FIRST QUARTER 2014 INVESTMENT COMMENTARY

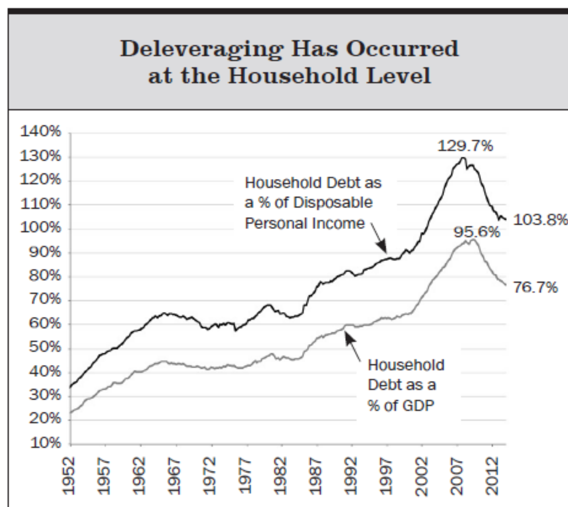

CHART 1 *Data as of 12/31/13. Source: Federal Reserve and Bureau of Economic Analysis.*

In our recent commentaries we've noted the significant improvement in household balance sheets (total net worth), driven by both a strong rebound in housing prices as well as a surging stock market. We have also noted many other improvements in the U.S. economy and the broader macro environment over the past year.

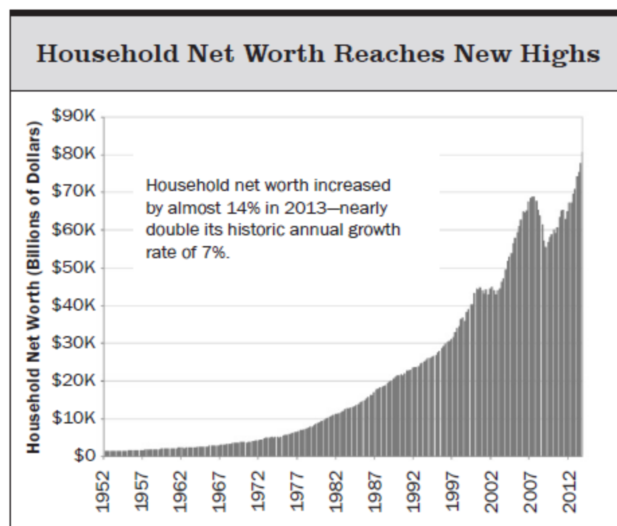

CHART 3 *Data as of 12/31/13. Source: Federal Reserve Board.*

These developments served as a catalyst for us to reassess the progress of our deleveraging thesis. Upon our review, we have concluded the following:

1. The deleveraging process is still ongoing, though it is probably progressing at a slightly faster pace than we expected. This is good news for the economy.
2. While median incomes have not gone anywhere in real (inflation-adjusted) terms, the key to any smooth deleveraging is that nominal incomes do not decline. On that front, the stimulative monetary and fiscal policies we have seen since the crisis have worked well so far. And should the economic recovery continue, we would expect at least some improvement in household income growth. Moreover, household balance sheets have improved significantly as the housing and stock markets have risen and household net worth is now higher than pre-crisis highs.
3. Largely due to the Federal Reserve's QE policies, which make holding cash or safe assets with very low yields extremely painful for investors, we have not seen the high levels of risk aversion we expected would occur during a deleveraging process. With the Fed's commitment to gradually tapering QE and keeping rates low until unemployment and inflation reach levels they believe reflect a healthy economy, and most of the private sector deleveraging headwinds now behind us, we are increasing our base case P/E multiple from its previously more conservative level.

The result of this analysis is that our base case expected return, annualized, over the next five years for U.S. equities has increased. Correspondingly, our returns for developed international markets increase as well since our Europe model return is in part driven by our fundamental assumptions and return expectations for U.S. equities.

But We Have Not Yet Achieved Normal Status

In investing, there is always something to worry about. However, with a long investment horizon, which we have, things generally turn out fine. So, in normal times we'd generally be optimistic about the economy and the markets. But we are living in a period without historical precedent. We are still in the midst of an unprecedented monetary policy experiment, which has resulted in the Fed having a huge balance sheet. How that unwinds, or whether or not it will even fully unwind, and how the Fed will normalize interest rates such that lenders once again have an incentive to lend to productive investments are big unknowns, and they introduce considerable uncertainty. The Fed's creative monetary policy experiment (or QE) thus far has led to a surprisingly benign deleveraging process. For that we feel fortunate and thankful. But we worry that the steps taken to make the deleveraging process benign may have unintended consequences that neither we nor anyone else, including the Fed, can fully understand or anticipate.
One key question we struggle with is, can the Fed unwind its huge balance sheet and normalize interest rates without major disruptions in the markets? We observe two main sets of views on this among investors and other market participants. One group, and this seems to be the majority, sees it as a huge uncertainty and an unknowable risk. The other group offers a benign view and suggests the Fed has the tools to accomplish its goals without a major impact on the markets and/or the real economy. They even say the Fed may decide not to unwind its balance sheet, and through its new inventions control the flow of excess reserves into the economy (and hence inflation) without compromising its ability to target short-term interest rates. (There is also a third group that sees the Fed's actions as leading inevitably to another crisis, such as hyperinflation.) While it's possible the Fed can have its cake and eat it too, it's hard for us to gain conviction in this benign view or to base investment decisions on it. We think this is a risk we should factor into our decision making, at least until we better understand the new era of monetary policy the Fed seems to be embarking upon.

As a related point, much of the private sector deleveraging has been accomplished by shifting debt from the private to the public sector. As such, overall U.S. debt levels remain uncomfortably high. There are a few reasons why it may not be as big a concern as private sector indebtedness, at least not in the near term. First, the United States, through its privilege of being the world's reserve currency, is still a preferred destination for the world's savings, which are in excess supply. This gives the United States greater flexibility to manage its deleveraging and to grow out of its indebtedness. Second, the fiscal deficit has turned down and debt is no longer growing faster than nominal GDP growth. So, the U.S. public sector deleveraging may already be underway. However, a sharp increase in interest rates is a big risk to the still-levered economy, and to housing in particular. Further, while we are saying private sector deleveraging is close to being over, we are not saying it's completed yet.

We continue to see causes for concern outside the United States as well, foremost among which is how China's massive credit and infrastructure bubble unwinds. In recent months we have seen defaults from Chinese entities unable to generate sufficient cash flows to service their debts. This may just be the beginning of a credit-bubble unwind that would be hugely disruptive for global markets. In another part of the world, Europe

continues to flirt with deflation and a credit crunch. Structural imbalances between creditor and debtor countries are far from resolved, and there remains a meaningful risk of a debt crisis stemming from the weaker peripheral countries. The banking system is undercapitalized and in need of a credible backstop such as a region-wide banking union. To conclude, significant uncertainties and risks remain and they will continue to impact how we think about valuations.

Revisiting Emerging Markets

As we highlighted earlier, our concerns related to China have increased slightly, and the turmoil in emerging markets overall over the past year has led us to revisit our investment thesis. In hindsight, emerging-market countries in aggregate do not have as much control over their monetary policies as we had thought. In the past year, some countries have had to resort to raising interest rates at the wrong time (when their economies were slowing). Overall, rates haven't risen a lot. Nevertheless, this dynamic of capital flows forcing perverse monetary decisions on emerging markets has been evidence contrary to our thesis. Overall, the risk that poor investor sentiment leads to capital outflows, which in turn forces emerging markets into policy decisions that contaminate their fundamentals, is higher than we'd thought.

The past year has also reinforced the safe-haven status of the United States and the privilege it commands as a result of being the world's reserve currency. Emerging markets, despite their better balance sheets and better long-term fundamentals, remain susceptible to short-term capital outflows. Because these outflows can contaminate emerging-markets fundamentals, and we cannot know when sentiment will worsen and when outflows will occur, the risks we perceive with emerging-markets investing are slightly higher than they were a year ago. To be clear, we still do not believe emerging-markets fundamentals are as bad as they were in the late 1990s, though this view may not hold true if our worst fears regarding China play out. But we acknowledge that to some extent our thesis has not played out and that warrants a reassessment of our assumptions. Our reassessment of emerging-markets-related risks has resulted in changes to our emerging-markets equity assumptions. We are lowering their long-term estimated trend-line growth rate in nominal terms. Secondarily, despite the increase in the size of local corporate bond markets, liquidity remains relatively poor and most emerging-markets companies continue to tap foreign-currency debt, exposing themselves to currency fluctuations. We believe this warrants a slightly higher discount relative to U.S. equities. Our base case five-year return expectations for emerging markets range from 5% to 12%, with the lower end explicitly factoring in the China-related risk.

39 Broadway, Suite 1730 | New York, NY 10006
Office | 212.374.9008 | FrancisFinancial.com

A Quick Update on our Broad Economic Scenarios

Our review of our deleveraging thesis also led us to recalibrate our broad economic scenarios. The goal is to gain a qualitative sense of investment regimes we may experience and how best to position our client portfolios such that the odds are high they meet their risk and return objectives across a range of probable environments. Below we list three main scenarios we think are probable based on our reassessment. We also consider other scenarios not listed below as part of our sensitivity analysis and stress testing of portfolios and asset class expected returns.

- **Bear**: The economy falls into recession for any of various reasons, such as deleveraging/deflation from Europe or China, unexpected systemic shock, Fed policy error, etc. This scenario **does not** assume another severe financial crisis, i.e., not a repeat of 2008–2009. Key assumptions: corporate earnings are below trend; inflation is around 1.5%; and the 10-year Treasury yield is around 2.5% at the end of year five.
- **Base**: Moderate economic recovery continues with no major crisis, but a normal recession is likely within the five-year time horizon. GDP growth rates and interest rates start to "normalize" toward the end of our five-year horizon. Key assumptions: inflation is around the Fed's target of 2%–2.5%; the Fed slowly raises rates; the 10-year Treasury yield is in a range around 4% at the end of year five.
- **Bull**: U.S. economic growth is above average and/or earnings end the period above the long-term trend line. A self-reinforcing global growth cycle develops, helped by stronger non-U.S. growth, releveraging of the U.S. consumer, and corporate investment spending. Key assumptions: inflation increases but remains relatively mild largely because wage pressures remain subdued due to technology and globalization forces; the Fed exits its accommodative policy without major economic or market disruptions, although a normal recession within the five-year period is still possible; the 10-year Treasury yield is in a range around 6% at the end of year five.

Concluding Thoughts

Five years after the worst financial crisis since the Great Depression, we feel fortunate to be where we are. The overall economy and our clients would be in far worse financial shape if our concerns related to deleveraging were realized. Yes, there are still lots of problems and there is a laundry list of concerns and uncertainties. The question we always ask is how material are these risks and what's the likelihood of them playing out. In our minds, a disruptive deleveraging process was a risk scenario we felt was prudent to protect our clients against. Part of that protection came from underweighting equities. At present the biggest risk in the equity markets is valuation risk. Stocks are not egregiously expensive (yet), but they are definitely not cheap and do not adequately compensate investors for taking on full equity risk.

We have frequently written about our focus on generating absolute returns and mitigating downside risk rather than reaching for relative returns. Many strategists, even some we respect, would overweight stocks at a much lower return hurdle, citing very low interest rates. But that stance does not adequately factor in equities' higher absolute downside risk in our opinion. Also, rates will eventually normalize: even if we don't know precisely when, we still have to prepare our portfolios for the possibility of what will happen when they do. Moreover, in the current period of extremely low bond yields where there isn't a lot of cushion against a recession or an economic shock, the need to insure against downside risks is

greater than when yields were higher. Ultimately our asset class weightings—and, specifically, our willingness to take on equity risk—rest on our view of return and risk potential for the asset class as well as the objectives and risk threshold of each portfolio. These are our foremost, and ongoing, considerations as we manage our portfolios and work with our clients to achieve their goals**.**

—The Francis Financial, Inc. and Litman Gregory Investment Team (4/9/14)

39 Broadway, Suite 1730 | New York, NY 10006
Office | 212.374.9008 | FrancisFinancial.com