SEVEN SUMMITS CAPITAL

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APRIL 2014 INVESTMENT COMMENTARY

WHAT COULD BE IN STORE FOR BOND INVESTORS? · U.S. ECONOMIC POTENTIAL · WHY ALTERNATIVE INVESTMENTS?

As we say goodbye to the first quarter of 2014, U.S. equity markets have lost significant traction compared to how they ended in 2013. The Dow Jones Industrials and the small cap oriented Russell 2000 is down YTD, with the S&P 500 and Nasdaq up less than 2%.

In our January commentary, I stated that "entering 2014, I am more cautious than I have been since 2007". Needless to say, what the markets have been doing over the last several months is not surprising given how I interpreted the investment environment at the beginning of the year. What has been surprising, however, is that most broad bond indices, including high-yield bonds, have out-performed the major stock indices. In my opinion, this is due to investors being hesitant to push stock valuations any higher than current levels and not being particularly concerned about a meaningful slow-down in economic growth in the foreseeable future. If economic concerns were present, high-yield bonds would not likely have out-performed stocks, as perceived economic weaknesses will tend to put downward pressure on the securities within this asset class.

The market action over the first quarter of this year has largely been consistent with the various limitations to a continuation of the strength that persisted during 2013. Cautious is the right term to describe how we view the major stock and bond indices for 2014. But that caution does not lead to inaction. If anything, it leads to the opposite when it comes to risk management and constructive repositioning of portfolios. If the current investor sentiment persists, the multiple expansions that occurred in the equity markets during 2013 will most likely come to an end, meaning that broad valuation metrics have peaked. For bond investors, the prospect of higher interest rates will make adding to bond allocations less appealing. This, along with a seemingly fully valued stock market, will lead many investors to become uncertain regarding their investment strategy due to the apparent lack of attractive opportunities within the major asset classes of stocks and bonds.

From my experience, if market participants believe that opportunities do not exist, investment time horizons will shorten, and the concept of margin of safety will become more prominent. In this environment, high multiple "momentum" oriented stocks will tend to struggle to maintain their premium valuations. These premium valuations have largely been rationalized through very optimistic long-term projections of growth. Similarly, when interest rates are unacceptably low, investors turn to bonds with higher than market yields. These investors are willing to trade safety and liquidity for securities with long maturities, below average credit quality, and/or opaque leveraged high yield products. The concern with these types of fixed income investments boils down to risk versus return. In today's low interest rate environment, without the prospect of bond price appreciation from ever lower interest rates, the increased likelihood of anemic total returns or even losses provides an unacceptable risk/return dynamic.

WHAT COULD BE IN STORE FOR BOND INVESTORS?

It is very challenging for most investors today to comprehend what it will be like to invest during a multi-year period of rising interest rates. In order to illustrate what bond investors may look forward to over the next several years, assuming an orderly increase in market yields, I have compiled a history of market yields and total returns during two multi-year periods when yields rose consistently for seven years or more:

	10 YEAR T-NOTE	
YEAR	YIELD	RETURN
1954	2.48 %	0.96 %
1955	2.61 %	1.66 %
1956	2.90 %	2.56 %
1957	3.46 %	3.23 %
1958	3.09 %	1.78 %
1959	4.02 %	3.26 %
1960	4.72 %	3.05 %
1963	3.83 %	1.68 %
1964	4.17 %	3.73 %
1965	4.19 %	0.72 %
1966	4.61 %	2.91 %
1967	4.58 %	-1.58 %
1968	5.53 %	3.27 %
1969	6.04 %	-5.01 %

When analyzing the above data, two important take-away observations are: (1) during an orderly multi-year increase in bond yields, bond investors experience annual total returns that are lower than the coupon yield of the prevailing bond, and (2) the average annualized total return during these periods was lower than the beginning treasury note yield, 2.29% versus 2.48% during the 1950's and 1.51% versus 3.83% during the 1960's.

I believe that this analysis of the two longest protracted periods of rising interest rates in post-WWII United States is important to consider as we enter a period of Federal Reserve QE tapering.

Also, it is important to remind ourselves what has preceded the recent trough in U.S. interest rates and the policy reversal from the Federal Reserve. The 10 Year Treasury Note hit a low last April of approximately 1.60%, which was the conclusion of a 34 year trend that began with the 10 Year Treasury Note hitting a high of 15% during 1981. However, rates have not come straight down year after year over the last 34 years. In fact, following President Reagan taking office in 1981, there were 12 years when the yield on the 10 year Treasury Note rose year-over-year. Yet, when viewed by the decade, the average yield of the 10 year Treasury Note measured on January 1 of each year was as follows:

DECADE	AVG 10 YEAR TREASURY YIELD
1980s	10.55 %
1990s	6.60 %
2000s	4.47 %
2010 - 2014	2.77 %

From a historical context, we began this 34 year period with extra-ordinary monetary tightening in order to break the cycle of stubbornly high inflation that was threatening economic growth and stability. We ended this period with extraordinary monetary easing in order to stabilize a fragile economy that needed to deleverage many decades of excess credit expansion, fostered in part by a persistently easy monetary policy. When inflation was the biggest threat to the U.S. economy, President Carter appointed Federal Reserve Chairman Paul Volcker who used the blunt instrument of monetary tightening to curb inflation expectations. Four Presidents later, President George W. Bush appointed Federal Reserve Chairman Ben Bernanke who had to use blunt monetary easing and extra-ordinary QE measurers to ensure that deflationary expectations did not take hold. So opposite extremes in inflation resulted in opposite monetary policy activism in order offset economic imbalances.

Today, interest rates have seemingly bottomed out along with borrowing costs. Future interest rate increases, along with the baby boomers moving into retirement, imposes pronounced economic headwinds after several decades of relatively smooth sailing.

In spite of the economic challenges facing the U.S., our economy has proven itself to be remarkably resilient and adaptable thanks to a culture of capitalism and entrepreneurial risk taking. Therefore, in spite of the headwinds that our economy currently faces, I fully expect the U.S. economy to adapt and continue to out-perform other developed nations over time.

U.S. ECONOMIC POTENTIAL

Regarding the current stubbornly slow recovery from the 2008-09 recession, I am not surprised that the U.S. economy is struggling to achieve a 3.0% annual GDP growth. It is unrealistic, in my opinion, to expect our economy to recover, even with extra-ordinary monetary stimulus, as it did during the past decades. Because of this view, I did not join those who feared another imminent recession each time the economy felt like it was stalling over the last several years. Instead, by focusing on the structural changes to both our population and economy, I was able to objectively conclude that we were experiencing a period of muted growth and recalibration. Some might call it an "economic hangover" or "new normal", but regardless of the labeling, it is an economy which is in a long-term state of healing and adjustment.

To listen to most pundits, one would think that the 1.8% to 2.8% annual GDP growth that we have had since 2010 is a new phenomenon. In fact, from 2003 to 2007, the U.S. economy grew within that same range for three of those five years. During the two years of stronger growth, the annual growth was sub-4%. It should be noted that those five years had the "benefit" of a very large tax cut, significant credit expansion and a housing bubble that was inflating. During the last four years, the U.S. consumer has been reducing debt, taxes on the wealthiest Americans rose, and the housing market has been slowly recovering, not booming.

What has helped me put the state of the U.S. economy in context is a JP Morgan Economic Research report that I have had on my desk for the last 9 years titled The rise and fall of U.S. potential – *U.S. potential GDP growth is slowing to 2.5%*. This report was written by economists Bruce Kasman, Michael Feroli, and Robert Meliman on September 20, 2006. The 23 page report includes a lot of forecasts for the labor force, productivity, demographics, and the effects technology on the economy. Some of these forecasts were rendered inaccurate due to the unforeseen severe financial crisis and recession, however many of the report's forecasts turned out to be reasonably accurate. The first paragraph of report stated what now has become a hotly debated topic among economists:

> *In a stark reversal of its 1990's ascent, the US potential growth rate is now falling. From an estimated 3.5% pace at the start of the decade, it has already slowed to 2.7%. This slide is not complete; US potential growth is likely to average 2.5% over 2007-10, the lowest in the post-World War II era.*

In the context of this 2006 assessment of the U.S. potential GDP growth rate, without factoring in the damage done to our economy by the 2008 financial crisis and the resulting deep recession, it should not surprise anyone that the average GDP growth rate over the last four years has been 2.25%, just 0.25% short of the potential growth rate forecast within this report.

The JP Morgan economists also dove into what is now a much talked about labor statistic, the commonly misunderstood Labor Force Participation Rate. The report made the following observation:

> *The slower growth of labor force supply in the current expansion (2003-06) will be reinforced by the aging of the labor force. Labor force participation rates begin to decline as workers approach 60, and the aging of the baby boomers will produce inexorable downward pressure on overall participation over the next decade.*

In light of the aforementioned paper's insight into a very unpopular, but unfortunately very realistic forecast of the U.S. economy, I have been able to largely ignore much of the partisan "blame game" cause-and-effect economic analysis that followed the 2008-09 recession.

WHY ALTERNATIVE INVESTMENTS?

Investing in an environment where demographic and economic trends are counter to those that most investors have become accustom to is challenging. The patterns and correlations that most of today's investors have used are no longer as predictive as they once were. Success today requires an objectivity that can only be accomplished when realistic expectations and a forward-looking perspective are applied. This objectivity is what has driven me to redefine traditional asset allocation options to include non-correlated alternative investments. These investments perform based upon the merits inherent in the investment versus other extraneous (systematic) forces such as stock market booms and busts and interest rate direction.

Seven Summits Capital is certainly not alone in shifting client allocations toward non-correlated alternative investments in a meaningful way. However, we seek out non-traded strategies that are focused on investment opportunities that can be easily understood. These predominately non-traded investments are more attractive, in our opinion, than recently created and commonly used complex and expensive traded alternative asset mutual funds. According to a recently published Barron's article in the magazine's Penta section, which caters to high net worth investors, wealth managers are, on average, recommending 20.4% of client balanced portfolios to be invested in alternative investments, such as private equity, real estate, and hedge funds. Investment News, in an article titled *The Perfect Storm: Why Alts Make Sense*, written by Jeff Benjamin and published on March 30, 2014, stated that, "A recent survey of wealthy investors conducted by MainStay Investments found that 61% of respondents are using alternatives in some form, with an average portfolio allocation of 22%". At Seven Summits Capital we believe that alternative allocations for a balanced wealth management portfolio should fall between 20% and 30%. Depending upon the unique needs of each client, some allocations to alternative investments are below this range and others can justify higher allocations.

This commentary is focused on matters that I would characterize as top-down considerations or macro factors within in the realm of what an investment manager must pay attention to. Although these broad market and economic considerations do not directly impact our security selection process, our understanding and more importantly, our interpretation of these issues provide clarity under during circumstances that can act to cloud good judgment.

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