MARKET PERSPECTIVES

STC Investment Committee

Bruce L. Swanson

January 15, 2015

This is the season during which I make my deep dive into research. Accordingly, I wanted to share some thoughts with you as they begin to coalesce around potential near- and mid-term investment strategies.

As mentioned in an October presentation to one of our clients, I thought that the 7-sigma move (once every 7 billion years) in the Treasury bond market in mid-October might be a precursor to "big moves" in other financial markets. While I did not anticipate the collapse in energy prices, the 50% fall in crude since late September certainly qualifies as a major event. More recently, only two days after promising to maintain its ceiling on the value of the Swiss Franc in Euro terms, the Swiss National Bank removed the ceiling, causing the Franc to appreciate 40% against the Euro intra-day.

As I work on my strategy piece, one goal is to identify other markets with potential for similar moves and at least try to avoid being on the wrong side of them when they happen. Potential candidates might be markets where sentiment and positioning contrast with long-term valuation metrics. Ideally, they should be in markets where the speculative positioning is based upon a leveraged foundation, which could make them even more susceptible to abrupt and substantial reversals.

The US equity market remains an obvious candidate for a sudden air-pocket, as sustained outperformance, safe-haven perception and complacency over Federal Reserve Board rate moves seem misplaced in an asset class that is at least 20% overvalued. Conversely, I am actually targeting a small overweight to international equities, especially in the Eurozone, as sustained underperformance and attractive local market and currency valuations lend support. Elsewhere, long-only strategies remain unattractive.

While many analysts are calling for the Euro to reach parity with the dollar over the next year, particularly after its recent de-coupling from the Swiss Franc, I see the Euro as moderately undervalued at these 1.15-to-the-dollar levels and would be happy to take on additional unhedged Eurozone equity risk. It seems likely that the ECB (European Central Bank) will engage in a limited form of quantitative easing by the end of January, but the news is already priced into the market. In any case, I think Euro weakness is self-correcting as the zone already generated a large current account surplus when oil prices and the currency were much higher.

The stakes are bigger in Japan, where many investors, including our hedge fund vehicles, have fully hedged their Japanese equity exposure with the expectation that Abenomics (economic policies advocated by Shinzo Abe, Japan's prime minister) would succeed in weakening the Yen. This has worked out well so far, with the currency already down 50% against the dollar since the end of September, 2012. While investors universally expect that policy-makers' efforts to further inflate the central bank's balance sheet with bond purchases will result in an even weaker Yen, I estimate the Yen to be 15-20% undervalued at these levels and, as such, vulnerable to a sudden reversal. Such a reversal would negatively impact global markets as the Yen has been the perfect "funding currency" for leveraged investors.

While we probably will not execute the trade, I think the situation sets up well for a long Yen/short RMB (China's Reminbi) currency pairs-trade, especially as a hedge. Being somewhat pegged to the dollar, the RMB has reached a new high in trade-weighted terms just as the Yen has collapsed. Yen weakness pressures other trade partners in the region to cheapen their currencies to boost competitiveness. The strong RMB hurts the Chinese

Continued on back.

economy just when the manufacturing, commodity and property sectors are already faltering. I remain bearish on Chinese growth prospects and feel that the combination of lower interest rates and the potential reversal of hot-money inflows will weaken the currency by more than the 2% expectation reflected in the non-deliverable currency forward market.

Another market vulnerable to potential volatility is the US Treasury market, where bears have already capitulated, removing an important potential buying source should bonds crash. Longer-term Treasuries have continued their 2014 rally, with yields dragged down partly by disappointing growth and central bank actions elsewhere, but mostly by the collapse in energy prices. I find it very strange that the one-time plunge in crude prices has triggered a similar move in long-term inflation expectations. I think an attractive investment would be to buy a long-dated inflation swap: for example, the 20-year CPI swap is trading at 2.0%. Even should oil not recover next year (December 2016 market expectation is $60), Treasury bulls need to reconcile the market's expected 1.6% Fed Funds rate for year-end 2016, with the Fed's own 2.6% forecast, especially as many of Fed Chair Yellen's labor market indicators are rapidly improving to levels not far from pre-Lehman highs.

With the increasing volatility of markets worldwide, identifying significantly overvalued asset classes, markets and sectors will be important to avoid major losses. Conversely, significantly undervalued and out-of-favor assets will present significant upside potential. Identifying these risks and opportunities is a major objective for our investment strategies over the coming year. I plan to provide more insights and predictions in upcoming publications.

Sentinel Trust Company

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

sentineltrust.com