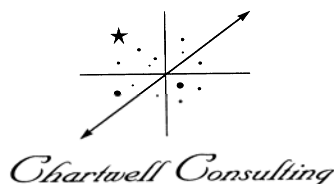

CHARTWELL REVIEW

October 2014 **THIRD QUARTER 2014** *Volume XXI, Issue No.3*

Stop Your Yellin'!!

It's hard to recall the last time the Fed didn't occupy front of mind status with global investors. We are still in the midst of the most controversial global monetary policy experiment since Volcker broke the back of double-digit domestic inflation, by taking the Fed Fund's rate to over 20%, slamming down credit, and precipitating a recession.

Today, Bernanke/Yellen remain engaged in nearly the opposite tack. Trying to keep the economy from slipping back into a recession and raise sustained inflation to a still-modest 2%, by nailing short-term rates to the floor and pushing a few trillion of dollars of raw liquidity into the system through various quantitative easing measures. The European, UK, and Japanese central banks are all caught up in the experiment, with the ECB still dragging its feet a bit, at Germany's insistence.

This year has been about the QE3 wind down (it expires in October), and half of the third quarter's newsprint was spent on that. But the other half was spent to conjecture about when the zero interest rate policy would end, how far the Fed Fund's rate might rise in order to "normalize" the yield curve, and how fast it might rise. As the 3rd quarter ended, the market's guesses were - the third quarter of 2015, around 1.75%, and by the end of 2016. That would be the most gradual tightening on record, during what has been the most gradual economic recovery since WWII.

But, it all hardly matters. The Fed will soon be exiting the stage. Even if Treasury rates rise 200 bps, that won't be the reason the global economic recovery is cut short. The problem is insufficient growth in aggregate demand. The kind of weak demand that keeps inflation under 2% despite unprecedented monetary policy. After five years of massive pump priming, it has become increasingly clear that all this "yellin' about Yellen" is not getting us anywhere. We need to re-start making stuff and buying stuff. It can't be just about Wall Street for much longer.

Domestic large-cap stocks remained your best bet by a wide margin during the quarter, but even this sector rolled over during the first half of October. Summertime's over.

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	3Q 14	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	1.1	19.7	23.0	15.7	8.1
U.S. Top-cap Stocks	1.7	20.5	23.0	15.4	7.7
U.S. Mid-cap Stocks	(1.7)	15.8	23.8	17.2	10.3
U.S. Small-cap Stocks	(7.4)	3.9	21.3	14.3	8.2
Non-US Stocks (**devel**)	(5.8)	4.7	14.2	7.0	6.8
Non-US Stocks (**emerg**)	(3.4)	4.7	7.6	4.8	11.0
3 mo. T-Bills	0.0	0.0	0.1	0.1	1.5
U.S. Aggregate Bonds	0.2	4.0	2.4	4.1	4.6
High Yield Bonds	(1.9)	7.2	10.9	10.4	8.2
Global AGG, $-hdgd	(3.1)	1.2	1.2	2.7	4.4
CPI, annualized	*(0.5)*	*1.7*	*1.6*	*2.0*	*2.3*
Bloomberg Commodity	(11.8)	(6.6)	(5.3)	(1.4)	(1.0)
FTSE Nareit All REIT's	(2.6)	13.4	17.0	15.7	7.7
Chartwell Global 65/35	*(2.7)*	*8.9*	*12.9*	*9.2*	*7.8*

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	3Q 14	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
U.S. Large-cap	0.2	16.8	21.8	14.6	8.0
U.S. Mid-cap	(2.9)	11.9	21.7	15.2	9.3
U.S. Small-cap	(6.8)	4.5	21.0	14.5	8.7
International Lg. Cap	(5.8)	4.2	13.7	6.9	6.8
International Sm. Cap	(7.1)	4.4	16.0	11.1	9.3
Emerg. Mkt. Equity	(3.5)	5.3	8.5	5.0	10.3
Balanced/Hybrid	(1.1)	9.1	12.3	9.3	6.5
General Bond	(0.1)	4.5	3.6	4.9	4.9
High Yield Bond	(1.9)	6.1	10.1	9.5	7.1
Equity Hedge Index	(1.2)	6.8	8.4	5.5	5.3

*Annualized trailing returns for periods ending 9/30/14

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Economies, Economics, Prices, and Policy

	9/2014	6/2014
CPI - All, yoy	1.8%	2.1%
Real GDP Growth - 1yr	2.6%	1.5%
Employment / Population %	59.0%	58.9%
Not in Labor Force as % of Adult Population	37.3%	37.2%

The Fed continued to taper its QE3 program of long-term Treasury and mortgage bond purchases during the quarter. The original $85bn/month program will be zeroed out during October. The fact that Treasury bond prices have rallied throughout the year suggests there are other, larger, sources of marginal demand – especially foreign private and sovereign investors.

On the fiscal policy front, the Congressional Budget Office announced that the 2014 federal budget deficit (FYE September) was $483 billion. That's 2.8% of GDP, and $197bn less than for 2013. By comparison, the 2009 deficit was $1.4 trillion, and over 10% of GDP. Some deplore the deficit's decline for its implicit restraint on the economy, and others deplore that we have a deficit at all after a 5-year expansion. But, you've got to acknowledge the progress.

Figure 3: Breaking Down Real U.S. GDP

% Change from Preceding Period
(seasonally adjusted at annualized rates)

Factor	2Q '14	1Q '14	4Q '13	3Q '13
Real GDP Growth	**4.6**	**(2.1)**	**2.6**	**4.5**
Nominal GDP Growth	**6.8**	**(0.8)**	**4.2**	**6.2**
Final Sales	**3.2**	**(1.0)**	**3.9**	**3.0**
Personal Spending	2.5	1.2	3.7	2.0
Private Investment	19.1	(6.9)	3.8	16.8
- Fixed, Businesses	*9.7*	*1.6*	*10.4*	*5.5*
- Fixed, Residential	*8.8*	*(5.3)*	*(8.5)*	*11.2*
*- Chg. In Inventories (**$bn**)*	*$85*	*$35*	*$82*	*$96*
Export growth	11.1	(9.2)	10.0	5.1
Import growth	11.3	2.2	1.3	0.6
Government Spending	1.7	(0.8)	(3.8)	0.2

The third report of 2nd quarter **real domestic GDP** was released in late September. The economy grew at an annual rate of 4.6%, as we rebounded smartly from an extremely difficult winter. As we see in Figure 3, the biggest swing factor was gross private domestic investment, accounting for 60% of the turnaround. Of this, inventory growth was the biggest element. Export growth accounted for the remainder of GDP growth. Quite a bit of that was due to aircraft sales' timing.

3rd quarter GDP growth had been forecast at 2.5-3.0%. But, the consensus was recently marked down to just 2.0-2.5%, with full-year 2014 forecast at 2.0%.

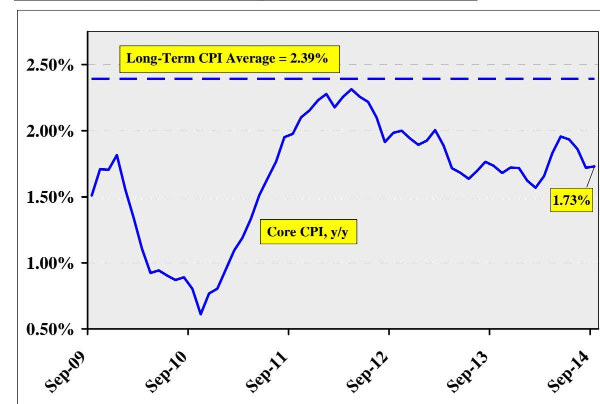
US employment once again increased smartly during the quarter. Adjusted for seasonality, non-farm payrolls increased by a very robust 671k, after rising 816k during the first quarter. Conversely, the household survey reported that employment increased only 379k persons, compared to 479k in the second quarter. The Employment-Population ratio was flat at 59.0%, and the Labor Participation rate declined to 62.7%.

Disaffected workers (want work; aren't looking right now) remained at 2.2 million persons in September, essentially unchanged from a year earlier. During that time, non-farm payrolls have risen by 2.64 million persons. This "overhang" of marginally attached workers, plus high levels of part-timers, may help explain why real average weekly earnings increased by just 0.6% for the year ended in September.

Labor productivity rebounded to grow at an annual rate of +2.3% in Q2, after falling at a rate of 4.5% during the weather-affected first quarter. Year-over-year, it had increased just 1.1% through June. Real wages typically won't increase faster than labor productivity, unless a labor shortage develops.

The **Core CPI** (ex-food and energy) index has spent very little time above 2% during the current market rally, despite the Fed's efforts. It popped up marginally to 1.9% year/year through June, but subsequently dropped back once again during the third quarter (see Figure 4). The overall CPI index (including food and energy) was also up just 1.7% for the one year ended September. **Producer prices** for final goods and services fell very slightly during the third quarter. This index is up just 1.6% over the past year.

Figure 4: Inflation Experience since 2009



With forecasted growth in very short supply, investors are increasingly on the lookout for any weakness in the data. September's advance report on **retail sales** provided some. The month's sales declined from August on an adjusted basis, and both August and July numbers were revised downward. Stocks sold off aggressively on the news.

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Quantitative Ending

Seasoned Bond Yields	9/2014	6/2014
Fed Funds	0.10%	0.10%
5-year Treasury	1.78%	1.63%
10-year Treasury	2.51%	2.54%
AA Credit	2.25%	2.09%
BBB Credit	3.60%	3.40%
Fannie Mae 30-year	3.06%	2.98%

Domestic bond market yields were mixed during the quarter, with the 10-year Treasury ultimately lower by only 3 basis points (bps). However, the story was told in parts. Treasury prices, especially for long-term bonds, rallied hard through August. The 10-year's yield closed August at 2.35%, off 19 bps for the QTD and nearly 70bps for the YTD. The 30-year's yield fell to only 3.08% (off 26 bps QTD). Investment grade credit bonds underperformed, but still posted solid positive QTD returns through August in the +1.5% range.

Then, everything backed up in September. Not one broad bond category posted a gain for the month. The results can be seen in Figure 5. With the yield curve flattening by nearly 30 bps, the long US Treasury index was by far the best performer. All major non-government sectors lagged Treasuries due to geopolitical pressures and lagging global growth. Long credit bonds returned only 0.1%, as widening credit spreads overcame the positive duration effect. Shorter-date corporate bonds, which had no duration advantage, produced a slight negative return. High yield bonds were the worst performing sector, as their yields backed up by over 75 basis points due to large net outflows from the sector.

Looking further at domestic sectors, financial bonds performed much better than industrials and utilities. Agency MBS underperformed on a spread basis, but overall returns were protected by the much lower interest rate sensitivity. Higher coupon non-agency and commercial mortgages were bid up during the quarter.

Increased concerns about the potential onset of a recession in Europe, along with substantial deflation risk, saw investors once again aggressively bid up longer-term sovereign bonds. German and Swiss bond yields dropped over 20bps. British, Italian, and Spanish sovereign bonds all yielded less than US Treasuries by quarter's end. These ultra low developed market yields have spurred investors to rotate into US bonds. In turn, that trade saw the US$ rally hard versus the major (and minor) currencies. As a result, the unhedged Non-US Global Bond Index declined 5.4% for the quarter, while the hedged index returned +2.1%. Dollar-based emerging markets bonds sold off 1.7% during the quarter, but were still up 7.3% for the y-t-d. Local currency EM bonds lost 5.7% for the quarter, and have just broken even during 2014.

Figure 5: Primary Bond Sector Returns (%)

Index	3Q '14	1 Year	3 Years
US Aggregate Bond index	0.2	4.0	2.4
US Gov't: 1-3 Yrs.	0.0	0.5	0.5
US Treasury: Long	2.7	11.6	2.0
US Inflation-Linked	(2.1)	1.9	1.4
Mortgage-Backed	0.2	3.8	2.1
CMBS	0.2	3.7	2.1
Asset-Backed	0.1	1.7	1.8
Inv. Grade Credit, 1-10yr	(0.1)	4.3	4.4
Inv. Grade Credit, 10+yr	0.1	13.4	6.7
US High Yield Credit	(1.9)	7.2	11.1
Municipal Bonds	1.5	7.9	4.6
Global Aggregate, ($ hdgd)	1.1	5.5	3.9
Global Credit	0.3	6.8	6.6
Emerg. Mkts Bonds (US$)	(1.7)	8.3	7.7

Figure 6: Primary US$ Bond Yields in 2014

US Treasuries	Sep-14 (%)	Jun-14 (%)	Mar-14 (%)	Dec-13 (%)	Y-T-D Change (%)
3-month	0.02	0.05	0.03	0.07	(0.05)
2-year	0.59	0.46	0.43	0.39	0.20
5-year	1.78	1.63	1.73	1.74	0.04
10-year	2.51	2.54	2.73	3.01	(0.50)
30-year	3.21	3.34	3.56	3.94	(0.73)
BarCap Aggregate	2.36	2.22	2.40	2.49	(0.13)
BBB Credit	3.58	3.36	3.67	3.88	(0.30)
AA Credit	2.24	2.08	2.19	2.25	(0.01)
Agency MBS	2.90	2.79	3.11	3.26	(0.36)
Emerging Mkts ($)	5.38	5.35	5.56	5.88	(0.50)
US High Yield	6.13	5.30	6.10	6.37	(0.24)
UST30y-UST2yr	2.62	2.88	3.13	3.55	(0.93)

Figure 7: Sovereign Bond Yields, selected countries

10 yr. bond yields	Sept-14 %	June-14 %	Mar-14 %	Dec-13 %	Y-T-D Change
United States	2.51	2.54	2.73	3.01	(0.50)
Germany	1.01	1.26	1.57	1.94	(0.93)
Switzerland	0.57	0.76	0.94	1.25	(0.68)
Britain	2.50	2.98	2.77	3.29	(0.79)
Poland	2.99	3.43	4.25	4.34	(1.35)
Italy	2.37	2.74	3.34	4.09	(1.72)
Spain	2.15	2.70	3.27	4.22	(2.07)
Greece (new bonds)	6.25	5.88	6.86	8.57	(2.32)
China (5 year)	3.93	3.85	4.15	4.49	(0.56)
Australia	3.61	3.59	4.11	4.23	(0.62)
South Korea	2.98	3.22	3.55	3.57	(0.59)

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Size Matters

The domestic equity market's volatility increased substantially during the 3rd quarter, and this volatility has extended itself into 4th. As with bonds, the stock market's story for the quarter was one of many parts. The large-cap market, i.e., the S&P 500, treaded water during July, raced to break the symbolic 2000 level right at the end of August, followed through to a new all-time closing high of 2011 on 9/18, only to then plunge by 9.2% during the next 4 weeks. Some fear the September 19th Alibaba IPO, the largest in stock market history, will mark a historic top. Overall, domestic stock prices once again edged higher for the quarter, with the S&P index ultimately gaining 1.1%, although small cap stocks lost considerable ground.

In terms of risk factors, the size effect (*smaller-caps > larger-caps*) was once again soundly reversed. Large-cap stocks eeked out positive returns during the quarter, mid-caps lost 1-3%, and small-caps declined a hefty 6-9%. This continued a trend we've observed during much of 2014. For the past year large-caps have outgunned small-caps by a very large 15-18%. In a classic case of mean reversion, this year's small-cap underperformance has caused the 3-year annualized returns of both large and small stocks to have now moved very close together, in the 22% range.

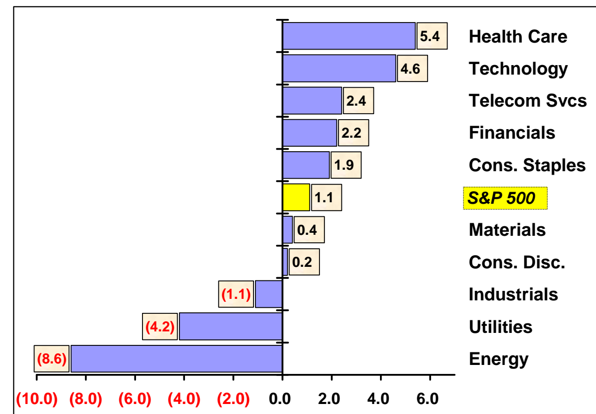
Figure 8: U.S. Equity Market - Size/Style Returns

		Trailing		
	3Q '14	**1-yr**	**3-yrs**	**5-yrs**
Growth				
Large Cap	2.5	21.4	22.4	16.4
Mid Cap	(0.7)	14.4	22.7	17.1
Small Cap	(6.1)	3.8	21.9	15.5
Value				
Large Cap	0.9	19.5	23.6	14.4
Mid Cap	(2.6)	17.5	24.7	17.2
Small Cap	(8.6)	4.1	20.6	13.0

The top performing large/mid-cap sector was health care, including Gilead, Amgen and Regeneron amongst the leading contributors. Information technology was a slightly bigger contributor to returns, due to its much larger total market cap. Apple, Microsoft, Facebook and Intel were the top tech names. Both of these sectors are more heavily represented in growth indices, leading to their outperforming the value indices. Financial services stocks, especially select "too big to fail" names, like Berkshire Hathaway, Bank of America, and JP Morgan posted strong contributions to value portfolio returns.

On the other side of the performance ledger were energy and utilities stocks. These were the weakest sectors during the 3rd quarter, having been the best performing sectors during the year-to-date through June. Energy names in the S&P 500 index dropped 8.6% in cap-weighted terms, led down by Conoco, Chevron, Schlumberger, and ExxonMobil. The much smaller utilities sector was off -4.2%.

Figure 9: US Sector Returns – 3rd Quarter 2014



Small-cap stocks reflected weakness across all sectors during the quarter, as the market segment suffered a major correction during the period amidst high volatility. The Russell 2000 index peaked on 7/1 at 1206, dropped over 7% in July, rallied almost 6% in August, and fell 8% in September. Early October losses took the index down to 13% below its 7/1 peak. The biggest contributors to small-cap losses during the quarter were energy and industrials stocks.

Looking at other risk factors for US stocks during the quarter, the positive contributors were high quality (high margin and high ROE) and positive investor sentiment (price momentum and analyst revisions). Important negative factors were risk-related (high beta and high volatility).

Figure 10: P/E Ratios by Style and Size - Sept. 2014

	Value	Blend	Growth
US Large	16.1	18.3	21.0
US Mid	19.5	21.6	24.0
US Small	18.0	20.7	24.5
EAFE		15.7	
Emerg. Mkts		12.7	

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International Markets – Stumble and Slide

Global stock markets declined in third quarter, weighed down by geopolitical turmoil, economic troubles in Europe and concerns about the impact tighter monetary policy in the US might have on emerging markets. US stocks managed a modestly positive return with the S&P gaining 1%, as the US economy showed signs of growth, but the MSCI World ex-US (developed markets) index dropped -5.7% for the quarter. The US dollar rose very sharply, gaining 8% versus the euro and the yen. This pushed positive local currency market returns into negative territory for US investors. Regionally, the Pacific region outpaced Europe for the quarter, dropping -3.6% versus -7%. Canada, which was the top performing developed market in 2Q, dropped -4.5%, as falling oil prices pulled down oil-related companies.

European stocks declined amid weak economic growth, mounting **de**flationary pressures and a depreciating currency. These conditions prompted the European Central Bank to cut its primary lending rate to 0.05% in September and launch a QE-style bond-buying program in an attempt to boost the euro-zone economy. Germany, the euro-zone's largest economy, dropped over -11%, France fell -8.4%. Smaller Austrian and Portuguese markets declined -22% and -25%. Finland held up best, dropping only -2.9%.

In the Pacific region, Japanese equities posted the least negative results amongst developed countries, down just -2.3%. BOJ Governor Kuroda reiterated his pledge to maintain the pace of monetary easing. A rapidly depreciating yen helped propel exporters (Sony, SoftBank, Panasonic), but the advance was broad-based, including companies in the technology, healthcare and materials sectors (Murata Manufacturing, Astellas Pharma and Fanuc). Australia (-7.9%) suffered from falling commodity prices, as iron ore prices hit 5-year lows. Hong Kong (-2.6%) retreated amid pro-democracy demonstrations in the city's central business district and a third straight month of gaming revenue declines in Macau. A surge in Chinese IPOs helped buoy the financial sector.

Emerging markets (-3.5%) fell on concerns over the potential impact tighter monetary policy in the US might have (ala 2013, when tapering was first mentioned) and geopolitical instability, but still held up better than developed markets. Despite concerns, about the pro-democracy protests in Hong Kong, most Asian markets rose, with China gaining 1.4%, India 2.3%, Indonesia 3.4% and Thailand 7.7%. South Korea fell -7.3%, as Samsung and Hyundai both pulled back during the quarter.

Weakness in Latin American markets (-5.5%) was driven by Brazil, which dropped -8.6% amid dramatic market swings in the run-up to October's presidential election. 2Q GDP came in at -0.6% versus -0.2% in 1Q, placing the country in a technical recession.

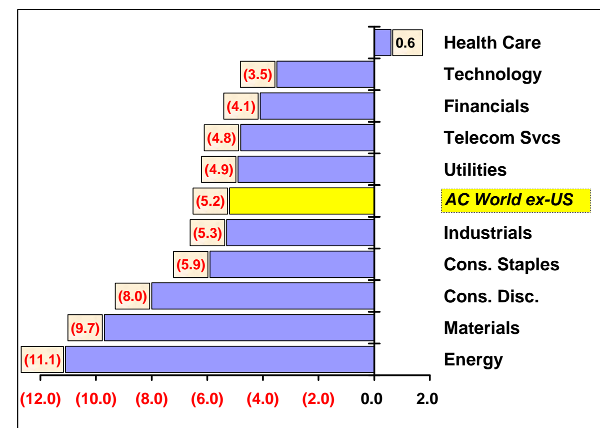
In contrast, Mexico gained 2%, as economic growth accelerated and the government moved forward with reforms. The weakest region was Europe (-12.4%), led down by Greece (-20%), Turkey (-11%) as instability in the Middle East arrived on their border, and Russia (-15%) as a result of their aggression in Ukraine and increased sanctions from the West. Most emerging market currencies depreciated against the US dollar. The best performing countries during the quarter were in the Middle East, including Egypt (28%), UAE (23%), and Qatar (18%).

Figure 11: International Equity Markets - Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 9/30/14	3Q '14	1-Yr	3Q '14	1-Yr
World ex-USA	**(5.7)**	**4.9**	**0.9**	**11.6**
- MSCI Growth	*(5.2)*	*4.0*	*1.5*	*10.8*
- MSCI Value	*(6.2)*	*5.8*	*0.3*	*12.3*
- Europe ex-UK	(7.5)	5.7	0.1	13.3
- Pacific, ex-Japan	(5.9)	1.4	(0.9)	5.9
- Japan	(2.3)	0.6	5.8	12.5
- United Kingdom	(6.1)	6.1	(0.9)	6.0
Int'l Small Cap	**(8.3)**	**3.4**	**(1.9)**	**10.2**
Emerging Mkts	**(3.5)**	**4.3**	**0.6**	**8.3**
- EM Asia	*(1.6)*	*9.0*	*0.4*	*9.4*
- EM Europe	*(12.4)*	*(13.5)*	*(3.3)*	*(1.7)*
- EM Latin América	*(5.5)*	*(1.0)*	*2.3*	*6.9*
- EM BRIC	*(3.3)*	*3.0*	*1.3*	*7.5*

From a sector standpoint, energy, materials and industrials were the weakest sectors as oil prices sank and global growth slowed. The consumer discretionary sector was pulled down by automakers and luxury goods companies. Healthcare was the lone positive performing sector in US$ terms. Technology bounced back from a major sell-off earlier in the year.

Figure 12: Ex-USA Sector Returns (in US$ terms)



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Back Page Perspectives: Walls of Worry

After reaching 2019 during the middle of September, the S&P index dropped down to 1862 on 10/15. On the same day, the 10-year Treasury yield hit 1.85%. We have since bounced off those lows, but the magnitude of both moves took many investors' breath away. These shifts, in combination with 3rd quarter activity, serve to highlight some key questions about the strategic positioning of portfolios at this juncture.

First things first, there are lots of worries out there -

- US Economy: Slowdown or Secular Stagnation?
- Fed Tightening: When and how much?
- US Profit margins: When will they fall?
- Eurozone: Recession and Deflation?
- Japan: Sharp decline in GDP due to new VAT?
- China: Growth slowdown; Commodities Impact?
- Russia/Ukraine/Kazakhstan?
- Ebola

Sadly, we can't adequately address any of them. The problem with the future is that it's hard to predict. Especially when you have few historical datapoints.

We would acknowledge that global and domestic inflation is pretty much priced off the table right now. The market's money is betting that the Fed won't get its wish for consumer prices to rise by 2.0% p.a. before 2019. Instead, based on current market prices, annual inflation will only average 1.6% until then.

If so, TIPS, commodities, real estate and other real asset exposures should be looked at for reduction. But, sustained CPI averaging only 1.6% seems low to us, so we did some digging. We've got monthly CPI data since January 1989 (I know, get a life). In that time, annualized inflation during any five-year period has averaged 2.6%. Standard deviation of 0.5%. So, it's a *really* high probability, based on the last 25 years of historical data, that we're going to average more than 1.6% annualized inflation over the next five years. Like, over a 95% chance. Which suggests to us that the markets have once again overdone it on the risk-off trade. Strategically, at current levels we think long-term investors should consider adding to underweight TIPS, hard assets, and real estate positions.

But, what about the risk-on prospects? What's the current relationship between expected returns from stocks versus bonds? Figure 10 can help us with that. The trailing PE ratio of the S&P 500 was 18.3x at the end of September (w/o negative earnings). Inversely, that equates to an earnings yield of 5.46%. At that time, the 10-year Treasury yielded 2.51%, a difference of nearly 3%. This is a conservative, no-growth assumed estimate of the Equity Risk Premium (what investors are expecting to get paid, at a minimum, to take equity risk). With October's stocks and bonds volatility, this figure briefly gapped up to 4.0%.

Is a no-growth ERP of 3% any good? Yes, compared to the end of June, when the number was 2.1%. Yes, compared to the end of 2009, when the premium was just 75 bps. And, yes, compared to the end of 2007, when the premium was just 50 bps. Although, you could have done better at the end of 2011 (remember all the noise and tumult coming out of Washington?), when the market PE dropped to a 13x multiple despite Treasury yields of only 1.93%. That works out to an ERP of 5.75%. Ah, the good old days.

Over time, a base ERP of 3-3.5%, has turned out very well for equity investors, *depending on whether earnings grew from that point*. Which brings us back to fundamentals. Second quarter earnings compared to 2013 were up by 12%, 12%, and 9% for US large-, mid-, and small-cap stocks, respectively. Third quarter earnings growth is forecasted at 12%, 21%, and 34%, respectively. Fourth quarter estimates are higher still.

On that basis, a base ERP of 3-3.5% points to an overweighting of domestic stocks, compared to your strategic current targets. And, given the attractive relative value of international stocks (Figure 10), *the overweight looks like it may beneficially extend to global equity allocations.*

This represents a shift in our position, based on large changes in the numbers. In effect, bonds have gotten quite expensive again, while global stocks and real assets (especially natural resources) have gotten cheaper. *So, in terms of relative value, we recommend underweighting bonds compared to targets.*

What risks are we underwriting in this shift? Well, certainly the course of future inflation. If we are going into serious disinflation mode (the 1.6%), than bonds will not be a bad place - especially if managers can identify "safer" risk-on sectors.

Second, we're underwriting the risk of a least some degree of continued earnings growth. The above-noted estimates reflect huge growth at this stage of the economic cycle, particularly in light of nominal GDP growth in the 5-6% range (Figure 3). And, they were logged before the US$ rose so sharply versus other currencies, commodities/energy prices fell by 15%, and global growth estimates got knocked down a peg.

Thus, our shift in position viz. equity exposure is tempered by our concern that earnings over the next year will come in under expectations. Because of this, we also re-affirm our previous recommendation to overweight cash/liquidity, as a risk buffer.

Sell high, buy low. See you next quarter!

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