INVESTMENT STRATEGY
APRIL 2014

The stock market has been consolidating gains after surging nearly 30% in 2013. So far in 2014, the S&P 500 suffered a shallow correction of 5.8% early in the quarter, yet managed to post a 1.3% gain overall. As we anticipated, the market became more volatile as troubling events unfolded overseas. You may recall we first forecasted problems for the emerging markets in our July 2013 Investment Strategy. This prediction quickly became more accurate than even we anticipated as unrest surged across the world. Not foreseen by anyone was the rapid fall of the Ukrainian government and the subsequent move by Russia to annex Crimea, home to Russia's strategic Black Sea ports. A more economically significant situation is developing in China as their credit-fueled hyper-growth is showing increased signs of distress. These overseas disruptions increase our confidence the U.S. will be the ultimate investment winner over the next few years. We believe investors and corporations will continue to move capital to America, resulting in faster growth, higher stock prices, and a stronger dollar.

The current troubles in the Ukraine offer a perfect example of our fears regarding many, if not most, emerging markets. We pointed out in our last strategy that for many of these countries, citizens' expectations and media penetration have increased much more rapidly than economic development over the past fifteen years. In the Ukraine, there was growing unhappiness because economic progress was being stymied by poor policies and widespread corruption. However, the majority of the people held out hope for a free trade agreement being negotiated with the European Union. When the Ukrainian government broke off these talks and instead turned back to Russia for a lesser aid package, large-scale protests occurred. These protests escalated over several weeks, resulting in the overthrow of the pro-Russian Ukrainian government. Although the details are unique to Ukraine, restless populations unhappy with their meager economic opportunities are a growing issue on every continent. Meanwhile, the ability of governments to meet these expectations is becoming even more difficult as capital returns to developed economies. Unfortunately, we do not believe this will be the last instance of similar widespread civic unrest.

Following the overthrow of the Ukrainian government, Russia immediately moved to take over the Crimea region. Crimea is a critical asset for Russia because it is home to Russia's only warm-water port. In fact, Russia's Navy had been stationed in Crimea for more than 200 years. Therefore, it is not surprising that Russia moved quickly to secure this area. However, outside of its strategic importance to Russia, Crimea is a financial burden estimated to cost the Ukraine $1 billion a year. This burden will only increase with Russia in possession and will be a long-term drain on Russia's one-dimensional economy. Thus far, Europe and the U.S. have responded with sanctions against Russia's leaders and oligarchs. In addition, Europe will likely make stronger commitments to move away from Russian-supplied oil and natural gas over the next decade. This response should sidestep an escalation with Russia that could result in economic ramifications that Europe and Russia can ill-afford at this point. If a further escalation is avoided, Crimea will be remembered as a political disturbance, but will have little impact on the global economy.

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The same cannot be said about the unfolding credit-bubble in China. We have been watching the Chinese economy very closely over the past few years and are alarmed by their credit-fueled hyper-growth. We have purposely avoided the subject in our Investment Strategies because we believed that China could continue to "kick the can down the road." However, cracks are starting to show and the day of reckoning may be closer than most realize. The first thing to know about China is that their reporting of economic data and banking figures are highly suspect. As a result, detailed financial analysis of Chinese banks or the Chinese financial system is impossible. Therefore, we have been looking for "signposts" or "tells" to inform us about the true state of Chinese finances. Beginning last summer, we began to see the first signs that all is not well in the land of the Red Dragon.

Last June and again in December, China's interbank lending markets seized up and interest rates jumped sharply higher. This means that China's banks were unwilling to lend to each other, the same way U.S. banks were unwilling to lend after Lehman Brothers went bankrupt. Much like the U.S. in 2008, the Chinese central bank has flooded the system with billions of dollars to unfreeze this market. Interbank lending markets stop functioning when banks have a shortage of cash on hand. In the U.S., rapidly falling asset prices and souring loans during the financial crisis caused this shortage of cash. In contrast, China refuses to recognize bad loans and is instead offering undeserving borrowers even larger new loans to rollover these bad debts. This behavior is causing credit to expand uncontrollably, leaving banks short of cash. Needless to say, China is playing a very dangerous game.

Chinese banks have also emulated pre-Lehman U.S. banks by engaging in a large amount of off-balance-sheet financing, also known as "shadow financing". In the U.S., banks pooled large amounts of substandard mortgage loans and sold them to unsuspecting, but sophisticated, investors. The Chinese banks have taken this a step further by packaging low-quality loans to companies and even local governments. These investment products are then sold to depositors looking for higher returns. Chinese citizens are willing to purchase these products because they believe they are implicitly guaranteed by the government. Some estimate there are $6 trillion of these investments outstanding. A second major signpost occurred when one of these large investment pools fell into distress in January. Allowing this investment to fail would likely have sparked a panic, causing a cascade of other failures. As a result, the government stepped in at the last minute and covered the product.

We received several additional signposts in the past month. The first-ever default on a domestically issued bond occurred in early March. Shortly thereafter, a private developer with roughly $550 million of debt collapsed. This developer borrowed $400 million from banks before turning to the shadow lending market we just described. Even more telling, the Chinese government has engineered a sharp and very rapid weakening of their currency by more than 3% in three weeks. The government claims they are punishing speculators, but we suspect they are trying to provide breathing room for their heavily-indebted exporters.

China is walking an economic tight rope and their next move will have sizable ramifications for their emerging market brethren. China can choose to slow their growth and institute financial reform or allow their credit bubble to balloon larger. Either way, the other emerging markets in Asia and the resource-based emerging markets around the world will be very treacherous for investors. However, China will not spark a Lehman-sized crisis. Unlike the U.S., China's financial industry is largely self-contained within their borders and the Yuan is not widely used in other countries. At worst, China could spark another Asian financial crisis like we endured in 1997. Although we consider this unlikely, this event did not cause a global recession or significantly affect the U.S. economy.

Most important for U.S. investors are the gains in housing, employment, productivity, and manufacturing we continue to enjoy. Although the abnormally stormy winter suppressed activity early in the year, economic statistics in March indicated a reacceleration in growth. Investors should also remember that we actually inflicted an economic drag of 1.5% on ourselves in 2013 by sharply cutting government spending and raising taxes! This drag is quickly fading and should boost upcoming growth figures. Notably, while GDP increased only 1.9% for all of 2013, it accelerated to a 2.6% growth rate in the fourth quarter.

While we need to pay close attention to how China deals with their credit bubble, we are confident in the continued success of America and the leading companies operating from here. American companies are generating record profits and lead the world in innovation and creativity. In addition, the U.S. provides unique opportunities that allow the best and brightest from around the world to immigrate and prosper. If the world becomes more chaotic, it will only further drive the most talented and entrepreneurial to our shores. For example, only in America can a young capitalist like Elon Musk (from South Africa) come to learn, innovate, and raise the capital needed to create major economic wealth. He seized this opportunity by building Paypal, the leading on-line financial payments company, and has gone on to become CEO of both revolutionary electric-carmaker Tesla Motors and the leading private rocket service, Space-X. The unique American attributes that not only allow, but foster, this kind of creativity are not going away, regardless of the more turbulent world we anticipate. Going forward, we believe more and more investors will be reminded of these distinctive traits and will realize that many of the best investments available today reside within the U.S. Meanwhile, our clients are well positioned to benefit.

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