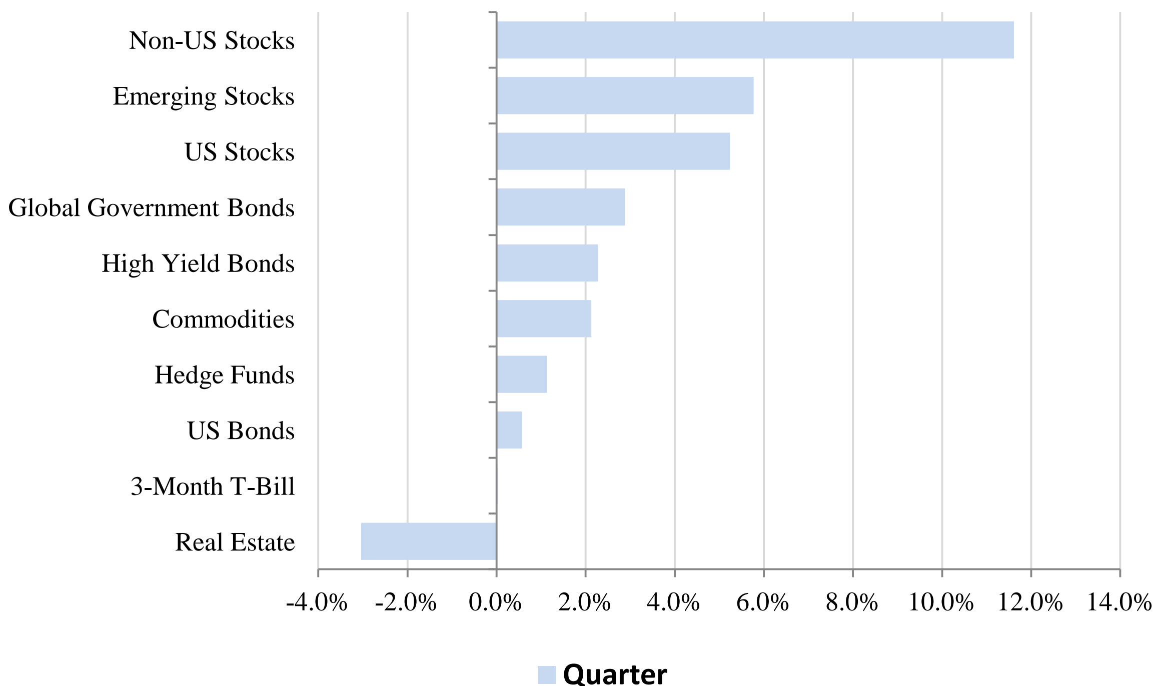
THE MCCABE PERSPECTIVE

Third Quarter 2013

In the third quarter, global equity and commodity markets rebounded from a weak prior quarter. During the latter, Chairman Bernanke's taper talk held back the advance in US equities and contributed to a major decline in non-US equities, commodities, and global bonds. The market recovery in the third quarter would have been stronger had there not been concerns that the US government would be shut down after September 30, 2013.

Investment markets have become increasingly frustrated with the lack of leadership and governance at the federal level in the US. However, US government shutdowns have been more frequent during the last 32 years than commonly realized. During this period, Congress has only passed the entire federal budget by the September 30 deadline four times. In addition, it has shut the government down 17 times with relatively minimal effects on the US stock market. However, this shutdown is the first since 1995/96.

Exhibit 1



Source: S&P 500 Index, MSCI EAFE Index, MSCI Emerging Markets Index, Barclays Capital US Aggregate Index, Barclays Capital US 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. All returns in US Dollar terms.

What is different this time is the degree of rancorous debate, polarization, and an unwillingness to communicate on both sides. Moreover, attention has now shifted from closure of some parts of the government, which occurred on October 1, to the possibility that the Treasury department will reach the limit to its extraordinary measures to work around the debt ceiling on or about October 17 (this date may be postponed to November 22).[1] The ceiling on US federal debt, which has already been hit, is a wholly arbitrary one. Only one other developed country, Denmark, has such a ceiling. The US has gotten away with playing fast and loose with the debt ceiling once before in 2011. Its borrowing costs fell, even though its debt was downgraded by S&P. In the words of Gideon Rachman in the Financial Times, "This has bolstered inward looking complacency in Washington."

In our opinion, once the Treasury can no longer use the extraordinary measures it is currently employing, outright default is highly unlikely. The US government's tax revenues substantially exceed its interest obligations. Principal payments can be made through rollovers without violating the debt service limit. The government is likely to prioritize interest payments on its debt, i.e., make most other payments in arrears. To stay under the debt ceiling, a tightening of fiscal policy by almost 5% of GDP would then need to occur rapidly. The reduced expenditures associated with this budget tightening would cause a very deep recession, unless they were reversed quickly. Moving quickly to a balanced budget, though self induced in this case, has effects similar to those of forced austerity in Greece and Spain which were brought on by pressure from the IMF, the EU and the markets.

If such extreme fiscal tightening were anticipated by markets, or even if the government were to delay payment on its obligations for a short period of time or incur technical defaults, expectations and uncertainty would cause a substantial reduction in private sector final demand. Thus, going substantially beyond the October 17 (November 22) deadline without raising the debt ceiling by a credible amount would result in US GDP along with US equity markets and the dollar falling much more than the US Treasury market.

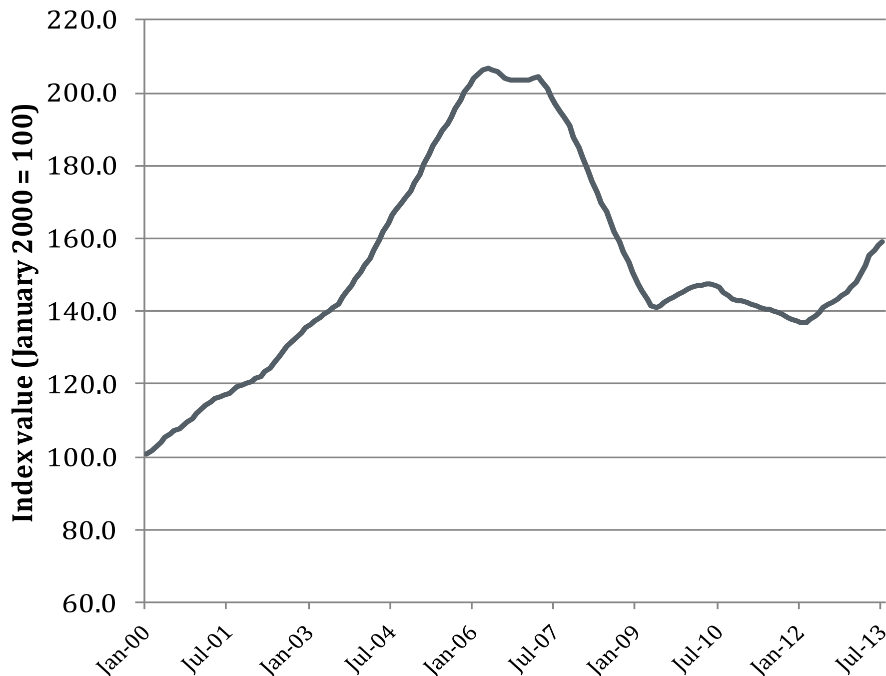
US Economy and Markets

Despite the dysfunction in Washington D.C., the US economy continues to grow, albeit at a subpar pace. Assuming the current debt ceiling debate does not result in severe fiscal tightening, we expect this growth to continue and even improve in 2014 since the impact of the tax increase and across the board spending cuts (sequester) enacted in 2013 are likely to weaken going forward. Evidence of this can be seen in key economic indicators such as the improving Institute for Supply Management's Manufacturing and Non-Manufacturing surveys, rising capital goods orders and modestly falling unemployment claims. In addition, the housing market continues to heal as evidenced by the 11.0% increase in house prices for the year ended July 31, 2013, according to data provided by the Federal Reserve Bank of St. Louis.

[1] This is the date the Treasury will exhaust its borrowing authority. The Treasury could conceivably continue normal payment until the end of the month.

While mortgage rates have trended higher over the last few months, they remain low by historical standards and, in our view, should not pose a threat to the housing recovery. Combined with strong equity market returns over the past year, house price increases are contributing to a positive "wealth effect" that should bode well for improved consumer spending in 2014. Also contributing to our positive outlook on consumer spending is the impact of lower gasoline prices which have benefited from falling oil demand and the lack of military action in Syria. Finally, we expect that the US Federal Reserve will maintain their accommodative stance given the recent nomination of Janet Yellen, who has significant experience at the institution and who has been a supporter of the current policy. We believe the extraordinary monetary support will likely continue (in whole or in part) given the uncertainties surrounding the fiscal situation, the slower than expected improvement in the employment picture and the fact that inflation is still well under control given the economy is not operating at full capacity.

Exhibit 2



Source: S&P, Federal Reserve Bank of St. Louis, FRED.

We believe the US equity market is fairly valued, but not overvalued on an absolute basis, and we favor US equities relative to US bonds on a forward looking total return basis. US small cap stocks have led the US market higher while the defensive (yield oriented sectors) have trailed as bond markets have declined. According to Bloomberg's forward earnings data, the US equity market was trading at a forward P/E of 15.3 as of September 30, 2013. While not expensive relative to history, the increased multiple has come primarily from rising prices opposed to earnings increases.

The US corporate sector is very healthy and is operating with record profit margins, but the growth rate has slowed since 2011. This is not only due to subdued top line growth in the US economy, but global revenues have been negatively impacted by another recession in Europe and slower growth in the emerging economies. If there is a modest improvement in global growth, as expected in 2014, earnings could again begin to rise and this would be good for valuations. This is especially true outside the US where, as of September 30, 2013, the forward price earnings multiple for the UK is 12.9, for Europe Ex-UK 14.4, for Japan 14.6 and for emerging markets 11.2.[2] While equity prices have advanced in the past year, we believe that valuations are below extreme levels.

Exhibit 3

Source: Federal Reserve Bank of St. Louis, FRED, September 30, 2013.

While there continues to be Fed support in the bond market via the $85 billion/month bond purchase program, a policy that has propped up both US Treasuries and US mortgage-backed securities, this will not last forever. With the policy rate pegged at historically low levels and the back up in the ten-year yield that started in May, the yield curve has steepened quite significantly. Once the fiscal uncertainty clears, we could see the yield curve steepen further. This would put further pressure on Treasuries and Treasury Inflation Protected Securities (TIPS). Over the course of the last several years, investment grade corporate bonds and high yield bonds have performed strongly and as bond

[2] Bloomberg

yields started to reverse, these categories within the US bond market have held up best, particularly those with shorter maturities. While US bonds may not provide as strong a return as they did in the past few years, we believe they still play an important diversification role within portfolios and can protect against growth disappointments.

Non-US Developed Economies and Markets

European growth seems to have bottomed and signs of positive growth are evident in the recent Institutional Supply Management (ISM) and the Center for European Research (ZEW) surveys. Most importantly, growth outside of Germany is starting to improve which suggests that economic growth is broadening out. In the third quarter of 2013, the MSCI Europe ex-UK Index rose 14.4%, outperforming the developed markets Index (MSCI EAFE) by 3.0%. The second quarter real GDP for the Eurozone was -0.5% which, although negative, was an improvement over the prior -1.0% contraction and a small indication of recovery. The Eurozone flash composite Purchasing Managers Index (PMI) for August rose to 52.1, higher than the prior encouraging 51.5 reading, which also points to improving economic activity, both in the manufacturing and non-manufacturing sectors. Spain and Italy were among the top performing markets for the quarter returning 25.6% and 19.6%, respectively, in USD terms, net of withholding taxes.[3] The Italian markets remained surprisingly calm after Italy's former Prime Minister, Silvio Berlusconi, withdrew his ministers from the coalition with Enrico Letta and threatened to derail the government. While this threat was eliminated in early October, it remains to be seen whether the upcoming government bond auctions that roll over portions of the maturing Italian debt will be successful.

In a recent Bank Credit Analyst conference held in New York on September 23-24, 2013, the Governor of the Central Bank of Cyprus warned that, "The main problem with the euro area project is that for a small fraction of euro member states (Germany, Austria, the Netherlands, Finland), the benefits of membership outweigh the costs; for the rest, regrettably, the reverse is true. Because the euro area is a loose confederation of states and the election cycles differ, there is always an election campaign underway. As a result, each member state rewards and elects those leaders who extract the most that they can from the whole."[4]

Overall, Western Europe's business cycle is about to transition to a recovery stage. However, the region's valuation discount seems to fairly reflect the remaining risks plaguing the region. There may be some opportunities within the Eastern European as well as the Middle Eastern and African markets which continue to trade at a significant discount compared to other emerging markets. Lastly, small cap stocks in developed Europe seem attractively valued relative to their North American peers.

Largely a result of accommodative monetary policy, Japan's economy is beginning to exit from deflation and growth is showing signs of revival. The Tokyo CPI Index ex Food & Energy continued its gradual rise but was still in negative territory at -0.3%. Japan's second quarter GDP grew 3.8% (1.2%

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[3] Bloomberg.
[4] "Easy Money Versus Weak Growth: Can The Bull Market Be Sustained?" BCA New York Investment Conference, September 23-24, 2013.

on a year over year basis), primarily due to increased government expenditures for the national defense budget. After a significant decline at the beginning of the year, the Japanese Yen stabilized and finished the quarter at 97 versus the US dollar. Japanese ten-year government bond yields fell from 0.86% in May to 0.69% in September,[5] after the US Fed delayed the end of its quantitative easing program. Like other regions around the world, the Tankan survey measuring business and consumer confidence, is showing strength. Whether Japan will be able to sustain its recent above trend growth remains to be seen, particularly as the government looks to increase tax revenue in 2014.

Emerging Economies and Markets

While US monetary policy has been a factor in the performance of emerging equity, bond and currency markets, the underlying reason behind the weakness has been and continues to be weakening economic growth. It is important to differentiate within the emerging markets and as a result, we believe an active approach to security selection and country selection is prudent in an environment where some economies are improving while others are still under pressure. The "taper talk" in May led to a severe capital flight from all emerging markets. This was especially damaging to those countries that depend on foreign capital for growth (i.e., those with the largest current account and budget deficits – see Exhibit 2). The Federal Reserve's decision not to taper prompted a strong rally in the emerging markets in the third quarter, particularly those that suffered significant currency losses. However, we feel that the Federal Reserve has only delayed the eventual start of the tapering program and as such, these markets remain at risk.

Exhibit 4

Country	Region	YTD Implied Currency Return*	YTD USD Return	Current Account Balance (% of GDP)	Budget Balance (% of GDP)	Government Debt/ GDP (% of GDP)
SOUTH AFRICA	EM EMEA	(7.7)	1.5	-6.5	-5.3	40.0
TURKEY	EM EMEA	(11.2)	(11.8)	-6.0	-2.1	36.1
INDIA	EM Asia	(12.3)	(12.1)	-5.4	-5.9	49.6
PERU	EM Latin America	0.0	(31.8)	-3.5	-0.8	16.6
POLAND	EM EMEA	(0.7)	(0.0)	-3.3	-3.9	57.1
COLOMBIA	EM Latin America	(6.3)	(10.6)	-3.3	-1.9	40.6
INDONESIA	EM Asia	(16.1)	(18.2)	-2.8	-1.5	23.0
CZECH REPUBLIC	EM EMEA	0.3	(9.6)	-2.7	-4.4	45.6
BRAZIL	EM Latin America	(7.2)	(9.3)	-2.4	-2.6	58.8
MEXICO	EM Latin America	(1.0)	(4.5)	-0.8	-2.6	35.9
THAILAND	EM Asia	(1.8)	(2.0)	-0.4	-4.6	44.5

*(MSCI USD –Local Index return) is used as a proxy for currency movements.
Source: Bloomberg, September 30, 2013.

Within China, the largest and one of the fastest growing emerging markets, the main concerns of leverage and misallocation of capital remain. The Bank Credit Analyst points out that while central

[5] Bloomberg

government debt is low, non-public non-financial debt is close to 200% of GDP.[6] Against this credit concern, China is growing slower than it has in many years with real GDP measured in the second quarter at an annualized 7.5% rate. However, there are signs that recent government attempts to stimulate the economy are having a positive impact. The official Purchasing Managers Index for China reached 51.1 while the HSBC Markit PMI index rose slightly in September to 50.2. Both figures indicate that the economy is expanding again.

One of the key risks associated with China is the financial services sector given the likelihood of large non performing loans resulting from poor capital allocation over the past five years. The Communist Party leaders will meet in November to discuss and further implement reforms in the financial services sector. One recently implemented reform in the sector was the removal of the bank lending rate floor; this is poised to provide relief, in terms of borrowing costs, to the heavily indebted private and local government sectors; it will also reduce the banks' profit margins. As the financial sector reforms progress further, the bank deposit rate ceiling is also expected to be removed which should further squeeze the banks' profit margins, but will also help rein in the so called wealth management products as banks will offer more attractive deposit rates and attract capital.

From a valuation standpoint, emerging market equities are trading at relatively attractive levels on the surface. However, two large segments of these economies (commodities and banks) are the cheapest sectors and, in our view, have the highest risks. The higher quality sectors, such as consumer staples, remain at elevated valuations. In addition, analysts have been reducing growth rate projections for certain major emerging market economies, such as India, Russia and Turkey. Some emerging market central banks are raising policy rates to attract capital and contain inflation.

Summary

We remain cautiously optimistic on global economic growth and global equity markets but guarded on the US bond market. The tug of war between self-sustaining economic growth and the need for continued support from the world's central banks continues to be the primary dynamic driving global markets. In our view, we are nearing the end of the extraordinary monetary stimulus era and transitioning to a period of self sustaining growth, however, we are not there yet. While the Federal Reserve postponed their decision to taper, they will resume at some point. Most global economies are not operating at capacity and the pace of growth remains unsatisfactory and therefore continued central bank support is warranted, in our opinion. In fact, at the Bank Credit Analyst's New York conference in September, former Treasury Secretary, Larry Summers, and former Vice Chairman of the Board of Governors of the Federal Reserve, Donald Kohn, agreed that in a world of fiscal constraints, expansionary monetary policy was warranted, especially if there was little evidence of inflation.

The headwinds to faster growth included the austerity measures put in place in the US and in Europe in order to stem the rise in public debt, and the slowing of internal growth within key emerging market economies such as China and Brazil. There are signs in the US, Europe and China that these

[6] Bank Credit Analyst, Emerging Markets Strategy.

headwinds are becoming less severe and if this is the case, we would expect economic growth to accelerate.

Given our outlook for increased growth in Europe and the US in 2014, as well as continued monetary expansion in developed markets, we recommend that clients maintain their strategic global equity weighting since the Federal Reserve is likely to taper bond purchases, especially if the US economy picks up. We also recommend a continued tactical tilt toward shorter duration bonds.

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