Quarterly Market Outlook & Strategy Letter

Third Quarter of 2012

October 2012

Executive Summary

- Financial markets delivered strong returns in the third quarter of 2012, as the Fed announced additional steps to support the US economy (via open-ended purchases of mortgage-backed securities) and as the housing and labor markets showed further signs of recovery. Although the European and Chinese economies have not yet turned the corner, it appears that the worst may soon be behind them.

- Equity markets, and foreign currency-denominated stocks in particular, delivered the highest returns over the quarter. Barring another major shock, we expect foreign markets to continue to perform relatively well. After a long period of superior returns, US equities may lag; valuations overseas are now much more attractive, while cyclical conditions have become more supportive. Taking a page from the Fed's playbook, the European Central Bank has committed itself to lower government bond yields, which will reduce borrowing costs for European corporations and households. Moreover, we expect renewed stimulus in China as the leadership transition gets underway.

- With the global economy on a firmer footing, attention will now turn to the US Presidential election and its aftermath. The overriding economic and financial challenge facing our next President and Congress is, we believe, the massive accumulation of public and private sector debt. There are five key realities that we think everyone investing in the financial markets should understand:

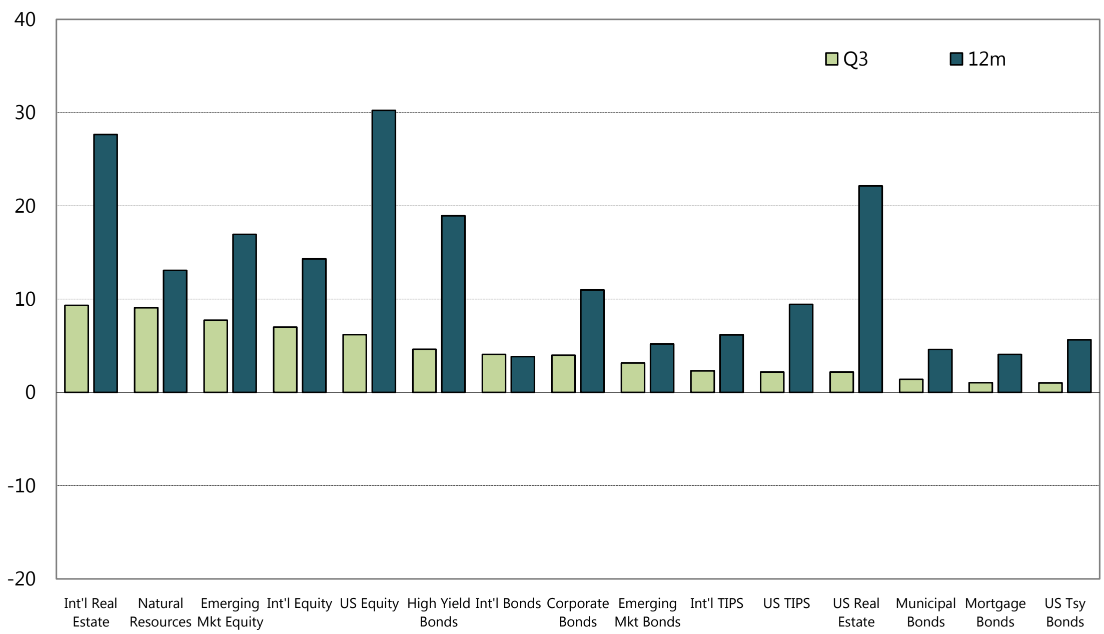
    1. *The debt overhang threatens our national prosperity and financial stability. The longer we wait to address the problem, the bigger it will become.*
    2. *Our biggest fiscal issue is entitlements, especially Medicare and Medicaid.*
    3. *Because the US issues debt in its own currency, the path of least resistance is an easy monetary policy that will weaken the US dollar and lead to higher inflation.*
    4. *How the debt burden is shared will have enormous consequences for the distribution of income and wealth in this country.*
    5. *Yes, the boy has been crying wolf for many years. But what has long been a latent risk will soon be a huge problem.*

- We will strive to protect your assets from the effects of inflation, financial repression, currency depreciation and market instability. To that end, we will: keep more cash on hand; identify high-quality sources of income; focus on investments that are attractively valued and unencumbered by debt; seek opportunities in overseas markets, and favor those investments that hold their value in the face of inflation.

Introduction

Investment markets delivered strong returns across the board in the third quarter, as improving US economic data (particularly housing and employment statistics) were reinforced by the Fed's announcement of a third round of financial asset purchases. Investors are becoming cautiously optimistic that the economies of Europe and China are bottoming, resulting in a surge performance of overseas markets. By contrast, "safer" US fixed income sectors (US Treasuries, government-guaranteed agency securities and municipal bonds) lagged behind, although these still delivered positive returns on the quarter.

Figure 1. Relative Asset Class Performance



Source: Bloomberg

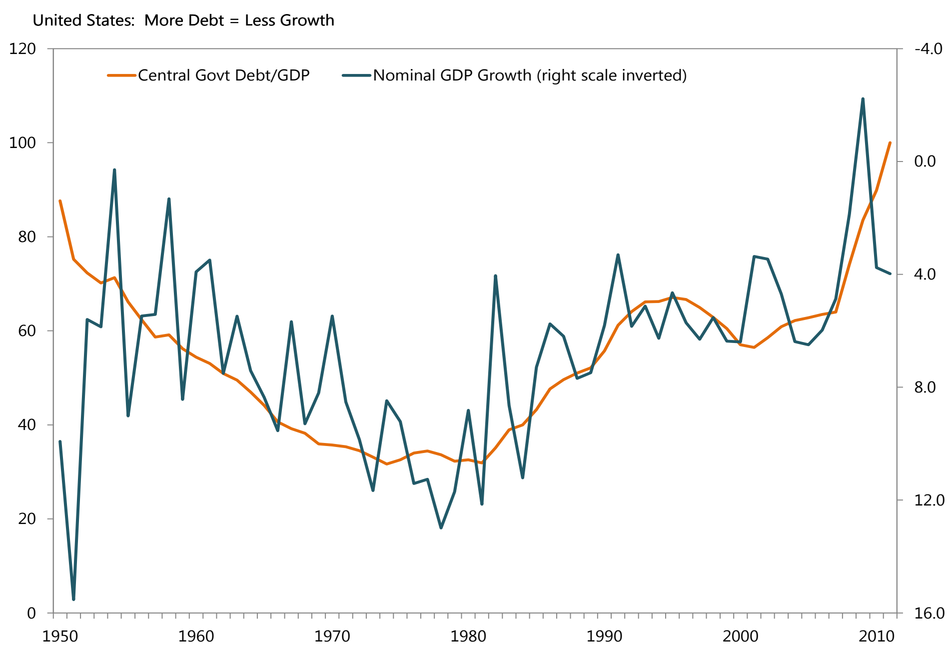
Looking ahead, attention is turning to the US Presidential election and its consequences for US fiscal, tax and regulatory policy. The critical issue that, we believe, will influence economic and market performance in the years ahead is our large public sector deficit, and increasingly onerous debt burden. How quickly—and how credibly—policymakers confront the challenges of reducing and financing their deficits will determine both the economic costs of the inevitable budgetary retrenchment, and the extent to which private sector activity will compensate for the loss of public sector stimulus. One thing is clear: the longer fiscal adjustment is delayed, the greater will be its ultimate cost.

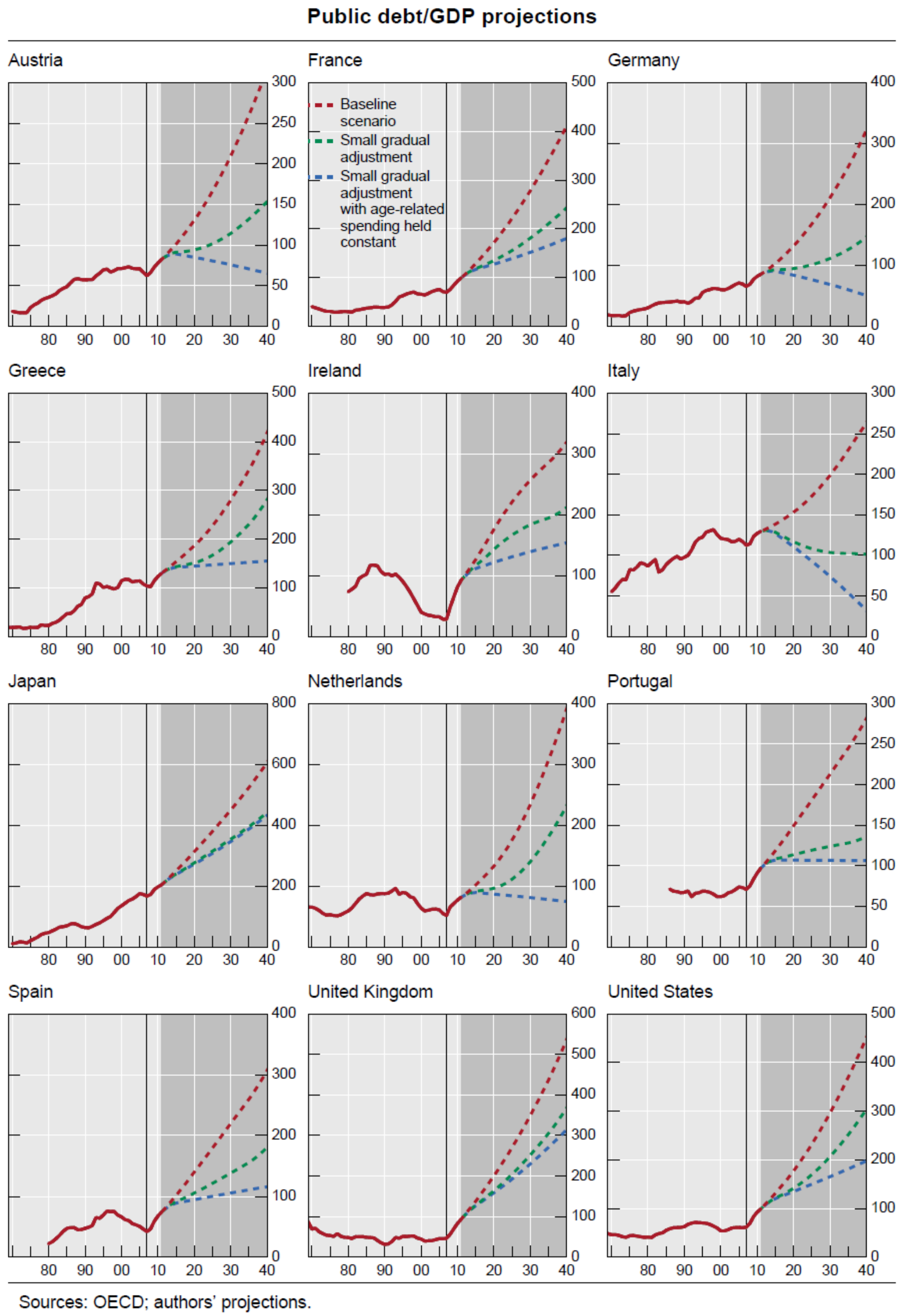
Houston, We Have a Debt Crisis

1. *The debt overhang is the overriding economic & financial challenge of our time.*

   Research by leading scholars Carmen Reinhart and Kenneth Rogoff has shown that once public sector debt reaches 100% of GDP, the economy and financial system enter a "critical state" in which mildly unfavorable events can have sudden and massively destabilizing consequences.[1] Along the way, private investment is crowded out by government borrowing, much of which is used to meet interest obligations. Economic growth slows, shrinking the tax base. Public sector debt rises faster than the economy, increasing the cost of interest payments. As these negative debt dynamics snowball, confidence in the government's ability to repay its obligations can suddenly evaporate, as the European crisis so clearly illustrated.

   As the chart below shows, higher debt levels are associated with weaker growth, and are both a cause and a consequence of it.[2] We have already reached the danger zone in the United States. Moreover, as the charts from the Bank of International Settlements (BIS) on the following page show, deficit spending in the US (and in other mature economies) will accelerate over the coming decades, doubling our debt burden from 100% of GDP in 2011 to 200% or more by 2040. Meanwhile, interest payments could escalate from 5 percent of GDP (roughly half of the 2011 deficit) to a staggering 20%.



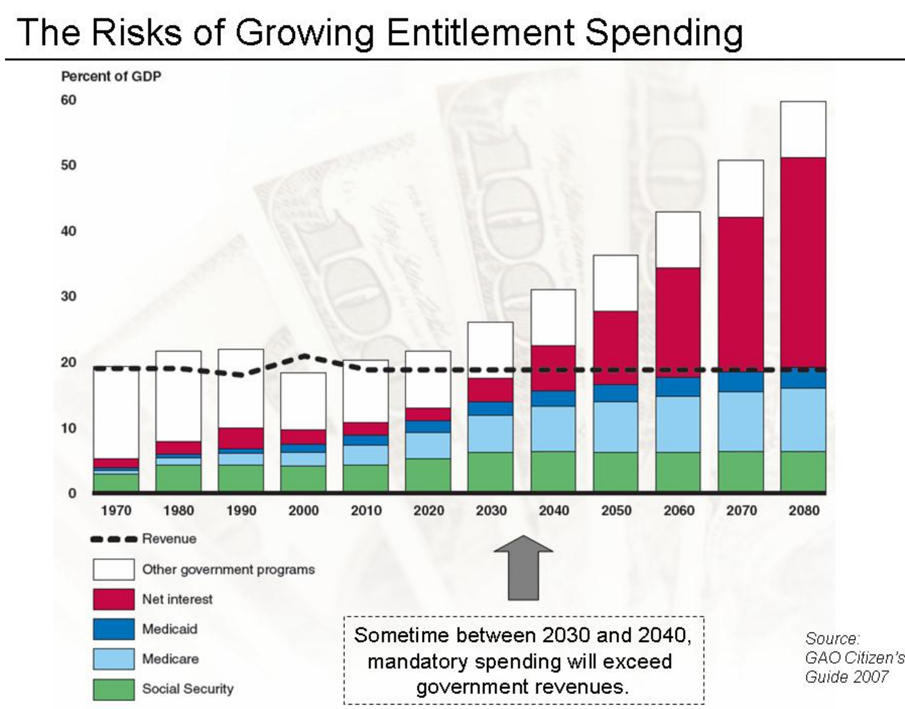


Source: Cecchetti, Mohanty and Zampolli, "The Future of Public Debt: Prospects and Implications." Bank of International Settlements Working Paper No. 300. March 2010.

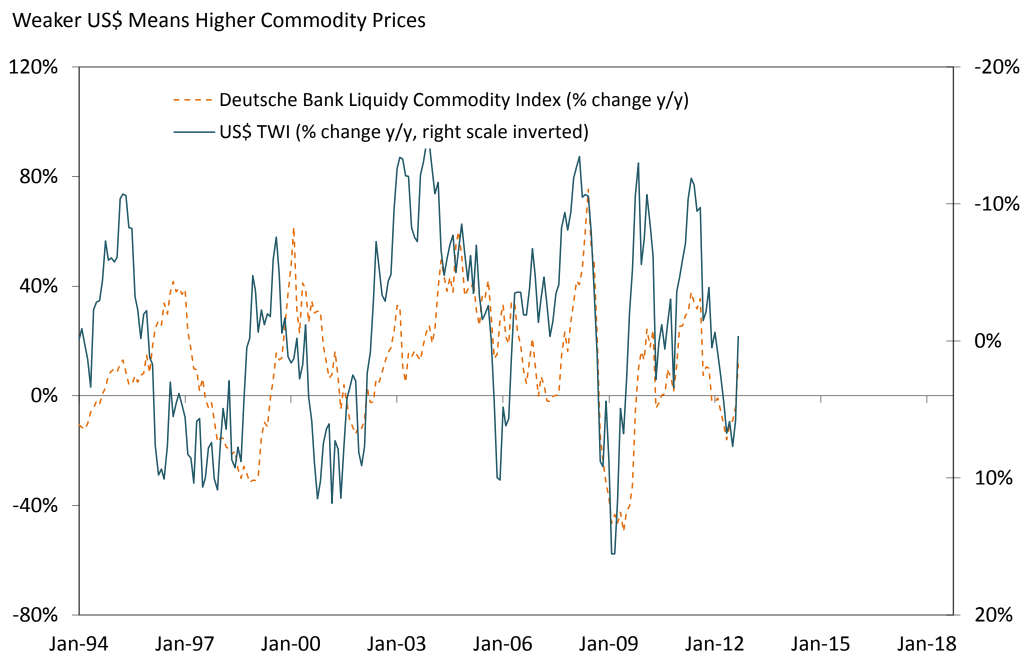
The BIS's baseline scenario cannot, in fact, occur, since the economy and bond market would collapse long before we reached that point. Even so, rapidly rising debt is a foregone conclusion, even if age-related entitlements can somehow be stabilized. To cope with this burden, fiscal policy in the US and other mature economies will be geared toward raising and capturing private savings—either directly (through tax and/or spending policy to reduce the deficit) or indirectly (through inflation and/or financial repression, to reduce the cost of government debt service). The inevitable consequences are slower growth and greater economic fragility.

2. *Our biggest problem is entitlement spending, especially on Medicare and Medicaid.*

Age-related entitlement spending is the biggest driver of our debt spiral. Social Security is but a small part of this equation; progressive and moderate increases in the retirement age can solve its problems, since most Americans don't have enough money to retire on—with or without Social Security benefits. They will continue working (and paying into the system) while deferring withdrawals. The main driver of entitlement spending is rising health care costs for a growing number of retirees. The $64,000 question is: how can our political leadership rein in age-related entitlements when the largest voting cohorts are those in or near retirement?



3. *Because the United States has the privilege of issuing debt in its own currency, and because so much of our debt is owned by foreigners, the path of least resistance is an easy monetary policy. Easy monetary policy will lead to a weaker US dollar and—eventually—higher inflation.*



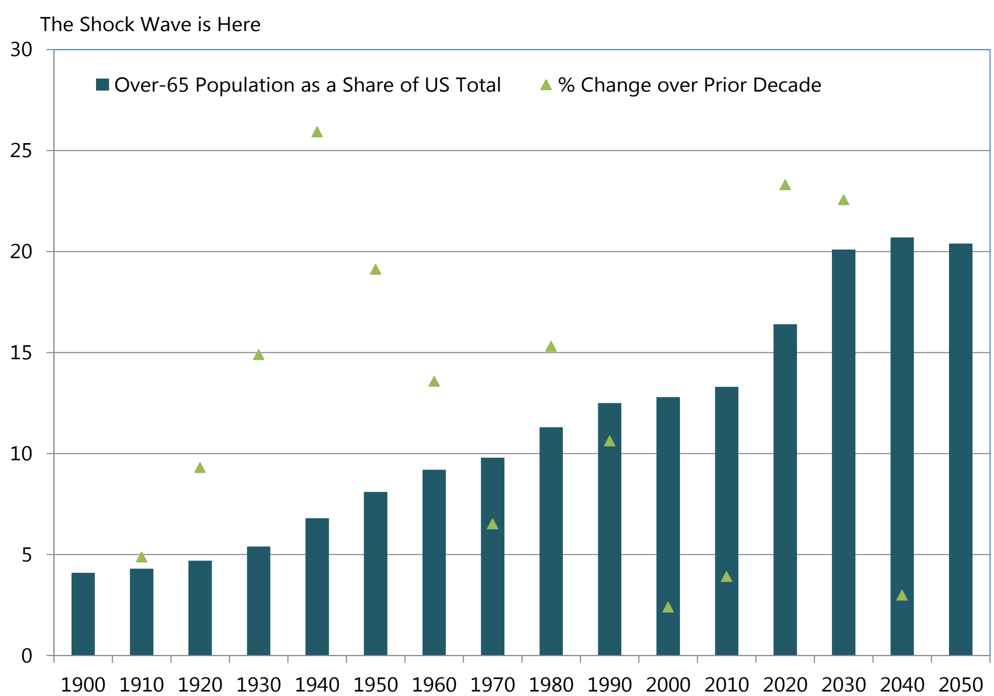
Currency depreciation will reduce the cost of servicing our debt to foreigners (relative to our exports) and will contribute to higher inflation. This will, in turn, erode the value of government debt held by domestic residents. We are already witnessing the effects of a weaker currency in the form of rising commodity prices—these are inversely correlated to movements in the US dollar, as the chart above shows. Commodity inflation has not yet led to generalized inflation due to slack in the economy, but as that slack is absorbed (or as unused labor and capital become obsolete) the risks of higher inflation will grow.

Continued easy monetary policy can be justified as the economy undergoes budgetary retrenchment. However, given the difficulty in calibrating the available policy tools, the Fed is likely to err on the side of doing more, reasoning that a little inflation is better than the alternative. Already, many influential economists and central bankers are saying that higher inflation would be a good thing. Unfortunately, the historical evidence is that inflation is not only destabilizing to corporate earnings and investment (as managers find it difficult to distinguish relative from general price changes) but is also inequitable.

4. *How the debt burden is shared will have enormous consequences for the distribution of income and wealth in this country.*

Programmed spending on age-related entitlements (Social Security & Medicare) will pay benefits to retirees over the next 5-10 years that are larger than what those individuals have contributed to the system. Conversely, contributions from younger workers will likely exceed the benefits they receive in retirement. Unless inter-generational bequests (or estate taxes) even the scales, our entitlement programs will create a major inter-generational transfer of wealth from the young to the old. Moreover, our current monetary policy is redistributing wealth from the less affluent to those with greater financial resources. Lower- and middle-income households spend a larger share of their earnings on food and energy than do upper-income families, yet are enjoying smaller wage gains. Nor are they benefiting from the "wealth effects" created by ample liquidity, since these households typically own few financial assets. Of course, there are important transfers via income and estate taxes that go in the other direction—although these have been reduced in recent years.

5. *Yes, the boy has been crying wolf for many years. But what has long been a latent risk will soon be a huge problem.*



Source: US Census Bureau.

It's understandable that many citizens and investors thought the policy wonks have been crying wolf. From 1990-2010, the growth in the elderly population was moderate—indeed, considerably slower than during the 50 years prior. However, from 2010 to 2020 the share of the population over 65 will rise by a staggering 22%, with a further sizable increase in the decade following. We've heard that it's coming, but it's only now that the pay-as-you-go Ponzi scheme that we call entitlements is finally breaking down.

Most mature economies are coping with the same challenges. With the highest ratio of debt/GDP in the industrial world, it is no coincidence that Japan has stagnated for two decades. By contrast, the fiscal and economic situation in most emerging markets is much healthier. That's why we believe they will be a better place to invest in the future—as we discussed in our Q1 Market Outlook and Strategy letter to clients.

6. *As investors of your savings, our job is to protect your assets from the effects of inflation, financial repression, currency depreciation and market instability. To that end, we believe it is prudent to:*

    a. Be nimble and keep more cash on hand (to make market volatility work for you)
    b. Insist on value (it will be easier to control the downside than predict the upside)
    c. Seek diverse sources of income (steady returns are higher long-term returns)
    d. Evaluate all assets' ability to hold their value against inflation (and taxes)
    e. Seek opportunities in economies, sectors and entities unencumbered by debt
    f. Focus on non-US$ denominated investments
    g. Take the long view, but be decisive when conditions change

KPF Global Portfolio Strategy

With the above principles in mind, we have been managing our clients' portfolios with a focus on investments that meet our criteria for attractive valuation (i.e., international, and especially, emerging market equities), a high-quality income stream (i.e., low-volatility US dividend-paying stocks, mortgage-backed securities, and short-duration high-yield debt), and foreign currency-denominated assets that are good hedges against a weaker US dollar and higher inflation (emerging market corporate and government bonds, as well as international real estate). We are maintaining higher levels of cash and cash equivalents (i.e., 5-10% of our clients' portfolios), in order to profit from market volatility and dislocations. And, as always, we are looking ahead to anticipate future opportunities and potential risks.

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[1] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*. Princeton University Press. 2009.

[2] As economic activity weakens, public sector deficits (and thus government debt) rise. That's because the tax base shrinks and "automatic stabilizers" in the form of tax credits and transfers increase government spending. Rising public borrowing eventually crowds out private investment and consumption, contributing to slower economic growth. Note that the negative relationship is clearest between *nominal* growth (output measured at current prices) and debt. That's because inflation boosts the measured value of output (the denominator), reducing the ratio of debt to GDP. The long reduction of public debt to GDP during the 1960s and 1970s was a consequence of robust growth *and* rising inflation.