NOW'S A
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GOOD ADVICE

Diversification Normalizes

Inter-market relationships have begun to normalize this year. The asset classes that performed poorly in 2013 are the best performers in 2014. While the S&P 500 is up slightly for the year, the DJIA is down; our multi-asset approach has done nicely: fixed income, REITs, gold and natural resources are all up in 2014. International equities are slightly underperforming the S&P.

In our last economic outlook letter we outlined our expectations for a topping process in the U.S. Equity market that could run through March of this year. Currently, market internals still support this expectation, so investors should remain prepared for a 20% or greater correction sometime in 2014. In addition to the risk of a decline, there is very little upside to be found in U.S. Equities. The risk of a correction is not a problem for other asset classes where the declines have already occurred.

World/US Economy

While world growth has stabilized at a low level, less than 2%; there are no indications that it will re-accelerate anytime soon. Developing nations are growing around 3%, developed economies at 1.5% and Eastern Europe 1% [1] China's growth may be less than the 7.5% forecasters are expecting. Recently Chinese exports declined 18% from a year earlier.

The U.S. economy continues to grow at less than 2%, in line with the average 1.9% growth rate since 2009. Consumer spending is subdued and the housing recovery is stalling. Exports remain vulnerable to ongoing economic weakness occurring with trading partners. Leading economic

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indicators for the U.S have been weakening since December. They are now at the lowest level since 2012, even as the stock market has gained 35%! There is a huge disconnect between the liquidity driven stock market and the reality of subpar economic growth.

Ukraine

Outcomes for financial markets in response to geopolitical events cannot be known over the short term. In most cases the responses tend to be short lived and mostly psychological in nature. However, if markets are already fundamentally and technically vulnerable, geopolitical event escalation can lead to a stock market decline. Were this to occur, our positions in gold and bonds will prove defensive and should be safe havens. So far markets have brushed aside any concerns over an "invasion", but that could change rapidly. How the Ukraine government, Europe and the U.S. react could well be a turning point as it is inconceivable that Putin will withdraw from Crimea. While this may be the catalyst for the 20% correction we are looking for, we would tilt the probabilities to a peaceful solution – in this case, Western acquiescence in the annexation of Crimea and the creation of a new national unity government in Kiev acceptable to Putin. We will be monitoring the situation closely.

Emerging Markets Turmoil

All equity markets dropped sharply in January, primarily because of emerging markets turmoil, with particular concerns surrounding slowing economies in China and India. While developed stock markets came back in February, emerging markets continued to lag. We do not expect investors' concern over emerging countries will go away any time soon. The Bank Credit Analyst suggests a case that many of these economies will slip into a growth recession (A growth recession refers to very low but still positive GDP growth} this year. In addition, BCA thinks consumer spending will decelerate and capital investment will likely contract. Political uncertainty and volatility will weigh on both domestic spending and investor sentiment. Slowing developing markets will have a non-trivial impact on global growth. The developing world is no longer a small part of the global economy, it now accounts for 40% of world import demand compared to 23% in 1999 (the last time there was an emerging market crises). These economies will be a headwind for the developed world. U.S corporations have considerable exposure as well; in 2011, 34% of the sales of U.S. multinationals majority owned affiliates were in emerging markets up from 25% in 2000.[2] It is too early to make a big bet on emerging market stock markets and further deterioration in their economies could be a catalyst for declines in the developing world stock markets.

Asset Allocation

Currently we are underweight cash and U.S. stocks and overweight fixed income, REITs, gold, natural resources and international equities (avoiding emerging markets). The U.S. market has limited upside potential and significant downside risk. For our U.S. holdings, we favor health care, biotechnology, utilities, technology and materials. We are concerned about bubbles in some sectors. For example, prices of "social network" stocks have exploded in recent months. These high-flyers are trading at 12-13 X sales (sales not earnings), and their average P/E ratio is almost infinite, as most of these companies have little or no earnings as of yet. In addition, over the past six months, nearly 75% of all IPOs (Initial Public Offerings) announced in the U.S. were money-losing companies and still went up in price after their offering. This is eclipsed only in early 2000 in the past 25 years of history.[3]

Also, in our most recent outlook, we argued that the biggest surprise in 2014 would be bond prices rallying and interest rates declining. Virtually no one thought it would happen, but it did; fixed income is doing quite nicely this year and we think there is additional upside for prices from current levels. We favor Treasury bonds or Treasury bond ETFs because: we foresee slow economic growth in coming quarters; they are attractive to pension funds and life insurers for matching their liabilities; and they are a safe haven in a sea of global trouble. We also favor municipal bonds which sold off because of Detroit's bankruptcy and troubles in Puerto Rico. We do not recommend high yield bonds at this time.

Lower interest rates have been good for REITs. We prefer apartment and residential REITs. Investor concerns over slowing cash flow growth from increased residential property supply eased as results were less negative than feared. Apartment and residential REITs also show a meaningful discount to private-market property values. If the market continues to price REIT properties below what they are worth in the private arena, REITs will look for strategic alternatives to realize the value of their assets. REITs have also been a safe haven play in times of market turbulence.

Gold and gold stocks have been the big winners this year. Gold bullion is up 11.2% and gold stocks are up 23%. Gold has started a new cyclical bull market that could last another twelve months or longer. Geopolitical instability is positive for gold, particularly when the major powers are at odds. Demand for physical gold (coins, bars and jewelry) increased throughout 2013 and into 2014. China is now the world's largest gold buyer. There are rumors that the Bank of China stockpiled 500 tons of gold during the recent price weakness. China and India combined now account for 55% of world-wide demand in jewelry, coin, and bar consumption. China's gold imports averaged more than 100 tons per month in 2013 – a first that even India cannot claim. Gold bullion prices declined in 2013 because of excessive investment supply due to ETFs selling their positions. In January, gold ETFs bought gold for the first time in a year instead of selling it.[4]

Natural resources and natural resource stocks topped out in 2010. They have massively under-performed the relentless gain in stock prices since then and are now starting to rebound from deeply oversold levels. We do not think they are entering a new cyclical bull market because world growth is too tepid, nevertheless we do believe they could have a good year in 2014 in a counter cyclical rally. The main bearish case for commodities is that China is slowing down. While this is true, it is important to remember that China's intake of commodities will remain large in absolute terms, because the size of the economy is so much bigger than ten years ago.

International equities are a mixed bag. Latin America, Japan and Eastern European markets are underperforming the U.S. market. Peripheral Europe (Spain, Italy and Sweden) is up but France and Germany are down. Europe is attractive but Crimea is an issue. Consumer spending has improved and manufacturing surveys are pointing toward expansion. European equities are selling at discount to historical averages and all sectors except Materials are trading below their historical medians.

Summary

The global economy has stabilized at a growth rate less than 2%. The asset classes that performed poorly in 2013 are doing much better in 2014: fixed income, REITs, gold, and natural resources. International equities are slightly underperforming the U.S. market. We recommend over weighting the areas above and under weighting cash and the U.S. stock market. We believe a new cyclical bull market in gold and gold stocks is underway. Gold, along with fixed income, can become a safe haven in troublesome times. We foresee a 20% correction in the U.S. market will occur in 2014 and in the meantime we await confirmation that momentum has turned decisively negative; it is too early to get overly bearish in equities.

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[1] *Cass Research Associates*
[2] *www.bcaresearch.com*
[3] *www.bcaresearch.com*
[4] *www.gold.org*

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