MARKET
PERSPECTIVES

STC Investment Committee

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Despite disappointing economic growth in the US and abroad, the promise of continued monetary accommodation encouraged buying of everything (other than cash) such that virtually all asset classes saw gains for the quarter and calendar year with global equities up 6.2%. With the exception of a modest 0.1% loss for June in Treasuries, all 26 markets tracked by our consultant reported gains for both the month of June and 2014 y-t-d. Commodities recovered on the back of dovish global monetary guidance and turmoil in the Ukraine and the Middle East. Gold rallied 6.1% in June (10.0% y-t-d), while the GSCI index gained 2.1% (5.7% y-t-d). The volatility index, one measure of "fear" in the market, declined to near record lows for both equities and many other asset classes.

Despite outsized recoveries for small cap and growth segments in June (Russell 2000 growth up 6.2% versus +2.1% for the S&P 500), large cap value stocks have outperformed for the year (+8.7%), while small cap growth stocks have lagged the broad market, 2.2% versus 6.9%. The STC domestic equity composite benefitted from these style factors and has returned 450bp in excess of a strong overall equity market.

International equities have returned 5.6% through June y-t-d, with small caps and emerging markets leading and Japan the laggard at +0.7%. Sentinel International Trust (SIT) also outperformed its benchmark despite a 25% index weight, as the portfolio benefitted from a large emerging market and small cap overweight. For 2014, the fund has returned 6.1% versus an index return of 4.9%. With the continued outperformance of emerging markets into July, we are trimming exposures but maintaining an overweight.

An apparent stabilization in Europe, growth disappointments (offset by a modest fiscal stimulus in China), soothing words from central bankers and headline turmoil produced a virtuous cycle of lower bond yields, leveraged purchases and lower bond yields. This reach for yield continued in the credit and riskier parts of the bond market, as high yield bonds (+5.5%) and emerging market debt (+9.5%) have had good years. While increasingly underweight strategic levels as bonds have rallied throughout the year, our fixed income vehicles have put up very good standalone performances. SFIF-Core benefitted from its "barbelled" positioning and returned 3.56% relative to 2.29% (five year) and 4.23% (seven year) benchmarks. Despite a lack of high yield bond exposure, SFIF-Opportunity's 7.74% returned nearly matched the 7.9% custom benchmark as higher yielding municipals outperformed virtually all other fixed income strategies.

The best that can be said for our flagship hedge fund strategies was that performance recovered from a poor first quarter and that the "hedged" aspect was not needed during a year when all long-only strategies performed well. The good second quarter recovery left both SUF and SHEF only modestly in the black, but only 1-2% behind hedge fund peers.

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Mid-Year Update: the Fed Doubles Down; Investors Should Hunker Down

Our December, 2013 On Watch report summarized opposing viewpoints for a range of asset classes and provided my own odds as to which view would prevail. In general, while my caution on global growth prospects appears to have been warranted, the Fed's dovish announcements have supported continued risk-taking. In response to blistering criticism from central bank peers that it is creating credit bubbles, the Fed dismissed such concerns and reiterated its commitment to highly accommodative policies. The recommended response to diminished return expectations, high levels of investor complacency and a clueless Fed is a further portfolio risk reduction, particularly in yield sensitive asset classes.

The BIS (Bank for International Settlements), a Basel-based supra-national official bank, facilitates cooperation between global central banks and serves as a depository for international settlements. More importantly for our purposes, the BIS is one of the thought-leaders behind efforts to integrate credit cycle dynamics into conventional macro-economic analysis. Most importantly, it is the group best known for its criticism of former Federal Reserve Chairman Greenspan's accommodative policies and its prediction that the credit bubble Greenspan created would result in a financial market crisis. Recently the produced a lengthy white-paper seemingly directed at the US Fed and scathingly critical of the Fed's failure to acknowledge its culpability for past bubbles and misguided current policies that are resulting in a new credit bubble that has had little positive effect on the real economy. They reject quantitative easy, monetary rate accommodation and fiscal stimulus and call for entitlement reform, supply-side reforms and the withdrawal of tax incentive to borrow funds. Since they have sounded a lot like me for a number of years, it's no wonder I agree with them and think they are correct!

Fed-watchers anxiously awaited Fed Chair Janet Yellen's response to this heated attack (at least by the standards of academic economists) and to her credit, she did not back down. She reiterated that accommodative policies would continue for some time after rates first rise and that credit market dynamics are "not well understood". What is most troubling about the Fed is not that they are wrong (which I believe they are), but that they act as if they are certain they are right at a time when market forecasters with better track records have been humbled. Despite the moral hazard problem (they worry it may not inspire confidence for them to admit the possibility), the Fed should concede that there is much that economists do not know (let's start with the inflation/employment trade-off). While counterintuitive, a small degree of intellectual honesty would greatly boost Fed credibility.

Inflation is the dog that did not bark. What is interesting is that investors forget that it didn't really plunge as it was supposed to in the Great Recession; so should we be surprised that it hasn't raced up during the recovery and expansion? Some of these may be due to the owner's equivalent rent component of inflation; some may be due to the global nature of traded goods and some services. A less appreciated factor may be the rebirth of the domestic oil industry due to new technologies. In the past, central bankers would see demand-driven energy spikes as harbingers of renewed inflation pressures and would raise rates accordingly. With energy prices seemingly in check, a risk is that the Fed waits for a pick-up in more generalized inflation-and by that time they are already too late and behind the curve. At today's extremely low interest rates, even a modest inflation scare of 3% could wreak havoc in the bond market, with contagion to the broader credit markets, where herd-like investor selling could overwhelm an undercapitalized dealer base.

While Yellen (who is a labor economist) believes that the unusually high levels of long-term unemployment will suppress wage gains and overall inflation until underemployment reverts closer to more normal levels, other labor experts are not so sure. With unemployment rates for the short-term unemployed already back to full employment levels, a number of Yellen's labor market "dashboard indicators" not far from normal levels and a self-described credit bubble, it is hard to imagine what the Fed is thinking in terms of an extended period of monetary accommodation.

In contrast to most observers, I thought global growth would disappoint. While investors were correct in foreseeing a synchronous recovery with the Eurozone and Japan moving into the positive growth column, they overlooked that growth would remain below historic levels in most regions. While the U.S. -2.8% growth shocker was weather induced, subsequently the economy has failed to snap back. Despite the tailwinds from rising asset values and reduced fiscal drag, consumers are restrained by continued deleveraging in a macro sense (they foresee that taxes will increase and/or entitlement benefits will be cut) and while capital spending by US firms has disappointed only because it has been shifted overseas. Elsewhere, 2015 growth is likely to slow in China and Japan, as current readings are somewhat misleading: China has once again tweaked fiscal spending to maintain a 7.5% growth rate; Japan's rate was buoyed by front-loaded consumption spending in front an increase in the sales tax.

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The Treasury market rally has wrong-footed many observers, including me, who thought that bond yields would continue to head higher in 2014. Instead, Ten-year Treasury bond yields from fallen from 3.03% to 2.47% this year; thirty year yields have fallen 70bp to 3.26%. Interestingly enough, the weather-induced first quarter growth surprise less a driver, then somewhat nebulous factors: the gravitational pull of record low Eurozone bond yields (German inflation-indexed bonds promise a negative real return); the suspicious footprints of Chinese reserve purchases of Treasuries (the Renminbi weakened as their Treasury bond holdings spiked); finally, the Fed's mark-down of long-term trend growth potential to 2% argued for lower equilibrium yields. To be fair, a 20bp decline in intermediate term inflation expectations to 2.45% lent some legitimate fundamental support to the Treasury rally.

In terms of the outlook for Fed policy and Treasury bond yields, the issue is less when the Fed first raises rates and more the pace of tightening after the initial rate increase, expected to be the first or second quarters of 2015. With full-employment (as conventionally defined) upon us by the end of 2015, it is hard not to see a positive real Fed rate. Given a not unreasonable 2% inflation assumption, Fed funds could be 2.5%-3.0% in eighteen months, roughly twice the current market expectation. Since Yellen has doubled down on extended monetary accommodation in the face of criticism from better informed central bankers and despite plunging unemployment rates, the risk is that markets force the Fed's hand and they find themselves leading from behind.

Recent tactical asset class shifts and manager allocations reflect my response to an unattractive investment opportunity set. Domestic equity valuations are suggestive of low single-digit returns and a high degree of risk. The equity investment environment is different, yet more challenging than the 2000 tech-bubble era: while there are only pockets of froth, in contrast to that time there are also no bargains. This is best evidenced by the aggregative equity market cap/GDP ratio, which is 10% higher than tech-bubble peaks; a reversion to the twenty year average would result in a 33% market decline. This downside risk, alongside record low levels of short selling, is a dangerous combination. Our internal research (on a stock by stock basis) suggests a less catastrophic outcome but is still alarming: valuations on both the S&P 100 and our actively managed default portfolio are within five percentage points of their all-time least attractive levels. Our work shows large cap stocks to be 20% overvalued, with projected index returns in the 3% range. This is reminiscent of early 2007, with a similarly valued market and a model portfolio with a large financial sector overweight. While the current model portfolio has a large overweight to seemingly defensive utility and telecom sectors, both may be vulnerable to a pick-up in interest rates.

International stocks are more attractively valued than US stocks, but are not significantly undervalued in an absolute sense at a 9.4X EV/EBITDA ratio (an unlevered cash earnings ratio) and a 2.75% yield. By comparison, USA stocks trade at 12.1X EV/EBITDA ratio and a 1.7% yield. Other metrics show a greater valuation disparity, reflective of either the amazingly high profit generating performance of US stocks or the risk that our profit margins revert to lower levels (probably a combination of the two): the US sells at 2.8X book value and 2.4X sales, metrics far above international levels of 1.6X and 1.0X. Not surprisingly, Eastern Europe (read Russia) is the cheapest region, trading at 4.0X EBITDA, 4.7% yield and 0.7X book value.

My two year overweight to emerging markets has been one of my worst tactical calls in fifteen years, as the group has lagged both domestic and developed international markets. While our international vehicles have outperformed over the period, due to active manager outperformance, I hate to be this wrong. To some extent, I am guilty of what I have accused the Fed of overlooking (the credit cycle) and also I failed to make appropriate analytic adjustments for the variations in sector mix by country. The takeaway is that emerging market stocks are much less undervalued than I had previously thought, particularly after the double digit rally thus far in 2014 (outperforming both US and developed markets). Accordingly, I am reducing emerging market exposure from a strong overweight to a modest overweight.

With municipal bonds outperforming even a strong Treasury market, I have reduced client exposure to the asset class to less than 85% of target, particularly in the high quality core segment. Within municipals, we are modestly tilting away from our barbell strategy, as both long-term Treasury yields the shortest term (less than two year) municipal yields have plummeted.

With even the Fed on-board with the high yield bond/leveraged loan bubble in the context of a global reach for yield, there is very little to do in the taxable fixed income credit space. With higher yielding municipal spreads grinding lower, expected returns are lower, but still higher after-tax than comparable taxable issues. While there has been a nice recovery in the emerging market local debt market, valuations are neutral and the sector is vulnerable to either dollar strength or risk-aversion. SFIF-Opportunity exposure has been reduced to 75% of strategic levels.

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July market perspectives continued.

Hedge funds are the default portfolio fallback in a world with such unattractive long-only opportunities. While both of our flagship funds were whipsawed in the first quarter, second quarter performance was much improved and the long-only performance bar is set a low levels. SUF is constructed to be a portfolio anchor, with dedicated short US stock and short high yield bond exposures.

Private equity (and private real estate) represent both unusual challenges and opportunities at present. On the one hand, for leveraged strategies, the cost of debt whether measured in nominal or real terms has rarely been so low. This results in a statistically wide "arbitrage gap" between the cost of borrowing and cash yields on either corporate assets. While the environment is indeed conducive to "doing deals" and earnings a near-term spread, the real risk is that both the spread and terminal values disappoint as borrowing costs increase and profit margins revert somewhat towards more normalized levels. While commercial real estate is less exposed to a reversion of profit margins, it has greater sensitivity to credit markets, both rates and spreads. While interest rates are the proximal cause, venture capital reflects excesses both at the seed level and the later stage rounds, where frothy public valuations lead public market investors to take on illiquidity risk and private company founders to raise more private funds at prices tied to inflated public valuations. While anticipating that our existing managers will seek to monetize investments and return capital near-term, our new manager commitments will be back-loaded from a timing sense and emphasize niche situations such as micro-cap European buyout and Chinese loan origination/bad loan strategies.

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