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Market Outlook & Strategy

First Quarter of 2014

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Executive Summary

- **After a stellar year in 2013, global equity markets got off to a slower start in the first quarter of 2014.** The U.S. equity market was the highest performer at +1.97%, with other developed market economies (Europe and developed Asia) gaining +0.75%.

- **International returns were negatively affected by Germany, which had a particularly poor quarter declining -1.29%** (EWG returns) due to its proximity to the Ukraine. Japan also struggled, declining by -5.1%. Emerging markets declined by -0.43%.

- **A surprising result of the quarter was that returns from corporate debt – both investment grade and high yield – were higher than global equities for the first time since mid-2012.** Even emerging market bonds, which yielded large, negative returns in 2013, rebounded sharply. They posted the highest returns of all fixed income segments (except long-dated U.S. Treasuries) at +3.9%.

- **The quarter ended on a high note, underpinned by some encouraging U.S. manufacturing data,** which suggested the sector is gradually recovering the weather-related disruption at the start of the year. Finally, **data out of Europe improved late in the quarter with the PMI (purchasing manager's index) showing its ninth consecutive month of expansion.**

- **This issue's special focus is on China's growing debt problems**. We conclude that while growth is likely to continue to slow in China, such a change does not represent a major macroeconomic risk to the U.S. and Europe. It does, however, imply that emerging market and commodities investors are likely to continue to be disappointed over the next couple of years.

- **We are not making any substantive changes to our portfolios currently,** although we are lightening up a bit on smaller company stocks in the U.S. in favor of their brethren in Europe, where we believe there is still room to run. We have no immediate plans to adjust our fixed income strategy.

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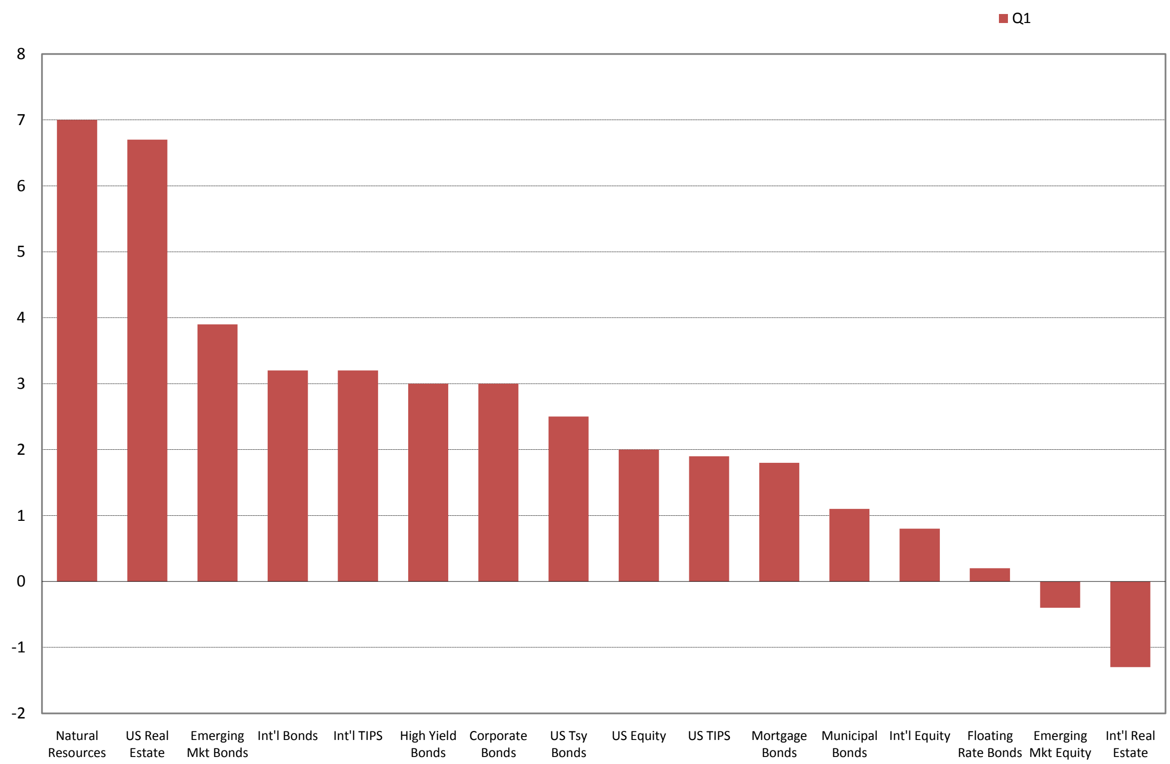
Markets in Review

After a stellar year in 2013, global equity markets got off to a slower start in the first quarter of 2014. The U.S. equity market was the highest performer at +1.97%, with other developed market economies (Europe and developed Asia) gaining +0.75%. International returns were negatively affected by Germany, which had a particularly poor quarter, declining -1.29% (EWG returns) due to its proximity to the Ukraine. Japan also struggled, declining by -5.1%. Finally, emerging markets declined by -0.43%. See Figure 1.

Figure 1: Asset Class Performance in Q1 2014 (percentage points)



These relatively muted returns were, by and large, due to market volatility in late January, when the S&P 500 fell by -5.6% in eight trading days for no apparent reasons other than worries over the impact of the Fed's tapering and a general belief that equities were overdue for a correction. Nevertheless, the market rebounded quite quickly, ending February above its prior year-to-date peak value, and continued its upswing through March.

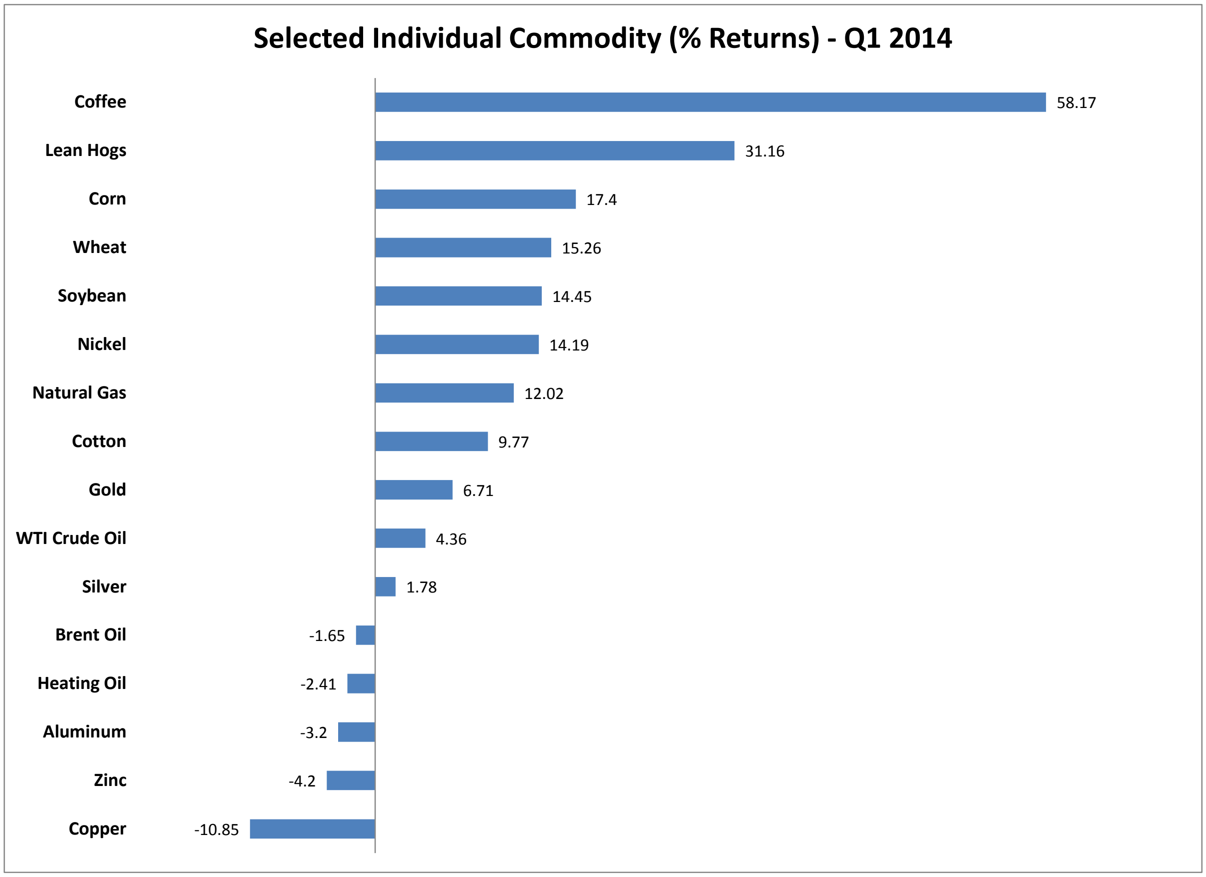
One surprise was a late-quarter rally in emerging market equity (+3.6% in March and more into April). As I have written about before, during the past year, emerging markets have been periodically whip-lashed by concerns about Chinese growth, U.S. tapering, political unrest and lack of sufficient labor and financial market reforms. I am doubtful this rally will be long-lasting, particularly considering the ongoing challenges in China (see next section for more on this), and the lack of real progress in implementing structural reforms to accelerate growth. Indeed, some analysts speculate that the rally in emerging market stocks is largely due to traders unwinding their short emerging markets / long U.S. stocks positions as high-flying U.S. stocks begin to correct. **In short, without a material change in emerging market fundamentals, it is tough to argue the rally will persist**.

Perhaps the most surprising result of the quarter was that returns from corporate debt – both investment grade and high yield – were higher than global equities for the first time since mid-2012. Even emerging market bonds, which yielded large, negative returns in 2013, rebounded sharply posting the highest returns of all fixed income segments (except long-dated U.S. Treasuries) at +3.9%. These results are certainly counter to most analysts' predictions (including yours truly) that stock returns would leave bonds trailing again in 2014. The main cause appears not to have been the Ukrainian crisis, as the only month the S&P declined and fixed income got maximum boost was in January, before the crisis unfolded. My guess is that harsh weather and anxiety over whether company profits were going to decline had folks rotating into safer bets.

Another nice surprise was that U.S. real estate and commodities both had very high returns at 10.4% (equity REIT returns only) and 7.0%, respectively. The latter was in part due to soaring agricultural commodity prices, which does not bode well for future inflation, especially in developing countries. (See Figure 2 next page.)

Fortunately, the quarter ended on a high note, underpinned by some encouraging U.S. manufacturing data, which suggested the sector is gradually recovering the weather-related disruptions at the start of the year. Janet Yellen, the new Federal Reserve chairwomen, helped as well by offering some reassurance that U.S. monetary policy would remain accommodative for some time to come. **Finally, data out of Europe improved late in the quarter, with the PMI (purchasing manager's index) showing its ninth consecutive month of expansion.**

Figure 2



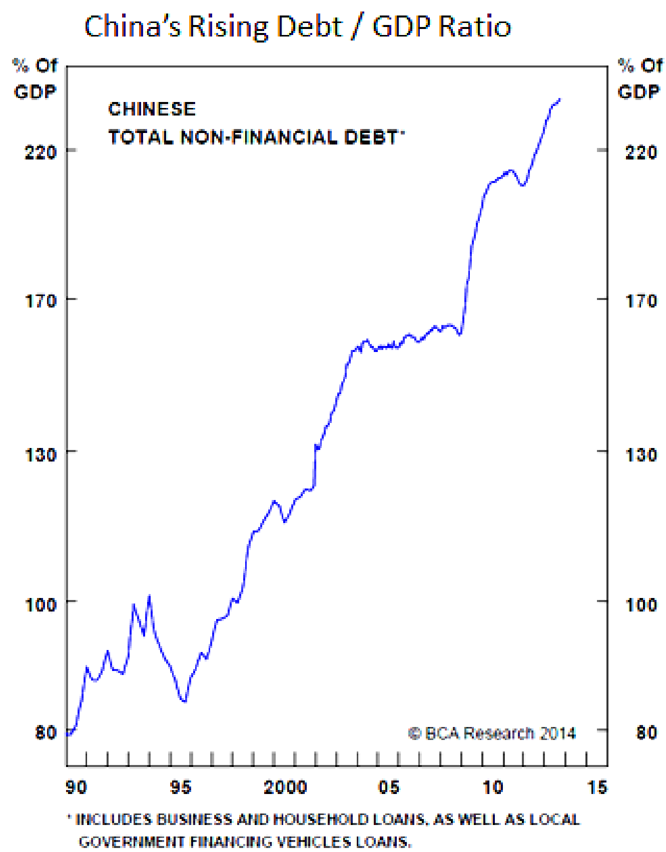
Source: Dow Jones

What's Going On in China?

For those of you who read financial news, you will have no doubt noticed many experts voicing concerns about China. The bad news includes the country's first corporate bond default in recent history, and more recently, the collapse of a highly indebted real estate developer. While the odd default or bankruptcy is hardly anything to worry about, **these issues are arising at a time when China's *private and local government* sector debt/GDP ratio has surged to almost 230%, making China one of the most indebted countries in the world. (See Figure 3.)**

The spate of bad news has prompted some commentators to go as far as suggesting that China could soon be facing a Lehman Brothers moment — that terrible moment in which liquidity suddenly dries up, credit stops flowing, one or more financial institutions moves to the verge of collapse and panic ensues. In the past few years, China has racked up a large amount of debt. Starting in 2009, to offset the potential effects of the global financial crisis, the government encouraged a huge credit boom. The credit was largely used to finance real estate construction and infrastructure, helping China grow 45% from the end of 2008 to 2013.

Figure 3



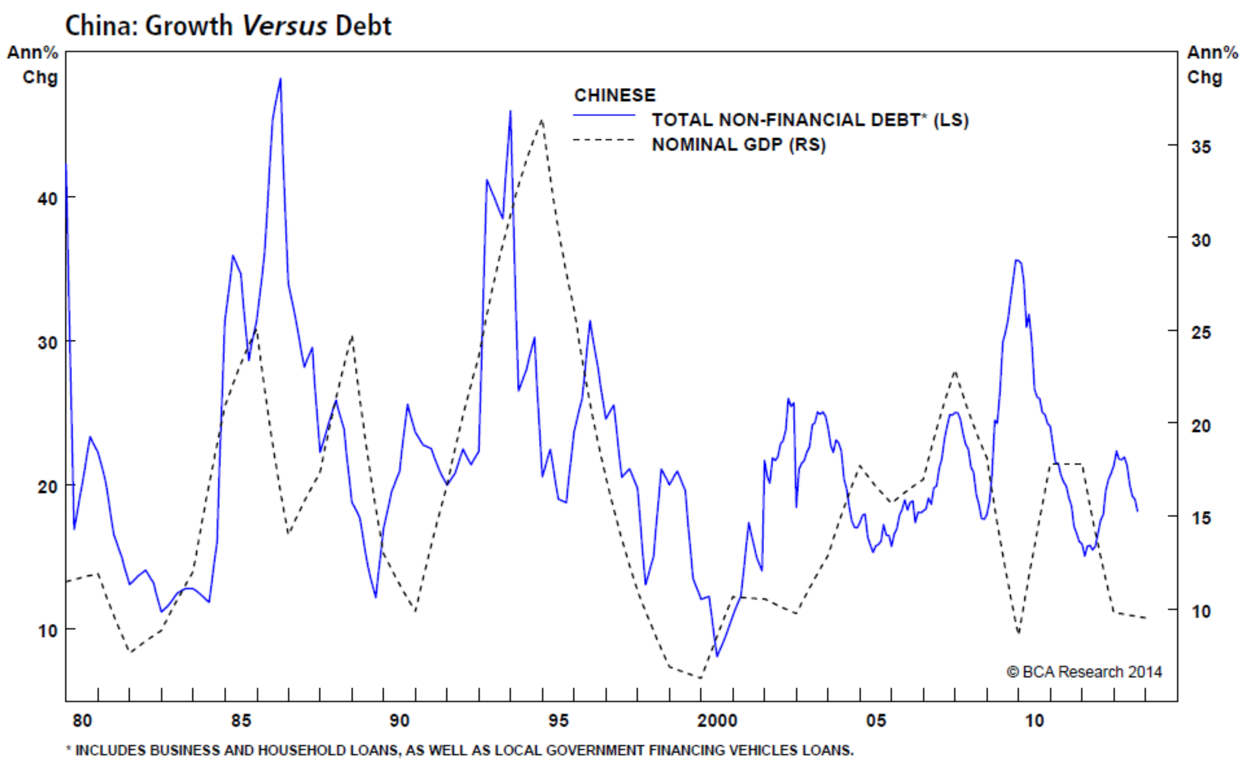
Source: BCA Research

Chen Zhau of BCA Research[1] argues that we should not be overly concerned. He reminds us that debt (or equity ownership) occurs because savings must be translated into

[1] Zhao, Chen. "Special Report: Is China on a Precipice?" BCA Research. March 14, 2014

investment, and China's domestic savings rate is a whopping 50% of GDP. Unlike the U.S., the Chinese equity market is not as well developed and so the country must rely on banks to lend for financial intermediation. Therefore, savings, investment, borrowing activity and GDP growth are all strongly positively correlated. Figure 4 shows the strong relationship between debt and nominal GDP in China.

Figure 4



Source: BCA Research

While the above may be true, the debt/GDP ratio can't keep rising forever. The real question is not whether is will stop, but how and when. Fortunately, the Chinese government has the ability to react. Unlike most developed economies, the central government is not overly indebted and could easily bail out any institutions that find themselves in trouble. Indeed, **if one adds the vast foreign exchange reserves held by the government, the net debt position of the Chinese central government is actually negative, running at roughly -18% of GDP.** (By comparison, the net debt/GDP ratio for the U.S. public sector is about 90%.) **Thus, if liquidity dries up like it did in 2008 in the U.S. and elsewhere, the Chinese Central Bank can easily supply it.** In addition, unlike many other developing countries, China still has exchange controls so domestic investors cannot just take their money and run.

For all of these reasons, there is a strong argument to be made that China is not going to spin out of control. **But this doesn't mean there won't be winners and losers.** One of the more serious problems in China is that the so-called shadow-banking sector (which grew rapidly to circumvent interest-rate controls) has not been subject to sufficient oversight. Recently, the Chinese government stated that the shadow-bank financial instruments (including so-called "wealth management products" financing real estate and trust products) will not be bailed out. **Thus, a slowdown in Chinese credit growth seems inevitable, and true GDP growth could easily turn out below the 7.5% target the Chinese government has set for 2014.**

Another area of concern is that rising debt and mediocre growth may signal a misallocation of capital. The reason is that when debtors have insufficient cash flow to service or retire their debt, they have to borrow more to service their old debts. If numerous debtors do this, credit growth will be robust, but output growth will disappoint as the credit growth is not financing new business. To avert this problem, either bailouts and / or some stimulus are required.

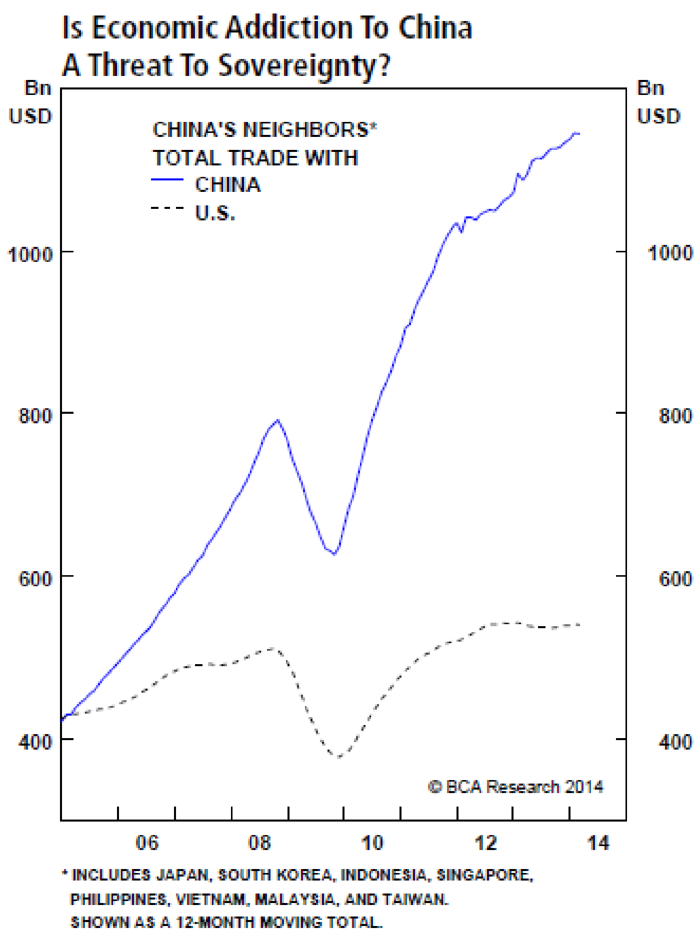
Thus, a vital question on investors' minds is when and how the Chinese government will respond to the economic weakness. In early April, Chinese authorities did announce a few mini-stimulus measures, including accelerating the construction of rail lines and lower taxes on smaller companies. The issue is that even with reasonable assumptions, analysts project that the potential size of the required fiscal stimulus or state-directed credit injections at near 10% of GDP. The above announcements only scratch the surface.

Should we be concerned? First, it pays to remember that China is still only a small portion of the world economy. According to the IMF, world GDP was $73.5 trillion at the end of 2013, while China's GDP was about $9 trillion, or 12% of the total. China's main link with the rest of the world is through trade with China's merchandise imports accounting for nearly 10% of the world's imports.

Fortunately, the U.S. and Europe export relatively little to China, so the direct impact on them would be small if China were to have a so-called hard-landing**. Asia would bear much more pain. In general, many of China's neighbors would feel the most pain (Figure 5), as would those countries which export raw materials to China (primarily resource-based countries in Latin America and Africa, as well as Australia and New Zealand).** And investors in commodities directly are likely to continue to be disappointed for at least a few more years.

All of the above points to the continued need (in my view) to be skeptical about the durability of the nascent emerging market equity and commodities rally.

Figure 5



Source: BCA Research

Artemis Strategy

Last quarter I wrote that I believed equity was going to outperform fixed income again in 2014, and therefore I was going to continue to overweight risk assets (equity and real estate) in client portfolios. Despite the results we have seen thus far in 2014, I still believe this to be true for the year in total, and I am not inclined to adjust our current exposure.

The bull(ish) case for equities largely comes down to expectations of a stronger U.S. economy later in the year; monetary policy remaining highly supportive; and the steady return of the U.S. consumer. Recent data support these drivers: retail sales appear to be rebounding nicely after the harsh winter; Janet Yellen is going out of her way to reiterate the Fed's strategy of continued stimulus; and Q1 corporate earnings announcements to date are not too bad.

I do think small company stocks in the U.S. are richly valued now, having increased by over 40% in 2013, and so I am lightening up in this category in favor of increased exposure to Europe, which I believe has further to run. And as I also said last quarter, we are not diving into Japan.

There has been a lot of recent press about whether credit markets are getting frothy. Seth Klarman's quarterly letter to his investors (Seth Klarman is a highly respected manager of the Baupost Group, a Boston-based hedge fund), stated "a sceptic would have to be blind not to see bubbles inflating in junk-bond issuance, credit quality and yields." But for the market to collapse, one of two things needs to happen: either the economy needs to deteriorate sharply, or a group of investors have to turn into forced sellers.

In terms of the economy, the U.S. economy is steadily growing, with no signs of a recession around the corner. Moreover, the Fed has signaled that it has no intention to increase interest rates this year. And there is no sign of default stress – indeed, the default rate on high-yield debt was only 2.9% last year. That compares with a long-term average of 4.7%. Moreover, the credit-rating agency Moody's is predicting a default rate for junk bonds of only 2.2% this year.

In summary, despite some counter-intuitive results in the fixed income sector in Q1, we remain confident that the credit-sensitive segments of the market will continue to perform nicely for a little while longer at least.