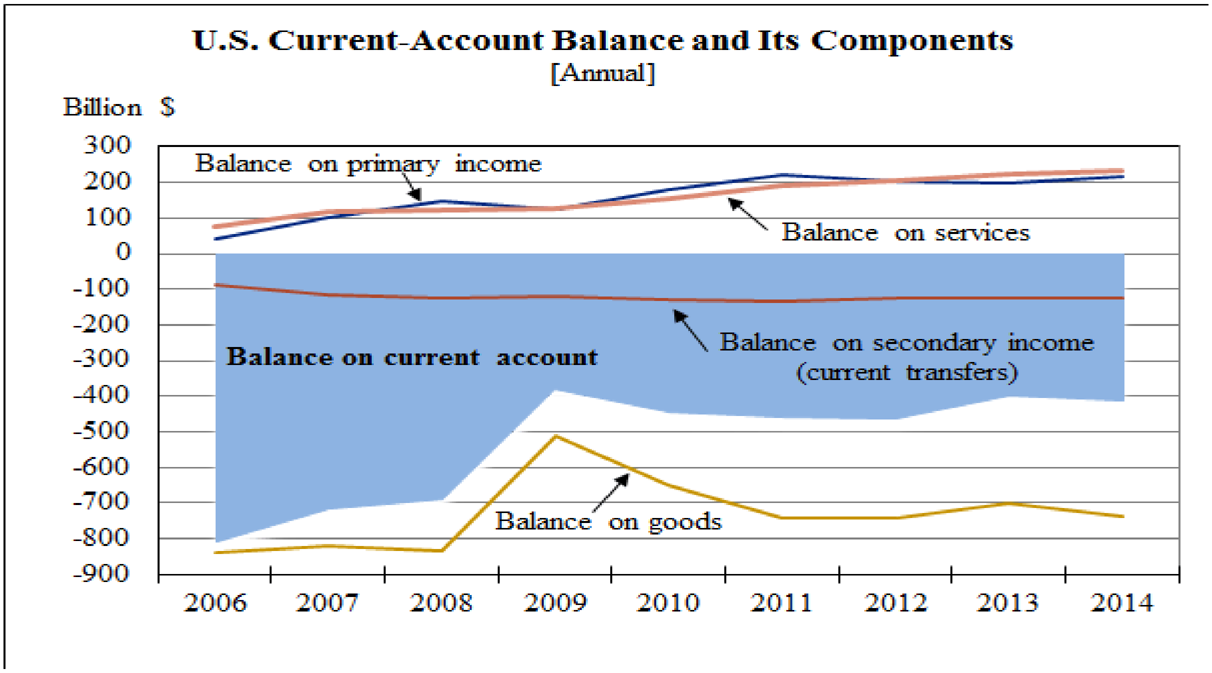

Regarding Mian's third point concerning the improving Current Account deficit, in a recent issue of Macro View, Scott Minerd, Global CIO of Guggenheim wrote:

> "On Friday, it was announced that U.S. gross domestic product rose an annualized 2.6 percent in the fourth quarter—a marked slowdown from the 5 percent growth we witnessed in the third quarter of 2014. ***But what the market took to be bad news was actually a sign of economic strength.***
>
> ***Falling net exports subtracted a full percentage point from GDP growth. But net exports—exports minus imports—only looked relatively weak because consumer demand for imports was so strong*** (emph. added), growing at an annualized rate of 8.9 percent quarter over quarter. In fact, this past December, U.S. companies imported $48.8 billion worth of consumer goods, an all-time record figure.
>
> In the fourth quarter, household consumption was the main driver of GDP growth, up by over 4 percent. This is a positive sign for the U.S. economy, particularly when considering that nearly 70 percent of economic activity in the United States stems from private consumption."[12]

Thus despite the improvement in the deficit from capital inflows, as the next chart depicts[13], stronger US consumption drives an increase in Imports, which, all else equal, creates demand for the currency of the exporting country and downward pressure on the USD.

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[12] http://guggenheiminvestments.com/perspectives/macro-view/the-good-news-behind-gdps-decline
[13] Ibid. # 13

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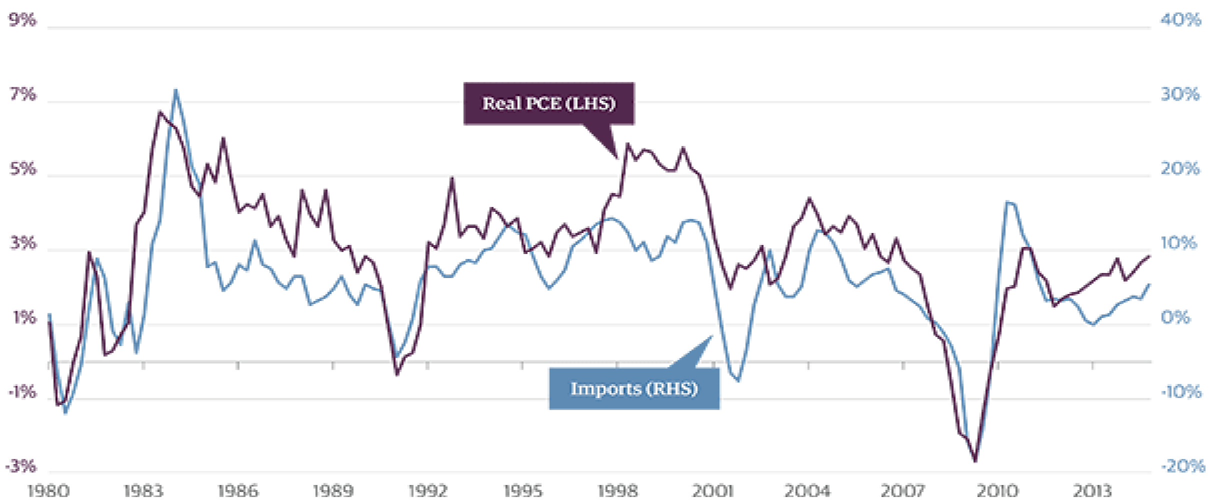


Mian echos this thinking. He writes:

> "One of the less-cited factors for dollar strength is the improvement in the US current account. **The chief benefit of QE was the cheapening of the dollar to its lowest level in the postwar era.** It was among several factors that led to a decline in the current account deficit from a peak of 6% of GDP in 2006 to about 2% of GDP in 2014. It was partly the reduction in the current account deficit that led to fewer US dollars being available in the global market,... The last time the US had a current account surplus was in 1991, when the trade-weighted dollar was nearly 40% stronger than it is today. So the fact that even with the dollar's major undervaluation since 2011, the US has been unable to return to a surplus suggests that the current account deficit is really structural in nature. **We think the dollar is now vulnerable to a rewidening of the current account deficit on the back of stronger household consumption.**"[14]

A stronger US consumer, and consequent stronger underlying US economy would support demand driven inflation pressure. This frames the intense dillema the US Federal Reserve bank finds itself in. If they're overly concerned with deflationary pressures and diminishing global economic growth, they run the risk of waiting too long to raise/normalize interest rates thus fueling the perception that they're "behind the curve".

Jim Paulsen of Wells Capital Management elaborates on the issue of market perception. In a portion of his Economic and Market Perspective, entitled "Bet Against the U.S.Dollar in 2015", he writes:

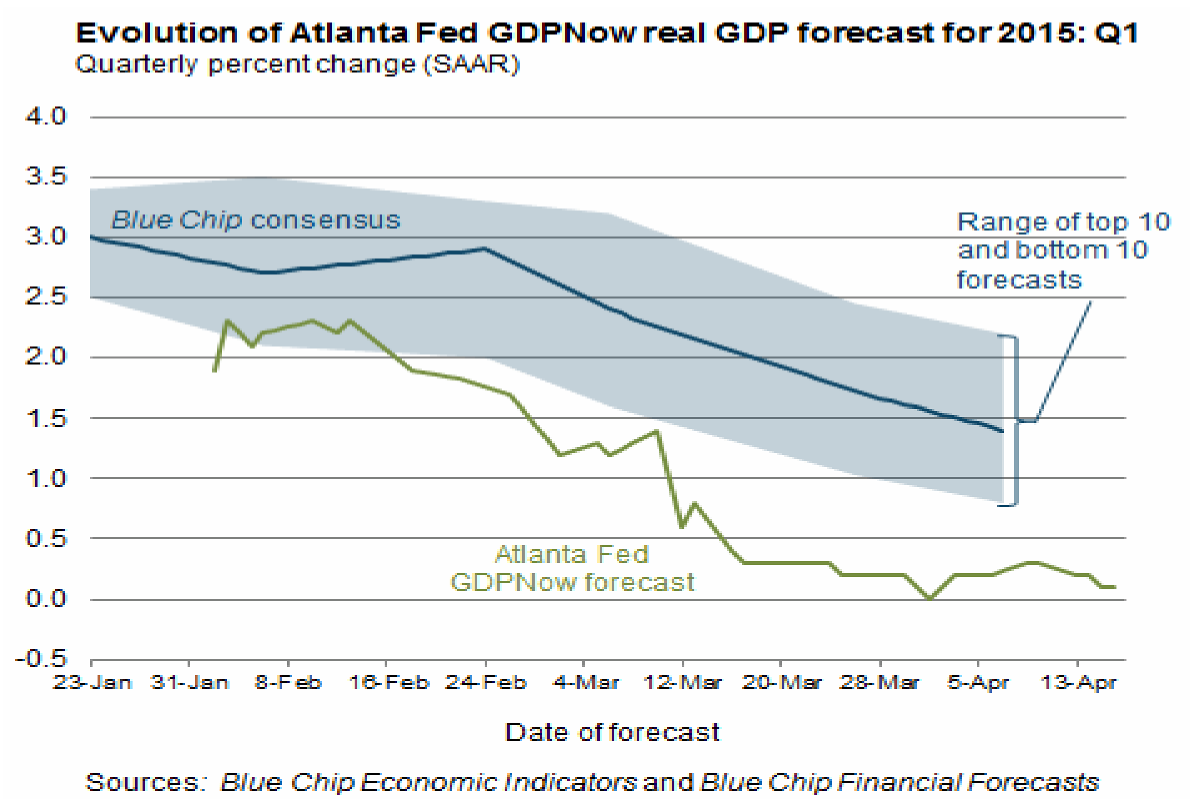
> "…it is not the different monetary policy actions which matter most for the currency. Rather, ***it is how those actions are perceived*** (emph. added). If the more aggressive policies in the eurozone and Japan work and boost economic growth, it should bring

[14] Op. cit. # 8

> a bid to both the euro and the yen. Conversely, if the Fed begins raising interest rates but only after most investors believe they are behind the curve, worsening
>
> inflation anxieties would reduce the value of the U.S. dollar….That is, if inflation/ overheat/Fed behind the curve fears escalate, the U.S. dollar is likely to retrace some of its recent gains."[15]

All these views share one common theme - the assumption that the US economy actually has traction *and* the Fed responds too slowly. As a result, capital inflows and the improving trade balance begin to reverse. However, recent data coming out of the US challenge assumptions of significant US economic growth. It's become a recurring truism in recent years – bad weather/rough winters (along with the strike at the Port of Los Angeles this past winter) cause a temporary slowdown in the economy, but it comes roaring back in the spring. That seasonal distortion might not repeat this spring.

The Federal Reserve Bank of Atlanta has developed a forecasting model, called GDPNow, that provides "real-time" estimates of GDP. They compare their projections with projections from the "Blue Chip Concensus", a group of private sector forecasters. GDPNow is relatively new, but to date, their forecasts have been far more accurate than the private forecasters. Thus, it's worthy to note that ***the model is currently projecting real GDP growth of 0.1% for the first quarter of 2015***. This is significantly lower than what the Blue Chip consensus estimates.[16]



[15] http://www.wellscap.com/docs/emp/20150105.pdf

[16] https://www.frbatlanta.org/cqer/researchcq/gdpnow.cfm

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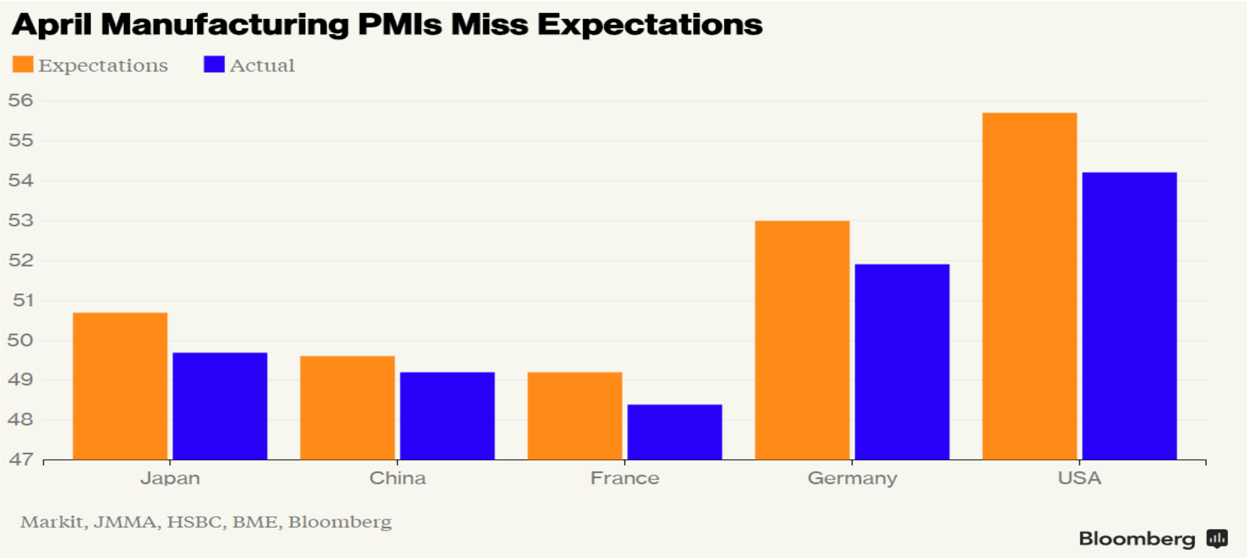
So, what if the "Blue Chip" consensus forecast is wrong and US economic growth – the primary engine of global growth at this point – falters, and undercuts any nascent global recovery? As the below chart shows, recent manufacturing data is not encouraging.[17] The title of the article, "*We Just Got Disappointing Manufacturing Data From All Around The World*", really says it all.



Of particular concern here is that Japan, China and France all had readings below 50, meaning their manufacturing sector is <u>*contracting*</u>. If global growth is still slowing, does capital then continue to flee emerging economies and flow back into the US and the USD? This would eventually put unsustainable stress on the Emerging Market (EM) economies, conjuring up scenarios of the 1997-98 "Asian Contagion", the Rouble collapse and Russian default, and the consequent collapse of hedge fund Long Term Capital management. These events also occurred during a period of a strong and rising USD, weakening oil prices, and overleveraged emerging economies. As a recent FT article points out:

> "Developed market investors have pumped debt into the alphabet soup of "Brics" and Mints" (ed. note; Brazil, Russia, India China, and Mexico, Indonesia, Nigeria and Turkey) since the crisis, encouraged by rapid economic growth and soaring commodities prices. According to McKinsey, total emerging market debt rose to $49tn at the end of 2013. It accounted for almost half the growth in debt worldwide since 2007.
>
> But recent events show these same investors starting to pull back, unnerved by the strong dollar, soaring political risk … and tumbling commodity prices that have crushed growth rates across the developing world. The 15 largest emerging

[17] http://www.bloomberg.com/news/articles/2015-04-23/we-just-got-disappointing-manufacturing-data-from-all-around-the-world

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> economies experienced their biggest absolute outflow since the crisis in the second half of last year, according to ING.
>
> (Of particular concern)…is the changing nature of cross-border lending to emerging markets. Traditionally most of the capacity came from international banks. While they remain significant lenders, the banks have curbed their appetite for new exposure because of tighter regulation.
>
> ***Into their shoes have stepped the capital markets***… (Emph. added).[18]

The article cites as an example, mutual fund manager Franklin Templeton, who had apparently accumulated around one third of the entire amount of Ukraine's international debt just prior to Russia seizing Crimea. Franklin Templeton has since hired Blackstone to help with a debt restructuring![19]

The chart from BIS economist Hyun Song Shin shown above (see US dollar credit to non-banks outside the United States) clearly portrays the surge in overseas corporate borrowings, and the decline in the amount of these new loans that have been originated by the traditional bank lenders. An FT article, by Henny Sender cites BIS statistics showing that emerging markets issuance in international debt capital markets last year were $359bn, or double the amounts issued by the developed markets.[20] The article also discusses the woes of a traditional bank lender, Standard Chartered Bank, headquartered in the UK. The bank, she reports, "…is struggling because of its exposure to emerging markets. Once regarded as a proxy for the growth of Asian markets in commodity-rich nations like Indonesia, StanChart has today become a victim…***The volatile and depressed energy, metals and mining sectors accounted for a combined 29 per cent of StanChart's corporate and commercial loan book*** in the first half of 2014 (emph. added)." Sender also notes that the rate of loan growth in the region is finally subsiding from an 18% annual growth rate a few years ago, to 12% last year.[21]

Sender hopes that this slowdown in lending will lead to "better credit allocation". We would add to that wish to, "be careful what you hope for"! Once a credit fueled "bubble", or misallocation of capital has already been established, it usually ends painfully, and the beginning of that end usually coincides with a slowdown in the growth of the credit that's been fueling the bubble.

And, while on the topic of credit fueled bubbles, we'd be remiss if we didn't give a shout out to the Chinese stock market, as represented by the Shanghai Composite Index. As Marketfield Asset Management noted, "…the parabolic advance by the local equity market has shocked observers expecting to see a re-run of 2008. Clearly with a record 1.67 million

[18] "Turning of Emerging Market Tide Leaves Fund Managers Vulnerable"; Financial Times; April 13, 2015; pg. 14
[19] Ibid. # 17
[20] "Banks Must Lend More Judiciously to Prosper in Emerging Markets"; Financial Times; April 4, 2015; pg. 12
[21] Ibid # 20

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accounts opened in a single week and 33.38 billion active account we are witnessing a wave of local speculation rather than a considered allocation of capital."[22] And, Bloomberg

cites a strategist at Bocom International Holdings Co., one of the top 5 leading commercial banks in China, who just issued a bullish call on the Chinese market. Despite "…soaring price-to-earnings ratios, the shrinking yield advantage that stocks offer over bonds and the fact that mainland-listed equities now trade at a 34 percent premium over nearly identical shares in Hong Kong…(this analyst states that) '***Our traditional market models may not be able to capture the full picture***' (emph added). In this vein of being doomed to repeat history, it's beyond ironic that the title of the report is "Price-to-Whatever: A Bubble Scenario".[23] The analyst feels that as long as the government supports the rally and keeps rates low, the market has nowhere to go but up!

We feel the above scenarios are perfectly captured by Scott Minerd, in his March 27th Market Perspectives entitled "The Money Illusion. He observes:

> "…In a recent research piece published by Bank of America Merrill Lynch, global economic growth, as measured in nominal U.S. dollars, is projected to decline in 2015 for the first time since 2009, the height of the financial crisis.
>
> In fact, ***the prospect of improvement in economic growth is largely a monetary illusion*** (emph added). No one needs to explain how policymakers have made painfully little progress on the structural reforms necessary to increase global productive capacity and stimulate employment and demand. Lacking the political will necessary to address the issues, central bankers have been left to paper over the global malaise with reams of fiat currency.
>
> With politicians lacking the willingness or ability to implement labor and tax reforms, monetary policy has perversely morphed into a new orthodoxy where even central bankers admittedly view it as their job to use their balance sheets as a tool to implement fiscal policy…
>
> Essentially, monetary authorities around the globe are levying a tax on investors and providing a subsidy to borrowers. Taxation and subsidies, as well as other wealth transfer payment schemes, have historically fallen within the realm of fiscal policy under the control of the electorate. Under the new monetary orthodoxy, the responsibility for critical aspects of fiscal policy has been surrendered into the hands of appointed officials who have been left to salvage their economies, often under the guise of pursuing monetary order.
>
> The consequences of the new monetary orthodoxy are yet to be fully understood…
>
> In the long run, however, classical economics would tell us that the pricing distortions created by the current global regimes of QE will lead to a suboptimal

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[22] "The Weekly Speculator"; by Marketfield Asset Management; April 2, 2015; pg. 2

[23] http://www.bloomberg.com/news/articles/2015-03-25/china-bulls-adopt-price-to-whatever-ratio-as-market-math-upended

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> allocation of capital and investment, which will result in lower output and lower standards of living over time…
>
> The cost of QE is greater than the income lost to savers and investors. ***The long-term consequence of the new monetary orthodoxy is likely to permanently impair living standards for generations to come while creating a false illusion of reviving prosperity*** (emph added)."[24]

As always, time will tell. Minerd is an astute observer of the global financial landscape. But, perhaps we are somehow able to slog through, reduce/restructure the amount of outstanding debt overhanging the global economies, and allow the markets and the innate creative drive of humanity to generate new growth. While we're sympathetic to Minerd's view, for the nearer term we're actually seeing signs of improvement in the equity markets and retain our overweight position there. In several of our models, we're beginning to implement options strategies that should help performance in the event of a sudden downside shock. However, beyond the risk of a shorter term geopolitical or financial shock, we're seeing various advance-decline lines making new highs, and a broadening in the overall market participation, both of which typically portend many more months/quarters of an up-trending market.

We will continue to closely monitor the direction of the USD and global growth. In the meanwhile, spring has finally arrived in the Northeast. The crocuses and tulips are blooming and hopefully this will prove to be an accurate metaphor for renewed growth in the US and globally. We hope that you are all able to shake off the winter and find time to enjoy the longer days and nicer weather.

Regards,

Jason Waxler

[24] http://guggenheiminvestments.com/perspectives/market-perspectives/the-monetary-illusion?utm_source=intermediary&utm_medium=banner&utm_content=market%20perspectives&utm_campaign=GI%20Home%20Banners

First Quarter 2015 Market Data (25)

	Total Returns	
Index	**First Quarter 2015**	**Year-to-Date**
DJIA	0.33%	0.33%
S&P 500	0.95	0.95
Nasdaq Composite	3.48	3.48
S&P MidCap 400	5.31	5.31
Russell 2000	4.32	4.32

Index	First Quarter 2015	Year-to-Date
Barclays U.S. Aggregate Bond Index	1.61%	1.61%
Credit Suisse High Yield Index	2.59	2.59
Barclays Municipal Bond Index	1.01	1.01
Barclays Global Aggregate Ex-U.S. Dollar Government Bond Index	-4.63	-4.63
J.P. Morgan Emerging Markets Bond Index Global Diversified	2.01	2.01
Barclays U.S. Mortgage Backed Securities Index	1.06	1.06

	Total Return	
MSCI Index	**First Quarter 2015**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	5.00%	5.00%
All Country World ex-U.S.A	3.59	3.59
Europe	3.58	3.58
Japan	10.34	10.34
All Country Asia ex-Japan	4.90	4.90
EM (Emerging Markets)	2.28	2.28

	Total Returns	
MSCI Index	**First Quarter 2015**	**Year-to-Date**
Emerging Markets (EM) Index	2.28%	2.28%
Asia Index	5.26	5.26
Europe, Middle East, Africa (EMEA) Index	2.02	2.02
Latin American Index	-9.49	-9.49

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

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