KPF GLOBAL
INVESTMENT STRATEGIES LLC

## First Quarter of 2012

***April 2012***

KPF GLOBAL INVESTMENT STRATEGIES LLC

***Executive Summary***

- The first quarter of 2012 saw a continuation of the strong financial market recovery that began late last year. In classic mean-reversion fashion, those asset classes that experienced the sharpest declines during the summer and fall of 2011 enjoyed the strongest gains.

- US Treasuries delivered the highest returns of all asset classes over the past 12 months. Ten-year Treasury bond yields are now under 2%, below the rate of consumer price inflation, and below the rate of real economic growth. The incentives for private saving are low, since after-tax, inflation-adjusted yields are now approaching *minus* 2%. By contrast, the incentives for spending and investing are high, since the cost of borrowed funds is now well below the potential return from deploying them. These easy financial conditions should support a continued, albeit slow, recovery of the US economy.

- Liquidity that does not find its way into the real economy has been supporting financial asset prices. Until recently, most of this money has been flowing into bonds. Indeed, the "safest" assets (i.e., US Treasuries) are now the most expensive, whereas the riskiest (i.e., emerging market equity) are among the cheapest. For this reason, although we acknowledge the unusually high degree of uncertainty at present, we think it's fair to conclude that a great deal of risk has already been "priced in" to financial markets.

- We think a continuation of the "muddle through" scenario for financial markets is the most likely outcome, with risk assets continuing to ascend the proverbial wall of worry. The deepening recession in Europe, worries about a hard landing in China, and the looming fiscal debacle in the Unites States will undoubtedly create bouts of anxiety and associated market volatility. This will offer buying opportunities for investors with a long-term horizon.

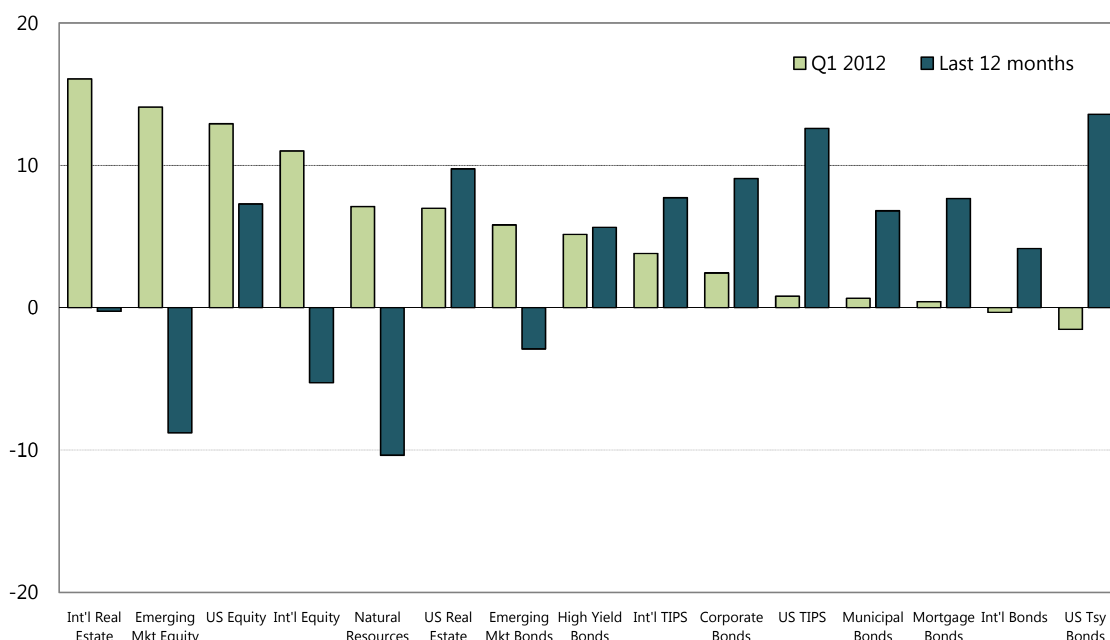
- We remain constructive on equity markets over the longer-term, certainly relative to bonds. We are looking for opportunities to increase our investments in the emerging markets, which are attractively valued and poised to benefit from an eventual reacceleration of the global business cycle. We are already overweight emerging market debt, which should fare better in a sluggish economic scenario. The combination of relatively high yields and currency appreciation potential make these bonds an attractive investment.

- Otherwise, we have curtailed our clients' exposure to interest rate risk, trimming positions and shortening maturities in the TIPS, municipal, corporate and (soon) high-yield debt sectors. We would rather hold cash for potential investments, since the opportunity cost of doing so is shrinking as yields fall.

***Introduction***

The first quarter of 2012 saw a continuation of the strong financial market recovery that began late last year. In classic mean-reversion fashion, those asset classes that had experienced the sharpest declines during the summer and fall of 2011 enjoyed the strongest gains (Figure 1). After a sharp rally in 2011, the US dollar stabilized, allowing emerging equity and debt markets, as well as natural resources, to stage a strong recovery. Developed foreign equity and real estate markets also delivered double-digit returns, although mature overseas bond markets continued to be plagued by worries about default in Europe. US real estate and high-yield bonds posted further steady gains, as investors persisted in their search for yield.

Figure 1. Relative Asset Class Performance

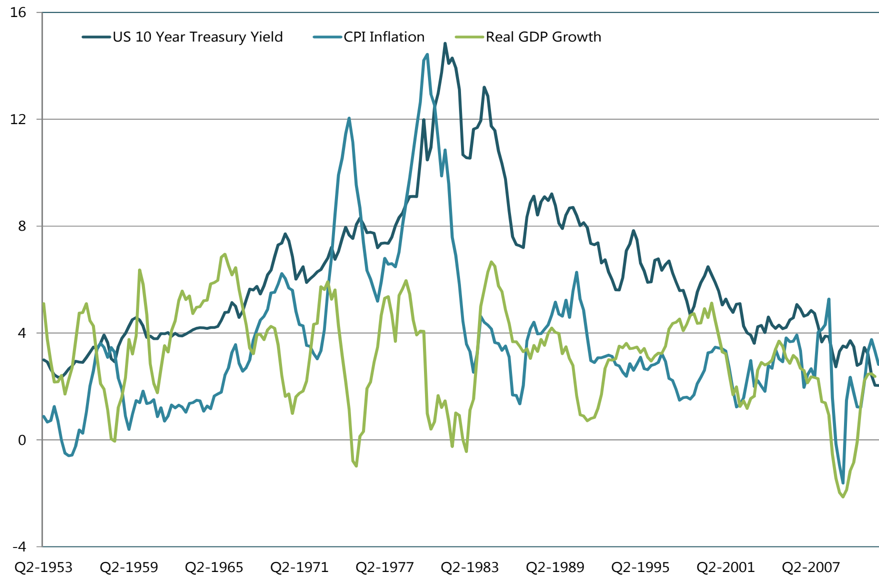



Source: Bloomberg

***Easy Money Supports Gradual Recovery***

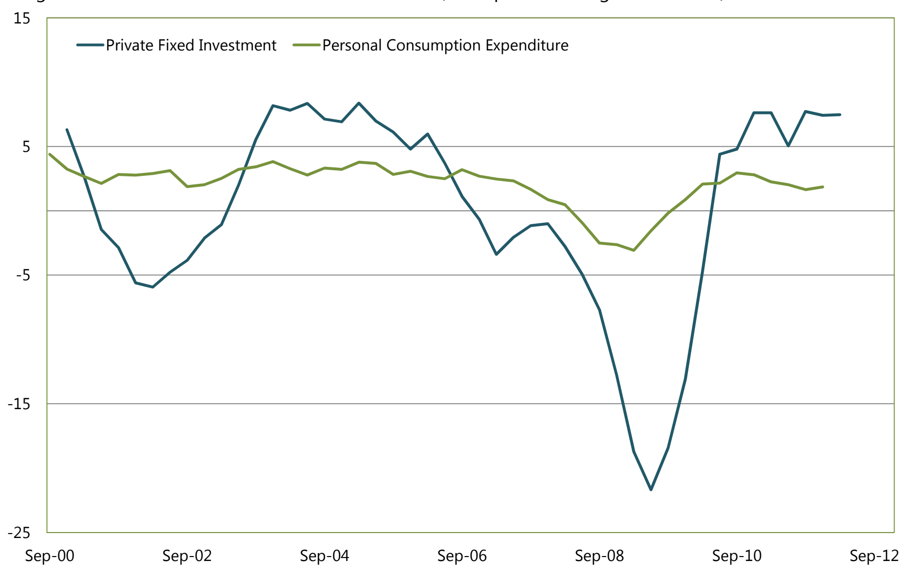
On a 12-month basis, US Treasuries, including inflation-protected bonds (TIPS), delivered the highest returns of all asset classes. Treasury bonds returned a whopping 12.5% last year, bringing yields on these instruments to a postwar low. 10-Year Treasury bond yields are now under 2%, below the rate of consumer price inflation, and below the rate of real economic growth (Figure 2). As a consequence, the incentives for private saving (at least using this "safe" instrument) are low, since after-tax, inflation-adjusted yields are now approaching *minus* 2%. By contrast, the incentives for consumption and investing are high, since the cost of borrowed funds is now well below the potential return from deploying them (nominal GDP growth is running at ~ 5%).

Figure 2. United States: Bond Yields Now Below Inflation and Real GDP




Excessive indebtedness by banks and households has limited the economy's response to these extraordinarily easy monetary conditions. Even so, the progressive reduction in debt burdens is beginning to bear fruit. Bank lending has begun to recover and, given the strength of corporate earnings, has created ample scope for borrowing to finance new investment. Indeed, corporate fixed investment is running at the fasted rate in a decade (Figure 3). Household spending has also picked up to a trend-like pace, helped by a significant reduction in household interest payments (helped by lower rates).

Figure 3. United States: Sources of Final Demand (four-quarter average annual rate)



***"Risky" Assets are Cheap, "Safe" Assets are Expensive***

Liquidity that does not find its way into the real economy has been supporting financial asset prices. Until recently, most of this money has been flowing into bonds, according to mutual fund data from the Investment Company Institute (Figure 4). Although many asset prices have been elevated by the Fed's liquidity tide, the "safest" assets (i.e., US Treasuries) are now the most expensive, whereas the riskiest (i.e., emerging market equity) are among the cheapest[1]. That is an indication that risk appetite remains subdued. The S&P 500 has been moving sideways for the past decade (Figure 5) leaving its 10-year performance near the lowest levels in a century. Investors have been disappointed for so long, they have a hard time believing stocks will deliver consistent future returns.

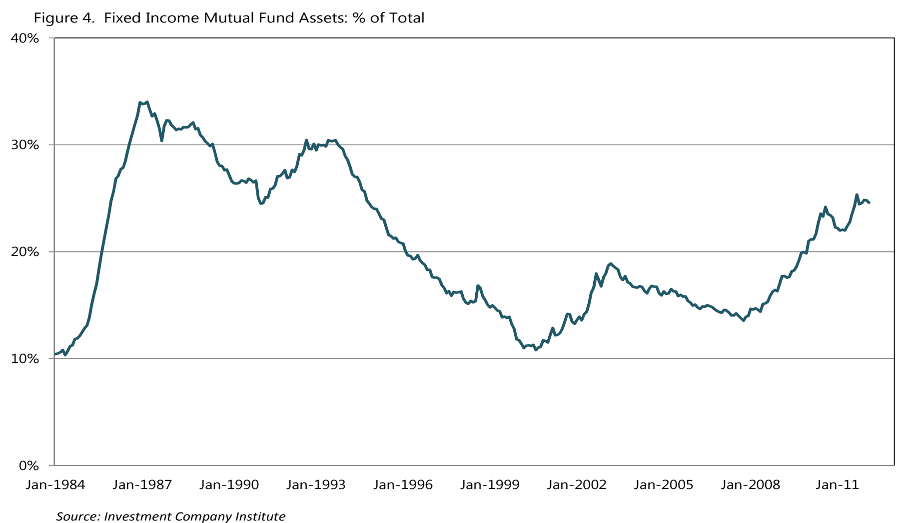


Figure 4. Fixed Income Mutual Fund Assets: % of Total

*Source: Investment Company Institute*

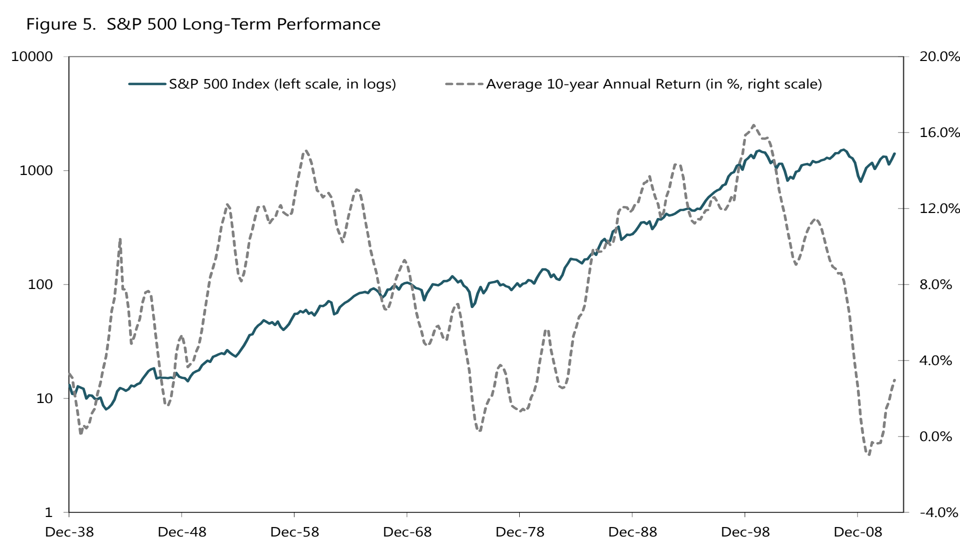


Figure 5. S&P 500 Long-Term Performance

[1] Based on a comparison of current valuation indicators vs. their historical distributions.

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***Emerging Markets May be Volatile, but Offer Good Value***

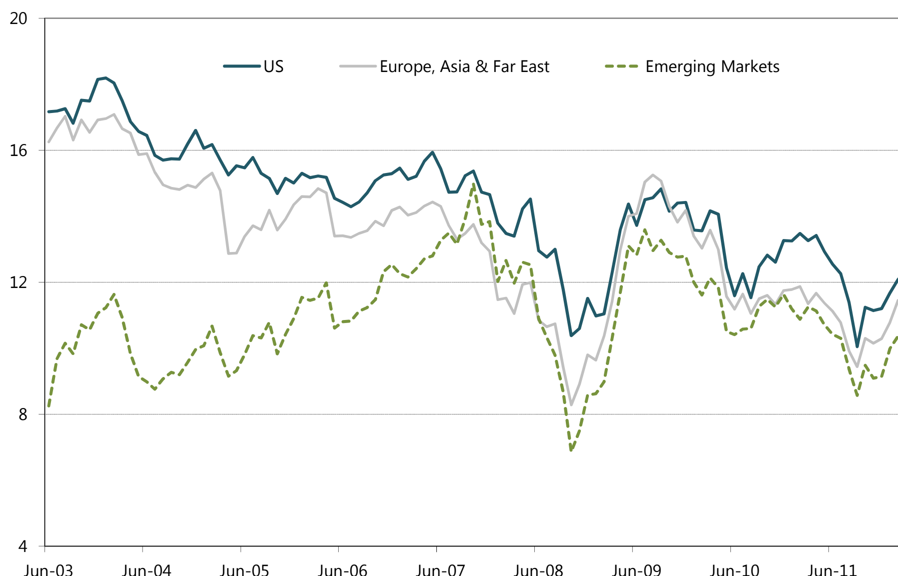
We remain constructive on equity markets over the longer-term, certainly relative to bonds. As we highlighted last quarter, dividend-paying US stocks are an attractive (and relatively safe) way to gain equity market exposure. At the other end of the risk spectrum are emerging market equities, which we advocate for investors with a long-term horizon. These stocks suffered large losses amid the market volatility of last summer, as valuations had become stretched, worries about the global economic cycle intensified, and returns across cyclically-sensitive asset classes became highly correlated. US dollar strength compounded the declines.

Current valuations make these asset classes an attractive investment. Emerging market equity price-earnings multiples are lower than in the mature markets (albeit not by as much as a decade ago). Yet P/Es should, arguably, be higher, given faster rates of economics and earnings growth, not to mention generally better macroeconomic fundamentals (Figure 6).

| Figure 6. Selected Macroeconomic Indicators | **GDP Growth** % change | **Consumer prices** % change | **Unemploy-ment rate** % | **Current-account** % of GDP | **Budget balance** % of GDP | **Federal debt** % of GDP |
|---|---|---|---|---|---|---|
| United States | 1.6 | 2.4 | 8.2 | -3.1 | -7.8 | 98 |
| Euro Area | 0.7 | 2.4 | 10.8 | -0.2 | -3.4 | 90 |
| Britain | 0.5 | 2.8 | 8.4 | -1.5 | -7.6 | 75 |
| Japan | -0.6 | -0.1 | 4.5 | 1.7 | -8.3 | 215 |
| Australia | 2.3 | 2.7 | 5.2 | -2.7 | -0.5 | 20 |
| Canada | 2.2 | 2.2 | 7.2 | -2.3 | -3.5 | 85 |
| Poland | 4.3 | 3.4 | 13.3 | -3.8 | -4.5 | 55 |
| Russia | 4.8 | 5 | 6.5 | 4.3 | -0.9 | 11 |
| Turkey | 5.2 | 9.3 | 9.8 | -8.6 | -1.7 | 42 |
| Israel | 3 | 1.9 | 5.4 | -0.6 | -3.5 | 76 |
| South Africa | 2.9 | 5.3 | 23.9 | -4.5 | -5.1 | 35 |
| China | 8.9 | 3.7 | 4.1 | 2.1 | -1.8 | 33 |
| India | 6.1 | 8.1 | 9.8 | -2.8 | -5.8 | 69 |
| Indonesia | 6.5 | 5.2 | 6.6 | 0.5 | -1.5 | 27 |
| Singapore | 3.6 | 4 | 2.0 | 19.6 | 0.1 | 101 |
| South Korea | 3.4 | 2.9 | 3.7 | 1.1 | 2.8 | 33 |
| Brazil | 1.4 | 5.4 | 5.7 | -2.7 | -2.5 | 65 |
| Mexico | 3.7 | 4 | 5.2 | -1.5 | -2.4 | 43 |
| *Advanced economies* | *1.4* | *1.9* | *7.9* | *-0.4* | *-5.6* | *108* |
| *Emerging markets* | *5.6* | *6.2* | *5.9* | *1.7* | *-1.0* | *34* |

Whereas equity multiples in the developed markets have been in long-term decline (Figure 7) in response to slower growth, heightened competition, weak productivity gains, and rising debt burdens, emerging market P/Es have been trading at the lower end of a stable long-term range (10-20, based on trailing earnings).

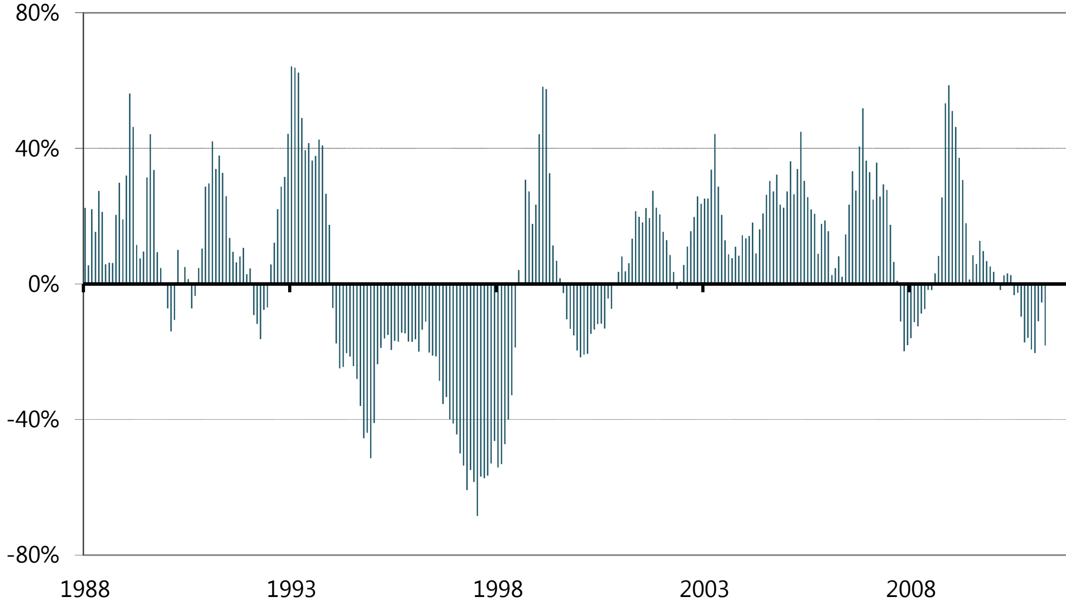
Figure 7. 12-month Forward Price-Earnings Ratios




The convergence of price-earnings ratios between the developed and emerging markets is reflected in a fairly consistent pattern of superior returns for the latter (Figure 8). Periods of emerging market underperformance (whether vs. the US or other mature markets) have generally been modest and brief. However, emerging equity markets are still very sensitive to changes in the tempo of the global business cycle, and have a high "beta" to the US equity market. As a result of the US$ rally and investors' recent focus on higher-quality, less-volatile stocks, the 12-month relative return of emerging market vs. US equities now lies in the 24$^{th}$ percentile of the historical distribution. In other words, emerging market equities have begun to recover from the growth scare of last year, but have a long way to go. Emerging markets still represent a very small share of global equity assets (Figure 9), and there is considerable upside from structural portfolio reallocations to this rising asset class.

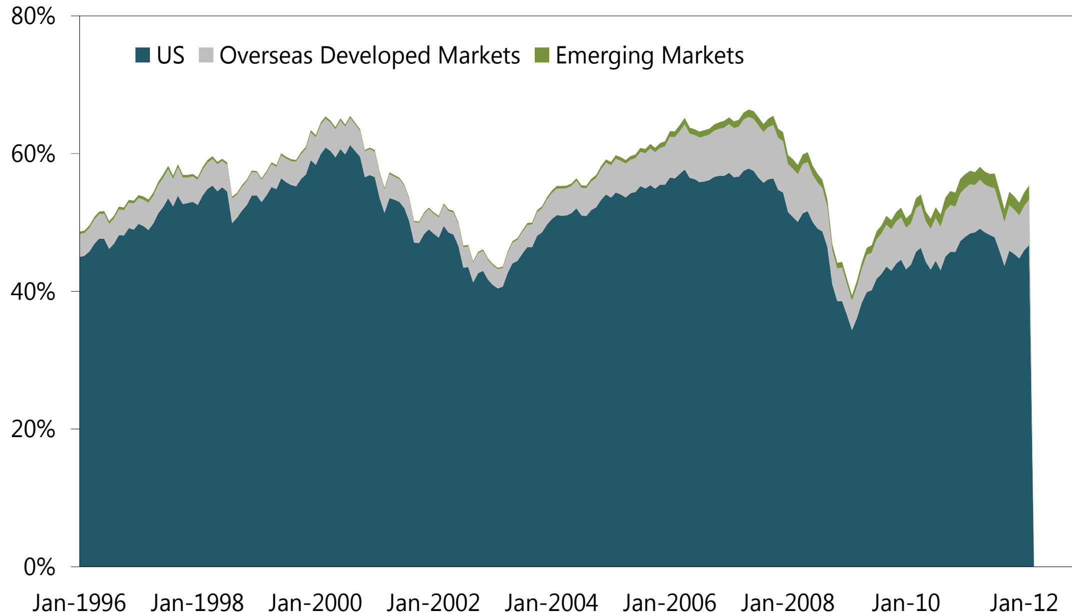
Emerging market debt is also attractive vs. other bond markets, offering low valuations in US$ terms and relatively high yields (both in the context of their own history, and vs. other countries, Figures 10-11). Historically, 12-month returns to emerging market bonds have ranged from -10% to +25%—a strong positive skew—and are now running at -5%. Their volatility is moderate, about midway between investment-grade corporate and high-yield bonds.

Figure 8. Relative Performance of MSCI Emerging Markets vs S&P 500
(% change y/y, in US$)




*Source: Bloomberg*

Figure 9. Equity Mutual Fund Assets: Regional Shares




*Source: Investment Company Institute*

Figure 10. Central Bank Policy Rates

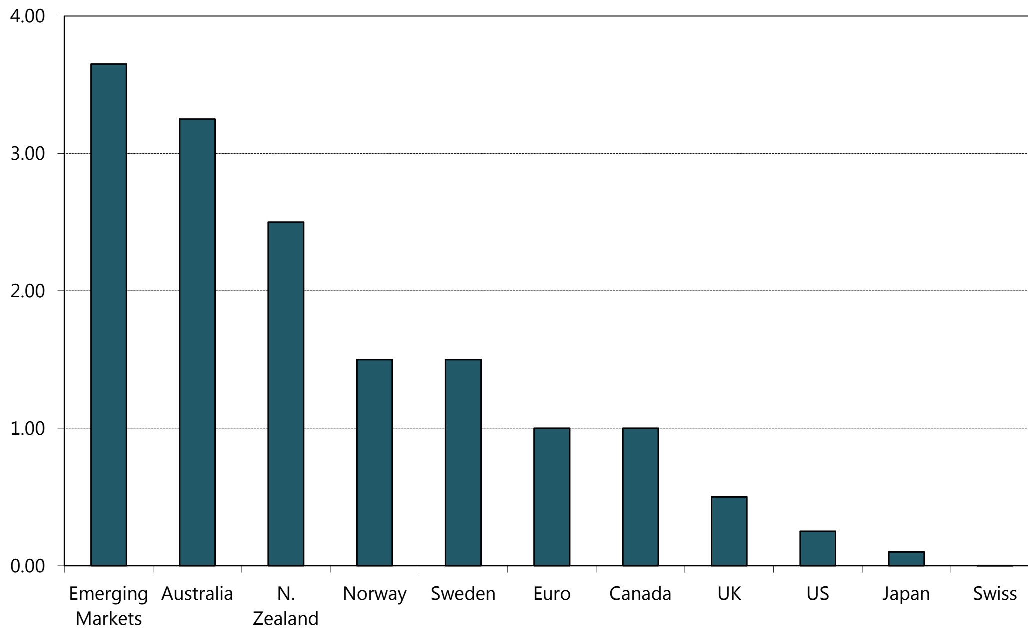
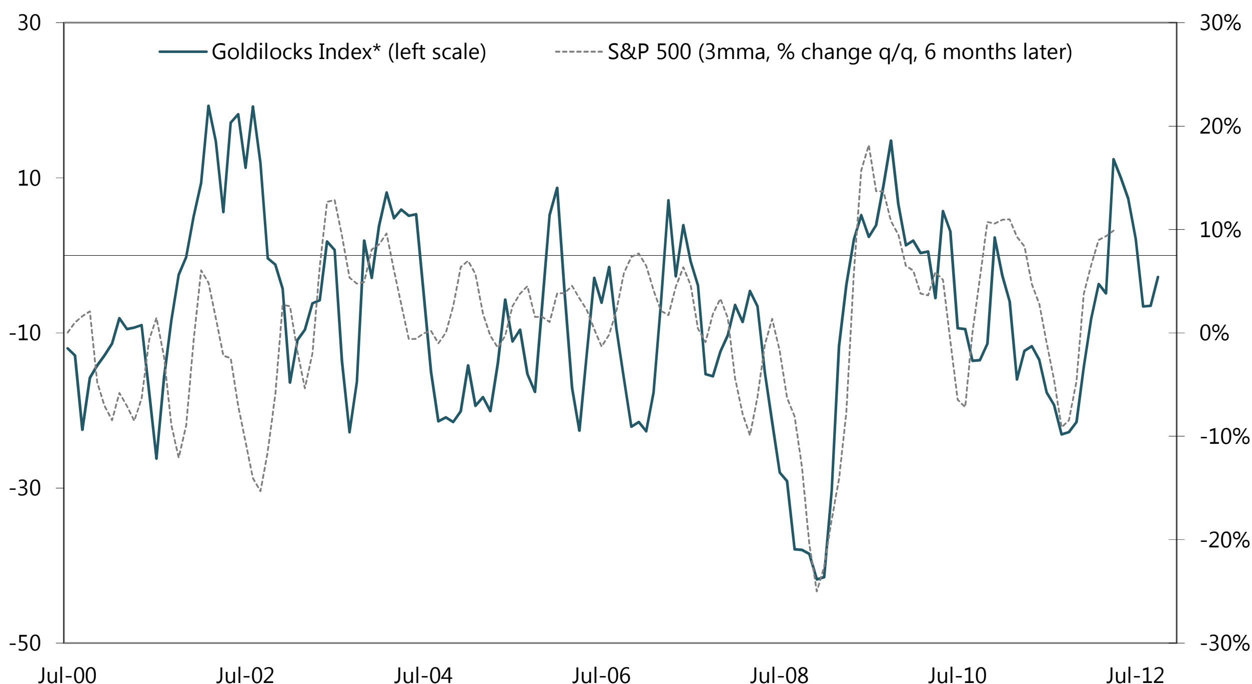



Figure 11. Emerging Market Bonds: Average 2-Year Yield

We trimmed our clients' positions in both emerging market debt and equity early last year, out of concern about valuations, correlations, and cycle risks. While valuations (and, to some extent, correlations) have improved, there are lingering risks to the global business cycle stemming from the situation in Europe and the ongoing slowdown in China. So far, the US economy has proved more resilient than expected, and is helping to bridge the gap in global demand. Longer-term indicators of the business cycle suggest that the 2011 dip was a mid-cycle correction, and that global activity will broaden and firm over the next several years.

Even so, late 2012 and 2013 could be rocky. Record US corporate margins will be squeezed by decelerating global demand, although softer commodity prices will ease input costs. Our "Goldilocks" indicator for corporate profit margins suggests some further upside to US equities over the next few months, but the market could stall in the summer and fall (Figure 12). The US Presidential election is approaching, which will no doubt heighten public awareness of the looming fiscal challenge and the dysfunctional policy responses (i.e., political posturing) that have been offered to deal with it. Further ahead, the Fed will have to figure out how to withdraw its massive monetary stimulus so as not to ignite inflation, or derailing the weak recovery. The economic situation in Europe remains fragile, and it is not yet certain that China will succeed in achieving a soft-landing for its economy.

Figure 12. United States: Goldilocks Index vs S&P 500




** Institute for Supply Management New Orders Index/Prices Paid Index*

Overall, we think a continuation of the "muddle through" scenario for financial markets is the most likely outcome, with risk assets continuing to ascend the proverbial wall of worry. Bouts of anxiety about the economic and political outlook will likely give rise to periods of market volatility, creating buying opportunities for investors with a long-term horizon.

***KPF Global Portfolio Strategy***

At present, our clients' dynamic asset allocations are fairly close to their strategic targets, consistent with our assessment that most markets are trading close to fair value. The notable exception is the US Treasury bond market, which remains very overvalued, in our opinion. We have responded by scaling back interest rate risk. We have reduced our clients' investments in fixed income instruments, taking profit on most of their TIPS allocations and allowing municipal allocations to shrink as bonds mature. We anticipate trimming our clients' high-yield bond holdings, which have also performed very well. As a substitute, we have increased exposure to non-agency mortgage-backed securities, as well as emerging market bonds. We have also been increasing our clients' cash levels, to take advantage of opportunities that may be created by future market volatility.

We continue to favor less-volatile, dividend-paying stocks as a core position for those clients who are seeking consistent income from their portfolios. It is early days, but so far our low-volatility equity income strategy is performing as expected: delivering moderate returns across market cycles, with significantly less volatility than the broad market. The strategy is tracking at roughly 70% of the volatility of the Russell 3000 since inception in February, with a total return that is about two-thirds of the Russell. This is what we would expect in a strong market; in April, when stocks declined, the strategy gained 0.86%, vs. a loss of 0.67% for the Russell.

Given the balance of opportunity vs. risk, we have kept close to our strategic targets for emerging market equity, but plan to use periods of market weakness and volatility to establish overweight positions. We are already overweight emerging market debt, which offers a larger margin of safety in terms of valuation, and which is likely to perform better than equities in a weak-cycle environment.