GRESHAM

2014 Mid-Year Update

Surf's Still Up

Surf's Up! Or so we said at the beginning of the year in our Annual Outlook of the same title. Since we published our piece several months ago, many of the same economic conditions and capital market dynamics remain. Central to our view over the last few years are the unprecedented central bank policies that have allowed investors to ride waves of liquidity to impressive returns. Further, central banks appear likely to remain engaged with these supportive policies, as global growth remains anemic compared with past recoveries and employment gains remain similarly subdued.

Summary

Economic growth rebounded sharply in the second quarter from a dreary, weather-impacted decline during the first quarter of the year. While more robust economic growth is certainly an encouraging sign, the U.S. remains mired in the slowest economic recovery on record. In response, central bank policies remain accommodative with zero interest rates and quantitative easing in the form of bond purchases. While the U.S. Federal Reserve has begun tapering its bond purchases, the current policies are still the largest and most accommodative in history.

Global economic growth remains similarly lackluster in many parts of the world. As a result, most major central banks around the world are engaged in similarly accommodative policies to the Fed. The European Central Bank recently reduced interest rates yet again in an effort to stimulate lending and growth. Further, the Bank of Japan and the People's Bank of China continue their supportive policies, creating synchronized global liquidity with their peer institutions around the world.

In response to central bank liquidity, capital markets continued to perform well during the first half of the year. Which markets you ask? Almost of all them. Equity markets were up, bond markets were up and even commodity markets performed well. This is the proverbial rising tide lifting all boats or, to extend our surfing analogy, the equivalent of every asset catching a great wave. For historical perspective, it is quite uncommon for a wide range of markets to move up together for long periods, occurring only a few times during the last several decades.

For the first half of the year, U.S. equity markets rose over 7% and continued to reach new highs, with the S&P 500 index reaching 1,962. Similarly, international equity markets performed well, rising 5.6%, with emerging market equities following suit by increasing 6.1%. Not to be left behind, fixed income markets also performed well, as the threat of inflation and concerns about tapering appear to have abated for the moment. Further, the riskier the debt instrument, the better the performance was likely to be, as spreads also tightened on many lower-rated bonds.

The two most troubling aspects of the current environment are enormous investor complacency and elevated valuations. The primary questions for investors in the face of these concerns are: How long will it last? How high will it go? And, how violently will it unwind? Despite these questions, we continue to find interesting investment opportunities.

First Half Capital Market Review

The first half of 2014 is now in the books, capping a six month period that was characterized by a rally with breadth not seen since the first half of 1993. Fixed income, equities and commodities all notched respectable gains, a very rare occurrence that served as testament to the power of accommodative central banks.

U.S. equities continued their upward march, reaching record levels along the way. As shown in Chart 1, U.S. equity markets increased 7.1% during the first half of the year and were led by the healthcare, energy and utilities sectors that increased 10.6%, 13.0% and 18.7%, respectively. Over a five-year period roughly coinciding with the end of the global financial crises, U.S. equity markets have increased at over 19% per annum, one of the strongest five-year periods on record. Many now believe the U.S. markets are becoming overvalued relative to their historical averages.

International equity markets were also strong, returning 5.6% during the first six months of the year. Japan was the notable laggard among the developed international markets, declining 3.0% in local currency terms. Emerging markets staged a modest recovery from their dismal performance in 2013 (-2.6%), increasing a healthy 6.1%. Over the last three years, emerging markets have provided investors with a negative return, while U.S. markets have increased over 16% per year and developed international markets have increased nearly 6% per year. As a result, valuation metrics, such as price-to-earnings ratios, for many emerging market countries and sectors have become relatively more attractive. This is a key element of our increasing interest and exposure to these markets.

Fixed income markets also produced positive results for investors, as interest rates declined over the last two quarters due to increasing comfort with the concept of central bank tapering. Further, benign inflation metrics and slow economic growth provided additional incentives to chase income producing investments. The yield on the 30-year Treasury bond declined from nearly 4.0%, where it had risen late last year, to under 3.5%. Similarly, the yield on the 10-year Treasury note, after nearly reaching 3%, fell to 2.4% during the first half of the year. As a result, bond performance was

Chart 1. Performance and Valuation			Performance		Valuations	
			Annualized		Forward P/E	
Market	Index	1st Half 2014	3 Year	5 Year	June 2014	Dec. 2013
U.S. Equity	S&P 500	7.1%	16.6%	18.8%	15.9x	15.5x
International Equity	MSCI AC World ex U.S.	5.6%	5.7%	11.1%	14.1x	13.1x
Emerging Market Equity	MSCI Emerging Markets	6.1%	-0.4%	9.2%	10.2x	10.2x
					Spread vs. Treasuries	
10-Year Treasury	Citi Treasury Benchmark 10-Year	6.1%	5.0%	5.0%	–	–
Municipal Bonds	Barclays Mgd Money Short/Int	2.3%	3.1%	4.0%	81 bps	92 bps
U.S. High Yield Bonds	Barclays High Yield Corporate Bond	5.5%	9.5%	14.0%	396 bps	397 bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	9.1%	7.6%	10.4%	318 bps	290 bps
Hedge Funds	HFRI Fund Weighted	3.2%	4.0%	6.5%		
Conservative Hedge Funds	HFRI FOF Conservative	2.2%	3.3%	4.0%		
Commodities	Dow Jones UBS Commodity	7.1%	-5.2%	2.0%		
Gold	Spot Price of Gold	10.1%	-5.4%	6.5%		

Source: Bloomberg, MSCI, JP Morgan

good, with the municipal bond market returning 2.3% and 10-Year Treasury bonds returning just over 6%.

Lower quality fixed income markets also performed well, as credit spreads compressed to record low levels. A paucity of income producing investment alternatives drove investor demand for higher-yielding investments to even greater gains, as U.S. high yield markets returned 5.5% and emerging market debt markets returned nearly 9.1%.

Global Economic Environment

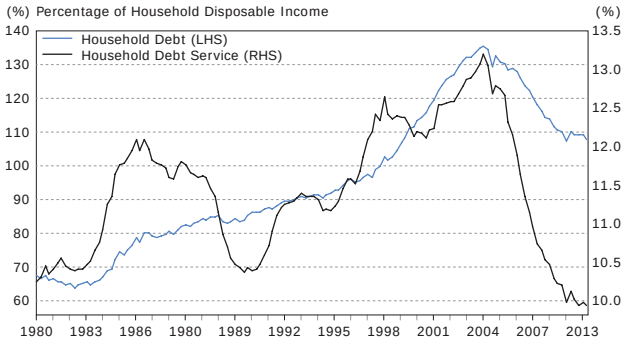
Six years after the global financial crisis, economic growth remains weak and continues to underperform analysts' already muted expectations. Not surprisingly, weak credit demand remains the lingering problem for the world economy on the heels of the largest credit crisis in history. As shown in Chart 2, U.S. household debt continues to decline and its associated debt service has plummeted with the additional assistance of low interest rates. Instead of releveraging on current low interest rates as in cycles past, consumers continue to restrain their borrowing activity. Over the long-term, the repairing of consumer balance sheets is likely to be quite healthy; however, in the short-run this is restraining growth.

Further, real wage growth remains muted as employment has not fully recovered (see Chart 3), despite official unemployment statistics to the contrary. As a result of the combination of restrained credit growth and weak employment, consumer spending, which accounts for roughly 70% of U.S. economic activity, remains weak by historical standards for a recovery. We remain positive on long-term U.S. economic growth potential, but in the near-term we will likely continue to muddle along.

In Europe, the picture remains bleaker. Economic growth is so weak that the risk of price deflation remains a key challenge. With the exception of the U.K., price inflation in the euro zone has fallen to a level that is close to zero. In response, the ECB recently eased interest rates once again, but they have yet to take the drastic quantitative easing approach that the U.S. Federal Reserve has enacted. Few analysts believe the current policies and economic conditions have put Europe on a path to sustained economic growth. As a result, the eurozone economy will likely continue to limp along with the real possibility of deflation and little or no economic growth.

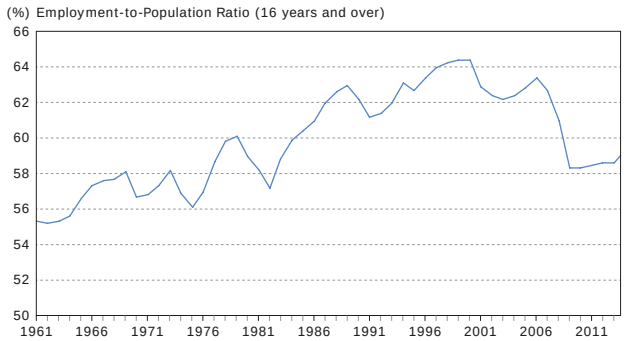
While most headlines warn of slowing Chinese economic growth, the reality is that even at its current reduced growth rate of around 7%, China is the envy of most of the developed world. Additionally, most economists believe that growth will likely rebound, as the Chinese government has begun adopting modest stimulus measures. This is important to the growth prospects of

Chart 2. U.S. Consumer Balance Sheets have Improved



Source: St. Louis Federal Reserve

Chart 3. Total Employment Has Not Recovered



Source: Bureau of Labor Statistics

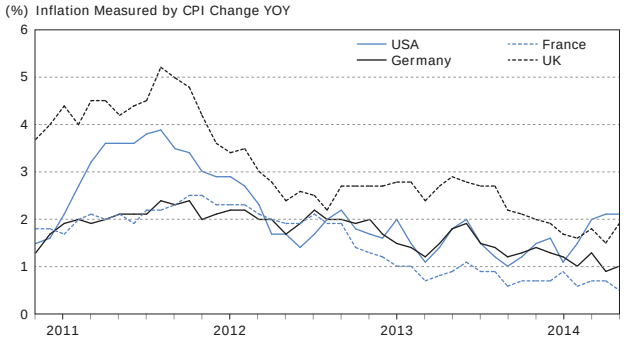
many Asian nations, as their economic linkage to the Chinese economy continues to grow stronger.

Central Bank Policies: Tapering?

Global central banks continue their unprecedented and synchronized campaign to stimulate economic growth through low interest rates and, in some cases, bond purchases or so-called quantitative easing programs designed to further reduce interest rates. As we move into the sixth year of this policy paradigm, economic growth has not responded to the degree that policy makers had hoped, but other consequences have emerged. While most of the central bank liquidity is not making its way into the real economy, it is making its way into asset markets, which is creating some difficult decisions for central banks.

Central banks around the world are now struggling with an acute policy dilemma between low and falling inflation on one hand, and high and rising asset prices on the other. While economic growth and price stability are generally considered the primary economic targets for central banks, central bank officials, including U.S.

Chart 4. Despite Unprecedented Central Bank Policies, Inflation Levels Remain Subdued



Source: St. Louis Federal Reserve

Federal Reserve Chairman Janet Yellen, have begun to send warnings about high prices in capital markets. While they can attempt to caution investors that the euphoria in financial markets is out of step with the sanguine economic conditions, the reality is that they have few tools to cool asset bubbles unless they are willing to risk an already fragile economic recovery with limited growth prospects.

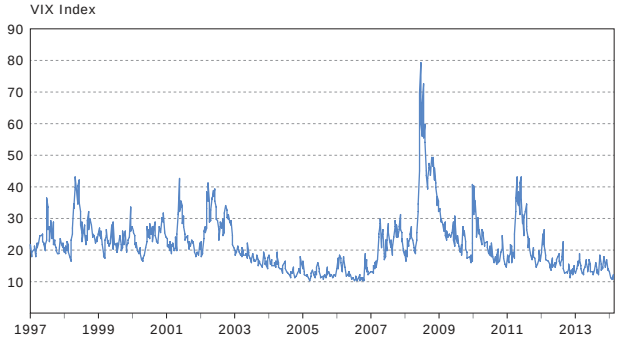
As a result, central banks are likely to remain accommodative for years to come, as employment, wage growth and inflation (see Chart 4) remain subdued. While the U.S. Federal Reserve has begun to taper its bond purchases, U.S. monetary policy remains near its most accommodative in history. Further, the other major central banks around the world maintain their accommodative policies. It appears we should reconcile ourselves to the idea that these capital market conditions will persist for some time.

Complacency, Compression and Bubbles?

As stated earlier, little of the liquidity created through these policies is making its way into the real economy and the spillover is pouring into asset markets, creating impressive returns for investors. While markets certainly needed to recover from the carnage of the global financial crises, most analysts agree that capital markets have more than fully recovered even if the underlying economic conditions have not. The problem now is that the pendulum appears to be swinging too far in some capital markets.

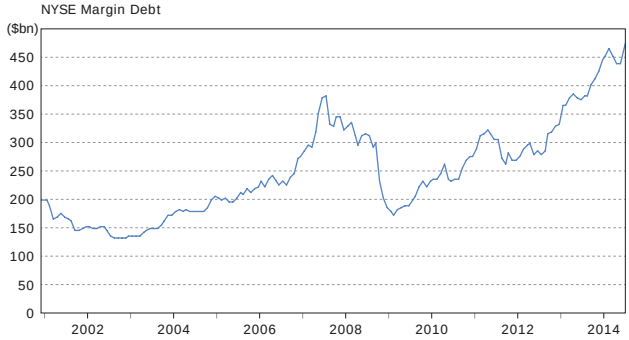
The New York Times recently coined the term the "Everything Bubble" in which "nearly every asset class is expensive by historical standards." While the New York Times is not a typical source for financial advice, it

Chart 5. Investor Complacency Hitting Extremes



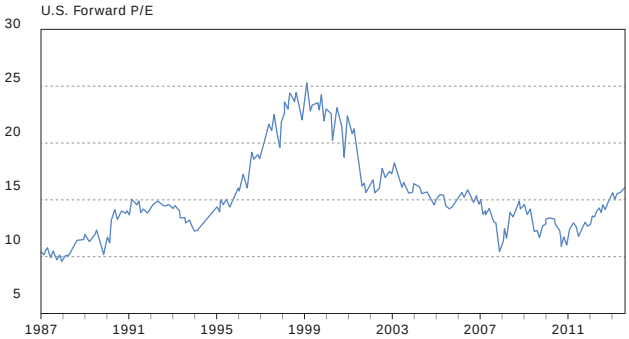
Source: Bloomberg

Chart 6. Investors Adding Leverage (and Risk) to Portfolios



Source: Bloomberg

Chart 7. U.S. Equity Market Valuations Becoming Elevated



Source: IBES, MSCI, Datastream, Morgan Stanley Research

provides a sense of how pervasive and well-recognized the problem of increasing valuations in capital markets has become.

Elevated valuations are not limited to public markets. Commercial real estate, farmland, and even late-stage venture capital are included in the many areas that appear to be rich by historical standards. We are in a world where there are few unambiguously cheap assets. While this doesn't mean that investors can't make decent returns from this point forward, it does mean that the probability of capturing great returns has diminished.

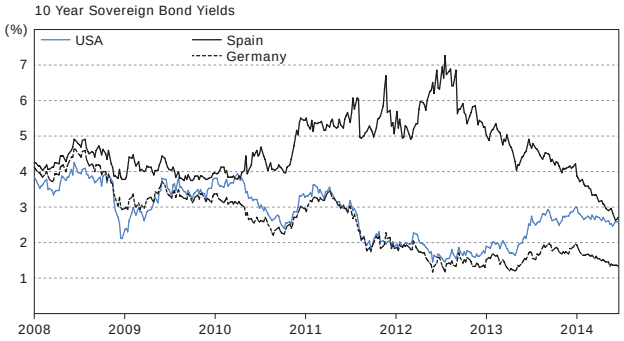
In our Annual Outlook, we described "a near rational bubble" in which current investor behavior of bidding up asset prices might be considered a rational response to zero percent interest rates. If investors earn nothing on their safer assets, they will logically continue to stretch for riskier and riskier assets in search of yield and performance. Unfortunately, with few negative consequences to this risk-seeking behavior over the last five years, investors have become complacent about accepting increasing risk in exchange for diminished expected returns.

The most visible symptom of complacency is captured in implied volatility indices. In equity markets, this can be measured by the VIX index, which some refer to as the fear index. Recently, the VIX has approached all-time low levels (see Chart 5) that we last reached in late 2006 just before the global financial crises. Further evidence of this complacent, risk-seeking behavior can be found in NYSE margin debt (see Chart 6), as investors continue to add leverage to their portfolios in pursuit of returns.

Equity market valuations are certainly elevated from several years ago, but they are nowhere near their recent peak in 2000. The forward P/E ratio for the S&P 500 is approaching 16x, which is above its 10-year average of 13.8x and above the 2007 peak of 15.5x, but still well below the 27x reached in 2000 (See Chart 7). It would be difficult to claim that equity markets are in a bubble, but we think it is safe to say that they are no longer glaringly attractive.

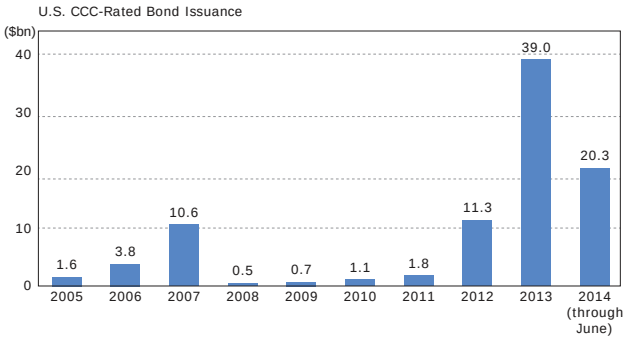
While equity market valuations may be elevated, bond market valuations are well beyond that point, whether we label them a bubble or not. The problem begins with artificially low interest rates due to central bank activity, and is exacerbated by credit spreads that are extremely tight. As evidence, the high yield index reached a record low yield of 4.8%. Further, sovereign debt issuers, who only a few years ago were the subject of widespread default speculation, are also reaching record low yield levels. For example, Spain was a prominent member of the so-called PIGS, which was a group of the most over-levered, profligate countries that were exposed during the financial crisis. The country recently issued bonds at the lowest yield in over 200 years. To put this in a different and perhaps startling context,

Chart 8. European Periphery Borrowing Costs have Collapsed



Source: Bloomberg

Chart 9. Less Creditworthy Borrowers Race to Issue Debt...



Source: S&P Capital IQ

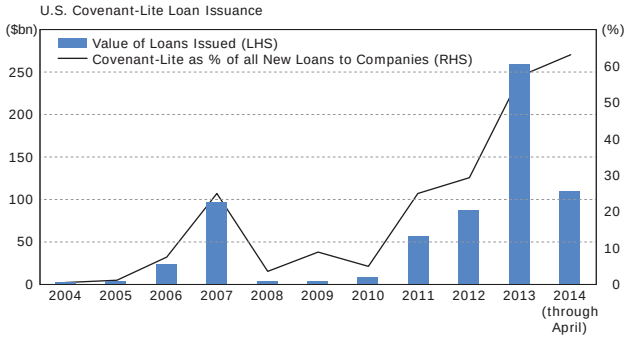
the yield on these Spanish bonds was also below that of current U.S. Treasuries (see Chart 8).

Bad behavior by both investors and issuers is most prevalent today in debt markets. Sales of junk bonds reached record levels last year (see Chart 9) and continued to accelerate during the first half of 2014, reaching a quarterly record of $148 billion, according to Thomson Reuters. That's up from average quarterly sales of around $30 billion before the credit bubble burst in 2007. Similarly, CCC-rated bonds, the lowest quality junk bonds, have seen a significant increase as shown in Chart 9. Further, credit standards are deteriorating as shown by the explosion of covenant-lite issuance, which limits investors' protection (see Chart 10). Whether junk bonds will be ground zero for the next unwinding is difficult to say, but it certainly is an area investors should consider avoiding.

What Should Investors Do?

Valuations in both the equity and debt markets are inflated, but history has shown that valuation on its own is a poor predictor of future market direction. Further, we have seen that markets can stay overvalued or

Chart 10. As Underwriters Loosen Terms



Source: S&P Capital IQ.

undervalued for long periods, potentially decades, and it is nearly impossible to predict market corrections. Exacerbating the possibility that valuations remain stretched, or get stretched further, is that central banks are likely to remain accommodative. In other words, the conditions that created these elevated prices are likely to persist.

One of our core beliefs is that the price one pays for an asset is one of the most important components of risk. The higher the price one pays, the riskier the investment. By this measure, capital markets are certainly riskier than they were a few years ago. However, while markets in general may be riskier, we continue to find interesting investment opportunities.

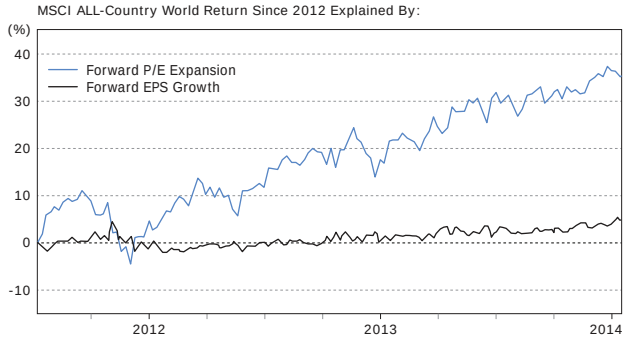
Fixed Income

Our long standing underweight to fixed income remains in place. Over the last three years, we have recommended that investors reduce or eliminate their exposure to high-quality fixed income markets as we felt the risk/reward proposition was unappealing. This has been a productive decision for our clients.

In our Annual Outlook earlier this year, we noted that long-term interest rates were beginning to normalize and more conservative investors might consider taking a small step toward unwinding this underweight in their portfolio, particularly in light of increased valuations in equity markets. That moment was short-lived, as the decline in interest rates during the first half of the year restored high-quality fixed income to its uninspiring risk/reward proposition.

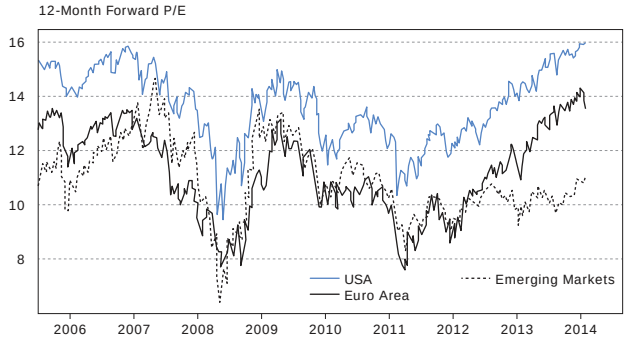
Relatedly, in other areas of the fixed income markets, spreads have become excessively compressed and the risk/reward proposition of corporate bonds, high-yield

Chart 11. Recent Equity Market Performance Driven by Multiple Expansion



Source: BCA Research

Chart 12. Emerging Markets are Cheap Relative to Developed Markets



Source: Thompson Reuters, IBES, Morgan Stanley

bonds and other riskier bonds is even less attractive. We recommend that exposure to these areas of the capital markets be eliminated as well.

Equity Markets

U.S. equity market valuations are above their long-term averages, but they are not excessively stretched. The primary challenge going forward remains growth in corporate revenue and earnings that might continue to justify current market pricing.

Over the last few years, the substantial equity markets rally has been driven by multiple expansion rather than growth in underlying earnings as shown in Chart 11. This divergence is clearly unsustainable. Future gains need to come from earnings growth or valuations risk getting stretched further. Given the potential for continuing gains, we recommend most investors maintain their equity exposure despite elevated valuations, but recognize the increased risk inherent in this allocation.

Emerging markets remain the most interesting and potentially attractive among public equity markets. To begin, these markets trade at a significant discount to developed markets, as shown in Chart 12, after years of uninspiring performance. Additionally, the potential for higher revenue and earnings growth rates, particularly in companies benefitting from relatively stable consumer demand, can be quite attractive.

Emerging markets are diverse, fragmented and inefficient, and making generalizations about them can be dangerous for investors. However, these inefficiencies can also present great opportunities for informed investors. Investors should be careful about generalizing these attractive valuations as generic metrics indicated by indices can be quite misleading. Active management in emerging market equity remains critical to investors' success.

Hedge Funds

When investors all begin to lean in the same direction, markets can become unbalanced, creating opportunities for nimble investors, such as hedge funds. We have seen interesting ideas develop in hedgefund portfolios that few traditional investors can exploit. Investors should be particularly cautious in these areas, as the dispersion among hedge fund returns can be quite large and many don't justify the significant fees they charge. In the public markets, manager selection matters more in hedge funds than in any other areas.

Private Investments

Private equity continues to be an important driver of long-term portfolio returns. In the larger end of the private markets, companies have not been immune to increasing valuations and higher debt burdens to finance purchase prices. As a result, we continue to emphasize managers who focus on smaller companies. While these companies present more risk to investors, they can typically be acquired at more attractive prices and will benefit more from the increase in professional management techniques and upgrades that some private equity firms can bring.

Venture capital remains an important allocation and our client portfolios have benefitted tremendously from recent exits and IPOs. Going forward, the space is more competitive and having access to the best managers is more important than ever. We remain attracted to private investment opportunities in China, particularly the venture and growth managers that can capitalize

on the robust and rapidly growing consumer segments of the Chinese economy.

We also continue to find interesting opportunities in our private real assets portfolio. Unlike the public markets, which have produced lackluster returns for several years, investments in this area have produced strong returns. We remain optimistic about future investments in these areas, but note that valuations have begun to increase.

Concluding Thoughts

As the world becomes more uncertain, whether it is through increased valuation or other means, an investor's path becomes more obscure. The wise investor will recognize that in the face of this uncertainty, the prudent course is to diversify. While no one can accurately predict how much longer the current rally will continue or when a correction will occur, it is important that investors build diversified portfolios that allow them to participate in future gains, while withstanding the inevitable correction. Rebalancing after significant gains is an essential element of a disciplined portfolio management process.

Both within and across asset classes, having an absolute sense of valuation, rather than a benchmark-relative view of risk, can tilt portfolios away from the most overvalued areas of the market (thereby reducing overall portfolio risk) and toward investments in areas that are potentially more attractive. Investing with managers that share this view of risk is important, particularly in today's market environment.

About Gresham

Gresham Partners, LLC is a nationally recognized, independent investment and wealth management firm that has been serving select families, family offices and endowments since 1997. Committed 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 at least $4.0 billion under management, Gresham's Risk Conscious® investment approach 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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