September 2013

STRONG SEPTEMBER RALLY SURPRISES MANY…ARE WE DUE FOR A REAL CORRECTION?

Macro Backdrop

After a volatile two months which sent major global equity indices up +4% and then down -3%, we entered September in a slightly defensive stance. The month began with a series of event driven headlines, some of which have come to pass, and others which still have the potential to create the correction many analysts are expecting:

- The use of chemical weapons in Syria triggered a potential US military strike in the Middle East and drew several countries into the debate. ***Syria's compliance has put it on the back burner for now.***
- The Fed meeting September 17th was widely expected to signal the beginning of the tapering process everyone expected. Instead, the Fed decided to delay tapering***. The Fed "non-tapering" decision is essentially insurance against a government shutdown and volatility is beginning to increase as Wall Street realizes it doesn't have a good handle on what the Fed will do next.***
- Without a continuing resolution, the US government will shutdown on September 30th. The shutdown looks increasingly likely given the House's vote to tie the budget to de-funding Obamacare. ***The markets are pricing the shutdown as a non-event as it is expected to last a short time and will not have a meaningful impact on the economy. Anything protracted is all downside.***
- After we get through government funding crisis, we will immediately be thrown in the debt ceiling debate reminiscent of the summer of 2011. Many Republicans are threatening not to approve a higher debt ceiling without other concessions. ***A protracted debt ceiling fight will negatively impact the markets as it did last time around when the equity markets lost over 20% in the span of 2 months and the US credit rating was downgraded – this is one of the top concerns right now.***

The Surprising Amount of Red This Year

Overall, globally diversified portfolios have performed poorly in 2013. As you can see, the only real bright spot has been US equities which are within a couple of points of their all-time highs. Rising interest rates combined with a noticeable slowdown in global growth has caused fixed income, commodities, and other credit oriented strategies to remain in the red:

S&P 500 Index(SPY):	**+19.32%**
Emerging Markets Index(EEM):	**-4.78%**
UBS Commodities Index(DJP):	**-9.72%**
Gold (GLD):	**-21.95%**
Barclays Agg. Bond Index(AGG)	**-4.65%**

YTD as of 9/23/2013 Source: Yahoo Finance

Our portfolios have participated in the US equity rally and we have benefited from an underweight to commodities and gold. We have also kept our fixed income allocation very short and in high quality credits to avoid the meltdown that has occurred in longer, more illiquid bonds. Our tactical sleeve has also performed well for you, up on average approximately 10%. However, we have suffered along with everyone else in emerging markets and fixed income.

Sticking to Our Guns

We have several overall themes for the remainder of the year and into 2014 which will drive our portfolio allocation and hopefully continue to generate solid and consistent risk adjusted returns:

- International equities will close the performance gap with the US (a gap which diverged as much as 25% at several points during the year) as Europe emerges from its recession and emerging markets stabilize. These are very correlated markets and the relative difference in prices is simply not sustainable. ***You have already seen it happen with our consumer focused emerging market equity ETF (ECON) posting a 14.81% gain versus a 5.4% gain for the S&P 500 in September. In addition, our decision to rotate a portion of our midcap and small cap US equity exposure into Developed Europe added +3% over the same period. We will continue to add to our European exposures in the next several months.***

- Interest rates will stabilize and may even come down in the short-term before marching upward later in 2014. The 10 Year Treasury yield has risen more than 84% from May to early September, one of the most rapid increases on record. ***We will maintain our short duration portfolio and look for opportunistic areas to generate additional yield but expectations should be tempered.***

- The US equity markets are close to their near-term highs and a correction is fairly probable as markets digest the Fed tapering (now expected) later this year along with the near-term political headlines. ***We will continue to add to our existing US core equity hedges (USMV, PHDG) which are designed to provide investors significant equity market upside and protect against downside volatility. Over the longer term, however, we plan to use any correction to add to US equities on a sector specific basis.***