The McCabe Perspective

First Quarter 2013

"The key battle is between the expansionary impetus stemming from the normalization of the private sector in the U.S. and the contraction stemming from global fiscal tightening and bank deleveraging in the Eurozone."[1]

Improving conditions in the U.S. and Japan, along with continued expansionary monetary support by major central banks, led to positive returns for the global equity index even though most emerging markets declined. There was a mild sell off in the global government bond markets. The MSCI All Country World Index returned 6.63% while the Citigroup World Government Bond Index returned -2.8% in the quarter. While the global equity index performed better than the global bond index, in a reversal from last quarter, the U.S. markets outperformed their non-U.S. counterparts owing to concerns over slowing growth in Europe and China. The first quarter's return in the U.S. equity market was one of the strongest historically but interestingly it was led by the traditionally defensive sectors of utilities and consumer discretionary and staples, whereas the growth-oriented technology and materials sectors lagged on a relative basis. Within fixed income, corporate issuers outperformed government bonds as risk appetite returned. Outside the U.S. Japanese stocks had a very strong quarter, returning 11.6% in USD, according to the MSCI Japan Index, a result of efforts by the Japanese government to stem deflation and weaken their currency via monetary stimulus. By contrast, the emerging market stock index's negative return was consistent with increased investor defensiveness within the equity space. The commodity price indices were either down slightly in the case of Dow Jones UBS Commodity Index, or up slightly in the case of the CRB Index, driven by changing expectations regarding oil and metals, slower than expected growth in China and a first quarter recession in the European Union countries.

1 Gavyn Davies, Financial Times, April 2013

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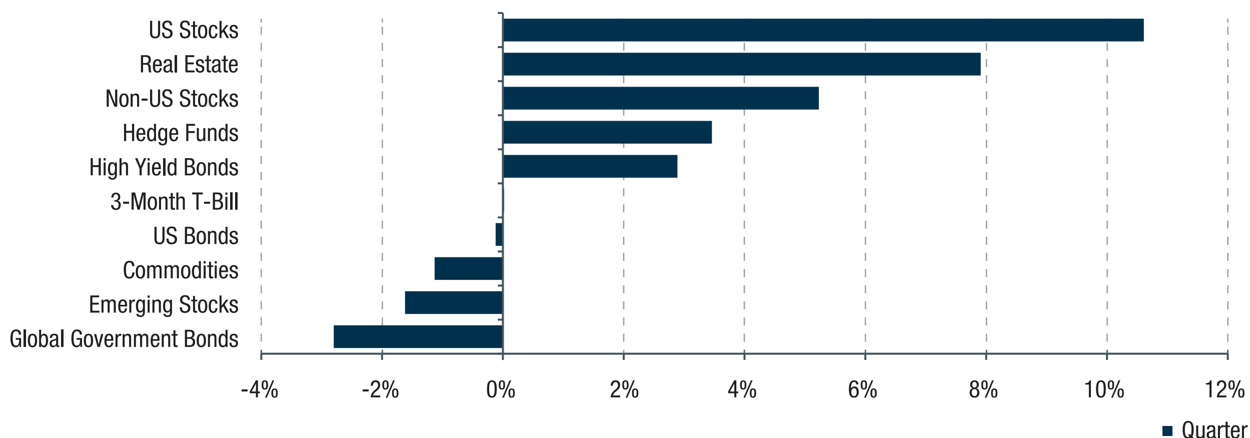
Exhibit 1: Global Capital Markets Overview (1Q 2013)



Source: S&P 500 Index, MSCI EAFE Index, MSCI Emerging Markets Index, Barclays Capital U.S. Aggregate Index, Barclays Capital U.S. High Yield Index, Citigroup World Government Bond Index, Dow Jones REIT, Dow Jones UBS Commodity Index, HFRI Fund of Funds Composite Index, ML 3-Month T-Bill.

US Economy

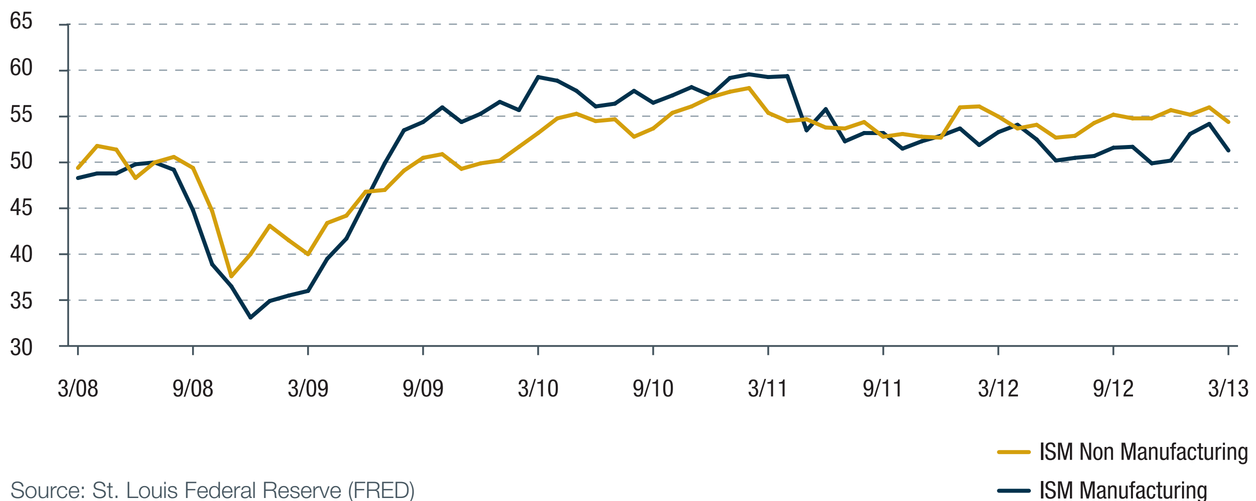
The U.S. private sector continues to heal despite the expiration of the payroll tax holiday and the headline grabbing debates over spending cuts and potential additional tax increases. The housing market has stabilized while house prices are moving higher. Employment is also improving in part because of historical low labor force participation rates and hourly wage rates are increasing although rates of growth vary from month to month, as evidenced by the March decline. Both trends bode well for future consumer spending. In addition, stock markets are higher and this tends to contribute to a "wealth effect" which could also prove to be a positive. Finally, according to the Federal Reserve Bank (FRB) G19 report consumer credit increased last year more than it declined in the prior two years and the trend is continuing this year with non-revolving debt increasing at a 10.0% annual rate and total consumer debt increasing at a 7.0% annual rate with banks financing home purchases. Thus consumer deleveraging seems to have paused. For these reasons a conservative analyst like Bill Gross of PIMCO is predicting about 3.0% GDP growth in 2013, though a 2.5% growth rate seems more realistic.

As we have pointed out in our earlier letters, the U.S. economy has been held back by fiscal drag caused mainly by a reduction in state and federal spending. According to Barclays Research Global Outlook 2012, the drag amounted to 0.5% of GDP in 2010, 1.0% of GDP in 2011 and 0.8% in 2012. In our fourth quarter 2012 letter, we estimated that this fiscal drag may be as high as 1.8% of GDP for 2013. While this drag will have an effect on overall economic growth, the potential benefits of more spending from the private sector (corporations and consumers) may be enough to offset much of this state and federal austerity by the second half of the year. According to the BCA special

report, “Capital Investment: Is the Outlook Brightening,” private capital expenditure has not yet recovered fully and we are three years into the recovery. This modest recovery is unusual since historical recoveries are often led by private capital expenditure. BCA highlights that because of the severity of the downturn in 2008, the subsequent increase in regulation and the general political and policy uncertainty that has plagued the markets since 2009, the confidence to increase capital expenditure in a meaningful way has been lacking. However, as the capital base in the U.S. ages and the policy uncertainty dissipates, the potential for increased capital expenditure from the private sector is there and this has the potential to benefit both industrial and technology companies going forward. In addition, stocks are trading well above replacement cost book value which creates an incentive to add capacity through direct purchases of plant and equipment rather than through acquisition.

The ISM Non-Manufacturing survey reading of 54.4% in March suggests that there is continued optimism about the trend of the service economy, although this was lower than the reading in February possibly owing to the uncertainty surrounding future spending cuts related to the Sequester. The manufacturing ISM also dipped in March to 51.3 but remains above 50, suggesting the economy is still expanding, but at a slower rate. Except for the March setback, the underlying components of each survey, including the new orders index and the employment index, have been generally improving over the course of the last several quarters. U.S. GDP growth was above trend in the first quarter as a result of inventory rebuilding but is likely to fall below 2.0% in the second quarter before recovering to the 2.5% level in the back half of the year. This outlook assumes that the recent weakening in economic data is just a temporary blip. However, the contractionary effects of fiscal tightening may be greater than anticipated and less likely to be offset by private sector normalization.

Exhibit 2: ISM Manufacturing and Non-Manufacturing Surveys (Mar 2008–Mar 2013)



Source: St. Louis Federal Reserve (FRED)

Developed International Economies

While the U.S. economy shows signs of strength and stability, the European economy continues to suffer. The most recent scare comes from Cyprus, a small island with a business and financial services and tourism driven economy. Because the two main banks there purchased Greek bonds which were subsequently restructured, they were in need of assistance from the European Union. In exchange for this assistance, the EU suggested a “bail in” consisting of a tax on all deposits. However, due to significant push back by the citizens of Cyprus they settled on a much larger tax for deposits in excess of €100,000 and associated capital controls to limit the potential for a bank run. Bank stock and bond holders were also wiped out. Because Cyprus is a small country, its impact on the European economy is relatively minor. However, the implications of this “bail in” for other Southern European nations, such as Spain and Italy, which are also struggling with slowing growth, high unemployment and weak financial institutions could be significant. While we do not expect the same “bail in” solution to be applied to other nations (Cyprus was an isolated case in this respect), it raises questions about the inconsistency of addressing the ongoing financial crisis in Europe and sets a bad precedent. There is reduced incentive for private investors to purchase bank debt and for depositors to continue their accounts in weaker banks. Economic growth in the Eurozone is expected to be negative in 2013, but with bank solvency and funding more of an issue, the question remains just how negative it will be. Consensus forecasts are for Europe to shrink by 0.3% and that is assuming that the Cyprus, Spain, Italy and Portugal situations do not deteriorate further.

Japan, on the other hand, has shown considerable resolve in addressing the deflationary pressures that have plagued the economy for a decade. According to the Bank Credit Analyst, Global Investment Strategy, the deleveraging process in Japan actually ended in 2000 and since then real GDP growth has been 1.0%. Chen Zhao, the Managing Editor of the Global Investment Strategy points out that if one adjusts this growth number for the declining population (which has been shrinking at a 2.0% annual rate) then the real growth rate per capita in Japan has been roughly the same as the U.S. The government’s shift in monetary policy has had a direct impact on the currency and as a consequence, the stock market. The Yen has weakened markedly over the past six months and this continued in the first quarter with an 8.5% depreciation of the Japanese currency versus the U.S. dollar. The behavior of the currency is an important driver of the stock market. Since 2005 the Japanese stock market (as measured by the Nikkei 225) has traded consistently with the Yen. As the trade weighted Yen[2] gets stronger, the stock market has declined and as the trade weighted Yen gets weaker, the stock market has risen. This is largely due to the importance of the export oriented economy that Japan depends upon so much given their global leadership in automobiles and electronics.

[2] J.P. Morgan Asset Management, Guide to the Markets, March 2013

Emerging Market Economies

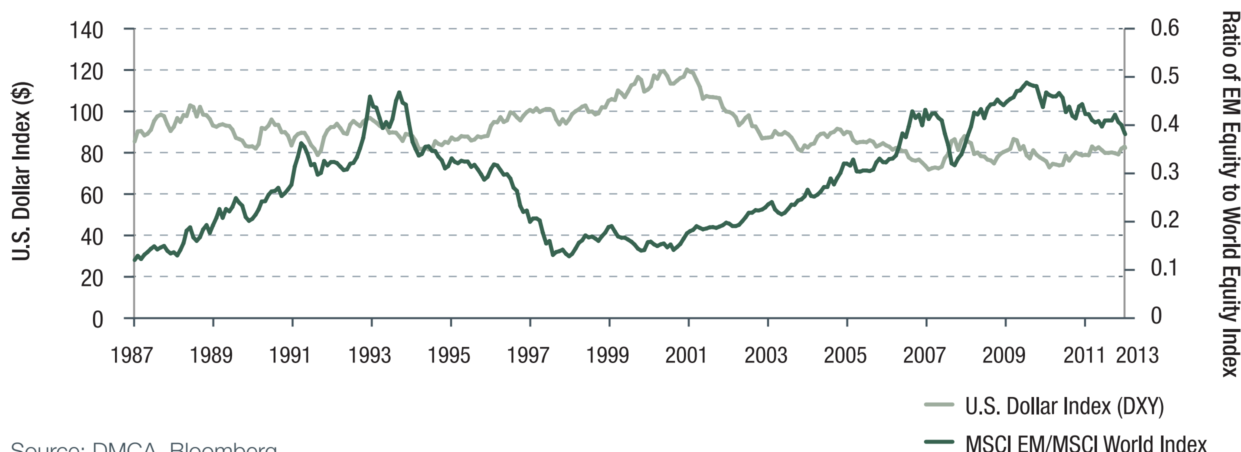
The key economies in the emerging markets; Brazil, Russia, India and China, (often referred to as BRICs) are each suffering from their own specific headwinds and they will likely be a drag on global growth in 2013. These four markets represent approximately 43% of the developing markets (MSCI EM) and their success ultimately drives the emerging equity asset class.

Brazil and Russia are commodity producers and typically suffer when demand for commodities slows as it is currently. India and China are users of commodities and as a result, benefit as prices fall. India is suffering from slowing growth and rising debt while China's growth rate is slowing owing to moderating growth in the property sector and declining external demand. In addition to the BRIC countries, South Korea is another major component of the emerging market index and is home to some well known global companies such as Samsung and Hyundai Motors. However, geopolitical risk has grabbed the headlines recently with North Korea stepping up its rhetoric with respect to its nuclear development plans. The geopolitical and growth risks in these markets have kept prices muted. The first evidence of this is the closure of the Kaesong industrial park that it operates jointly with South Korea.

Since 2000 China has been forced to spur demand three times in response to large external shocks. The U.S. recession in 2002, the credit crisis in 2008 and the European sovereign debt crisis in 2011 each resulted in a significant decline in global demand and in response China increased its domestic spending on infrastructure and real estate to compensate. While in the short term the supply is greater than demand, research by the Bank Credit Analyst's Global Investment Strategy suggests that China's industrialization and urbanization process is only just beginning and they compare it to South Korea's stage of development in the 1980s. While this bodes well for long term growth in China, the short to medium term risks related to slowing growth and unsustainable credit expansion remain. We continue to monitor key economic indicators such as the HSBC China Manufacturing PMI which came in at 51.6 for March. Though up from its 50.4 reading in February this indicator was still far from robust. The economy depends strongly on monetary policy for the remainder of the year. Much of the March increase in factory orders resulted from infrastructure spending and household consumption fueled by last autumn's monetary easing. While this is a positive sign, we remain cautious in the near term.

In Latin America the Brazilian economy is growing at its slowest rate in over 10 years (excluding the negative growth experienced in 2008 as a result of the global credit crisis). A large part of the economy is resource based and as global demand moderates, this will have a negative impact on the economy. Further, the government's efforts to increase the minimum wage, combined with slowing productivity, has increased unit labor costs and put pressure on corporate profits.

Exhibit 3: The US Dollar Index and Emerging Market Equities Relative Performance (Dec 1987-Mar 2013)



Source: DMCA, Bloomberg

Global Equities

The first quarter was quite a strong one for U.S. stocks (the S&P 500 returned about 10%). This move was driven largely by improving fundamentals in the U.S. economy (housing, employment and consumer spending all were positive) combined with less concern over the impact of the Sequester than previously thought and the managing of the still uncertain situation in Europe. From a valuation standpoint we feel that the U.S. stock market is fairly valued on an absolute basis, but is more attractive than U.S. bond markets on a relative basis. The ratio of price to forward earnings is very close to its long term historic average. While the equity risk premium (difference between the earnings yield on stocks and the 10-year bond yield) is close to its post credit crisis average, it is still well above its average since 1950 and therefore we feel there is still more room for it to fall, which would be positive for U.S. equities versus U.S. bonds.

By quarter end there was quite a lot of news about the U.S. equity market reaching new highs but it is important to put this into an historical context. The S&P 500 stock market level as of March 31, 2013 was 1569. If we compare this index level to other market tops (March 2000 [1527] and October 2007 [1565]) it seems quite similar, but there are important differences. Even though prices today are close to these previous levels, the market's forward P/E of 13.8 is much lower than in March 2000 when it was 25.6 and in October 2007 when it was 15.2. In addition, the bond markets offered a relatively attractive alternative in those two periods. In March 2000 10-year bond yields were 6.2% and in October 2007 they were 4.7%. As of March 31, 2013 10-Year bond yields were 1.9%[3], and the dividend yield on stocks is equal to or slightly better than that at this stage. In Exhibits 4 and 5, we show key metrics for the S&P 500 Index at previous inflection points along with a graphical representation of the S&P 500 Index since 2000.

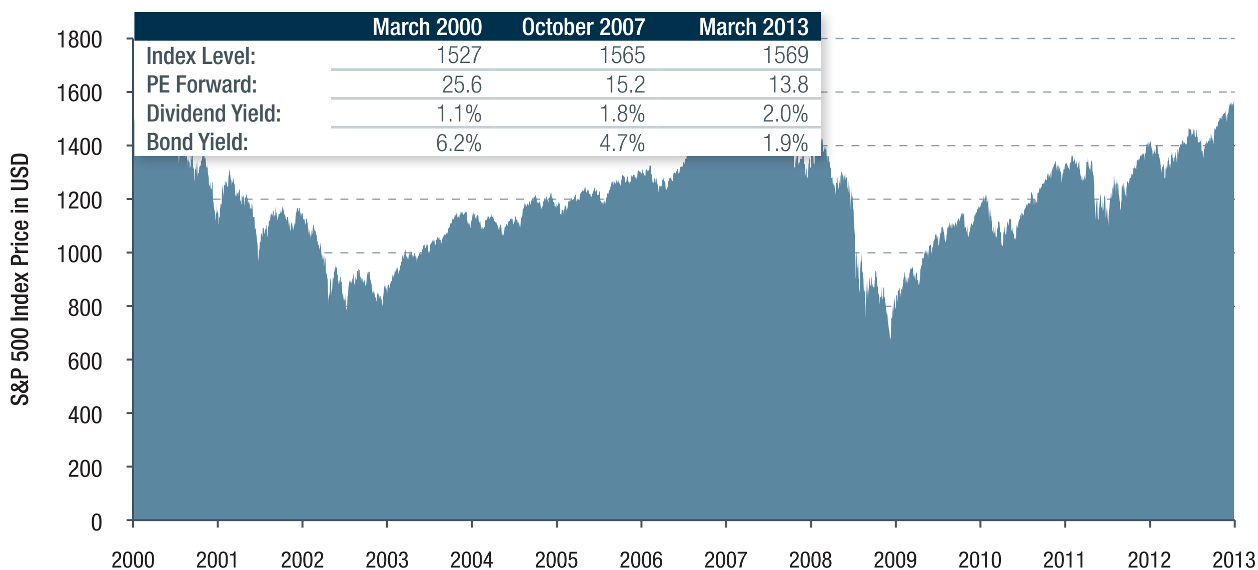
3 JP Morgan Guide to the Markets, March 31, 2013

Exhibit 4: S&P 500: 2000 vs. 2007 vs. March 2013

Metric	2000	2007	March 2013
S&P 500 Level	1527	1565	1569
S&P 500 Total Return Index	2107	2447	2759
CPI Adjusted S&P 500 (Mar 2000 = 100)	100	84	75
Trailing EPS	51.02	90.06	101.99
Trailing PE	29.9	17.4	15.4
Forward PE	25.1	15.0	13.6
Normalized PE	34.4	20.7	16.4
Net Debt/EBITDA	3.4	3.4	1.7
Price/Book Value	5.4	3.0	2.3
Enterprise Value/EBITDA	14.1	10.4	8.7
Dividend Yield	1.1%	1.8%	2.1%
10-Year Treasury Yield	6.2%	4.7%	1.8%

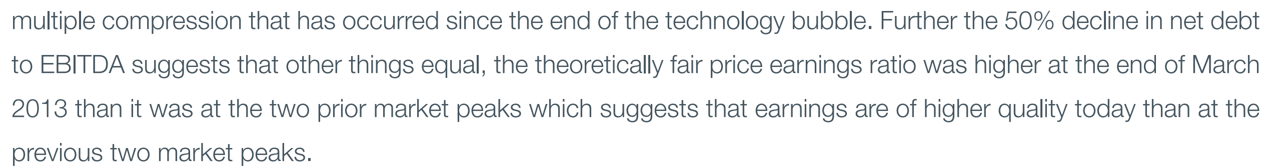
Source: BofA Merrill Lynch US Equity and Quant Strategy|United States March 28, 2013

Exhibit 5: S&P 500 at Inflection Points (Mar 2000–Mar 2013)



Source: JP Morgan Guide to the Markets, March 31, 2013, Bloomberg

As Exhibit 4 illustrates, current valuation metrics in addition to the forward price earnings ratio are lower than they were in previous peaks. In 2000, when the S&P 500 index level was at 1529, the trailing EPS for S&P 500 companies was about 51.02. By March 31, 2013, this level of earnings had doubled to 101.99, highlighting the significant



multiple compression that has occurred since the end of the technology bubble. Further the 50% decline in net debt to EBITDA suggests that other things equal, the theoretically fair price earnings ratio was higher at the end of March 2013 than it was at the two prior market peaks which suggests that earnings are of higher quality today than at the previous two market peaks.

Corporate earnings performance in 2013 should be the main determinant of whether the market (S&P 500 Index) falls below its current level by the end of the year, or rises further. The consensus estimate for S&P 500 earnings is $111.73 which means that at 1569 the S&P 500 is trading at almost 14 times forward earnings, substantially below its long term (trailing 200 year) average of 15. This suggests that the equity market is still undervalued. However, there is reason to believe that the consensus estimate for earnings (which calls for a 7.6% increase over 2012 levels) may be overly optimistic. This earnings growth rate exceeds the consensus projection of nominal GDP growth by at least 2.6 percentage points, which would probably require a further increase in the net profit margin from a near record level of 13.4% in 2012 or unexpectedly high global GDP growth. A number of bullish strategists have estimated 2013 S&P 500 earnings at substantially below the consensus level, including those from Goldman Sachs, Morgan Stanley and Deutsche Bank.

The argument for investing in Europe is largely based on valuation. In some of the more distressed markets (Italy, Spain), equity markets are between 60% and 70% below their peak and twelve month forward EPS for the Euro Area remains below that of the U.S. Both are indications of pessimism that ultimately may be proven wrong if conditions improve. The main risks to an investment in Europe today remain policy mistakes by European governments which have plagued the market since late 2011. However, this also means that European equities since 2007 have underperformed U.S. equities by 40% (cumulative) and on a valuation basis look attractive (P/B at 1.3 and 12-Month Forward P/E ratio of 11).[4]

Within emerging markets we remain cautious, but are intrigued by the pessimism currently gripping the markets. According to JP Morgan's, "Guide to the Markets March 2013," the Chinese equity market is trading at the low end of its historical valuation range which suggests that the concerns over growth and housing are reflected to some degree in current prices. However, given the current valuations of the asset class as a whole (which are not uniformly well below historical norms), the potential for U.S. dollar strength and the tendency for emerging market per share earnings growth to lag top line growth, one should be cautious about the entry point. We also note that the negative correlation between the forward price earnings ratio and the subsequent five year return is significantly higher in emerging markets than in developed markets and that the higher returns are achieved when the index is purchased at a lower than current price to forward earnings ratio in relation to its ten-year norm.

4 Bank Credit Analyst, Global Investment Strategy, March 2013

Global Fixed Income

The U.S. Federal Reserve Bank continues to support the U.S. economy through its monthly bond purchase program and the low Federal Funds rate and this will continue until the U.S. economy and job markets reach their stated targets. Fed chairman Ben Bernanke has been clear in his message to the market and the concern that interest rates would rise unexpectedly and quickly as they did in 1994 is unwarranted in our view. While this support may keep the U.S. government bond market at current levels, we do not see significant return potential going forward. In fact, with 10-year bond yields as low as they are (1.90% as of the end of March 2013) forward return expectations are modest at best and protection against any back up in rates is limited.

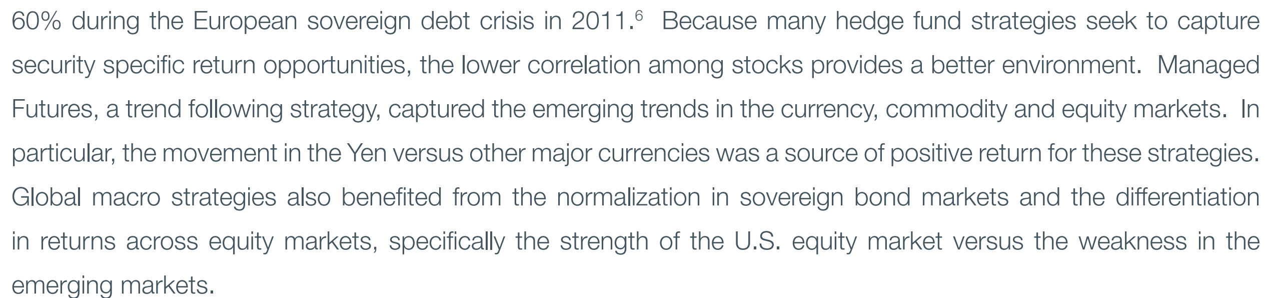
U.S. corporate bonds, both investment grade and high yield, have performed very strongly over the past 12 months and as a result their valuations are not as attractive as they have been historically. While we do not anticipate a significant increase in defaults at this point given the general strength of corporate balance sheets in the U.S., we feel that the market is pricing in high expectations and prefer to position client portfolios defensively. Global bond markets offer interesting investment opportunities in both the sovereign debt market and the foreign currency markets. Expansionary monetary policy in the U.S., Europe and in Japan has had the desired impact on stability and growth. The European Central Bank's pledge to do whatever it takes has taken some of the risks out of the European bond market, particularly in Italy and Spain. There are areas of value in the global markets, particularly those markets where real yields are still positive. These markets include those in peripheral Europe, Australia, New Zealand and Mexico.[5]

Any global investment brings with it currency exposure and despite the low interest rate in the U.S. market, the U.S. dollar has been strengthening relative to major currencies such as the Japanese Yen, the Euro and Sterling as monetary authorities attempt to stimulate growth through accommodative policies. The Australian Dollar has been strong relative to the U.S. dollar and is overvalued relative to history. This, combined with slower growth in emerging Asia, may lead to its depreciation.

Alternatives

Hedge fund strategies with higher equity exposures such as equity long/short and event driven strategies performed well in the first quarter. Not only did these strategies benefit from the general rise in global equities but the lack of a severe macro event meant that correlations among stocks dropped to more reasonable levels. A measure of this correlation for the U.S. large cap equity market dropped to 34.5% by the end of March 2013 from its peak of over

5 Colchester Global Investors, Client Luncheon, New York, March 2013



60% during the European sovereign debt crisis in 2011.[6] Because many hedge fund strategies seek to capture security specific return opportunities, the lower correlation among stocks provides a better environment. Managed Futures, a trend following strategy, captured the emerging trends in the currency, commodity and equity markets. In particular, the movement in the Yen versus other major currencies was a source of positive return for these strategies. Global macro strategies also benefited from the normalization in sovereign bond markets and the differentiation in returns across equity markets, specifically the strength of the U.S. equity market versus the weakness in the emerging markets.

Commodity markets were weak in the first quarter on recession in many European countries and slower growth in China. Taking a longer term view, commodities had a very strong ten-year run from 2000 to 2010 which led to a 3.7x increase in the CRB Raw Materials Index. Supporting this bull market was a weak U.S. dollar, limited supply side response and strong demand from China. Going forward there are headwinds to continued commodity price increases including the potential for the U.S. dollar to appreciate versus major currencies, significant supply side response (U.S. natural gas supply) and slowing demand in China.[7] Finally, Master Limited Partnerships or MLPs produced positive returns in the quarter, rebounding from a relatively weak 2012. Investors' demand for yield and improving prospects within the U.S. energy sector were the two primary causes.

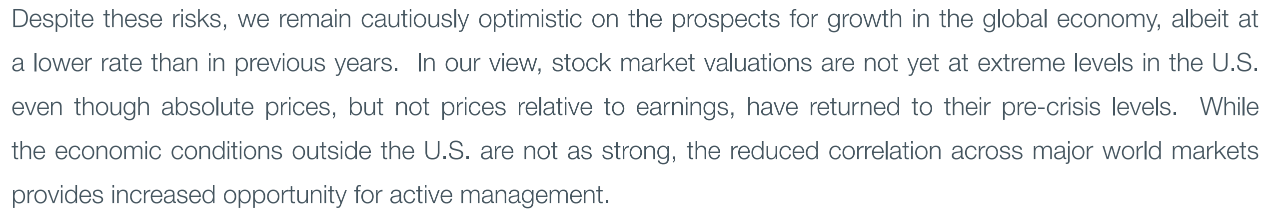
Summary

We are encouraged by the strength of the U.S. economy in the first quarter, but continue to monitor the impact that tax increases and spending cuts related to the Sequester will have on capital expenditure and consumer demand. While the U.S. economy is relatively stable, non-U.S. economies are more mixed with an improving Japan providing some relief from a slowing Europe.

There are three main risks to this outlook. First, there are still major political and policy risks that remain in the Eurozone of which the EU's approach to the Cyprus problem is a good reminder. In particular Eurozone leaders have yet to come to grips with the European Central Bank's (ECB) inability to provide equity and oversight to undercapitalized banks and with the lack of credible deposit insurance in the weaker countries. Second, with more positive investor sentiment and less conservative allocation strategy, especially in the U.S. and Japan, the risk of a steep contraction in equity prices increases especially in the presence of earnings disappointments or unexpected economic weakness. Third, the possibility of continued U.S. dollar appreciation against major currencies could be averse to emerging market economies as it was in 1990s as evidenced by the Asian debt crisis and the Russian default.

6 JP Morgan Asset Management, "Guide to the Markets, March 2013", Empirical Research Partners.

7 Bank Credit Analyst, Chen Zhao, March 2013



Despite these risks, we remain cautiously optimistic on the prospects for growth in the global economy, albeit at a lower rate than in previous years. In our view, stock market valuations are not yet at extreme levels in the U.S. even though absolute prices, but not prices relative to earnings, have returned to their pre-crisis levels. While the economic conditions outside the U.S. are not as strong, the reduced correlation across major world markets provides increased opportunity for active management.

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