GRESHAM

# 2013 Mid-Year Review

## Still Floating

Central banks around the world continue their experimental monetary policies in response to slow economic growth in the aftermath of the financial crisis nearly five years ago. These extraordinary policies were likely beneficial in staving off a deeper economic downturn and possible financial collapse in the post-crisis period, but appears to be only marginally helping economic growth today. While little of this liquidity is making its way into the real economy, it is working its way into asset markets, creating elevated valuations in many markets. These increasing valuations have helped investors benefit over the last several years and we believe these policies are likely to continue for the foreseeable future despite recent central bank rhetoric about "tapering" their support. Indeed, investors are still floating in a sea of liquidity.

## Summary

Since the writing of our Annual Outlook earlier this year, a few things have changed, but many of the larger secular forces continue unabated. The global economy continues to limp along at subdued growth rates. This rather lethargic progress masks wide divergences in economic health around the globe, leading Christine Lagarde, Managing Director of the International Monetary Fund, to frame global growth as a "three-speed world." Relatively fast growing emerging market economies continue to be the locomotive for the global economy. At the opposite end of the spectrum is Europe, which is mired in a recession that continues to underperform even the most pessimistic projections. In the middle is the U.S., whose growth rate lags all previous recoveries, but is the beneficiary of several encouraging structural tailwinds that are giving investors hope for a sustainable recovery.

Central Banks continue the largest monetary experiment in history, which is only growing larger with the Bank of Japan's decision to join the U.S., Europe and the U.K. in their loose money policies. While these efforts most likely staved-off a severe depression at the onset of the financial crisis, real economic growth benefits remain somewhat limited. We continue to caution investors that while little of this liquidity is making its way into the real economy, it is flowing into capital markets, leading to distorted prices and increasing risks to investors. Unfortunately, the longer accommodative central bank policies remain in place, the higher asset prices are likely to climb and the more investors will face an increasing risk of loss.

Equity markets, during the first half of the year, have generally been positive with the notable exception of emerging markets, including China, which many find an ironic outcome given their higher economic growth rates. On the other hand, fixed income markets declined during the first half of the year in response to Federal Reserve Chairman Ben Bernanke's comments that the U.S. Federal Reserve would begin to "taper" its asset purchases. The sharp sell-off may have given investors a small preview of the downside risk that can come from even the slightest hint at the draining of this liquidity. However, by the end of the second quarter, equity markets were once again testing all-time highs.

As we noted in our Annual Outlook, we believe investment opportunities exist despite increasing prices and risks. Many of our core investment themes remain unchanged despite valuation changes over the past six months.

- Most importantly, investors need to be mindful of risks in absolute terms. Looking at investment opportunities in relative terms can be quite dangerous when asset prices are distorted and risks are elevated. A good example of this can be found in high-yield debt securities, which are generally priced on a relative spread to Treasury bonds, which are still trading near record low yield levels.

- Our long-standing under-weight to fixed income continues to benefit investors, particularly in the second quarter, as Treasury bonds experienced one of the strongest sell-offs in their history. Despite higher yields, we continue to believe the rewards (yields and the potential for appreciation) remain uninspiring relative to the risks involved. Investors should remain underweight, despite the potential for short-term reversals of the recent sell-off.

- Emerging market equities continue to underperform and, hence, have become relatively more attractive, particularly given the higher growth rates available in some of these investments. Active management continues to prove very effective as a result of poorly constructed emerging market indices and the relative inefficiency of these markets.

- European equities also appear relatively attractive. However, we remain cautious as the deep recession is having a significant impact on the top-line revenue of many domestically focused companies. Security selection and active management is important for successful investments in these markets.

- Private equity remains a key long-term driver of portfolio returns for those with the ability to accept the illiquidity. Perhaps no asset class is more emblematic of the significant impact effective active management can have on return generation. As we discussed in our Annual Outlook, we remain interested in China, particularly in the venture and growth capital areas, but are balancing our portfolio back toward U.S. opportunities.

- We believe the potential for inflation remains high, but still off in the future. As a result, investors should maintain relatively modest exposure to inflation sensitive investments such as commodities, due to the potential for ongoing price declines and weak performance. Alternatively, we believe non-marketable exposure in this area, such as private real estate and natural resources investments, can produce reasonable returns so that investors who maintain higher exposures will be rewarded should inflation accelerate without incurring a substantial return penalty while they wait.

## Capital Markets

The most important development in capital markets during the past two quarters came in response to Federal Reserve Chairman Ben Bernanke's comments about the possibility of the Federal Reserve "tapering" its purchase of fixed income securities. As one analyst put it, "The financial markets have now seen what a world without quantitative easing is going to look like, and they don't like what they see one bit." In fact the mere mention of only a modest reduction in central bank support triggered one of the biggest sell-offs in bond market history. While it is unclear whether this was a temporary tremor or the canary in the coal mine presaging the deflation of asset markets, it is clear that investors have become addicted to the liquidity provided by central bank policies and the inflated asset values it is creating.

Despite the recent sell-off, the mood of equity investors at the end of the quarter appears positively buoyant. Renewed faith in accommodative central bank policies and some back-tracking by Fed officials

Chart 1. Implied Volatility Returns to Historically Low Level


Source: Bloomberg

Chart 2. Market Returns and Valuations

| | | Performance | | | Valuations | |
|---|---|---|---|---|---|---|
| | | 1st half | Annualized | | Price/Earnings | |
| Market | Index | 2013 | 3 Year | 5 Year | June 2013 | Dec. 2012 |
| U.S. Equity | S&P 500 | 13.8 | 18.5 | 7.0 | 14.6x | 12.7x |
| International Equity | MSCI AC World ex U.S. | 0.0 | 8.0 | -0.8 | 12.3x | 14.8x |
| Emerging Market Equity | MSCI Emerging Markets | -9.6 | 3.4 | -0.4 | 10.1x | 10.6x |
| | | | | | Spread vs. Treasuries | |
| U.S. High Yield Bonds | Barclays High Yield Corporate Bond | 1.4 | 10.7 | 10.9 | 537 bps | 549 bps |
| Emerging Market Bonds | JP Morgan Emerging Market Bond | -7.6 | 8.0 | 8.8 | 292 bps | 271 bps |
| Municipal Bonds | Barclays Mgd Money Short/Int | -1.9 | 3.3 | 4.7 | 88 bps | 73 bps |
| Hedge Funds | HFRI Fund Weighted | 3.6 | 4.9 | 2.5 | | |
| Conservative Hedge Funds | HFRI FOF Conservative | 3.3 | 2.9 | -0.6 | | |
| Commodities | Dow Jones UBS Commodity | -10.5 | -0.3 | -11.6 | | |
| Gold | Spot Price of Gold | -26.3 | -1.6 | 5.0 | | |

Source: Bloomberg, Morgan Stanley, JP Morgan, Hedge Fund Research.

on "tapering" appeared to calm fears of a renewed financial crisis, leading to a sharp rebound in U.S. equity markets. As we write this update, many U.S. equity indices have surpassed their all-time highs and the VIX, a measure of implied volatility in the equity market or what some have called the "fear index", is reaching lows not seen since before the financial crisis as shown in Chart 1.

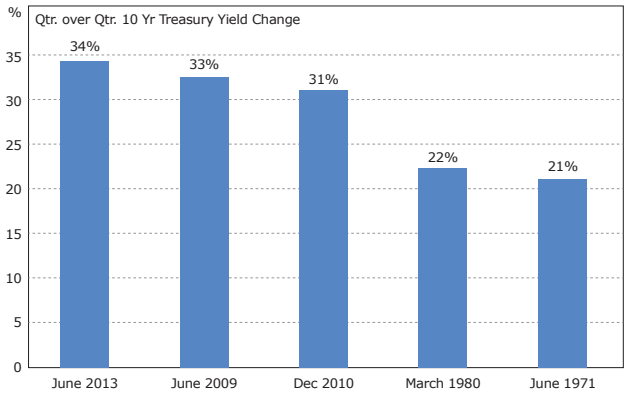
However, the story is less positive when we look beyond the U.S. equity markets as we can see in Chart 2. Global equity markets increased over 6% during the first half of the year, but we witnessed interesting divergences across markets. On the positive side, the U.S. and Japan have been key drivers of first half gains, as the S&P 500 gained nearly 14% and Japanese stocks climbed nearly 12% in U.S. dollars terms and nearly 34% in yen. On the not so positive side, Europe gained just over 2% and emerging market equities declined nearly 10% during the first half of the year.

Further, fixed income markets, which were the epicenter of the declines in response to fears of tapering, failed to recover their losses. The yield on the ten year bond increased from 1.6% to 2.5% in less than two months, which is the sharpest price decline in both absolute and percentage terms in history, as shown in Chart 3. Losses in bond markets were not isolated to Treasuries, as corporate bonds, high yield bonds, emerging market debt and even municipal bonds declined. It is too early to say if this is merely a blip that will recover in sympathy with the rebound in equity markets or if this is the beginning of a longer unwinding of artificially supported debt markets.

## Central Banks: Tapering?

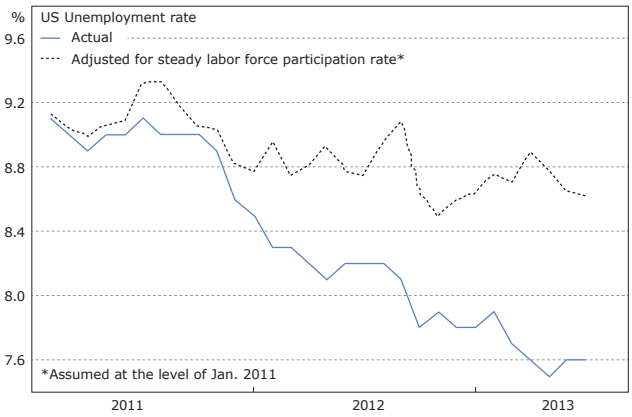
In late May, Fed Chairman Ben Bernanke triggered a minor market panic by raising the possibility that the Federal Reserve would begin to "taper" their bond buying activity. He and other Federal Reserve Board members spent the next month trying to clean up the mess he created by back-pedaling or softening many of his original comments.

Chart 3. Recent Bond Price Decline is Largest in History




Source: Bloomberg

Chart 4. Decline in Unemployment is Due to Decreasing Labor Force Participation



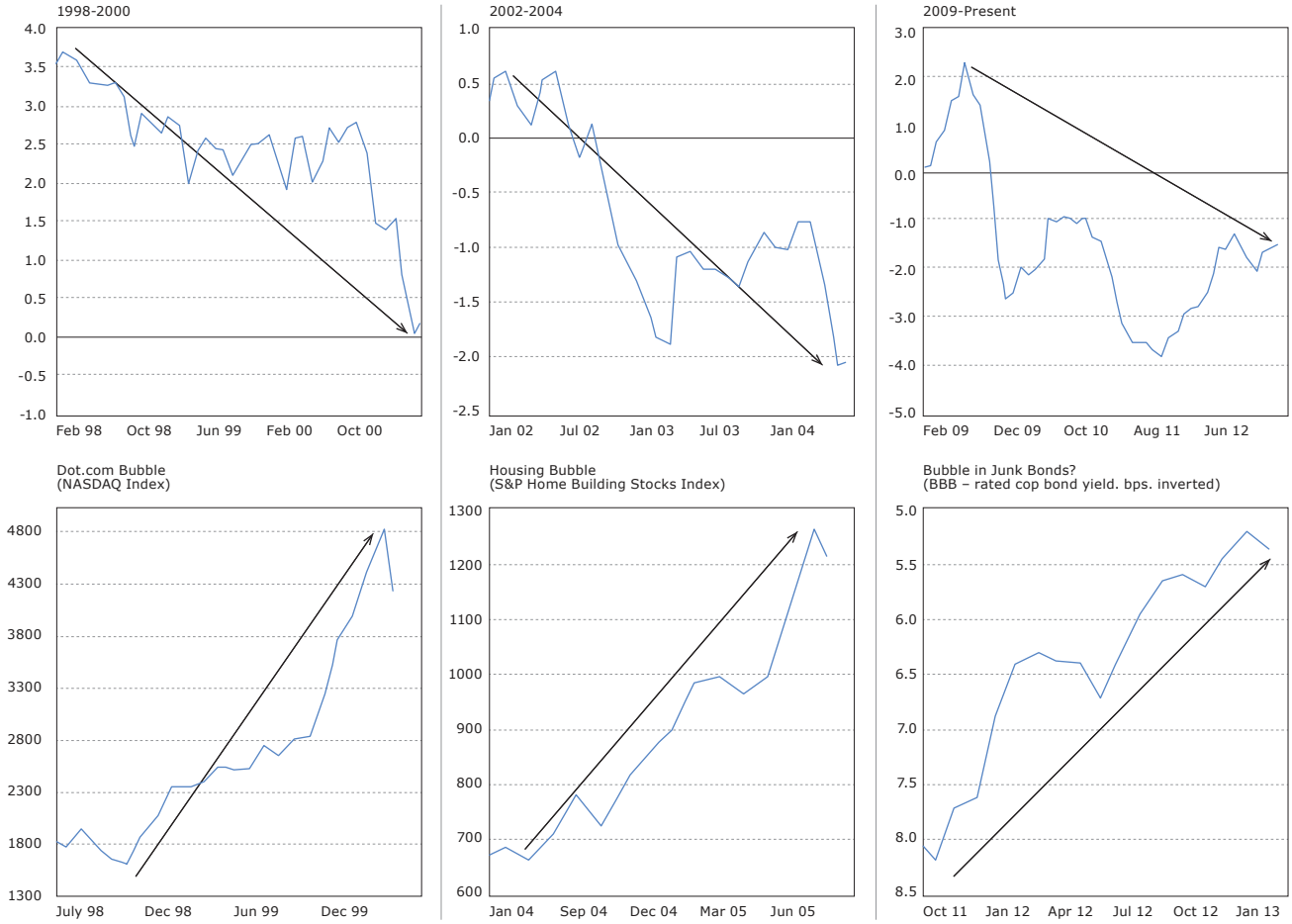

Source: BCA Research

While there is no way to predict with certainty what course they will pursue, the reality is that world economic growth is anemic and unbalanced. Further, employment remains weak, particularly when we account for frustrated job seekers who have stopped looking for work (as shown in Chart 4) and inflation appears well in check, providing the room required to pursue accommodative policies for the foreseeable future.

However, our primary concern with these policies remains. While limited central bank liquidity is making its way into the real economy to spur growth, it is flowing into asset prices. As we have discussed in the past, the Federal Reserve is still scheduled to purchase an amount nearly equivalent to all of the entire net debt

Chart 5. Excessive Easing Policies Encourages Asset Bubbles

Top charts show short-term real interest rates: 3 month Treasury Yield minus CPI YoY
Bottom charts show related asset bubbles.




Source: Haver Analytics, Gluskin Sheff

issuance in the U.S. in 2013, creating massive price distortions. While the effect is less direct in other markets, liquidity continues to inflate asset prices. Unfortunately, the history of accommodative central bank policy periods, the most recent of which are shown in Chart 5, have led to similar asset bubbles, none of which have ended well for investors who chase them.

## How Real is The Recovery?

Capital markets have been fueled by central bank liquidity, increasing valuation and risk in many markets. Have they gone too far? In our opinion that answer will depend less on whether the market's price-to earnings ratio or other valuation metrics are considered fair and more on the sustainability of the economic recovery. In other words: "How real is the economic recovery?" or can the post-crash economy continue to improve and justify the asset values we see in many markets?

Most analysts now believe U.S. equity markets have moved above fair value, but opinions vary as to the degree of overvaluation. If economic and corporate earnings growth is sustained or even accelerates, equity markets are likely somewhere near fair value or even attractive. On the other hand, if growth slows, dragging down corporate profitability and earnings growth, some equity markets appear to be expensive and at risk for a correction.

While corporate earnings can be difficult to project, the risk of disappointment is real. Over the last

three quarters, corporate earnings growth has been essentially flat. In fact, total quarterly earnings of the S&P 500 have yet to get back to their peak in the first quarter of 2012. Initial earnings reports this quarter continue to confirm this trend. Most concerning to us is that analysts are still projecting double digit growth rates for the second half of the year and into 2014. These are the estimates on which current market valuations are built.

The good news is that while central bank support remains in place, investors will likely be able to defer this question, as liquidity will support markets to some degree. On the other hand, should discussion of central bank tapering or other forms of tightening re-emerge, this question of the strength of the recovery will move back to center stage and the U.S. equity market will need to stand on its own.

We have often highlighted the negative side of the economic growth discussion to ensure investors understand the risks they face, but in the interest of balance and fairness, it is worth noting that the U.S. appears to have several structural forces that provide a foundation for optimism over the long-run. The U.S. energy market appears be reaching a significant inflection point as a result of shale oil and gas extraction technologies. This will provide domestic corporations and non-domestic corporations who locate manufacturing facilities in the U.S. with a significant cost advantage and incentives to create jobs and income. Additionally, U.S. technological innovation keeps the U.S. well ahead of other countries and provides a consistent productivity edge, and, finally, the U.S. banking system has been recapitalized and is well on its way to recovery.

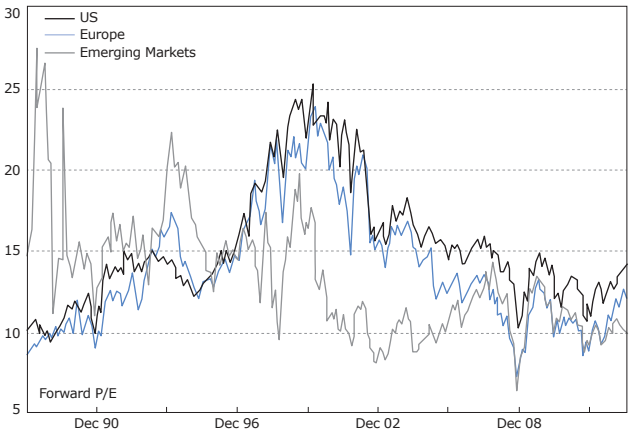
The question is not as clear for European investors, as little economic growth exists in these markets. Fortunately, the valuation of these markets is well below that of the U.S., as performance has lagged significantly. Over the last three years, U.S. stocks have increased at over 18% per year, whereas international stocks have increased at a more modest 10% per year. As a result, valuations of European equities have become relatively more attractive, as shown in Chart 6.

Emerging markets are particularly unusual in this regard. Despite much higher economic growth in many of these countries, emerging market equities over the last three years have increased just over 3% per year, lagging both U.S. and European markets. We believe this is creating an ever more compelling opportunity for investors to increase their allocation to these markets as discussed below in the Investment Themes section.

## China Questions

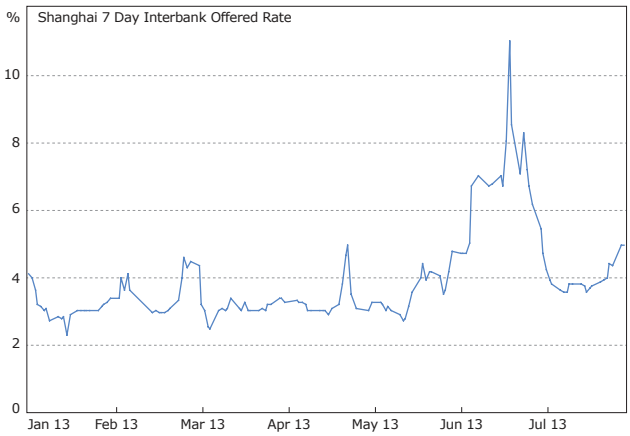
Many concerns in the emerging markets center on China, with its transformation to a more consumption-oriented

Chart 6. Europe and Emerging Market Equity Valuations are Relatively Attractive




Source: IBES, MSCI, Datastream, Morgan Stanley Research

Chart 7. Liquidity Squeeze in Chinese Banking System




Source: Bloomberg

economy and the increased debt levels accrued during the stimulus efforts of the last recession. These are all valid concerns. The good news is that the current leadership in China appears determined to pursue the needed reforms in the financial system to facilitate this transition. However, reforms of this magnitude rarely progress smoothly. For example, the Chinese banking system experienced a brief liquidity squeeze that scared a number of market participants, as shown in Chart 7. Additionally, we expect many older, inefficient state-owned enterprises will require significant restructuring and/or deleveraging throughout this transition as well. These disruptions will create both market volatility and investment opportunity. Carefully implemented active management (i.e. company selection) both in liquid markets and private equity will be crucial to surviving volatility and capturing opportunities.

## Investment Themes

### Fixed Income - Remains a Concern

For several years, we have recommended that investors underweight fixed income due to the uninspiring risk/reward relationship brought about by artificially suppressed interest rates. In 2012, this was beneficial to investors as equity investments and other growth oriented investments significantly outperformed bonds. In the first half of 2013, the downside risk in fixed income came to the fore, causing significant losses for investors as bond markets declined.

Today, even after the price declines we experienced in the second quarter, which saw the yield on the 10-year Treasury bond increased from 1.6% to 2.5%, we still believe that bonds offer an uninspiring risk/reward proposition. We will likely maintain our negative view of the sector until the Federal Reserve unwinds its stimulus policies and/or bonds reprice to more normal levels that will create real (inflation adjusted) return expectations more consistent with historical norms.

In the face of the recent bankruptcy filing by the city of Detroit, it is worth noting that our negative view on fixed income is driven more by low return expectations than general credit concerns in the municipal market. We believe that some municipal credits will continue to suffer under the burden of reduced tax receipts and increasing pension and healthcare obligations, but defaults and significant downgrades will be the exception, not the rule. However, due to the diverging credit fundamentals, we believe sound fundamental credit research capabilities and selective investments are critical to success in this area.

### Equity Markets - Divergent Valuation and Opportunities

U.S. equity markets have continued to deliver strong returns over the last several years. In doing so, valuation metrics, such as P/E ratios, have become more expensive as price increases have begun to outstrip earnings growth. As we discussed earlier, the central question for investors is whether economic growth and corporate profits can sustain their growth rates, particularly if the Federal Reserve were to reduce or eliminate its supportive policies. We are somewhat optimistic that U.S. economic growth will continue, albeit at a modest pace, given many of the structural tailwinds we discussed earlier. However valuations are becoming stretched, as we believe forward earnings estimates are likely overstated in the aggregate. Investors should maintain exposure, but elevated valuations present increased risks that, at a minimum, should keep investors focused on rebalancing after gains and avoiding the temptation to increase their exposure given the relative superior performance over the last few years.

European markets continue to lag U.S. markets, causing them to trade at an even wider discount, which is just below 15%. Europe remains mired in a stubbornly deep recession that is hindering the growth of many local businesses and these markets deserve to trade at a discount to more stable, faster growing markets. However, many European-listed businesses that operate on a global scale can benefit from growth in the U.S. and emerging markets and have been unfairly discounted with the broader markets. We believe opportunities exist in these markets and recommend exploiting selective opportunities to invest in businesses that have been inappropriately discounted.

Emerging markets equities are perhaps the most intriguing and difficult to decipher market. Over the last several years, these markets continue to underperform other equity markets despite higher economic and corporate profit growth rates. Today, emerging market equities trade at almost a 30% discount to U.S. markets. Perhaps this is partially justified given the uncertainty surrounding China's reforms and similar challenges in other EM countries. However, we believe these values offer investors a compelling entry point to further increase their exposure. As we discussed in our Annual Outlook, the construction of equity market indices in these markets is flawed, giving investors significant exposure to the older, slower-growing companies that represented the pillars of past growth, but do not adequately capture future growth opportunities from the emerging middle class consumers as these countries transition to more consumption-oriented economies. Non benchmark-oriented, active management is critical to investment success in these markets.

### Real Assets

We continue to recommend that investors underweight exposure to liquid real assets, such as commodities, as the risk of increasing inflation remains remote or well into the future. Our opinion is based on excess capacity in the economy, particularly in labor markets in most of the developed world, and slowing (but still relatively robust) growth in some of the emerging markets economies.

Alternatively, we believe opportunistic investments in illiquid real estate and natural resources can generate reasonable returns in the absence of inflation and very attractive returns should inflation accelerate. Once again, implementation of these ideas is important, as some real estate markets and property types have become expensive due to investors' search for income in a yield starved world.

It is worth noting that gold has been decimated in recent weeks, declining to nearly $1,200/oz., approaching levels we last saw in 2010. We believe that gold remains an insurance policy against the debasement of fiat currencies. At this point, the global economy does not appear capable of generating sufficient income to service and repay the hundreds of trillions of dollars of debt and future entitlement obligations that have been accrued in both the public and private sectors. This debt can only be repaid in one of three ways: (1) through defaults and restructurings (e.g. Greece) (2) through inflation; and (3) through currency devaluation. Paper money will continue to be devalued and gold will likely be one of the beneficiaries of that phenomenon as it always has in the past. Unfortunately, gold is a relatively small market and can be overwhelmed by speculative investment flows in either direction. It is clear, based on investment flows out of gold related investment products, that a large portion of the speculative demand has retreated. Our challenge with gold, as it always has been, is that it is difficult to determine its intrinsic value and hence identify when to increase and decrease exposures. Today is no exception, other than to note that gold is certainly cheaper than it was six months ago.

### Concluding Thoughts

Our clients will remember we believe that one of the most important drivers of investment returns is the price you pay for an asset. The higher prices go, the lower the probability of favorable outcomes. We are fond of the old investment adage that there is no such thing as a bad investment, only an investment that is purchased at a bad price. The reverse is equally true, such that there is no such thing as a good investment, only an investment that is purchased at a good price. In today's environment of increasing prices and risks, investors should be mindful of the prices they are paying for assets in absolute not relative terms, as the unwinding of high prices can be quite painful.

## About Gresham

*Formed in 1997, Gresham Partners LLC is a nationally recognized, independent wealth management firm that serves select families, family offices and endowments. Known for its commitment to delivering superior investment performance and highly personalized wealth planning, Gresham's client focused solutions feature hard to access managers without the conflicts typical of other firms. With over $3.5 billion under management, Gresham's Risk Conscious® investment platform and holistic planning are focused on preserving and growing clients' assets. The firm's team of highly skilled professional advisors allows families greater freedom to pursue career and personal interests.*

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