SIGNATUREFD

FALL 2013

MARKET SENSE:
A New Era for Investing

Investment markets typically ignore the rhythms of the Gregorian calendar. Yet investors still try to operate within this framework, measuring company and portfolio performance every quarter. In January, analysts make predictions for the calendar year. Even at SignatureFD, we update clients via quarterly letters.

In reality, the action in the economy and the markets is much more episodic. Sometimes trends remain in place for quarters or years at a time. In other environments, several years' worth of action can happen in a matter of weeks or months. We offer this background as a way of leading up to our message this quarter: We believe that we have entered a new market period, one that will be characterized by a slowing of central bank stimulus efforts and increased growth in developed market economies. This change has only happened over the last few months, but it will be critical for investors to adapt to what, in our opinion, will be a new era.

In this letter, we review the long-term trends that have underpinned the markets over the past decade, outline the changes underway and summarize how some of our portfolio themes are shifting in light of these developments. But first we will recap the last three months.

THIRD QUARTER RECAP

During the third quarter, the strong move higher that began late in 2012 continued, with the S&P 500 advancing more than 5%. In contrast to the last few quarters, international markets were also on an upward trajectory. This was especially evident in Europe, where many markets moved higher by more than 10%. The globally diversified MSCI All Cap World Index rose by about 8%. In fixed-income markets, the quarter started with a continued increase in interest rates, at one point hitting 3% on the U.S. 10-year Treasury. By quarter-end, however, the market stabilized and rates settled at 2.62%, up slightly from 2.48% at the beginning of the quarter.

SHIFTING MARKET DYNAMICS

The last decade has been marked by three distinct economic periods. The first began in late 2002 just after the technology bubble and equity market correction and was characterized by rapid leveraging across all major areas of the private economy: the banking system, households and corporations. This period came to a screeching halt in 2008 as the system buckled under declining real estate values and unsustainable debt levels.

From early 2008 through early 2009 we saw a short, but extremely sharp, correction. This second period was characterized by a rapid reversal in leverage and a historic correction in the value of all

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risk assets. As global policymakers came together and created a unified safety net under the markets and the economy, asset prices reversed course and economic growth returned, kicking off the third period.

The third period has lasted for almost five years, and during this time many market trends have been consistent. Equity markets have rallied significantly, with most major global indexes trading at or near record highs. Early in the period, emerging market and commodity-oriented equities performed the best. More recently, the U.S. markets have led the way. Fixed-income markets, especially the riskiest market categories (e.g., non-government mortgages, high-yield bonds, and secured loans) have mostly risen to pre-crisis valuations. The factor that has had the greatest impact on the market over the last five years has been the unprecedented amounts of liquidity from global central banks, especially the Federal Reserve. Moreover, major developed countries ran extremely large fiscal deficits, providing economic activity to fill the void left by private sectors that were de-leveraging and deflating. Importantly, overall debt levels did not materially decline as the massive private sector debt was flushed out and absorbed by the public sector.

A NEW ERA FOR THE MARKETS

This spring, markets started shifting away from a cycle driven by central banking liquidity. Fed chairman Bernanke's tapering plan for the Fed's third round of bond buying (QE III) triggered the shift. Investors' realization that underlying economic growth in the world's major developed economies was getting stronger was also a factor. The hint that policy would shift in response to stronger growth caused the re-pricing of all assets.

Since May, we have spent significant time and energy assessing the importance of this shift and determining our plan for the future. We spoke with smart investors, attended valuable conferences and challenged our research partners. The result is a strong conviction that we are entering a new period and that to invest successfully, material adjustments in strategy are necessary. The new cycle is likely to affect asset classes as follows:

1. **Developed market equities and currencies.** The world's major developed economies (U.S., U.K., Europe and Japan) are likely entering a period of better-than-expected economic performance. After a multi-year financial deleveraging in the U.S and U.K., a currency and debt crisis in Europe, and more than 20 years of stagnation and deflation in Japan, major markets show the potential for solid performance based on pent-up demand and improving structural stories. This will likely lead to continued equity gains in all markets, though we like Europe the best and believe the U.S. has priced in more of the positive news than the others. On the currency front, the euro and dollar will likely stay fairly strong, while the yen should continue to deteriorate.

2. **Fixed-income markets.** As economic strength builds, most central banks will reduce monetary stimulus. In fact, the European Central Bank's balance sheet is already declining as banks pay back loans taken out in 2011 under the long-term refinancing operation program and concerns about a eurozone break-up subside. The Fed has delayed the start of tapering, but it is clear that its next move will be a slow unwinding of the stimulus programs. Japan is an exception to this trend. In that country, tremendous amounts of stimulus will

THIS NEW MARKET CYCLE WILL LIKELY UNFOLD ERRATICALLY, FOLLOWING A TWO STEPS FORWARD, ONE STEP BACK PROGRESSION

likely remain for three to five years, with the goal of helping the economy stabilize after two decades of weakness.

As growth strengthens and central banks normalize policy, interest rates are likely to rise, which will put pressure on bond prices across many sectors, most notably government debt. Other segments of the so-called investment-grade financing markets are also likely to struggle as there is a one-in-three possibility of total return losses in these securities over the next three years.

3. **Emerging market equities and currencies.** It may seem unfair, but the end of stimulus programs in developed economies—especially the U.S.—could have the greatest effect on emerging economies. Just as a retreating tide is seen first and most noticeably in marginal areas such as marshlands and shallow tidal pools, the marginal liquidity the past five years has flowed into emerging markets and investments tied to their growth. The result of the end of stimulus programs in developed countries is likely to be weakening currencies and higher interest rates, which will slow economic growth in emerging markets. This trend, along with a structural change in the drivers of growth in China, may take two to four years to fully resolve. Equity markets and currencies in these regions have already underperformed in 2013, but we feel it will not be time to make major commitments until structural reform is instituted.

4. **Commodity and commodity-sensitive economies.** In the past decade, many commodities have been tethered to the growth in investment and infrastructure in emerging countries, especially China. As these countries are forced to adjust their economies, demand for many tangible assets is likely to slow. In addition to a shift on the demand side for commodities, the supply side will also shift. Following a decade of high prices and solid profits in the basic materials industries, the supply of commodities and natural resources is increasing. The increase will be most noticeable in industrial metals. While energy demand is likely to continue to grow, we are closely watching increases in supply (especially in the U.S.). Agriculture commodities will continue to be supported by the rising wealth in emerging economies, though supply has started to grow as prices have come up in recent years. As commodity prices weaken, emerging countries such as Brazil, South Africa and Russia may struggle with reduced liquidity. This could also affect developed economies such as Australia and Canada. But most developed economies are net users of commodities and dropping prices actually support further earnings growth and reduced inflation.

This new market cycle will likely unfold erratically, following a two steps forward, one step back progression. Unpredictable political events in D.C. and around the world will add to the confusion. As a result, the new era will be obscure to many investors, while providing observant investors with opportunities. Based on current analysis, we are confident that this is likely to be the major trend in the markets for some time.

POSITIONING THE PORTFOLIO

As we identify new market trends, we are beginning to shift some of our portfolio themes to position client assets to take advantage of areas of longer-term opportunity while limiting outsized risks. For the last four years, our portfolio themes have been relatively consistent, but in the first quarter we began making adjustments. We will continue to look for opportunities to reposition portfolios as appropriate.

- **Large over small in U.S.:** The current strategy in the U.S. is relatively consistent with our previous positioning. We have a modest amount of small-company exposure via our managers but no dedicated exposure. We anticipate keeping this the same in the future. We believe large companies, and especially multi-national companies, remain the optimal place for our U.S. capital. Resurgent growth in Europe and Japan should be a positive for those countries exposed to non-U.S. revenues. In addition, we believe the largest companies will maintain the cost of capital advantage, allowing them to be more competitive and continue to leverage their balance sheets by borrowing money and buying back stock.

- **International barbell:** Outside the U.S., we are beginning to shift our long-time focus of east over west. Going back to the first quarter we have trimmed emerging market holdings and focused on two separate extremes of the international markets. First, developed markets will see the greatest advantage from the trends outlined in this report and we have shifted capital toward Europe in 2013 after several years of limited exposure to those markets. On the other end of the spectrum, we have added capital to frontier markets. These are the smallest and least developed of all global markets, including many markets surrounding the Indian and Pacific Basins (Africa, the Middle East and Southeast Asia). Our view is that changes in China will positively affect these markets and that while no one country can replace China's lower-end labor advantages, a combination of them can.

- **Users over producers of commodities:** The commodity bull market cycle that began in the late 1990s has likely run its course. It is impossible to make this call on every specific commodity as markets are different, but we believe the strategy of owning a basket of commodities for the long-run is probably no longer viable. We have shifted our capital over the last few years away from this broad basket approach into two separate strategies. First, we have stakes in global infrastructure investments which are actually benefiting from lower commodity prices as capital spending is reduced. These investments are generally cash-flow oriented and provide some protection from inflation via their business model—both fundamental reasons for investing in commodities. The second strategy maintains modest commodity exposure by owning companies that have the lowest cost reserves. These companies are typically the least volatile and outperform when commodity prices decline.

- **Short-term over long-term in fixed income:** Our view of fixed-income investments has not changed materially. We continue to believe that interest rates will rise over the long-term. Thus, investing in bonds with shorter maturities will be the best strategy, all else equal. The trade-off for limiting the risk of longer-term bonds is to invest in more speculative types of bonds that are sensitive to economic cycles. These investments have performed well in recent years and mostly increased in price to the point that they provide a limited margin of safety. Although we are still comfortable with our credit-related fixed-income exposure and maintain our allocation to several of these investments, we are watching closely and are anxious to reduce our exposure at the first hint of economic stress.

We will continue to communicate with you as evidence emerges that either confirms or alters our thoughts about this new era. In the meantime, we welcome your thoughts, questions and feedback. We appreciate the confidence you have placed in our team.