Whitford

Americans Finally Have a President Who Listens to All of Them!

The current environment is reminiscent of "1984"; not the markets but the novel. Investors, despite the questionable activity coming out of Washington, continue to focus not on Pennsylvania Avenue but 20th and Constitution Avenue, home of the Federal Reserve. The Fed's quantitative easing is pumping massive amounts of liquidity into the monetary system which is re-inflating risk assets in the U.S. Large and small-cap equities in the U.S. put up another strong month. Developed and emerging international equities continue to suffer from the drag in economic growth primarily in the Euro-zone.

Table I: Global Equity Market Returns -%

	May 2013	YTD
Russell 1000	**2.22**	**15.50**
Russell 2000	**4.00**	**11.98**
MSCI- Developed	**(2.93)**	**6.12**
MSCI- Emerging	**(2.94)**	**(4.39)**
S&P 500	**2.34**	**15.40**

Source: Russell, MSCI and Standard & Poor's

Economy

The global economy is still bouncing along the bottom. The battle between public spending and perceived austerity remains at the center of policy discussions in the developed countries. At the heart of these debates is the persistent high level of unemployment. In the Euro-area unemployment remains over 12% with Spain topping the list at 26.5%. More disconcerting and possibly more dangerous is the unemployment rate of youth at 24.4%. Prime Minister Merkel of Germany recently commented that high youth-unemployment represents a huge crisis. Merkel also stated growth not austerity was the issue and those who were unemployed faced one solution to their situation—move! This did not and will not sit well with a European population that has become undeniably dependent on public spending and entitlement programs.

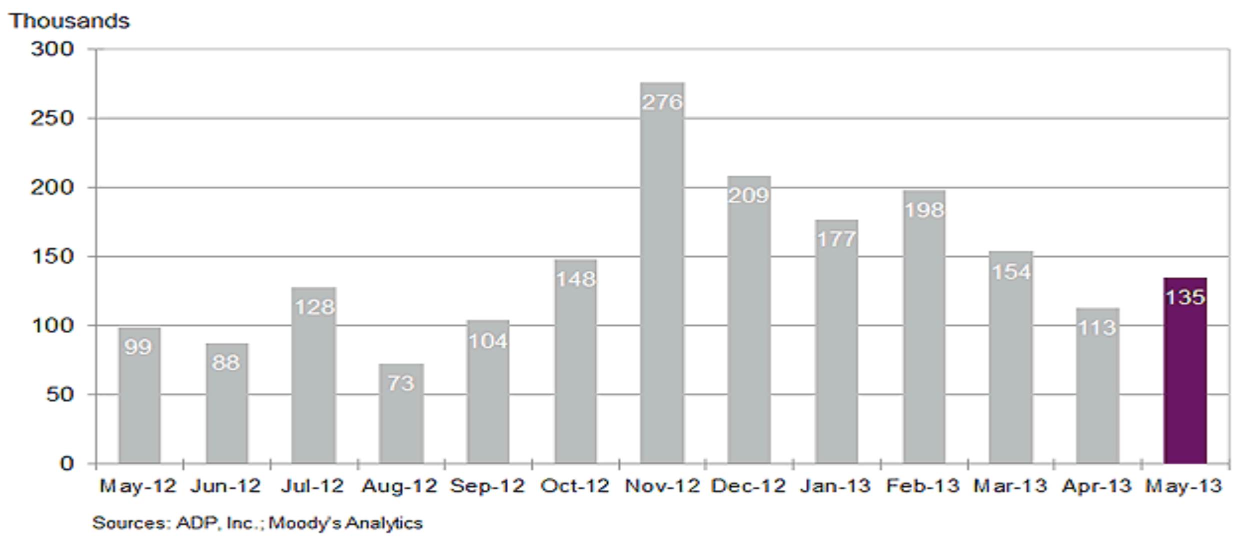
Those emerging economies, which have experienced stronger rebounds, are still restrained as the largest trade partners, the U.S. and Europe are mired in sub-par growth. The slowdown in China is also restraining global growth with the biggest impact affecting the BRICs. Global growth in 1Q 2013 was 2.0% and it is now expected to remain 1-2 points below pre-crisis levels for the next several years. This delayed growth is also increasing socio-political tensions leading to protests and outbreaks of violence. More discussion to follow later in this missive.

The U.S. economy continues to struggles with the worst post-recession recovery ever. The bright lights are few and several "flicker" for lack of persistent "juice". Unemployment, although not as high as Europe, clearly remains an issue that has severely restrained economic recovery. In May, the unemployment rate was unchanged at 7.6%. Non-farm payrolls rose 175,000 or 40,000 more than reported in the ADP National Employment Survey (Chart I). The main driver keeping the unemployment rate unchanged was an increase in the labor force of 420,000. As seen in Chart I, the trend in the employment survey for the past several months has been downward. Concurrently, the weak job data has propelled Food Stamp recipients to another all-time high, 23,146,441. The proponents of the government fix have argued that sequestration is the culprit, as mandatory cuts of $85 billion (out of a $3 trillion + budget) are killing growth. A recent report by the Congressional Budget Office stated that although spending cuts did have a slight impact on growth, the main culprits were tax increases on the wealthy and expiration of the payroll tax cuts.

One of the other devastating causes of slow growth is the heightened interference in the free market process through federal regulation. As the secrecy of ObamaCare and its byzantine mass of regulation is lifted, the force of reality is producing outrage, not just from the small business owner but also all the way to the halls of Congress.

Food establishment, colleges and others have, over the past few months, lowered hours of employees to avoid the incremental costs and expense of ObamaCare. Labor unions, once big supporters of everything Obama, have come

Chart I. ADP National Employment Survey



to the realization that the "blue chip" health care plans they have enjoyed will also feel the effects from the legislation they endorsed, as they will be subject to additional taxation. But the most recent protest (and you can't make this stuff up) comes from, yes, Congress itself who now complains ObamaCare may cause a brain drain in Washington as the exchanges would extract huge payments from workers. The irony is thick. Add this to the report by the IRS that the cheapest plan for ObamaCare would be $20,000/family and 2/3 may not be insurable under ObamaCare.

To combat the bad press, one of President Obama's University of Chicago acolytes, Cass Sunstein, has tried to defend Obama's overreach with a two-fold approach; regulation is good and Obama has passed fewer regulations than Bush, Clinton and Reagan. Unfortunately Mr. Sunstein uses the number of pages in the Federal Register as his measure – a questionable metric. If one only looks at ObamaCare and Dodd-Frank, those broad sweeping laws impact nearly 25% of the economy (16% health care and 8.4% financials). The downside to ObamaCare is becoming well documented but the gloomy stories of Dodd-Frank have yet to be written. One those stories concerns the large banks, the accused villains of the past crisis. The much discussed "too big to fail" doctrine has not been tested; however, concerns have been raised as the legislation stipulates higher capital requirements and, in the event of a violation, the "arbitrary" determination by a government bureaucrat that a bank is no longer a viable entity is the precursor to being taken over by the government. This will hamstring banks from increasing lending and limit their ability to raise funds. As we know loans in bankruptcy rank higher in the satisfaction of claims than bondholders. Bondholders are still smarting from this lesson during the auto bailout as their wealth disappeared, magically transferred to the United Auto Workers union.

In addition to unemployment, housing remains the most conflicted indicator in the global economy. Poorly structured loans and loose lending standards greatly contributed to the financial crisis globally. Central Banks have aided and abetted the crisis with artificially low rates. Now in the U.S., the federal government is re-introducing loose lending standards in the name of helping the middle class. The Veterans Administration is promoting "0% down" loans, which essentially transfer greater risk to taxpayers. Currently 90% of their loans are comprised of this type. The FHA is promoting 0-5% down loans and the current average down payment for FHA loans is 4%. The premise being that asset price increases will provide equity to the homeowner instead of using cash. (Sound's like an echo from 2007 when the same logic was used!) According to most indices of real estate prices they are, in fact, increasing. Less known is that price increases are the result of billions of dollars of institutional money has entered the residential market picking off cheaply priced excess inventory homes or distressed sales, with the intention of flipping them for fast profits. Additionally large price increases are being seen in wealthy areas such as San Francisco and New York. In San Francisco, the median sales price in April 2012 was around $700,000 and in April 2013 has skyrocketed to over $800,000. Foreign buyers are also pushing up prices. Russian buyers are spending millions for NYC condos, South American buyers are sweeping up Florida properties amidst celebrities like Howard Stern, who spent $52 million on a Palm Beach property. Properties in the Hamptons have increased 35%. In reality we are not seeing a true real estate recovery but money flowing from the central banks aiding those who are best positioned to capitalize on the new "easy money". The economy of the rich is booming.

At the other end of the wealth spectrum, we find cities, town and states that long have depended on federal government spending to support extraordinary benefits and entitlements, now dealing with the end of that party. The latest entrant to the poor governance hall of shame is Detroit. The city is defaulting on $2.5 billion of debt. Detroit expects creditors to accept 10 cents on the dollar. The underfunded pension claims will get less. Although a default such as Detroit has not been as widespread as some have predicted, it does remain a primary risk factor in municipal bond investing.

As interest rates hover near historic lows, credit spreads remain narrow. Consequently attractive fixed income investments are limited, even when embracing risk in search of greater yields. Corporate bonds and high-yield bonds are seeing spreads approaching the lows set right before the financial crisis. The QE by the Fed is quite likely to keep a lid on rising rates. The yields on Treasury bonds are on par with the dividend yield of the S&P 500. In Figure 1 below, we see an interesting picture of the historical mean reversion reactions of stocks and bonds over the past 100+years. From this we see that, based on historical data, neither stocks nor bonds are attractive and in fact may be trending to overvaluation. As we now experience, this does not mean that markets cannot continue to be overvalued for some time. It should however raise concerns about a heightened increase in risk in the markets. As we have said in prior months, the equity rally is the result of Fed policy and little else. The underlying economics are weak and company gains have been more a result of financial engineering and less about strong revenue and real earnings growth. For example, in the Dow Jones Total Market Index two-thirds of the companies have seen sales growth decline for the fifth straight quarter. Stock buybacks has reduced shares by 8%. Adjusting for the buybacks the absolute level of profits has dropped. Earnings guidance is also falling.

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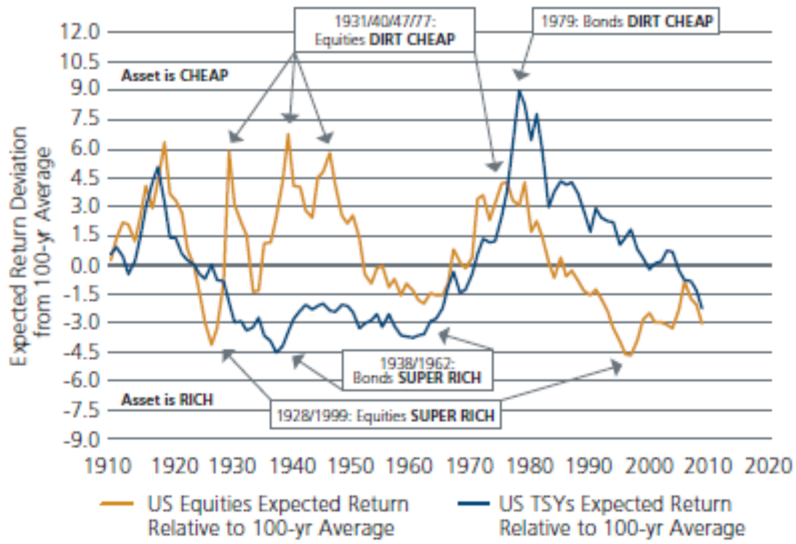
FIGURE 1: EXPECTED RETURNS ON EQUITIES AND BONDS ARE EQUALLY BELOW AVERAGE



Source: Federal Reserve, Robert Shiller, PIMCO calculations.
As of 31 May 2013.

The current market situation continues to argue for investors to initiate steps to protect capital for an environment in which market valuations are being artificially inflated by central bank policies, economies are struggling to grow and political unrest continues to be inflamed and increasing. Protests in Turkey have turned violent and are being echoed in Brazil, while civil war is escalating in Syria. President Assad fights to stay in power and if reports are accurate has crossed the international red line by using chemical weapons against his own people. President Obama after proclaiming nearly two years ago that Assad's days are numbered, must now act beyond delivering another speech. Iran and Russia however, remain supporters of the current regime. In addition to President Obama's preference to avoid providing military support, his administration is being deluged by scandals and security leaks.

Currently there is no definitive evidence that the White House,and specifically the President, was directly involved in clandestine domestic acts, the allegations are destroyiing trust in the government and may be planting seeds for unrest in the U.S., perhaps a harbinger to the unraveling of much of Obama's agenda. Although there have been questions about several actions in this administration, the most recent involving the IRS and NSA, has provoked even the most vocal Obama cheerleaders in the media to actually investigate some of the illegal activities. Much of the specualtion in the past has been blamed on Tea Party extremists. In a recent speech President Obama endeavored to re-direct public attention warning audiences to ignore calls that tyranny is around the corner. In the past, people viewed a scandal as one-off and not related to any overall plan. Now, as the stonewalling has failed and these scandals are stacking up like so much cereal on the grocers' shelves, it is enough to make a rational person go "Hmmmm!" At the heart of these scandals are actions intended to punish and inhibit any political opposition to President Obama. In no particular order we are now discovering: the EPA used private emails to affect new regulatory burdens on folks and even expose personal information on a farmer to environmental groups with whom he disagreed; Attorney General Holder signed a request asking for wiretap permission of a Fox News reporter. The warrant called him a flight risk and a co-conspirator in a security breach. Another CBS reporter revealed her computer was hacked after she had persistently wrote unfavorable stories about the administration for its actions in Fast & Furious and Benghazi. Both activities have been subject to much obstruction and misinformation about the adminstrations' actions in situations where U.S. citizens' lives were lost as a result of the administrations choice of action (or lack thereof). The IRS scandal is the most frightening. The IRS profiled conservative groups applying for tax-exempt status delaying their approval up to 2 years, costing applicants thousands of dollars. Questions being asked had no relevance to their applicatios. Some of those targeted had their personal information leaked to liberal groups. The IRS acquired 60 million personal medical records some of which were released to private groups. This is the same IRS that will now be the arbiter of our health care fate under ObamaCare. While these felonies were being committed by government agencies, the IRS was requisitioning assault weapons (Yes, the same ones Obama wants to ban citizens from owning), millions rounds of ammo and spy monitoring equipment. Now one doesn't have to be an extremist in a tin foil hat to stop and say, wait what is going on here. There will now be pressure to say and rightly so declare government oversized and out of control. Further budget cuts will be sought. This will bring a reaction equal in magnitude and opposite in direction. Tensions will rise and it is not inconceivable that violence may spring up. There are entire industries and infrastructure that have built up over the past 50 years of government growth. They will not go quietly. Add to this that the U.S. economy is weak and being ignored.

As a result, we expect to see wealthy investors retreat to buying hard assets. There are early signs that this is already happening. Real estate as we noted earlier is seeing new demand by wealthy buyers. Christie's recently auctioned over half a billion in art being purchased. One Jackson Pollack painting was expected to change hands at $25-35 million. The lucky bidder took it home with a record bid of $58.4 million. Similar happenings are being seen in fine wine auctions. One area that has been under downward pressure that may soon reverse course is gold. For the past several months gold has been under heavy selling pressure as several large hedge funds ran for the door. The growing unrest and relatively unchanged economic environment will likely encourage buyers as the government bond market will see yield curves adjust upward and gold prices bottoming.

Investors seeking to protect capital and lower volaitlity and increase income would be well served to seek out small active hedge funds and sound private equity and fixed income opportunities. New product and technology developments are providing solid risk:return exposure. Debt placements are showing wide spreads and solid credit for short duration funding of small and medium sized companies. Patience will meet with opportunity to provide shelter from the risk of the inflated markets.