HALBERT HARGROVE

Pigs Get Slaughtered

The 2nd Quarter of 2014 was marked by a continued expansion of asset class exuberance. US Stocks, as measured by the S&P 500, were up 5.2% on the quarter and are up 7.1% year to date. The Barclay's US Aggregate bond index has been a surprise success this year, up 2.0% for the quarter and up 3.9% year to date; essentially bringing that market back to even with its high water market pre "taper-tantrum" in May 2013. Commodities were flat for the quarter, but still show a healthy return year to date, up 7.08% as measured by the Bloomberg Commodity TR index.

To date, Global REITS (as measured by the FTSE/NAREIT index) were up 7.6% for the quarter and up 11.7% year to date. Global Infrastructure (as measured by the S&P Global Infrastructure benchmark) was up 8.1% for the quarter and up 15.5% year to date. It seems reasonable to suggest that the success of these sectors has been driven by the globally coordinated decline in interest rates, as well as the continued hunt for income for a yield starved investor.

In light of a continuation of "risk on" markets, we find it interesting that Small Cap US stocks are lagging their Large Cap brethren on the quarter and year to date are up only 2.1% and 3.2% respectively. This slight underperformance was echoed in International markets where Large Cap Foreign stocks were up 4.1% on the quarter while Small Cap Foreign stock were only up about 2.1%; year to date Large and Small Cap Foreign stocks are in line, both positive in the 5% range.

On the back of a stellar 2013, it would be easy to suggest that some mean reversion could be expected from the markets and that we are "overdue" for a correction. Of course, as Peter Lynch is famous for saying: "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves." Further, a "correction" does not have to be of the voracious bear-market type as markets can move sideways or even continue to chug along a positive slope given investor sentiment improvements. The latter may obfuscate a flattening or declining earnings denominator, which would not be a long term satisfactory position warranting a highly positive outlook on stocks. It could, however, allow for ample time for the economy to "catch up" to the market's view of the world.

However, we exhibit substantial anchoring biases when we look back at recent events and suggest that the S&P 500's incredible run from the lows of 2009 are "not sustainable". Indeed, that run rate of return (~19% per annum) may not be sustainable, but that does not mean that US Stocks won't continue to exhibit relative outperformance (i.e. vs. fixed income). All one has to do is look at the long term performance of US stocks to see that there are clear periods of decade plus bull markets following decade long sideways markets. The 5 year bull market in US stocks only catapulted our market above the last decade sideways movement on a price return basis in 2013 (on a total return basis in 2012).

Note that we did not start our missive suggesting "irrational" exuberance or use the term "euphoria" – both of which would suggest that our current state of affairs are unsustainable. Indeed, looking at University of Michigan's consumer sentiment index, we are just now reaching the average level of the last 40 years' consumer confidence level. Even being above "average" would not suggest a negative forward outlook on stocks, but clearly the more bullish we are in the collective, the less sanguine we are about prospects for outsized returns. Ernie Ankrim recently shared a series of sentiment indicators that he receives from a pair of his Market Strategist associates that tell a bit more of a "euphoric" tale:

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## Sentiment Indicators

| | Current | | Previous | | Signal |
|---|---|---|---|---|---|
| CBOE 10-Day Put/Call Ratio<br>*Below 80% is bearish; Above 95% is bullish* | 79% | | 81% | | Excessive Optimism |
| CBOE 3-Day Equity Put/Call Ratio<br>*Below 53% is bearish; Above 62% is bullish* | 52% | | 47% | | Excessive Optimism |
| VIX Volatility Index<br>*Below 16 is bearish; Above 22 is bullish* | 12.2 | | 10.7 | | Complacency |
| American Association of Individual Investors<br>*Twice as many bulls as bears is bearish; more bears than bulls is bullish* | Bulls:<br>Bears: | 44.7%<br>21.3% | Bulls:<br>Bears: | 39.5%<br>22.2% | Excessive Optimism |
| Investors Intelligence (Tracks the Advice of Wall St. Letter writers)<br>*55% bulls and/or less than 18% bears is considered bearish* | Bulls:<br>Bears: | 62.6%<br>17.2% | Bulls:<br>Bears: | 62.2%<br>17.4% | Excessive Optimism |
| National Assoc. of Active Investment Mgrs. (NAAIM)<br>*Below 30% is bullish; Above 70% is bearish* | 87% | | 91% | | Excessive Optimism |
| Ned Davis Research Crowd Sentiment Poll | Extreme Optimism | | Extreme Optimism | | Excessive Optimism |
| Ned Davis Research Daily Trading Sentiment Composite | Extreme Optimism | | Extreme Optimism | | Excessive Optimism |

All this said, “excessive optimism” can last a lot longer than expected; but it does cause us to temper our forward expectations. To quote Ernie “Of course, this does not imply the markets will head south immediately. It DOES stress the importance of a strategy that will direct an exit from the markets if they begin to show material weakness”. More on that point in a minute.

Looking across US Equity sectors, based on a simple trailing Price to Earnings measure it would be reasonable to suggest that US stocks are at “fair value” relative to their 20 year averages. Even using a CAPE (“Cyclically Adjusted Price Earnings”, colloquially known as a Shiller P/E), a method used to normalize and smooth inflation-adjusted earnings comparisons over time, the current 25.6 level is commensurate with the last 25 year average of 25.1.

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**Current P/E vs. 20-year avg. P/E**

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 15.0 / 14.0 | 15.6 / 16.2 | 18.3 / 21.0 |
| Mid | 17.0 / 14.1 | 18.4 / 16.4 | 19.8 / 21.8 |
| Small | 16.7 / 14.4 | 18.5 / 17.2 | 20.7 / 21.4 |

**Current P/E as % of 20-year avg. P/E**

*E.g.: Large Cap Blend stocks are 3.4% cheaper than their historical average.*

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 107.4% | 96.6% | 87.1% |
| Mid | 120.1% | 111.7% | 90.7% |
| Small | 116.1% | 107.6% | 96.5% |

Source: JP Morgan

Sector charts within the S&P highlight the fact that on a trailing P/E basis, Health Care, Consumer Discretionary, Consumer Staples and Materials look fairly valued and Utilities look substantially overvalued. Again, symptoms of yield chasing may be at work here.

**Equities**

| | | Financials | Technology | Health Care | Industrials | Energy | Cons. Discr. | Cons. Staples | Telecom | Utilities | Materials | S&P 500 Index |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Weight | **S&P Weight** | **16.1%** | **18.8%** | **13.3%** | **10.5%** | **10.9%** | **11.8%** | **9.5%** | **2.4%** | **3.2%** | **3.5%** | **100.0%** |
| Weight | Russell Growth Weight | 5.2% | 27.7% | 12.8% | 12.3% | 6.4% | 18.4% | 10.5% | 2.3% | 0.1% | 4.3% | 100.0% |
| Weight | Russell Value Weight | 28.5% | 8.9% | 13.1% | 10.5% | 13.9% | 6.3% | 6.9% | 2.3% | 6.3% | 3.4% | 100.0% |
| Return (%) | **YTD** | 5.0 | 8.9 | 10.6 | 4.0 | 13.0 | 0.6 | 5.2 | 4.3 | 18.7 | 8.6 | 7.1 |
| Return (%) | **2Q14** | 2.3 | 6.5 | 4.5 | 3.9 | 12.1 | 3.5 | 4.7 | 3.8 | 7.8 | 5.6 | 5.2 |
| Return (%) | **Since Market Peak** (October 2007) | -26.8 | 62.0 | 93.0 | 44.3 | 43.2 | 97.9 | 92.5 | 24.0 | 41.6 | 35.6 | 45.2 |
| Return (%) | **Since Market Low** (March 2009) | 299.8 | 239.4 | 211.1 | 296.7 | 162.3 | 358.1 | 170.0 | 136.8 | 147.9 | 223.0 | 224.4 |
| β | **Beta to S&P 500** | 1.43 | 1.12 | 0.70 | 1.20 | 0.99 | 1.13 | 0.57 | 0.63 | 0.48 | 1.28 | 1.00 |
| ρ | **Correl to Treas. Yields** | 0.33 | 0.09 | -0.08 | 0.29 | 0.23 | 0.18 | -0.15 | -0.35 | -0.43 | 0.16 | 0.11 |
| P/E | Forward P/E Ratio | 13.1x | 15.2x | 16.7x | 16.2x | 14.7x | 17.7x | 17.7x | 13.4x | 16.6x | 17.1x | 15.6x |
| P/E | **15-yr avg.** | **12.4x** | **21.8x** | **17.0x** | **16.5x** | **13.7x** | **18.0x** | **17.3x** | **16.6x** | **13.6x** | **15.8x** | **15.8x** |
| P/E | Trailing P/E Ratio | 15.9x | 19.0x | 24.1x | 18.0x | 16.2x | 21.1x | 20.0x | 10.8x | 20.4x | 19.4x | 18.5x |
| P/E | **20-yr avg.** | **16.3x** | **26.3x** | **24.4x** | **20.3x** | **17.4x** | **19.2x** | **21.2x** | **20.0x** | **14.8x** | **19.3x** | **19.5x** |
| Div | Dividend Yield | 1.8% | 1.6% | 1.7% | 2.1% | 2.3% | 1.5% | 2.7% | 4.9% | 3.7% | 2.1% | 1.9% |
| Div | **20-yr avg.** | **2.1%** | **0.7%** | **1.4%** | **1.7%** | **1.7%** | **0.9%** | **2.1%** | **4.2%** | **4.3%** | **2.1%** | **1.7%** |

Source: Standard & Poor's, Russell Investment Group, FactSet, J.P. Morgan Asset Management.
All calculations are cumulative total return, not annualized, including dividends for the stated period. Since Market Peak represents period 10/9/07 – 6/30/14. Since Market Low represents period 3/9/09 – 6/30/14. Correlation to Treasury Yields are trailing 2-year monthly correlations between S&P 500 sector price returns and 10-year Treasury yield movements. Forward P/E Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Trailing P/E ratios are bottom-up values defined as month-end price divided by the last 12 months of available reported earnings. Historical data can change as new information becomes available. Note that P/E ratios for the S&P 500 may differ from estimates elsewhere in this book due to the use of a bottom-up calculation of constituent earnings (as described) rather than a top-down calculation. This methodology is used to allow proper comparison of sector level data to broad index level data. Dividend yields are bottom-up values defined as the annualized value of the most recent cash dividend as a percent of month-end price. Beta calculations are based on 10 years of monthly price returns for the S&P 500 and its sub-indices. Beta's are calculated on a monthly frequency over the past 10-years. Past performance is not indicative of future returns.

Guide to the Markets – U.S.
Data are as of 6/30/14.

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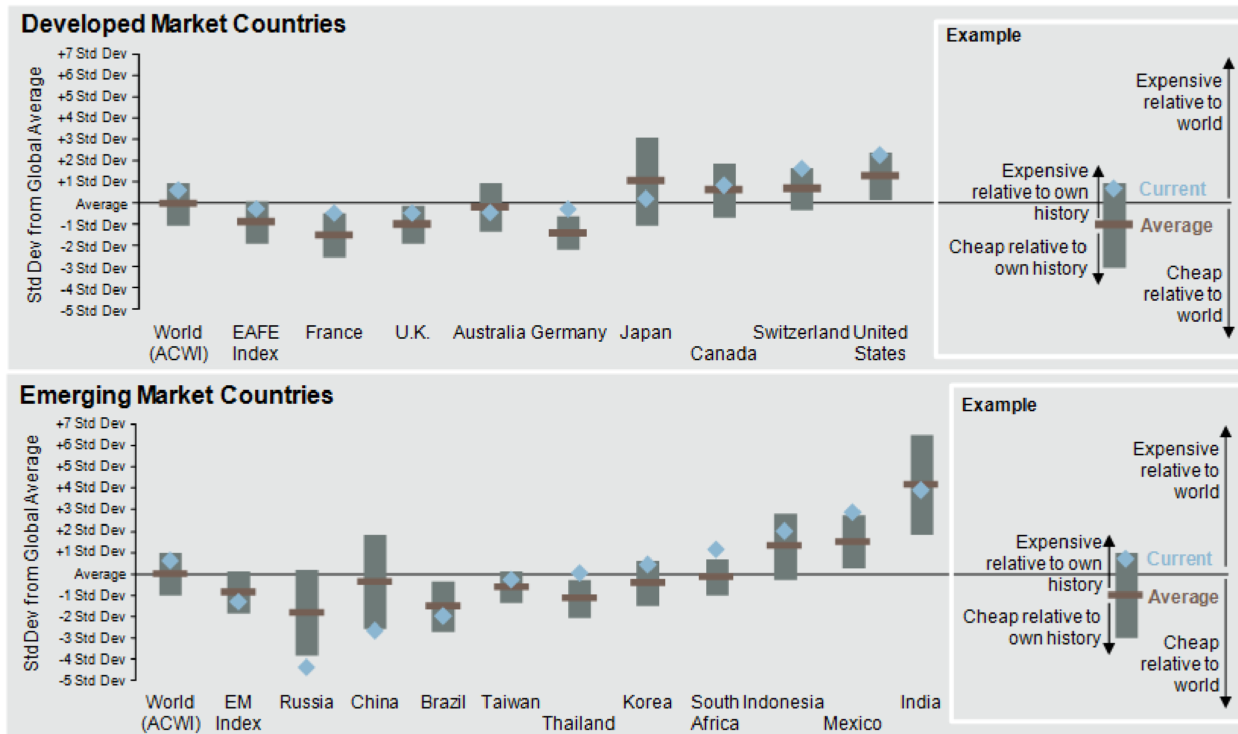
Interestingly, the cheapest area (based on P/E & Price to Cash Flow) of the US stock market right now looks to be the Mega Cap names. As of 7/14, on a trailing 12 month basis (using proxy securities):

| Name | P/E | P/B | P/CF | Div. Yield |
|---|---|---|---|---|
| Russell 1000 | 18.85 | 2.76 | 10.15 | 1.82 |
| Russell 2000 | 43.74 | 2.32 | 13.77 | 1.27 |
| Russell top 50 | 17.00 | 2.88 | 8.81 | 2.13 |

Unfortunately, valuations are not a great timing tool, but they can inform an outlook for future expected returns. To that end, looking at valuations would suggest the best opportunities are currently found in the International Developed and Emerging Market countries.




Of course, looking across the global economy, it's hard to suggest that there's anything but a relatively benign recovery from the global financial crisis. The BEA's third estimate of 1st Quarter Real GDP for the US declined at an annual rate of 2.9% which suggests that even if we were lucky enough to have a 4% (real) annual growth rate for each of the next 3 quarters, we'd only experience a +2% Real GDP statistic for the year (the expansion average is 2.1%). We hesitate to get too caught up over the past results of a quarter, especially one that clearly showed a greater than normal impact from weather. Per JP Morgan, corporations are likely to increase investment spending as they reach higher levels of capacity utilization and new peaks in employment, evidenced by some relatively robust M&A activity seen year to date. Further, household net worth has continued to reach new peaks. Net worth now stands 19% above the pre-crisis record and has increase by more than $25 trillion from the low of 2009. Financial assets have been the critical driver of this recovery with an increase in value of $22 trillion since the first quarter of 2009.

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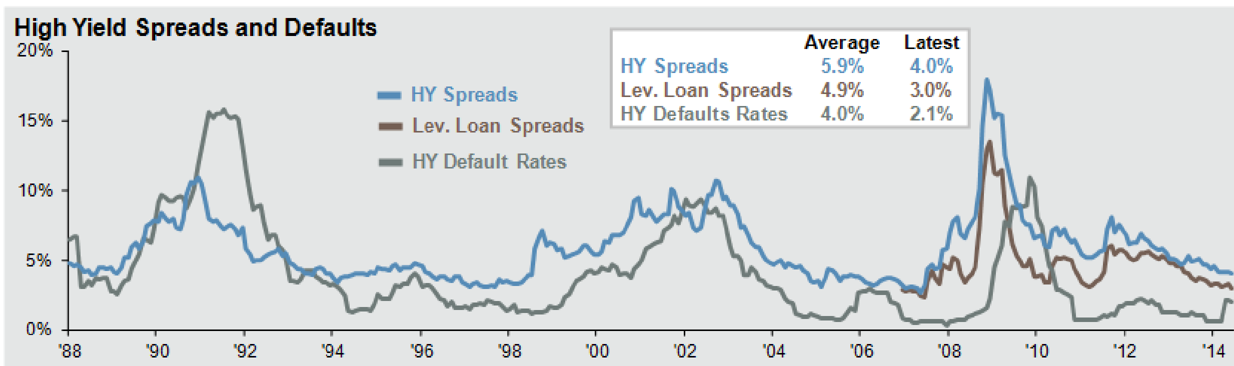
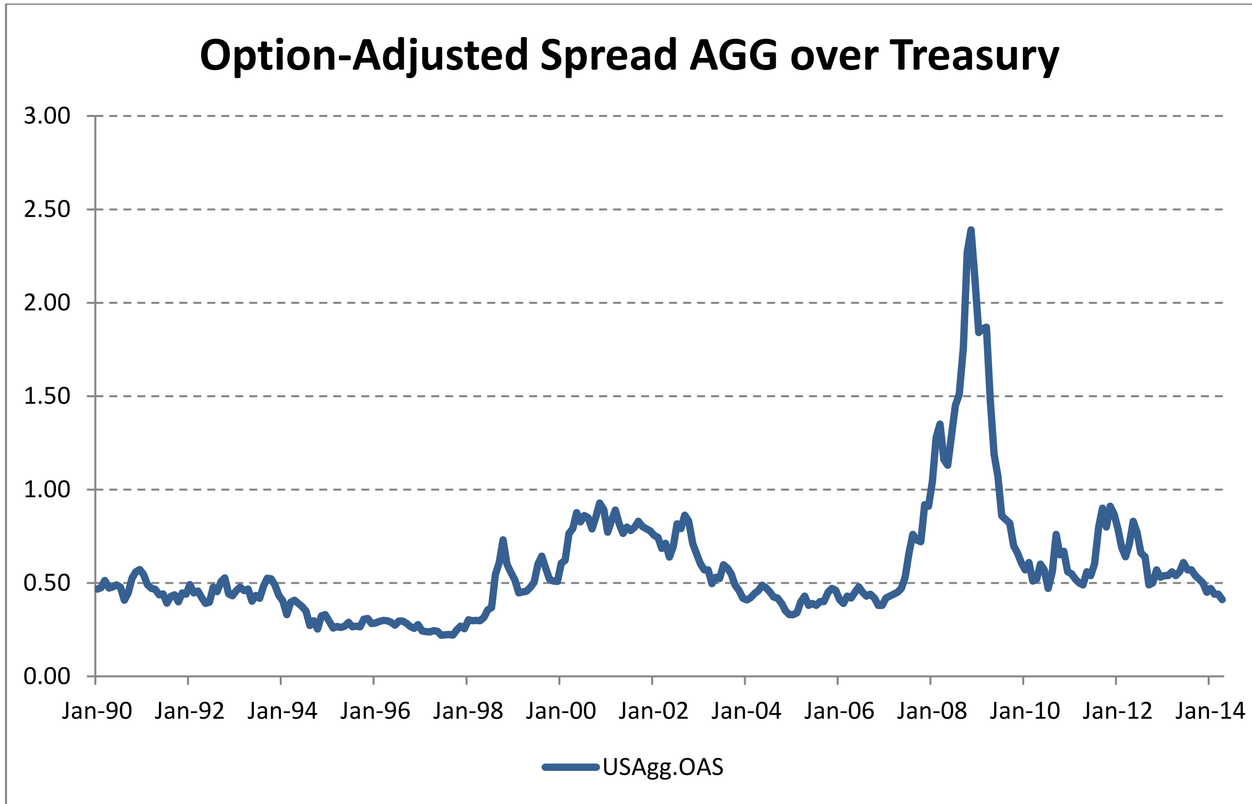
| As of June 2014 | UNITED STATES | EURO AREA | JAPAN | CHINA |
|---|---|---|---|---|
| IMF forecasted 2014 real GDP (annual percent change) | Steady, 2.8% | Weak but improving,1.2% | Improving, 1.4% | Steady, 7.5% |
| Unemployment | Improving, 6.1% | High but improving, 11.6% | Low, 3.5% | Steady, 4.1% |
| Interest rate policy | Low, no change | Rate cut | Low, no change | No change |
| Stimulus | Yes, tapering | Yes, more possible in the future | Yes, expanding | No |
| Recovery since market bottom (cumulative return 3/9/09-6/30/14) | +225% | +162% | +97% | +122% |

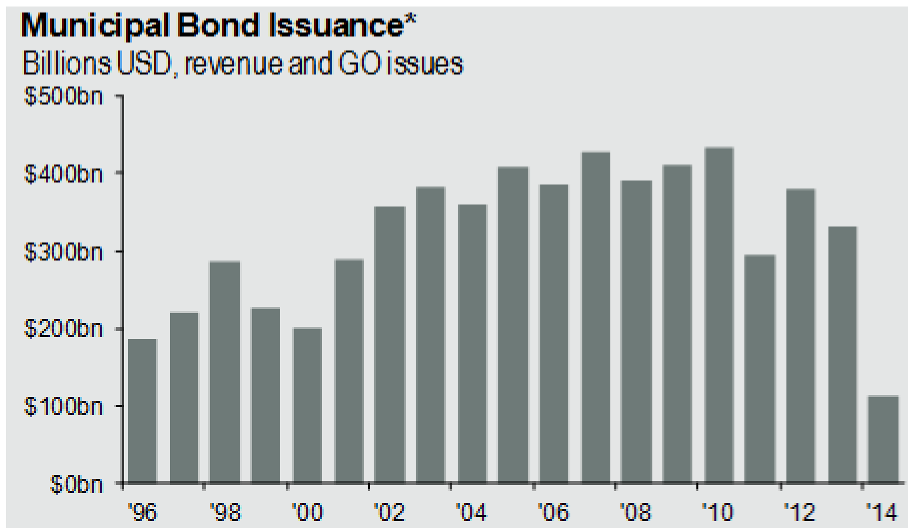
One of the major reasons for continued economic growth has been the historical low levels of interest rates. There is broad consensus that these low rates have only one way to go from here: up. The challenge is when and by how much. We continue to believe that one of the greatest risks to this market is a significant and abrupt increase in interest rates; particularly due to a "fumbling" of policy. Globally, central banks have continued to pursue a path of quantitative easing-- which has punished savers and rewarded those companies that use leverage to produce their earnings (see Utilities & REITs). Thus far, however, we have not seen evidence of credit strains:




We remain cautious on the high yield sector given a relatively tight spread. However, looking at the Option Adjusted Spread of the Barclay's Aggregate vs corresponding Treasury rates reveals that there may be more cushion, as a percentage of the available yield, than we've seen at spread-lows in the past. Another tip of the hat to Ernie, the average spread from January 1990 through April 2014 was 57 bps. As of April, the current spread was 41 bps. The smallest spread during this time frame was in June and September 1997 at 22 bps, which, at the time, was only 3% of the total Aggregate yield. With such low Treasury rates, the current spread equates to ~20% of the total Aggregate yield. There is room to rest, at least.




While it seems counter-intuitive to suggest any form of tailwind in the fixed income market, there is one area where the current supply/demand relationship may be favorable to outcomes: Municipals.




In a world of potentially increasing taxes, the value of tax-free income to an investor would be difficult to overstate.

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We are complacent about inflation's potential impact on fixed income. There is some debate amongst economists about the current state of employment in the US. Some believe that we are actually closer to "full-employment" and that the current rate of unemployment represents the impact of a demographically declining labor force and a mismatch in skills to available jobs. We tend to agree with this outlook and believe that there is a risk of tightening within the US, assuming that other traditional economic data points continue to show at least some form of stabilization (recent Real GDP prints are, after all, only hindsight measures).

Obviously, a significant and pervasive increase in inflation expectations can expose the fixed income market to fairly rapid declines as current issues are re-priced. To that end, active management geared to determining where to be within that sector should continue to bear fruit and, at a minimum, help defend against a deleterious long-term reversion to "normal" inflation rates. Of course, there are sectors that we believe may help offset some of that potential impact: namely, catastrophe bonds.

Reviewing all of the nuances of the Cat bond market is not the purpose of this review. We will only reiterate the basic reason for our interest in those securities:

- An alternative source of portfolio income independent of interest rate movements and/or dividend policies.
- Little correlation to financial markets, even in times of significant stress. Allows true diversification to stock, bonds and commodities. In fact, stressed investors found liquidity in reinsurance holdings during the financial crisis when other fixed income was not trading.
- Little "internal" correlation within the market of global natural disaster events.
- For the most part, traditional financial markets have no bearing on risks being insured by reinsurance bonds. The reinsurance bond market was liquid through the financial crisis of 2008/2009. These bonds are hard to buy (access) but easy to sell.
- The collateral yield for the securities is based on short-term money market rates: if short term rates increase, all else being equal, so does the overall rate of return for the securities. (Subject, of course, to the specific Cat bond instrument's realized outcome.)

We don't believe in strategically holding any material amounts of cash; particularly in the current yield environment. That said, cash can be a useful addition to the portfolio to allow for flexibility of deployment and buy assets cheaply when those markets trade at a significant discount. However, if the global economy continues to recover and growth/earnings related assets continue to outperform, the drag from cash may be more difficult to justify. Our recent meetings in Seattle were designed to help inform your understanding of the tools available to you as a way of either hedging market drawdown risk and/or improving returns by way of making rules-based decisions on opportunities. Our research therein is still on going, but is a near-term priority given our relatively mixed outlook for risk markets. The urgency of that effort is muted, somewhat, by the current cash component of your portfolio.

HH currently uses a model that evaluates a single pairing of Equities vs. Fixed Income, developed by the think tank at Russell Investment Group, which expresses insight on when a tilt should be made to favor Fixed Income over Equities. The most recent signal from their group suggests no-current tilt away from Equities:

**Current recommendation: no tilt**

**Valuation Date** 6/30/2014

| Model | Signal | Tilt |
|---|---:|---:|
| Momentum | 0.85 | 2.4% |
| Long-term Mean Reversion | -0.32 | 0.0% |
| Fed | 0.57 | 0.4% |
| Fundamental | 2.47 | 10.0% |
| BCI (JUL 2014) | 1.22 | 4.4% |

Each of the models above result in a positive tilt to Equities and suggests staying "long" the Equity market; only the long-term mean reversion signal shows any measure of risk. We are considering increasing the number of pairwise trades to evaluate using these methods.

Another simple method of a rules-based approach to protecting downside risk is following a simple Moving Average. The US and EM markets are currently ~7% above their 200 day moving average with the EAFE market about 3% above that level. Again, nothing here to suggest it's time to get defensive.

Bringing us back to the title of this Quarter's Review: "Pigs Get Slaughtered". Our general recommendation is to continue with the status quo: long risk assets buffered by cash and the development of a rules based approach to downside mitigation. In light of the complacency that is seemingly building across the globe-- well reviewed by Duncan in his June 2014 letter-- we do not recommend an *increase* of risk or duration in the portfolio. Active management can help find those gems within the equity and fixed income markets that may outperform during a less pervasive rising tide.

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