The Conservative Strategist

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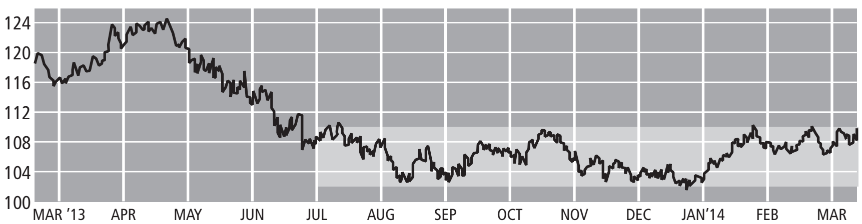
Economic strength ahead? Bonds and copper say otherwise.

With US stocks now priced in the upper decile of their historic valuation range, investors are counting on economic growth for further gains (and to justify current values). That's already a tall order five years into an artificially-created economic recovery. But now there are key signals from at least two other asset classes — bonds and commodities — that indicate there may be economic weakness, not growth, in coming quarters.

Bonds at a key juncture

Price of iShares 20+ Year Treasury Bond (TLT), March 2013 to date



After trading in a well-defined range since last July, US Treasury Bonds are threatening to bust up and out of that range. This means lower interest rates ahead, a development out-of-sync with the view that economic growth is in the offing. Source: JC Parets, All Star Charts

Bonds are rallying

When the economy grows, loan demand rises, which puts upward pressure on interest rates. Even the whiff of economic strength is enough to send rates higher and bond prices lower, as investors anticipate higher inflation.

But that's not what we're seeing here in the first quarter. Bond prices have firmed (interest rates have come down), and at quarter's end they threaten to punch through a key resistance level.

It is said that the stock market is middle school and the bond market is grad school. Not only does the bond market dwarf the stock market in size, but its traders tend to be more sophisticated. Even in the face of all the chatter about economic strength and the supposed upward pressure on rates by the unwinding of the Fed's easing program, bond traders are wagering on economic malaise, not growth. And in February and March, newly released economic indicators tend to corroborate that view.

Copper is sagging

Copper is known as the most economically sensitive metal. It was riding high in 2007 and 2008, trading at one point at more than $4.00 per pound. In the 2008-2009 crisis, it plummeted to under $1.30 per pound. In the subsequent economic recovery, it rallied to a new all-time high of $4.60 per pound in mid-2011. However, as stocks continued to rally on central bank easing, copper has declined steadily. It is now 30% below its 2011 peak, and in March pierced its 2013 lows, a key support area. Growth in the world's marginal demand source, China, is in peril.

Message received

Other industrial commodities are following copper's lead lower. Clearly bond and copper traders are not buying the rosy economic scenarios bandied about in the media. When assessing the economy's prospects, it's important to monitor the movement of these sensitive and often anticipatory asset classes. Today, their message is that trouble may lie ahead. That message is echoed by one of the world's most successful stock investors, Seth Klarman. *(For Klarman's warning, see page 4).* ■

The Markets March 31, 2014	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	1872.34	1.76%	1.76%
International Stocks (Vanguard Index)	16.76	0.77%	0.77%
Emerging Markets Stocks (Vanguard Index)	25.70	-0.40%	-0.40%
Real Estate Stocks (Vanguard REIT Index)	23.45	9.90%	9.90%
Bonds (30 year US Treasury/Vanguard Index)	3.56%	7.17%	7.17%
Dollar (US Dollar Index)	80.12	0.10%	0.10%
Gold (London Afternoon Fix)	$1291.75	7.24%	7.24%
Money Market Funds (IBC Index/7-day yield)	0.01%	UNCH*	UNCH*

*change in yield

Portfolio Planning

New ETF invests in scary-cheap markets—methodically

Last quarter, we mentioned that the 10-Year Cyclically-Adjusted P/E (CAPE) Ratio (also known as Shiller P/E 10) for the US market was historically high, and that meant trouble ahead. Over the past 100 years, high CAPEs have been associated with low subsequent 5- and 10-year returns, and low CAPEs have been associated with high subsequent returns.

The CAPE Ratio works globally. As the accompanying table shows: Across 32 countries in both developing and emerging markets, low CAPEs led to high returns and high CAPES led to low returns.

CAPE research

The research that formed this table comes from Meb Faber of Cambria Investment Management, one of the country's leading specialty investment researchers and innovators. Now Faber and Cambria have come up with an exchange-traded fund (ETF) designed specifically to invest in the world's cheapest countries according to the CAPE. It's called the *Cambria Global Value ETF* (symbol: GVAL).

From low valuations, high returns

CAPE Ratios and Future Returns for 32 Countries, 1980-2011

	Subsequent real returns				
Average CAPE	**1-year**	**3-year**	**5-year**	**7-year**	**10-year**
Less than 10	25.9%	17.0%	17.1%	13.4%	10.9%
10 to 15	22.8%	13.8%	12.2%	11.2%	9.6%
15 to 20	11.2%	10.8%	10.6%	8.8%	8.0%
20 to 25	4.4%	6.8%	5.6%	6.5%	5.7%
25 to 30	–1.3%	0.7%	3.4%	3.4%	3.3%

The numbers fall out perfectly: Over multiple timeframes, lower current valuations (according to CAPE) lead to higher returns, and as valuations rise, returns erode steadily. So constructing a portfolio of countries with CAPEs under 10, as GVAL does, offers much potential for outperformance. Sources: Global Financial Data, Morningstar, Cambria Investment Management

The cheap countries are a scary group

World's Cheapest and Priciest Stock Markets
(Based on CAPE Ratio, as of 3/1/14)

Cheapest	CAPE	Priciest	CAPE
Greece	4.54	Indonesia	28.46
Argentina	6.32	Sri Lanka	26.17
Russia	6.45	USA	25.41
Hungary	7.91	Philippines	24.35
Austria	8.81	Colombia	21.95
Ireland	9.03	Malaysia	19.99
Italy	9.31	Canada	19.85
Brazil	9.60	Peru	19.81
Jordan	9.68	Switzerland	19.50
Croatia	9.95	Japan	19.22
Average	**8.16**	**Average**	**22.47**

Most of the countries among the world's ten cheapest are less-than-glamorous and not at all popular. But that's what makes them buys. They are priced for crisis, and when those crises ease or even stabilize a bit, investors return and prices advance. Meanwhile, the world's most expensive stock markets (including the US, at #3) are priced for perfection and leave little room for disappointment. GVAL owns most of the markets on this bottom 10 list.
Source: Cambria Investment Management

GVAL facts

How does GVAL work? It regularly scans 45 of the world's stock markets, sorting them according to CAPE Ratio. It then invests in the cheapest 10 or 11 stock markets. Every quarter, it repeats the scan, and rebalances into the cheapest markets (they don't change very rapidly). In each of these 10 or 11 markets, it owns 9 or 10 of the most liquid and most representative stocks, for a total of about 100 stocks in the portfolio.

GVAL just started trading in March, and carries a reasonable expense ratio of 0.69%. As with any new ETF, liquidity is spotty, but we expect that to improve in the coming weeks, as this ETF's virtues are more widely recognized.

GVAL also maintains an absolute valuation limit, so when no countries meet its criteria (rare), it will simply allocate to cash until markets cheapen sufficiently.

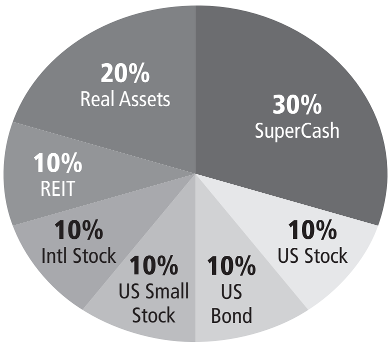
What's to like about GVAL

Until now, there has been no convenient way to invest systematically *in a non-emotional, indexed way* in the world's cheapest stock markets through a broadly diversified fund. It is hugely difficult to invest in, and stay invested in, many of these markets, as headlines blare about their crises and weaknesses. But the prices in these bombed-out markets often reflect all their ills — and then some. When the fog lifts, or even when things are no longer getting worse, their stock markets can rally hard. Hence the big numbers. ■

SuperDiversified Portfolios (SDPs)

Alternative assets overtaking stocks

SDP1 **Conservative**

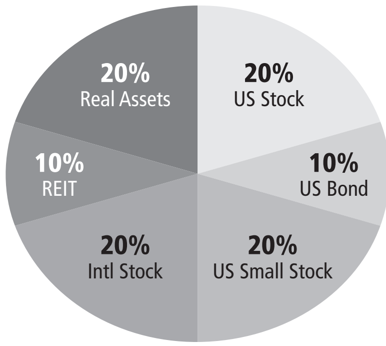


1st Quarter **3.48%**

Last 12 Months **5.98%**

This was the first quarter in some time that the SuperDiversifiers and Bonds outperformed our three stock categories as a group. For some time, stocks have levitated on a wave of central bank stimulus. They stalled this quarter, and a regime change may be in the offing.

SDP2 **Moderate**



1st Quarter **3.87%**

Last 12 Months **11.06%**

Alternative assets are rallying for reasons hostile to stocks. Commodities rose largely on a tension related rally in oil and a drought-related surge in agricultural assets. And bonds rose on poor economic data, including the eighth month in a row of declining housing numbers.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Europe far from out of the woods

Asset Class	Mutual Fund	Performance 1st Quarter '14	Performance Last 12 Months	
SuperCash	PIMCO Instl Low Duration	0.26%	-0.06%	Best
	Merger	0.50%	3.86%	Worst
	Calamos Market Neutral	0.46%	4.33%	
US Stock	Vanguard Index Trust 500	1.76%	21.65%	
US Bond	Vanguard Long-Treasury	7.17%	-4.87%	
US Small Stock	Vanguard Small-Cap Index	2.56%	25.11%	
Intl Stock	Vanguard Intl Index	0.77%	12.57%	
REIT	Vanguard REIT Index	9.90%	4.08%	
Real Assets	Oppenheimer Real Assets	5.70%	-2.48%	

Seth Klarman *(see page 4)* on Europe: "Europe isn't fixed either, but you wouldn't be able to tell that from investor sentiment.... Germany's own government debt-to-GDP ratio stands at 81%, up from 65% in 2008. The EU credit rating was recently reduced by S&P. European unemployment remains stubbornly above 12%. Various other risks lurk on the periphery: Bank deposits remain frozen in Cyprus, Catalonia seems to be forging ahead with an independence referendum in 2014, and social unrest continues to escalate in Ukraine and Turkey. And all this in a region that remains saddled with deep structural imbalances."

Israel

Israel has a lot going for it as an investment, not the least of which is that the Israeli stock market's CAPE ratio of roughly 11 puts it close to the 10 cheapest markets in the world *(see page 2)*.

In view of Israel's cheapness, consider:

- Solid demographics, with population growth at 2%+ and growing labor force participation.
- Unemployment 6% and declining.
- Inflation in 2013 only 1.55%.
- GDP growth (currently 3.3%) faster than the developed markets average for the past 12 years.
- Government debt-to-GDP far below that of the US and even the Euro area, and declining.
- Large discovery of natural gas off the coast which has lowered energy costs and enhanced energy independence.
- Technology leadership, a culture of innovation, and a highly skilled workforce.

So why the low CAPE ratio? Why is Israel so cheap? Three reasons:

Turmoil/catastrophe discount. Israel is surrounded by hostile neighbors, most of which don't recognize its right to exist, and at least one of which, Iran, has threatened to wipe it off the map.

Boycott/divestment discount. Disenchantment with Israel's treatment of the Palestinians, and with its settlement policy on the West Bank has sparked growing calls for boycotts and divestment.

Aid dependency discount. The US gives Israel roughly $3 billion per year in military aid. There is a widespread perception that Israel has grown dependent on this aid.

So Israel is cheap for specific reasons — but the reasons may not justify the depth of its valuation.

A very highly developed country

Israel's ranking on the UN's Human Development Index (HDI)

16th OUT OF 187 COUNTRIES

*The HDI is a comparative measure of life expectancy, literacy, education, standards of living, and quality of life for countries worldwide. It is a standard means of measuring well-being. Israel's #16 ranking puts it in the **Very Highly Developed** category, ahead of Singapore (18), France (20), Spain (23), and the United Kingdom (26).*

SEASONAL STRATEGY

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One of the world's greatest investors is very worried about US stocks

For more than 30 years, Seth Klarman and his hedge fund, *The Baupost Group*, have been at or near the top of the hedge fund world. His compound annualized return exceeds 19%, despite the fact that this highly conservative value investor has kept 30% or more of his fund in cash at most times. $10,000 invested in his hedge fund at inception would be worth roughly $1,000,000 today. So respected is Klarman that his long-out-of-print value investing classic *Margin of Safety* sells on eBay for $1,000 or more per copy.

Today, Klarman's writings are confined to his annual letter to *Baupost* investors — always an entertaining and informative read, but rarely available to the general public. A copy of his recent 2013 annual letter has leaked, and it's quite revealing of this value legend's current perspective. Klarman is now 40% in cash and sees so little opportunity that *he has returned $4 billion to investors.*

A few key excerpts from *Baupost*'s 2013 investor letter:

"A policy of near-zero short-term interest rates continues to distort reality with unknown but worrisome long-term consequences.... Fiscal stimulus, in the form of sizable deficits, has propped up the consumer, thereby inflating corporate revenues and earnings. But what is the right multiple to pay on juiced corporate earnings? Pretty clearly, lower than otherwise. Yet Robert Schiller's cyclically adjusted P/E valuation is over 25, a level exceeded only three times before — prior to the 1929, 2000 and 2007 market crashes. Indeed, on almost any metric, the U.S. equity market is historically quite expensive.

"A skeptic would have to be blind not to see bubbles inflating in junk bond issuance, credit quality, and yields, not to mention the nosebleed stock market valuations of fashionable companies like *Netflix* and *Tesla*. The overall picture is one of growing risk and inadequate potential return almost everywhere one looks.

"There is a growing gap between the financial markets and the real economy.

"Six years ago, many investors were way out over their skis. Giant financial institutions were brought to their knees....

"The survivors pledged to themselves that they would forever be more careful, less greedy, less short-term oriented.

"But here we are again, mired in a euphoric environment in which some securities have risen in price beyond all reason, where leverage is returning to rainy markets and asset classes, and where caution seems radical and risk-taking the prudent course. Not surprisingly, lessons learned in 2008 were only learned temporarily. These are the inevitable cycles of greed and fear, of peaks and troughs.

"Can we say when it will end? No. Can we say that it will end? Yes. And when it ends and the trend reverses, here is what we can say for sure. Few will be ready. Few will be prepared."

Ignore Mr. Klarman's words at your own peril. ■

Seth Klarman on this Truman Show *market*

"Ben Bernanke and Mario Draghi, as in the movie, are the "creators" who have manufactured a similarly idyllic, if artificial, environment for today's investors.... According to the *Wall Street Journal* (12/20/13), the Federal Reserve purchased about 90% of all the eligible mortgage bonds issued in November.... But what is fake cannot be made real.... Someday, the Fed's show will be off the air and new programming will take its place." — *The Baupost Group* 2013 Letter