KPF GLOBAL INVESTMENT STRATEGIES LLC

Third Quarter of 2013

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178 Drinkwater Road | Kensington New Hampshire 03833 | 617-202-9653 www.kpfglobal.com

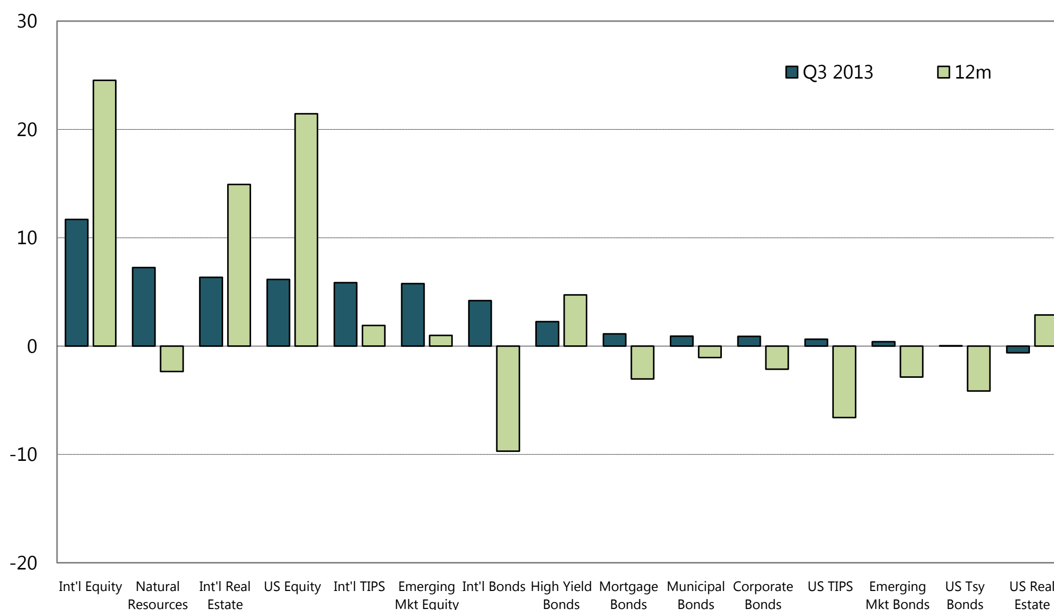
Executive Summary

- Global financial markets rallied in the third quarter, largely offsetting the second quarter's declines (Figure 1). Investors breathed a palpable sigh of relief when the Federal Reserve delayed scaling back its massive bond-buying program, given the sharp rise in yields occasioned by earlier tapering talk (which threatened the still-fragile US housing recovery). In delaying tightening US monetary policy, the Fed also expressed concern about the negative consequences for the economy from the fiscal disarray in Washington. The announcement of Janet Yellen to replace Fed Chairman Ben Bernanke was taken as a signal that monetary policy will remain relatively accommodative for some time to come.

- International markets (stocks, bonds, real estate and currencies) led the rally, as evidence mounted that the global economy is at last on the path to a synchronized recovery. US stocks notched another strong quarter, as did high-yield bonds. Other fixed income sectors produced modest positive returns; although tightening has been delayed, investors understand that stronger growth will, eventually, entail higher interest rates. Real estate lagged behind.

- We continue to see greater potential in overseas markets, given their more attractive valuations and the greater financial leverage that comes from deploying unused capacity. Typically, the emerging markets follow changes in the mature economies with a 6-12 month lag. After a long period of relative underperformance, these markets are beginning to shake off the effects of the slow US recovery, prolonged recession in Europe, and Chinese slowdown. Although pockets of fragility remain, we believe the emerging markets offer great value for long-term investors.

Figure 1. Benchmark Asset Class Returns

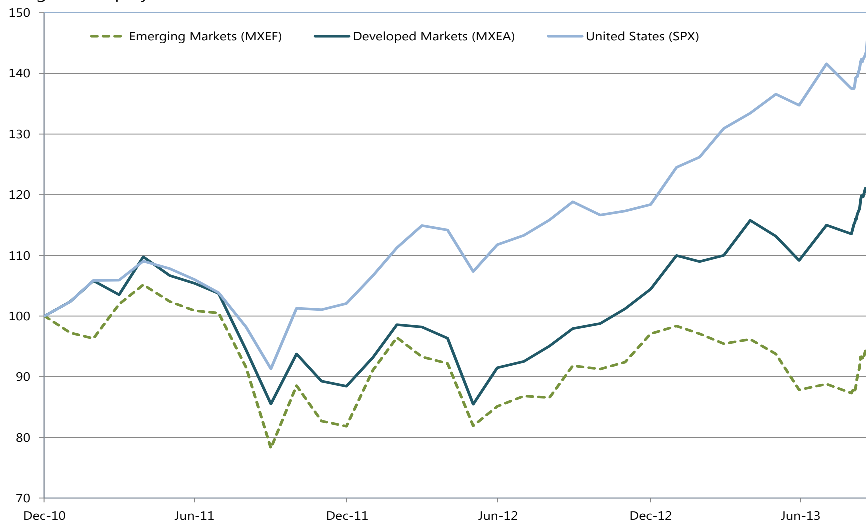


Source: Bloomberg

Opportunities in the Emerging Equity Markets

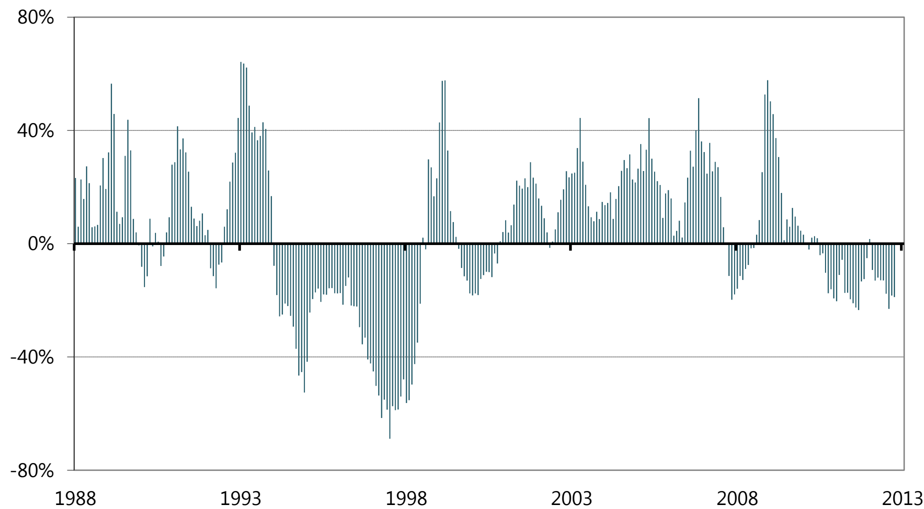
Over the past couple of years, emerging equity markets have lagged behind the US and other mature stock markets, as well as other cyclically-sensitive investments (Figures 2-3). It is the longest stretch of underperformance for this asset class in over a decade, suggesting a reassessment of its long-term potential. While structural problems have undermined investment prospects in a few emerging markets, we believe that macroeconomic and corporate fundamentals overall are far superior to what prevailed in the late 1990s—and in many ways superior to those in the mature economies. Cyclical factors appear to be the primary culprit for the recent market weakness, which represents a buying opportunity for long-term investors.

Figure 2. Equity Market Cumulative Total Return Since Jan. 2011



Source: Bloomberg

Figure 3. Relative Performance of MSCI Emerging Markets vs S&P 500
(% change y/y, in US$)

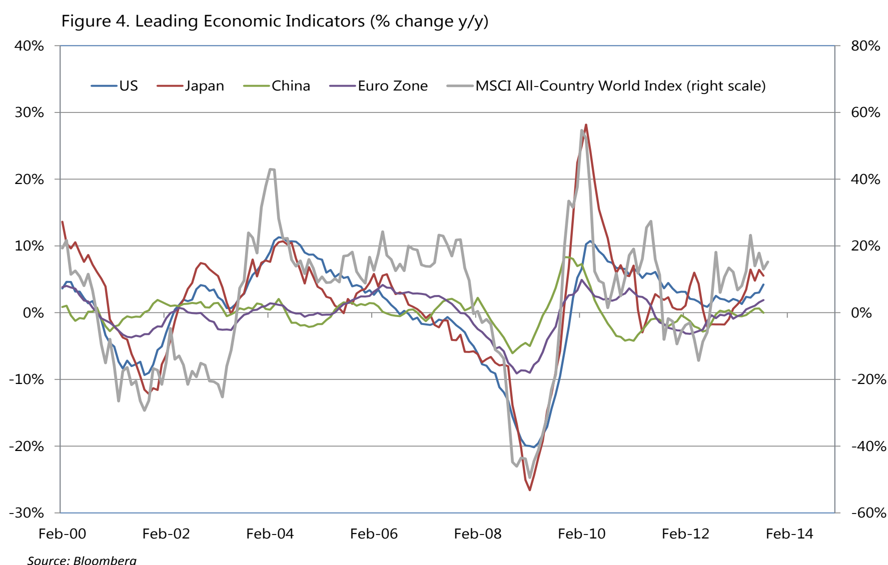


Source: Bloomberg

Those who hold a bleak view of the emerging markets argue that these economies remain overly dependent on global demand, which will continue to slow as a result of a persistent recession in Europe, a downshifting the Chinese economy, and chronically over-supplied commodity markets. Those who believe that the US dollar is now in a long-term uptrend have additional reason to be pessimistic on the emerging markets, pointing to the negative confluence of weakening currency and commodity trends.

We maintain a more constructive view. We believe that the recent emerging market economic slowdown is coming to an end, as the global economy enters its first synchronized upturn in a decade (leaving aside the post-crash bounce, which quickly fizzled—Figure 4). These countries are poised for stronger growth, supported by an expansion in global trade, stronger export growth helped by cheap currencies, firmer commodity prices, and improving corporate earnings. Emerging market corporate fundamentals have already bounced back from the slowdown of 2010-11, although analysts' earnings expectations have not yet been revised up. Emerging equity and debt markets are priced for trouble, even though the sailing looks considerably smoother ahead. Although liquidity will gradually tighten as the global recovery gains traction, markets are now in a "sweet spot," supported by easy money and improving growth. They will likely remain in this state for at least the next 6-12 months.

Figure 4. Leading Economic Indicators (% change y/y)



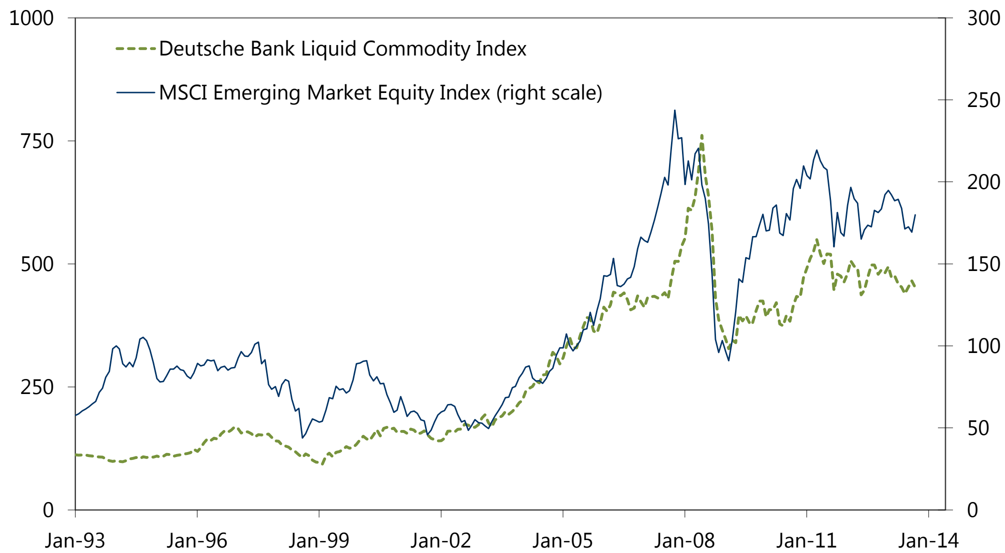
Source: Bloomberg

China & Commodities

The days of double-digit growth in China—and the support that growth provided to commodity exporters and the many emerging markets in that country's massive supply chain—clearly are behind us. China's new leadership is advancing structural reforms to promote a more moderate, and sustainable, rate of expansion. The emphasis is on improving efficiency, China's physical and financial infrastructure, consumer spending, and the social safety net—rather than capital spending and exports.

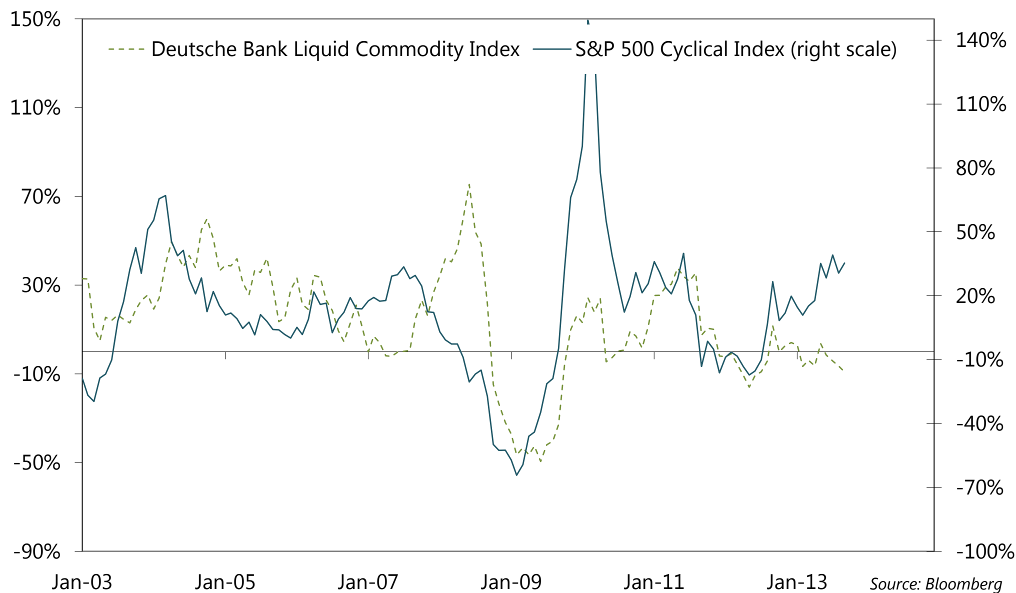
The transformation is already producing growing pains; the economic slowdown in China has been a major contributor to the weakness in commodity prices over the past two years. As Figure 5 shows, emerging equity and commodity markets have been highly correlated historically; stronger growth in the emerging markets is both a cause and consequence of rising commodity prices.

Figure 5. Emerging Equity Markets are Commodity Markets



Source: Bloomberg

Figure 6. Commodity Prices vs. Cyclical Stocks (% change y/y)



Source: Bloomberg

While the structural slowdown in China is real, growth in the world's second largest economy is still quite rapid. Moreover, that growth is applied to a now much larger GDP base. China does and will continue to drive global resource demand. At the end of September, China surpassed the United States as the world's top importer of crude oil, with other natural resource imports showing significant growth as well. Yet, as Figure 6 above shows, the performance of commodities (and by extension, the emerging markets) has been lagging behind other cyclically-sensitive assets. Some argue that the world needs fewer natural resources to produce the same level of output. While that is certainly true over the long run, we believe this short-term deviation is simply the result of a transitory supply-demand imbalance. Chinese government action to slow its economy coincided with a strong supply response by commodity producers to the high prices of the mid-2000s. We expect the gap to narrow as the global economy recovers.

Corporate & Macroeconomic Fundamentals

Even without rising commodity prices, emerging market equities look attractive. Their cumulative underperformance has brought the MSCI emerging market equity index back down to 2006 levels vs. the S&P 500. Price-earnings and price-book ratios are low; profit margins are high (but with room to rise); interest rates are set to fall; earnings growth is accelerating; and equity analysts are pessimistic. By contrast, US stocks are relatively expensive, at a time when profit margins are at a peak; interest rates are set to rise; earnings growth is slowing, and analyst expectations are high (Figure 7).

Not only are emerging market corporate indicators relatively healthy, these countries' macroeconomic fundamentals are also relatively good (see Figure 8). Certainly, growth has slowed from the breakneck pace of the last decade, but the same is true for most economies. Inflation is somewhat higher in the emerging markets, but has been stable for years—indeed, more stable than in the mature economies, who might wish for a similar result. Emerging market export volumes are relatively high, public and external debt levels are low; trade surpluses are large, and the accumulation of foreign reserves remains brisk. Admittedly, several countries suffer from serious deficiencies in their management. The so-called "Fragile Five" include India, Indonesia, South Africa, Brazil and Turkey. These countries are struggling with high inflation, rising interest rates, slowing growth, deteriorating external trade and weakening currencies. Clearly, such conditions are not conducive to a profitable investment. Eventually, these countries will do the right thing…after they've tried everything else. Elsewhere, fundamentals are good and getting better.

It bears reminding that emerging markets are, by definition, lessliquid. This spring's surge in US bond yields—which was triggered by a (now aborted) tapering of the Federal Reserve's quantitative easing policies—temporarily destabilized global financial markets. Emerging debt and equity markets were most affected, as local interest rates rose, stock markets retreated, and investors feared a sharp repatriation of capital. Short-term investors (leveraged hedge funds and the like) were forced out of their positions. Fortunately, US yields have since retraced about half of their rise, and the US dollar has resumed its weakening trend. The fear of a destabilizing outflow of capital from the emerging markets has abated.

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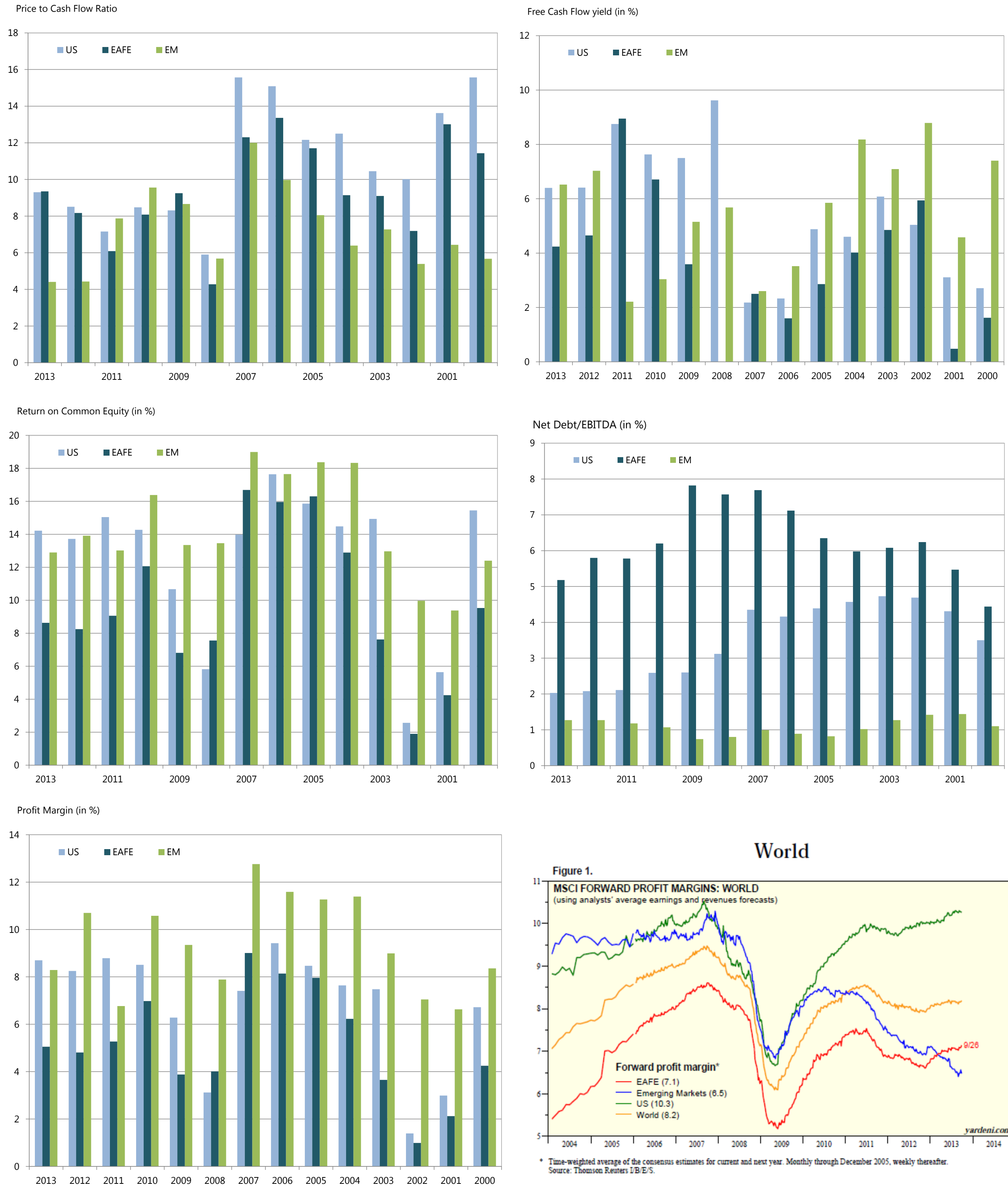
Figure 7. Corporate Fundamentals



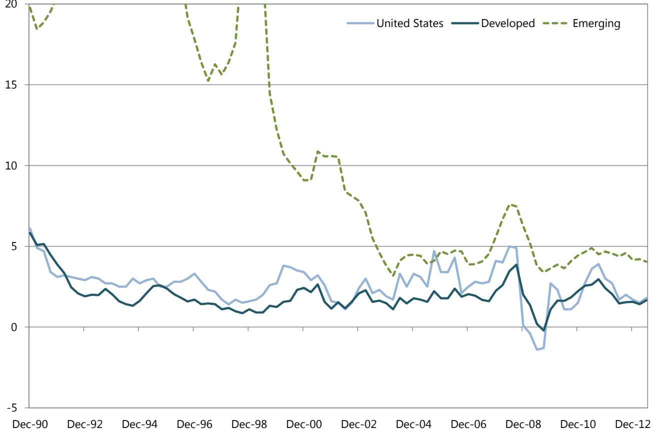
All data are based on MSCI equity indices published by Bloomberg, except forward profit margins, which are from Yardeni Research

Figure 8. Macroeconomic Fundamentals

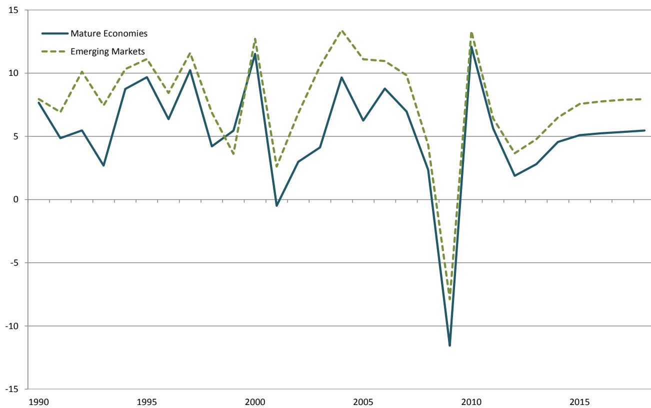
Real GDP Growth

Source: International Monetary Fund World Economic Outlook, April 2013

Consumer Price Inflation (annual % change)

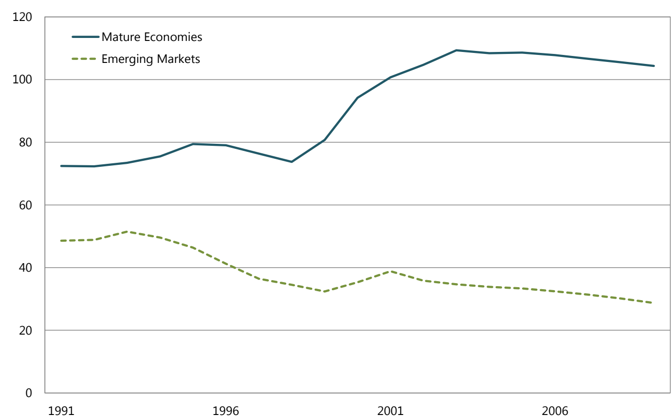


Growth of Export Volumes



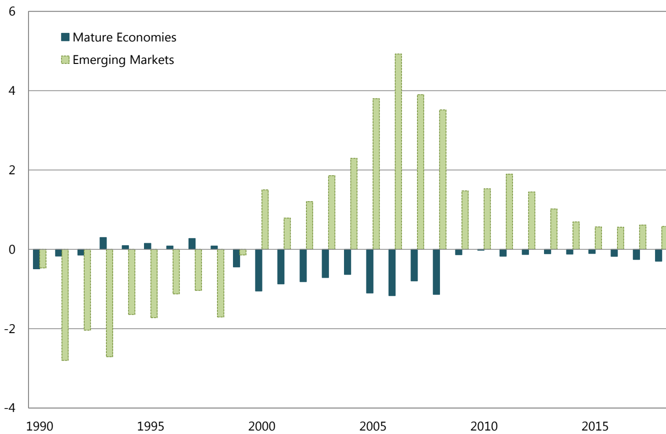
Source: International Monetary Fund World Economic Outlook, April 2013

General Government Debt (in % of GDP)

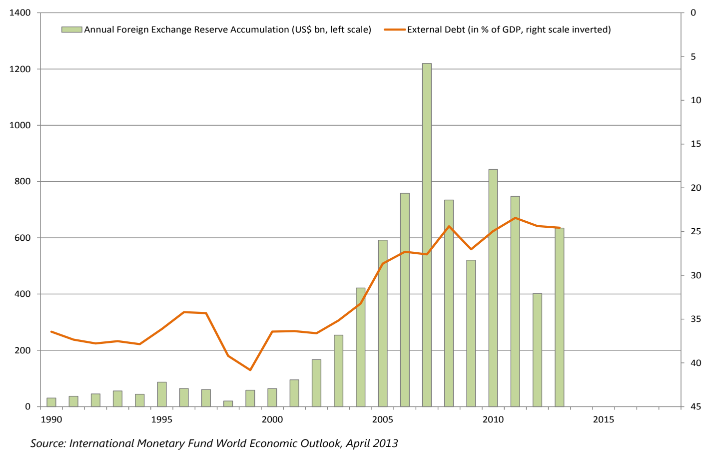


Source: International Monetary Fund World Economic Outlook, April 2013

External Current Account Balances (in % of GDP)



Emerging Market Reserve Accumulation & External Debt

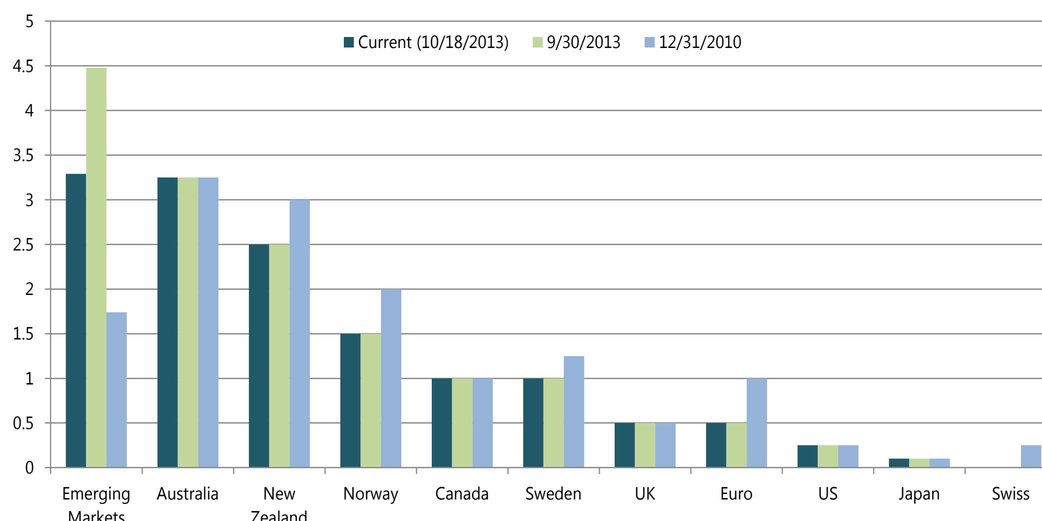


Source: International Monetary Fund World Economic Outlook, April 2013

All data and projections are from the IMF's World Economic Outlook, April 2013

US interest rates will eventually resume their ascent, when the Fed begins to taper its bond purchases. But that process will likely be gradual and undertaken in the context of a strengthening global economy. If so, it should not undermine the emerging markets. As Figure 9 below shows, EM yields are considerably higher than in the US and most other mature economies. Indeed, in many emerging markets, there is further room for rates to fall, which would support local assets.

Figure 9. Central Bank Policy Rates



Source: Bloomberg

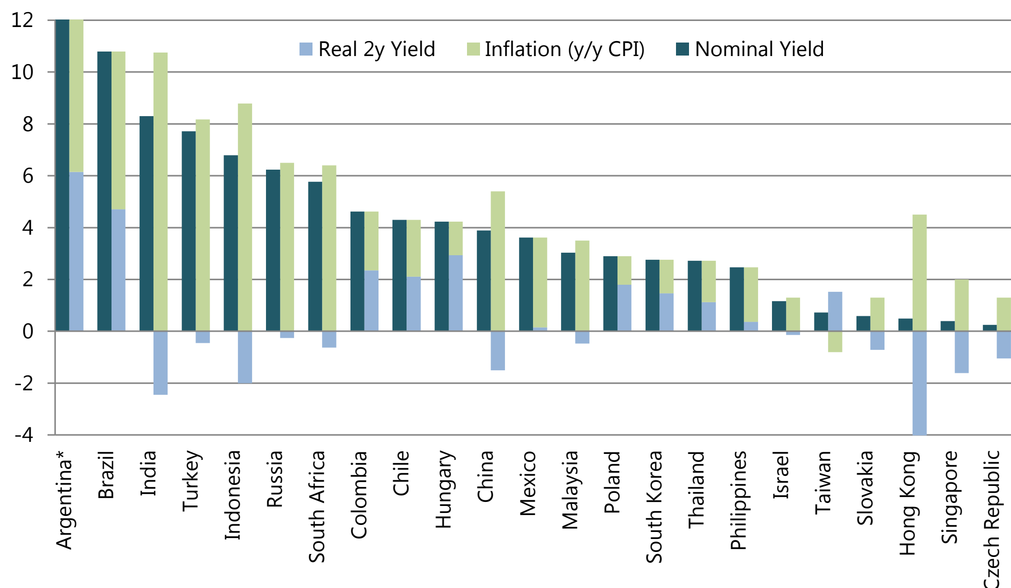
Emerging market bond yields have come down from their highs of the summer, but remain attractive to fixed income investors. High yields have been encouraging foreign capital to flow back into these markets, and foreign reserves are again rising. Indeed, reserves are above their pre-crunch levels, and far higher than they were during the 1990s. These reserves create a sizable cushion with which policymakers can (and have) defended their currencies. The defense is no longer necessary, as the tide has already turned; the emerging currency, debt and equity markets have all been rallying since late summer—moving them near the top of the global investment league tables.

Greater Differentiation

Typically, the US leads global economic and stock market performance, followed by Europe with a 3-6 month lag, and the emerging markets 6-12 months later. A continuation of this pattern points to a strengthening of emerging markets' relative performance in the latter half of 2013. However, much depends on the perceived scope and pace of Fed tapering. Every major tightening over the past 30 years has resulted in an "accident" of some sort in the emerging markets. Often, countries have pursued counterproductive policies to try to sustain growth in a context of diminishing liquidity; this has undermined their credibility with foreign investors (as Brazil, Turkey, South Africa and the Ukraine have

done recently). Elsewhere (as in Mexico, Chile, and many Asian economies) policymakers have responded with measures that reinforce their reputation and the attractiveness of their markets to foreigners. As the liquidity tide retreats, it becomes easier for investors to discern which countries have been overplaying their hand, so to speak. Typically, there is much greater differentiation among the emerging markets, and wider variation in their performance, when money is less plentiful.

Figure 10. Real Yield Composition



**Argentina's nominal yield is 28%* *Source: Bloomberg*

As noted above, a market's attractiveness in the eyes of investors is closely related to the rate of return on capital invested there. The domestic interest rate determines not only the coupon paid out on a country's bonds, but also the rate at which future corporate earnings are discounted by equity investors. When interest rates are high (with room to fall) and inflation is low and stable, prospects are more attractive than when interest rates are low and inflation rising. However, as Figure 10 above shows, the *nominal* interest rate can be misleading. A country's yield may be high, but if inflation is also high, the *real* value of the investment may be eroded—whether by currency depreciation or instability in prices and corporate earnings. Countries such as India, Indonesia, Turkey and South Africa all have nominal yields that are over 6%, but when adjusted for inflation, the real return is actually negative. The inability of these countries to provide a positive real return, despite their need for foreign investment, suggests policy mismanagement.

In general, we favor passive equity investments, since opportunities to add value to a portfolio through individual security selection (i.e. trying to beat the market) tend to be fleeting, while the cost of securing any benefit is often excessive. However, country-level mis-pricings and risks tend to be larger and more persistent. If we could identify an equity fund that was focused only on the healthiest countries, that

would be ideal. Unfortunately, such a fund doesn't exist, since the eligible countries collectively don't afford adequate diversification and liquidity. Moreover, the highest-quality investments are often "priced for perfection" leaving little opportunity for profit. Hence, we are approaching this asset class with a combination of funds that balance broadly diversified passive exposure with active investment opportunities focused on country and sector risk factors.

KPF Global Portfolio Strategy

We have made no major changes to our investment strategy. Our clients remain slightly overweight an array of risk assets, with a meaningful tilt toward the international and emerging markets that is beginning to bear fruit. With regard to the latter, we have taken steps to diversify our investment vehicles, to ensure broad market coverage, while retaining our traditional value-oriented approach. Elsewhere, we have trimmed our clients' allocation to mortgage-backed securities as that sector has recovered from the summer swoon. However, we are not retreating from fixed income, since (a) our positioning was relatively light going into the summer; (b) we believe interest rates will likely remain rangebound over the next several months; and (c) we continue to be pleased with the performance of our fixed income managers, who have performed well amid difficult market conditions. Our fixed income portfolios are tilted toward credit sectors, especially (short-duration) high yield debt and longer-duration emerging market debt. We are holding a slightly overweight position in commodities, with a focus on natural resource stocks.