Whitford
CAPITAL ADVISORS

# ECONOMIC AND MARKET OUTLOOK 2013

The markets in 2012 were largely restrained by the U.S. Presidential elections, debt limit and budget sequestration and the ongoing weakness in Europe. As the markets neared the end of the fourth quarter all caution was tossed aside and equity investors rode the bull. There were plenty of explanations offered but the major overriding factor has and will be the repression of interest rates by central banks. Despite the late equity rally the biggest winners in 2012 were investors in real assets and select commodities. For 2013, the U.S. game of Budget Russian roulette will be resurrected causing investors to rediscover risk.

**Table I. Asset Returns in 2012**

| **Equity** | | **Hedge Funds** | |
|---|---|---|---|
| S&P 500 | 16.00% | HFRX Global HF | 3.51% |
| Russell 1000 | 16.42% | HFRX Multi-Strat | 5.38% |
| Russell 2000 | 16.35% | HFRX Event Driven | 5.96% |
| MSCI EAFE | 19.12% | HFRX Global Macro | 0.65% |
| MSCI Emerging | 18.43% | HFRX FI-Credit | 7.65% |
| **Fixed Income** | | **Real Assets /Commodities** | |
| 3 mon. T-bills | 0.07% | DJ-UBS Commodity | -1.14% |
| Barclay US Aggregate | 4.22% | Crude Oil | -7.10% |
| Barclay US Treasury | 3.56% | Natural Gas | -30.70% |
| Barclay US 1-5 Gov | 0.97% | Gold | 7.10% |
| Barclay US 5-10 Gov | 11.26% | Soybeans | 23.85% |
| Barclay Corp HY | 15.81% | Corn | 18.91% |
| Barclay Municipal | 6.78% | Wheat | 9.68% |
| Barclay 1-5 Muni | 2.00% | NAREIT | 20.10% |
| Citi Emerging Markets | 17.00% | NCREIF Farmland | 19.00% |

**Source: S&P 500, MSCI, Russell, Barclays, JP Morgan. HFRX, NAREIT & DJ-UBS**

## Global Economy

The global economy remains in the shadows of the worst financial crisis since the Great Depression. Despite trillions spent in various stimulus attempts and central banker interventions to suppress interest rates, the economy cannot shake off the fallout of the crisis. The Eurozone is battling its way through rolling financial crises in Greece, Spain, and Portugal and to a lesser extend France and Italy. The United Kingdom has slipped into a double dip recession and Spain will be a recession for some time. It is quite likely that these countries have seen the worst however they are not out of the woods. European nations will suffer thorough many years of pedestrian growth after seeing the Euro zone contract -0.5% in 2012. Japan has now closed out its second decade of deflation. Unlike 2010-11, the emerging markets have not been able to pick up the slack of the developed countries and are expected to slow in 2013 as the result of sluggish trade and restrained foreign direct investment. The U.S. is suffering through the worst recovery from a recession ever. The long term average of real GDP growth from 1900-2012 is 3.3%. It is quite likely the U.S. will not recover to those levels for the next several years.

What is playing out across the globe is the age old Keynesian-Austrian economic battle as budget deficits and debt have skyrocketed while economic growth has lagged. The call, especially in Europe and to a large extent in the U.S. has been a Keynesian cry for more spending and higher taxes. In the Euro zone however budget limits have been a prerequisite for a bailout. There is also a growing movement globally by the wealthy to pull up roots, hand in their passports and move to a country where their personal capital is better treated.

**Table II.** **Global GDP, Inflation and Unemployment Rates- 2013 Estimates**

| | GDP% | Inflation % | Unemployment % |
|---|---|---|---|
| Global | 2.7 | 2.7 | 8.0 |
| EuroZone | 0.0 | 1.9 | 11.8 |
| Emerging | 3.0 | 5.5 | 7.2 |
| Asia Pacific (x-Japan) | 6.2 | 3 | 7.1 |
| Latin America | 3.5 | 8.1 | 7.4 |
| U.S. | 1.5 | 1.6 | 8.0 |
| U.K. | 0.5 | 1.8 | 8.0 |
| Germany | 3.0 | 2 | 6.5 |
| China | 8.0 | 3.5 | 4.1 |
| India | 6.5 | 8.2 | 8.9 |
| Japan | 1.6 | -0.50 | 4.5 |

**Source: PCM Partners, LLC**

Europe is slowly coming to grips with the reality that economic survival is diminished when the number of workers in a country working productively is exceeded by those who depend on them for much of their existence through entitlements and public jobs. Europe accounts for about 7% of the world population, produces 25% of global GDP and finances 50% of global social spending. The reality of the math has caught up with them. By aggressively raising taxes France (75% top rate) has facilitated a run for the border by the wealthy. Germany's Prime Minister Merkel has strongly hinted at the urgent need to cap social spending as it must overhaul its education, tax and labor markets to restore competitiveness. The lesson has escaped the politicians in the U.S. as spending, taxes, deficits and debt rise while employment and income fall.

## Global Interest Rates

Globally, interest rates since the financial crisis have dropped substantially. Central banks around the world have committed to buy unlimited amounts of mortgages (U.S.) and government debt for the foreseeable future as a means of reducing borrowing costs hoping to spur economic growth. To date trillions of dollars in bonds have been purchased with little palpable result. High yield spreads (JP Morgan High Yield Index) have dipped to their lowest levels since 2007, just before the financial crisis. There is growing concern of a "bond bubble" in the government markets. It can be argued that as central banks inflate their balance sheets to cap interest rate levels the risk to all financial assets grow. As seen in Table III. below, we estimate rates will move up marginally but we do not rule out a possible scenario whereby rates spike up sharply as the central banks will no longer be able to systematically contain rates.

**Table III. Global Interest Rate Estimates -2013**

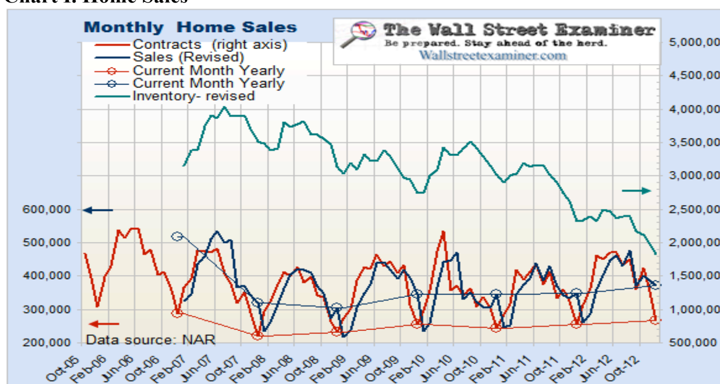
| | % |
|---|---|
| **Global** | 3.0 |
| **U.S.** | 1.9 |
| **Euro Zone** | 2.4 |
| **Emerging** | 3.8 |
| **Japan** | 0.8 |
| **UK** | 2.0 |

**Source: PCM Partners, LLC**

## Housing

One of the strongest drivers of the U.S. economy dating back to the early 1990s has been the housing market. With easy credit and rising prices homeowners parlayed real estate into large paper profits. When income growth did not keep pace with consumers desire to buy new goods and services, home equity loans allowed consumers to use their homes as an ATM. When the music stopped in 2007, the consumers were left with real estate prices in a death spiral; real estate lending became rarer than hen's teeth and to add insult to injury suffered from an economy that bled jobs. Housing inventories shot-up, foreclosures increased and consumers were severely tested. Chart I. below has lifted spirits that the worst may be over. We argue for two main principle reasons that residential real estate is not out of the woods yet.

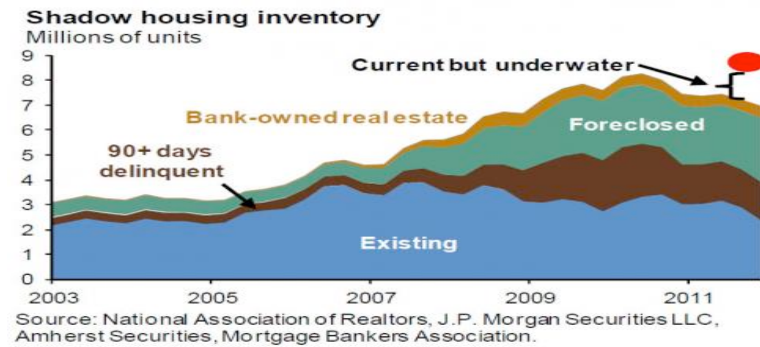
**Chart I. Home Sales**




In Chart II., the existing inventory that most real estate watchers agree shows an existing inventory of homes for sale at roughly 2 million. Banks have been quite methodical in using the foreclosure process. Prices have been under pressure and homes in the foreclosure process have experienced a 20% haircut in prices. There has also been a lengthy legal and regulatory agenda that has put lenders on the defensive as accusations of robo-signing and predatory loans has lengthened the process. A simple calculation of

combining the existing inventory along with lender inventory in various stages of default we see the home inventory triple. Lending standards are a bit more relaxed but not to the point that real estate sales will boom to 2006 levels. It is unlikely that lending standards will drop significantly until the unemployment falls to under 6% in real terms. Consequently we do not think the boost to the economy from resurgence in housing will be meaningful. One other interesting dynamic in housing is that homeowners have seen their insurance costs have increased. Commodity price increases has increased replacement values while an outright sale is showing a decline in prices. Downward pressure on prices has not bottomed and in certain areas there is a high probability of an additional 10-15% decline in prices. We discuss the issue of unemployment more fully below.

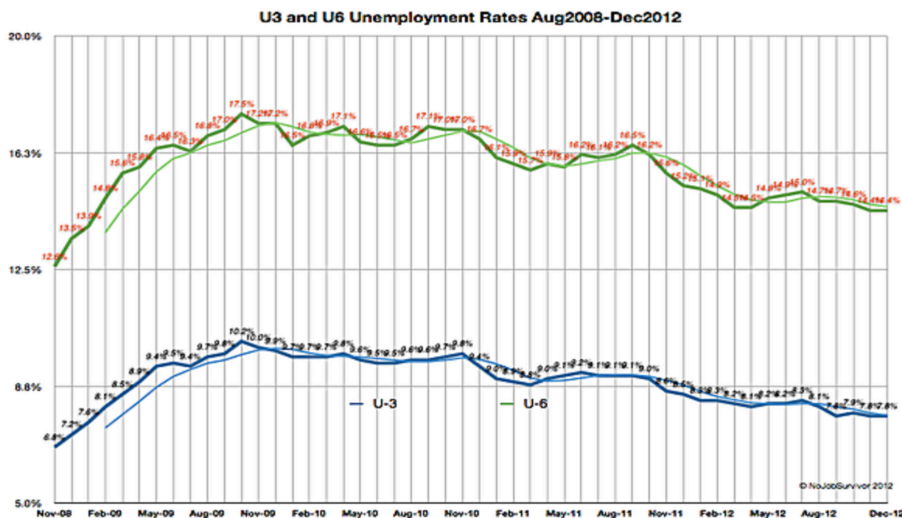
**Chart II. Shadow Housing Inventory**




## Unemployment

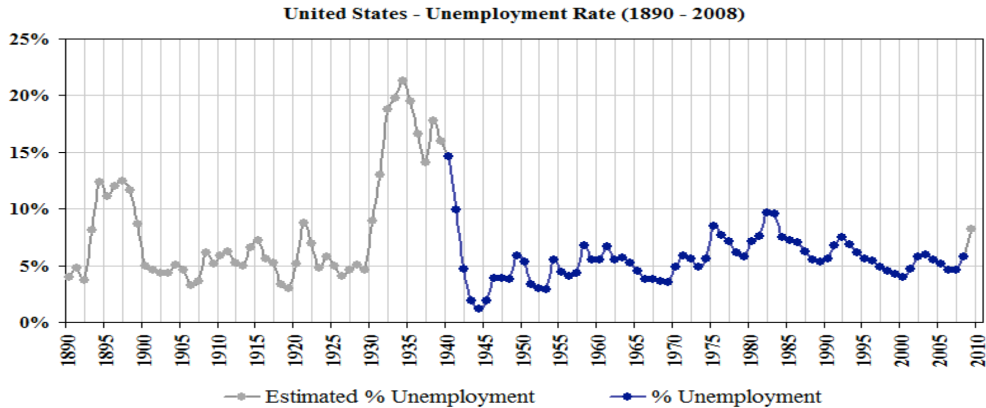
There is one unavoidable fact the U.S. economy must face; without meaningful strides in lowering the unemployment rate, housing and other sectors of the economy will never fully recover. Despite happy pronouncements out of Washington, job creation has been virtually non-existent. The much heralded Job Council that President Obama formed to lead the way to new job growth expired. In fact the Council had not met in over a year. Obama's pledge to focus like a laser on jobs has died of neglect. The drop in the unemployment rate has been illusory at best. The decline in the rate is a mathematical sleight of hand. In Chart III. below, the official data reported as U-3, shows unemployment hovering around 8% two years after the official end of the recession. If one considers many are underemployed, working part time or just have stopped looking for work, the U-6 suggests an unemployment figure closer to 14%.

**Chart III. Unemployment Rates**



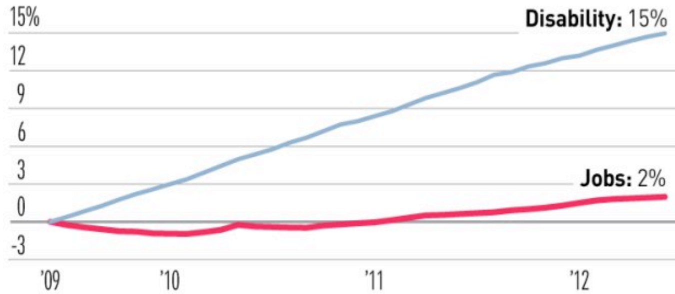
One interesting point illustrated in Chart IV. below shows that in past recessions and crises, unemployment went higher but recovered fairly quickly. It should also be noted that GDP growth rocketed higher which worked to shrink unemployment. The U.S. is suffering from persistent high unemployment and GDP growth that in 4Q 2012 contracted (-0.1%). The persistently high jobless rate and poor growth seem to follow the trend of the 1930s when similar counterproductive government policies were instituted. The unemployment rate is having a host of damaging unintended consequences although history will be a better judge if they were truly unintended. We now have a record 48 million people receiving food stamps. Additionally the rolls of those receiving Social Security Disability insurance payments have exploded upward. Chart V. plots this disturbing trend of the growth of those on disability to the growth rate of jobs since the end of the recession. Those on disabilities have grown at a rate of nearly eight times those that have returned to the workforce. The issue is two-fold in that people may be choosing to live off of government subsistence than to

**Chart IV. U.S. Unemployment Rates 1890-2008**




take a lower paying job they may think is below their abilities. Additionally there are fewer people paying taxes as more folks become beneficiaries of those taxes. This is an unsustainable trend and will lead to other unpleasant consequences. Without a severe change in U.S. economic policy the unemployment rate will stay above 7.5% (U-3) for the next several years.

**Chart V. Change in Social Security Disability Enrollment and Payrolls since June 2009**

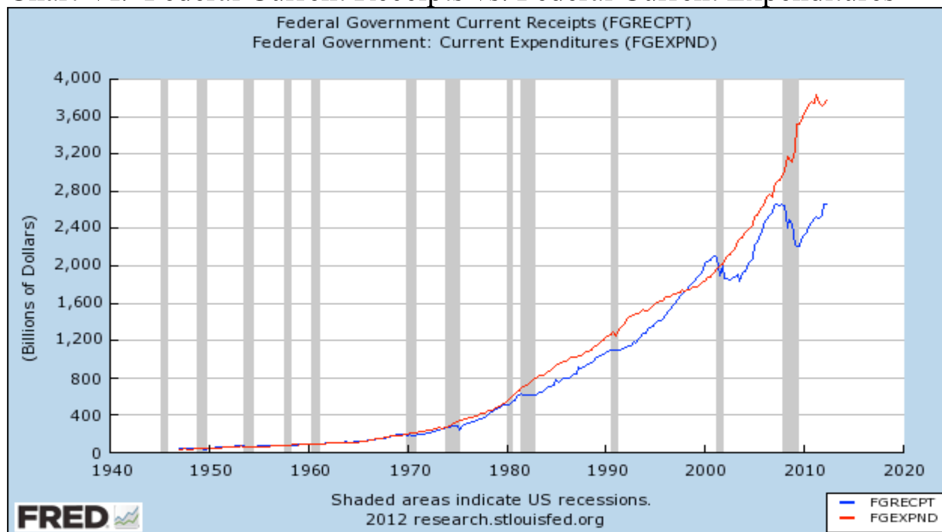


**Debt and Deficits**

Debt and deficits remains the most contentious issues globally. We believe this is also the greatest and most ignored source of risk to investors. In Europe, we have witnessed strikes, protests and riots in Greece, Spain, France and Portugal. Given the current stalement in Washington the probablity of similar unrest here has risen sharply. With high unemployment Europe resorted to its traditional class warfare of taxing the rich. Unfortunately for the entitlement state, the rich bolted for saner climes. The protests are the result of the government now making the hard choice that the entitlement machine of the past is a broken model. In the U.S., the current administration sees higher spending ridiculously referred to as "investments" and higher taxes as the only solutions. Fairness and balance are the weak defense for not making the hard decisions of returning the country to fiscal balance. The U.S. has suffered $1 trillion budget defficts for four years and have amassed over $16 trillion in debt. Despite the spending, the economy is teetering on another recession. The current Nanny state goes deeper than these two bell-weather figures. The trickle down affect of government's involvement has placed the taxpayer in deep hoc for guarantees and bailouts the government is likely to face.

President Obama and his supporters argue that we do not have a spending problem and he has already made spending cuts. Yet in Chart VI. that measures Federal government receipts versus expenditures we see that after the recesssion ended in 2009 and after troop withdrawal had begun spending accelerated faster than any time in the past 65 years. The much discussed cuts were "Washington "cuts. The rate of growth in spending was reduced and money not spent on the Iraq War was considered a cut.The most recent budget wrangling over the Bush tax cuts resulted in higher rates on the wealthy. This "fair share" will add $80-90 billion in new revenues. In days subsequent to that tax deal, Congress approved $50.5 billion in aid to those affected by Hurricane Sandy this past fall. Nearly the entire amount of new expected revenue. It is no surprise we have the problems we have.

Chart VI. Federal Current Receipts vs. Federal Current Expenditures




The biggest issue facing the budget has been and remains entitlement programs particularly health care. In a severe case of I told you so, ObamaCare opposition on a daily basis is being proven correct on positions they were once ridiculed. Doctor shortages, higher premiums and larger budget costs are becoming reality. Throw in the proposed immigration bill, the costs will explode adding further deficits and debt. Based on the average two-earner couple Social Security benefits and Medicare benefits (net of premiums) will outstrip their payroll tax contributions by over 26%

While Medicare and Social Security are often discussed, there is little conversation of another benefit tsunami—public pensions. We have discussed for years the impending problem as there is an approximate $2-4 trillion shortfall. Some states have tried to address the problem but have run into stiff opposition from the public unions who believe they are entitled to a larger share of taxpayer money to make their life complete. Currently most public pensions contribute a combined 18% of payroll split between employer and employee to the pension fund. Most pension funds use an expected annual return of 8%. The vast majority has failed to generate those levels of returns which balloons the level of underfunding. Let's assume that over the long term the pension funds earned around 4%; the contribution as a percent of payroll skyrockets to nearly 70% from 18%. A very difficult conversation and decision will be required shortly as the demographics do not favor a self-correcting problem. The state and local governments will have limited options: drastically cut services including education, raise taxes to economic destroying levels or cut the pension benefits. There is a whispered option and that is to have the federal government guarantee those benefits which will require enormous tax increases at the federal level. All options will foment unrest and disruptions. The probability that unrest will occur increases without substantial improvement to unemployment, real estate and general economic growth.

Another issue that is being buried in the current spending debacle is student loans. President Obama is pushing for more government aid and loans to develop a work force in the new economy. There are several problems with that policy and they all put the taxpayer on the hook for billions more. In 2011 it was reported the average student loan balance was $26,600. At the end of third quarter in 2012, student loan delinquencies shot up from 8.5% to 11%. Delinquencies are expected to grow as unemployment is ravaging this sector of the job seekers. At the risk of offending some readers we find the major issues with President Obama's policy is that it does not address out of control tuition growth nor the fact there is a growing number of graduates have degrees in Women Studies, Ethnic Studies, Asian American Studies, American Culture, Social Welfare, Media Studies etc. In addition to limited demand for those skills these studies do not address the need for minds trained in math and science that are required to compete in a global economy. Lack of useful skills, high unemployment and high levels of debt will generate calls for another taxpayer bailout. This raises the risk of a generational conflict of who gets bailed out, if at all, the new workers or the retirees.

**Political Risk**

The threat of political risk domestically and internationally has increased sharply. The weakness of the U.S. has given unstable states like Iran, Egypt, Syria and North Korea new courage to advance its hatred for the West. Despite the claim by the White House that al-Qaeda has been decimated, the increase in violence in the Middle East, North Africa and elsewhere contradicts that assessment. Problems in the Middle East may be further inflamed by the fact that Saudi Arabia's reign over oil may be diminished. They are suffering reduction in oil a revenue not from weaker world demand but from growing non-OPEC sources particularly the U.S. and Canada. This is ripe with irony as environmentalists in the U.S. have argued for decades the need to reduce dependence on Middle East oil. The wish has come true. Not through new alternative energy sources which have largely failed but through new technology in producing oil and gas wells. Falling OPEC revenues will add to the instability in the Middle East.

The biggest political risk remains dubious economic policies from the G-7 countries. At times it seems the policy making attempts are deliberate moves to de-stabilize countries in order to gain more power and control over the economy. What they fail to realize is that these attempts deepen the economic crisis and threaten the viability of long term stability. The belief that the end to the financial crisis can be achieved without any pain to the populace is foolish and misguided. In the Euro zone they have made strides to address budget deficits while the US is playing another round of Russian roulette as sequestration approaches. The State of Union saw a continuation of failed policies sprinkled with new entitlements all with a claim to that none will raise the deficit. In the end the stock and bond market actions will be sharp and negative. The manipulation by central bankers has not accomplished the goal of increasing economic growth and employment but has only re-inflated financial assets. In the end the central banks will need to

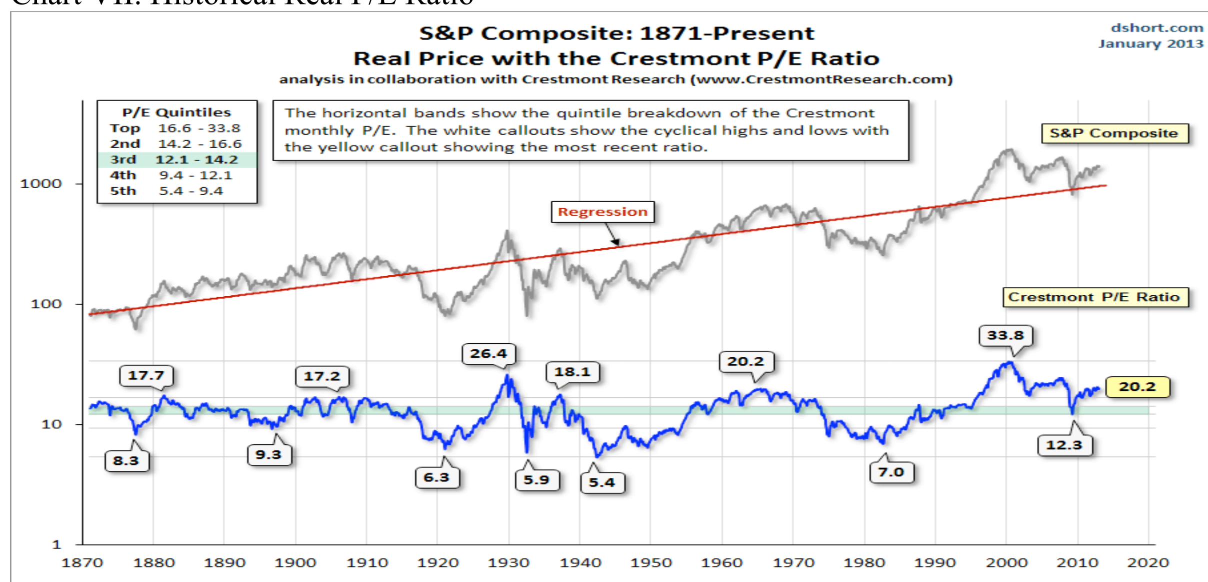
reverse course and the market distortions will unravel accompanied by higher inflation, higher interest rates and weaker currencies.

## Investment Outlook

### Equity

The equity markets will present challenges to investors. The manipulations by the central banks have given rise to strong rallies in domestic, developed and emerging markets. The ride can end as suddenly and as sharply as it began. It is advisable at this point to implement risk strategies aimed at protecting capital. Valuations are inflated and reducing exposure or hedging positions at this point may restrain some upside potential but will limit capital loss in what may be a significant sell-off. Based on the Crestmont P/E ratio (Chart VII.) the current equity market seems over valued by 20-35%. Earnings estimates for 2013 will reflect growth of about 4-6% which in the long term is unlikely to support a further expansion of the P/E ratio.

Chart VII. Historical Real P/E Ratio




The Developed and Emerging markets on a comparative basis trade at a discounted P/E to the S&P by 20-40%. These markets suffered sharper downturns and have not fully recovered. On a risk-adjusted basis these markets seem more attractive although that does not imply risk-free. The U.S. markets are still the markets of choice and if there is a large sell-off in the S&P, they will not escape unscathed despite lower valuations. The valuation of the U.S., developed and emerging markets are not so much undervalued as bonds and cash are overvalued, in general.

### Fixed Income

There is an ongoing discussion that the bond market is a bubble waiting to pop. Billions of dollars have begun to flow out of bond mutual funds as investors have switched to other investments in order to obtain more yield. Corporate bond funds in December experienced an outflow for the first time in nearly one year. U.S. Treasuries investors are actually receiving a negative real return. High Yield bonds saw more downgrades in credit than upgrades and spreads narrowed to the lowest margin since 2007. Municipal bonds are yielding around 90% of treasuries, high by historical measures. Unfortunately those yields are low and do not truly reflect the risks facing the municipal market. We have opined in the past of the issues facing municipal bonds. In addition to credit concerns as budget issues at the state and local levels are still under duress, the pension bomb is still ticking. Now

another pothole has appeared; the federal governments insatiable appetite for more revenue. As Washington has fumbled its way through the fiscal cliff, sequestration and deficits, tax reform has brought up the idea of limiting municipal bond deduction or taxability.

In order to find attractive fixed income investments that offer solid risk adjusted returns will require some creativity and rigorous analysis. The fixed income investor must understand risk from several areas; higher interest rates, declining credit worthiness and government tax policy. Regardless of the sector durations should be kept short (under 3 years). Attractive yields can still be found in certain high yield sectors, emerging markets, bank loan fund and small to mid-size company debt offerings. (More discussion to follow in Private Equity Section)

**Alternative Investments**

We consider three sectors under the alternative investment sector: hedge funds, private equity and real assets which include commodities, real estate (including farm and timber) and precious metals.

Hedge funds in volatile markets can be used in two ways. Fund exposure can be used to hedge exposure in the long equity market or as pure alpha generators. Both will be important to investors seeking to protect capital in the next 3 years. Many investors suffer from irrational fears that hedge fund fees are too high (and many are) and poor performance for those fees. Many folks come to those conclusions by looking at hedge fund indexes which have no real method in assigning fund type by objective to some arbitrary benchmark. The key to finding successful mangers to use in these markets are smaller funds which demonstrate low downside deviation and the ability to successfully hedge or to provide alpha through short selections.

The private markets will be a pleasant surprise to investors who take advantage of the growing number of opportunities in this sector. The weak economy and Federal Reserve policy has created a dynamic where there are many private companies performing well but in desperate need of capital as the banks have abandoned lending. Whether it is finding attractive equity opportunities or high interest debt from these businesses that are growing quite well; investors can avoid volatile markets while meeting their investment objectives. Overall our asset allocation targets the alternative sector to have the largest weighting as the risk-return profile is the most attractive; the underlying fundamental drivers are strong and should experience reduced exposure to volatility.

**Real Assets**

The allocation to real assets is divided between precious metals, real estate (including farmland & timberland) and various agricultural products. With the exception of REITs we are not a strong believer in the use of indexes for commodity exposure. Investing in commodities is often an area that ends in disappointment. Many investors view the result of commodity indexes and conclude (rightly so) that the risk-return profile is quite unattractive. Our approach has and remains to focus on areas within the real asset sector for opportunities that have attractive long-term potential and can be used to protect capital against various economic problems. Consequently we prefer to invest in specific assets such as gold, silver, natural gas, corn, soybeans or farmlands. We continue to believe precious metals offers a positive risk-return opportunity. For years doubters have suggested that gold was in a bubble and offered investors no value or cash flow payments. Much to their surprise and chagrin gold investors have seen strong performance as a hedge against the financial crisis, government failures, inflation, currency troubles and global unrest for the past 12 years. Although it is likely there will be a sell-off in gold, courtesy of liquidations by hedge funds, there are still plenty of reasons to remain allocated to precious metals.

Gold rose from $100 in 1970 to $800 in 1980 despite a 46% sell-off in 1975-76. The latest correction could be in the range of 15-30%. Global unrest is one of the leading factors that continues to make gold attractive. Additionally, budget deficits and currency manipulations is pushing investors to own gold as a storage of value. Structural deficit in the U.S. grows at 8% per year and needs to be reduced by $1 trillion per year and not over 10 years. Similar issues in Europe and the threat of hyperinflation from central bank easy money policies. Many say that is preposterous. Some recent events may suggest otherwise. The Bundesbank had stored half of its gold in the

Federal Reserve Bank of NY with a current market value of $200 billion (3,400 tons). They recently announced will move 1,500 tons back to Germany form the U.S. and an additional 450 tons from the Bank of France. Concurrently Venezuela repatriated 160 tons from Europe. What might be the result if China, India and Japan all call back their gold?

The action in gold suggests much concern about inflation. Despite the issues still ahead in housing, real estate offers an attractive risk-return profile particularly in farmland and timberland. These offer a duel benefit as an inflation hedge but also the opportunity for significant cash flows as demand for lumber and food will grow.

There are many factors that build a long-term investment case for agricultural commodities. Soybean, corn, wheat, sugar cane among others will see significant price and demand movements as food and water shortages affect food supply. Global unrest will also impact delivery of food as will misguided government policy, two factors that are not in short supply.

In addition to investing in agricultural products, the returns for farmland continue t be strong. Farmland investing will offer not only exposure to the impending expected food shortages but also act as inflation hedge. In fact real estate in general will provide that hedge against inflation. Although we re-state our concerns over the weakness in residential real estate prices, there are other attractive sectors in real estate to pursue. There are a growing number of private deals being developed that offer solid cash flow payments and respectable risk/returns on equity participation. This is another area where the lack of bank participation in lending has opened attractive possibilities for private investors.

## Asset Allocation Overview for 2013

We maintain an allocation that is expected to take advantage of the long term trend and protect capital from the adverse impact in the markets and economies that may occur. Our outlook for strategic asset allocations is displayed below. For further information on asset allocation please contact Whitford Advisory Services, LLC

**Strategic Asset Allocation – 2013**

| | |
|---|---|
| **Equities** | **20%** |
| **Bonds** | **22%** |
| **Alternatives** | **30%** |
| **Real Assets** | **23%** |
| **Cash** | **5%** |

*The information presented herein is highly confidential and is being delivered to a limited number of financially sophisticated prospective investors for general information purposes and is intended solely for their internal use. This presentation is not to be reproduced or distributed to any other persons (other than professional advisors of the prospective investors receiving these materials), and is intended solely for the use of the persons to whom it has been delivered. This presentation is not intended to be a risk disclosure document, and the information included herein is subject in its entirety to a definitive document pertaining to the services contemplated ("Agreement").*

*This presentation does not constitute an offer to sell or a solicitation or an offer to buy or sell any securities, and it is qualified in its entirety by the information contained in the final Agreement. In making any decision to invest, prospective investors should rely solely upon their own independent investigation, including a review of the Agreement. Neither Whitford Advisory Services, LLC ("WAS") nor any of its affiliates, employees, or agents are authorized to make any representations or warranties inconsistent with or in addition to those contained in the Agreement. Statements made here with respect to the Agreement are not necessarily complete, and all information contained in this presentation is subject to updating, completion, revision, amendment and final verification.*

*No representation or warranty (express or implied) is made or can be given with respect to the accuracy or completeness of the information in this presentation, or that any future offer of services will conform to the terms described in this presentation. Investing is speculative and subject to significant risks due to, among other things, the illiquidity of the investments, the nature of the investment activities and potential conflicts of interest and is suitable only for investors of substantial financial resources. Investors should have the financial ability and willingness to accept the risks and should consult their financial, tax and accounting advisors regarding the appropriateness of making an investment through WAS. WAS' services are made available only to investors who meet certain criteria. The Agreement describes in more detail risks of investing with WAS, and prospective investors must read the Agreement carefully before investing.*

*The information contained in this presentation is subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy or investment. Past performance is not a guarantee of future returns.*