

SIGNATUREFD

SPRING 2014

MARKET SENSE: An End to Extraordinary Stimulus



There is a classic Wall Street adage: “The market will always seek to frustrate the maximum amount of participants at all times.” That certainly seems to be the case in the first quarter of 2014, especially after a year like 2013, when trends seemed so entrenched. Most equity markets managed to eke out small gains this quarter, but these gains came with much higher volatility. Moreover, the shift from bonds to equities seemed to pause as longer-maturity bonds posted some of the best gains during the quarter. The table below provides returns for a few key benchmarks.

	1st Quarter	52 Weeks
S&P 500	1.8%	21.9%
Dow Jones Industrials	-0.2%	15.7%
MSCI EAFE (International)	0.7%	17.6%
MSCI EM (Emerging Markets)	-0.4%	-1.4%
Dow Jones—UBS Commodity Index	7.0%	-2.1%
Barclays U.S. Aggregate (Taxable Bond)	1.8%	-0.1%
Barclays 5-Year Muni (Tax-Free Bonds)	1.0%	1.0%

A QUARTER OF TWISTS AND TURNS

A lot happened in the market in the first quarter. We will take a deeper-than-normal dive into various returns in order to highlight what we believe could be some key developments.

First, as we forecast in our last newsletter, market volatility rose during the quarter. In late January, the market pulled back nearly 6%. In a historic sense, this is a mild decline, but it was the largest negative move since the first half of 2012. Market volatility, as measured by intraday moves and other indicators, began to accelerate by quarter-end.



INVESTOR SENTIMENT AS MEASURED BY BULLISH/BEARISH READINGS IS RELATIVELY HIGH. FROM A CONTRARIAN STANDPOINT, THIS GIVES US SOME PAUSE.

Second, the assets that performed well at the beginning of 2014 were much different from last year's strong performers. For the quarter, gold and bonds were the two best-performing assets, while stocks were middle of the road. This is nearly the opposite of last year. The bulk of gains for gold and bonds came in January and February. March saw a rotation of a different type. Stocks with the strongest value characteristics (as opposed to momentum or growth) and non-U.S. stocks started outperforming and the recent highfliers dropped back. More defensive and dividend-oriented sectors, namely utilities, performed well while biotech and Internet names, which surged last year, are off 52-week highs by 10–15%. Sometimes, this type of abrupt shift is called a change in market leadership, and it indicates a market that is churning under the surface—even as it continues to hit new highs.

Finally, some of our internal indicators are starting to raise the potential to trigger some additional volatility over the next two quarters. The so-called “breadth” of this market advance is weakening. Essentially, the market continues to move higher with fewer and fewer stocks actually trading at new highs. Investor sentiment as measured by bullish/bearish readings is relatively high. From a contrarian standpoint, this gives us some pause. Yet the idea of a full-blown correction (15%+) is on few investors' radar. Finally, confusing signals from interest rates, copper and emerging market stocks also signal a continued pause in equity gains.

THE DOMINANT MACRO CYCLE

Given the noise coming from markets in recent months, we believe it is more important than ever to step back and see the forest for the trees. In any given environment an investor should understand the dominant cycle and how this affects investing themes. We explained in some detail last year our thoughts on the new macro cycle, which began when the Fed first uttered the term “taper.” In summary, we see the current cycle as follows:

1. A positive economic backdrop in developed economies forces central banks to begin reducing stimulus.
2. Reduced stimulus negatively affects emerging markets as they suffer from reduced liquidity and growing competitiveness issues.
3. That, in turn, hurts commodity prices as aggregate global growth expectations are below expectations.
4. The cycles are reinforced as lower input costs continue to enhance developed economies' relative performance.

Assuming the above is an accurate assessment of the current macro environment, an investor can reach several conclusions. First, the recovery in fixed-income prices (i.e., lower rates, which move in the opposite direction of price) is likely a temporary rebound driven by large investors rebalancing portfolios after strong equity returns in 2013. Second, emerging markets, which have seen a modest bounce in recent weeks, are likely to continue underperforming as expectations for secular growth remain overly optimistic. Finally, developed economies, especially the U.S., could see better growth through the rest of this year than current estimates predict.



WITH A SYSTEM CURRENTLY FULL OF EXCESS BANK RESERVES ACTING AS MONETARY TINDER, A SPARK COULD BEGIN AN INFLATIONARY FIRE, WHICH COULD CAUSE A SURGE IN VOLATILITY.

Emerging economies will continue to grow faster than those in the developed world, but the drivers of the last decade's strong performance continue to move in the wrong direction. The export-focused economic growth in countries such as China is changing as they find it increasingly difficult to compete against developed markets like the U.S., Germany and Japan, as well as more geographically optimal areas like Mexico and Eastern Europe. The change in trend growth for the export countries has reversed commodity cycles and is putting downward pressure on prices in countries like Australia, Brazil and Chile that are highly dependent on raw materials. Finally, as the Federal Reserve reduces stimulus, liquidity flows are reversed, which takes away the cheap financing that was widely available in many of these countries. There will be an opportunity to invest in emerging markets, but a major position only becomes warranted when the majority of investors accept the change that has occurred.

CENTRAL BANK POLICY AND INFLATION SCARES

Federal Reserve policy will remain key to market behavior over coming quarters. A bridge was crossed last May when the first hint of tapering was announced. In our opinion, the second part of this story played out at the March Fed meeting when for the first time investors really began to recognize that interest rate normalization was within sight. While there was debate about whether this would happen in mid-2015 or later that year, the reality is that for the first time in recent memory people assumed that rates were going to lift from the zero level.

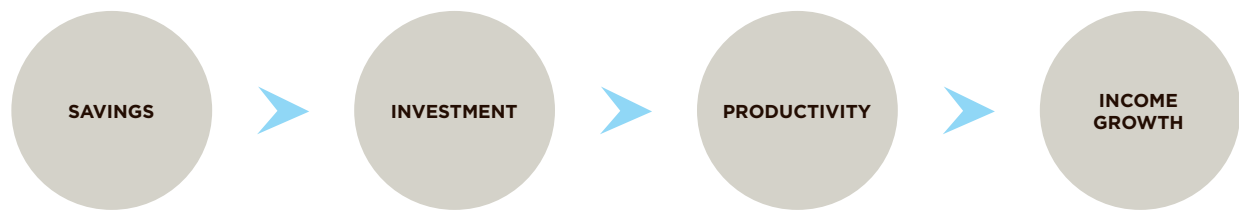
As mentioned above, we remain optimistic on the U.S. economy and would not be surprised if growth in the U.S. and Europe for 2014 is better than expected. But we also believe that

stronger growth raises the possibility of an inflation scare in the next few quarters, which could increase market volatility. The result would be the next stage of interest rate increases and fears of tighter Fed policy.

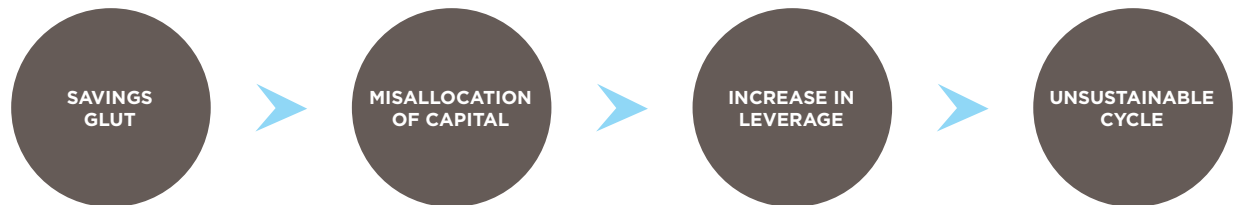
In a recent blog post ("Inflation vs. Deflation—Fire or Ice?"), we examined the inflation issue in more detail. One reason to expect an inflation scare is rising bank lending. Credit expansion (outside the federal government) has been weak since 2008, but this has recently changed. When credit creation is running ahead of total economic growth, inflation is always a concern. This could be a major story in coming quarters as the banks have regained their health and are likely to start putting a portion of their huge accumulated reserves to work in higher-earning assets. Thus far, the Fed has been able to maintain the appearance of a methodic, gradual normalization of policy. But with a system currently full of excess bank reserves acting as monetary tinder, a spark could begin an inflationary fire, which could cause a surge in volatility.

Longer term, the question will be how this newly created capital is used in the economy. The answer will determine if we have a more balanced long-cycle expansion or if we continue in a boom/bust pattern. The academic debate on Fed policy normalization has been intense, but now we will see the real-life scenario. Many economists propose that the income inequality and speculative behavior we have seen over the last few years stem from the fact that policymakers have altered the price of money via interest rates and bond purchases. Artificially altering the price of anything will impact the supply and demand equation for that item. Interest rates are the cost of money and are not immune to this economic reality.

In summary, if credit creation leads to investment in productivity-enhancing capital spending over the coming years, then the economy can wean itself off extraordinary stimulus and enter a sustainable positive cycle:



Alternatively, if credit creation leads to financial engineering, market speculation and poor capital allocation decisions, then another boom/bust cycle would result:



SPECULATION AND ACTIVISM

The above analysis brings us to the present. Investor confidence is mostly “back” as witnessed by global equity markets trading at or near all-time highs and investor willingness to hold high-risk securities. Savings rates have improved from before the crisis, corporate profits and cash flow remain extremely strong, and monetary policy is slowly normalizing. What remains to be seen is whether the aggregate decisions of investors and company management result in healthy or unhealthy capital allocation in the years ahead.

It is our opinion that corporations are on the cusp of unleashing significant amounts of excess capital. Banks are also getting involved, which could only accelerate the trend. But we don’t yet know if this capital, if deployed, will be invested in production or used for short-term financial engineering. A sound financial system must have markets that allocate capital to the highest-yielding long-term activities. By holding rates low, central banks can influence the deployment of capital, but they can’t dictate where it goes. If companies don’t truly believe long-term opportunity exists, then they will instead use this capital to reap short-term gains, since they believe they will be able to unwind their positions before everyone else.

Famed investor Seth Klarman wrote on the current challenges of capital allocation in his year-end letter, likening the current system to the film *The Truman Show*. In comparing today’s real-life Truman Show (orchestrated by Ben Bernanke and other central bankers) to the movie, Klarman says, “But there is a fly in the ointment: In Bernanke’s production, all the Trumans—the economists, fund managers, traders and market pundits—know at some level that the environment in which they operate is not what it seems on the surface. ... Can the clued-in Trumans be counted on to maintain their complicity or will they go off script?” At some level, we think the new Fed chair, Janet Yellen, and others recognize the risk of poorly allocated capital. We certainly hope they do and that they use the strengthening economy to normalize rates as quickly as possible so that there are incentives to encourage a healthy allocation of capital. This is what we hope for in advance. As to what actually happens, only time will tell.

One final character has come on to the scene recently that we have come to realize as important for the outcome of the movie—activist investors. These investors seek to use public pressure to

maximize business outcomes, usually financial. These goals can be worthy and exemplify the capitalistic attribute of creative destruction. But in the current environment it could be perceived that they are interested only in short-term reward—specifically, gaining access to the cash that sits on corporate balance sheets. Activist investors have the potential to do good, but we also fear they could leave companies hollowed out and over-leveraged. One of the biggest growth areas at big investment banks are activism defense groups. We recently heard that Goldman Sachs, a major player in the space, has more than 300 clients, up from less than 50 three years ago. This speaks to the significance of activism in determining how the coming cycle of capital deployment will be directed.

SIGNATUREFD PORTFOLIO DESIGN

In building portfolios, we take our macro views into account and match these with the “bottom up” confirmation we get from our regular interactions with money managers. Last year, we had nearly 1,000 interactions with money managers, both those who manage current investments in client portfolios and those we respect or are monitoring for future use. We believe this is a unique attribute of our firm: working hard to find where confirmation of ideas comes together.

We made several minor portfolio shifts during the first quarter. The most significant was a continued rotation from U.S. equity strategies to international markets where we believe better relative values exist. These international allocations continue to consist mostly of European and frontier market positions. We are encouraged by the performance of our underlying managers in the first quarter. Both our U.S. and international managers added significant value above benchmark returns. Our collection of fixed-income managers held up very well in spite of the sharp rally in longer-duration bonds, of which we have very few.

One other noticeable theme in our portfolios is a conscious shift toward more active and flexible managers. As we frequently state, we are agnostic as to strategy. However, in the current environment, we believe that active strategies have some advantages. As markets move more based on fundamental data and less on macro and policy-driven news, managers are better able to sort between winners and losers. Additionally, tactical and flexible strategies are currently being rewarded. This is most clear in fixed-income markets, but also in some strategies such as long/short equity portfolios.

Future portfolio shifts are never preordained and are made only when we have confirmatory evidence. That said, we typically have a game plan for a given year. In the quarters ahead we believe that volatility is possible and market declines could occur, as outlined above. We already have a meaningful portion of the portfolios allocated to nonmarket directional alternative strategies that should hedge the portfolio from some of this volatility. Future shifts could further this trend away from long-only U.S. positions toward these hedged (specifically long/short) strategies. We also will be watching the data in emerging markets, and ancillary areas like commodities, to determine when it makes sense to increase exposure.

We cannot promise what the future holds, but we can guarantee that our team remains ever-vigilant in trying to grow your capital while managing it in a way that minimizes the chance of permanent loss.

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