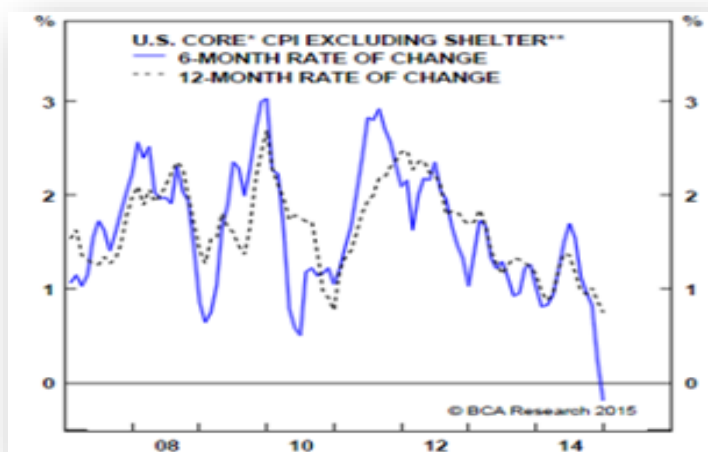


Like the starting of a chainsaw in a horror film, nothing strikes fear in the heart of central bankers more than the idea of deflation. Part of the vetting of a potential central banker must require a visceral reaction to the word deflation. Webster defines deflation as a “decrease in the amount of available money or credit in an economy that causes prices to go down.”

This sounds innocent enough and many rightly ask what is so wrong with lower prices. There are many positive elements of deflationary pressure. Lower prices that result from productivity gains (think computers) or lower commodity prices (cheap gas) are positive for economies and lead to higher discretionary income for consumers. No one is worried that 4K curved televisions that cost \$10,000 a year ago can be bought for \$1,500 today.

Bad deflation, the kind that makes central bankers wake in a cold sweat, involves declining prices as a result of falling demand. Prolonged periods of weak demand leads to future expectations of lower prices and leads people to put off consumption, expecting prices will continue to fall. Both asset prices and real wages fall during periods of deflation and history has shown it is very difficult to reverse that cycle once it starts in earnest.



The most common cause of deflation is debt, unproductive debt to be specific. Productive debt results in economic growth and greater opportunity for people. Debt used to Expand businesses and create jobs or provide infrastructure for increased productivity positively impacts an economy. Debt to finance transfer payments or consumption is deflationary by nature because it takes future consumption and brings it into the current. High levels of debt stifle investment, as income must be used for debt service. When prices begin to fall from lack of demand, the debt burden becomes worse. Greece is the

shining example of a debt-induced deflation as their economy has contracted more than 25% since 2008 and still is looking for a bottom six years later. By contrast, the Great Depression in the U.S. bottomed between years 4 and 5 at negative 25% and had fully recovered by the 9th year.

We see deflation as being inevitable for two reasons:

1. Fiscal and Monetary policy mistakes. Endless programs of quantitative easing and stimulus become counter-productive. Policies intended to ease today's pain will result in greater pain in the future.
2. The massive credit bubble. Global debt to GDP ratio has risen more than 300% in the last 35 years with very little used for productivity gains. Default-led deflation is very likely before the end of this decade.

The negative impact of the deflationary cycle is already being experienced in the U.S. but even more so in Japan and Europe. Unemployment is above 25% in Greece and over 50% among youth in Greece and Spain. Wages have been falling, and adjusting for inflation, they are lower than 2009 levels according to Fed statistics.

When the debt bubble begins to deflate, demand will fall and the economy will have to go through a painful process of readjustment. The more that central banks try to postpone the inevitable by expanding the monetary base, the more the velocity of money slows offsetting their policy efficacy.

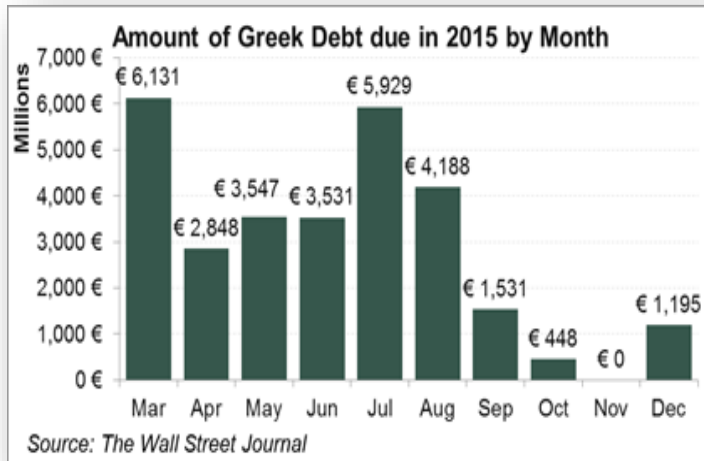
When the debt bubble begins to deflate, demand will fall and the economy will have to go through a painful process of readjustment.

The ability to predict when debt defaults result in global deflation is extremely difficult. Extraordinary measures are being taken. Some countries have negative interest rates (people paying to put savings in a bank) while others manipulate their currency by printing trillions of dollars. We expect the global financial system to move from stable to chaos quickly when true deflation is triggered.

Until that time comes, consumers will continue to enjoy lower prices and companies will be able to leverage low input costs and labor to maintain high levels of profitability.

Greek Mythology

The new anti-austerity government is getting a hard lesson in the realities of over indebtedness and unfortunately, global financial markets have been taken along for the ride. The recent volatility in equity markets has largely been driven by the tug-of-war between Brussels and Athens. On February 21st Greece and the troika agreed to a four-month extension of the bailout terms, postponing Greece's day of reckoning. Global equity markets applauded the announcement with U.S. markets hitting record highs and European markets hitting multi-year highs.



In question is the roughly €26 billion that is coming due by the end of August (see chart). Greece does not have the revenues from taxes or other sources to pay it off. And they cannot easily go to the capital markets to roll over this debt as no one wants to lend them money at this point. As a result, Greece is left with needing more bailout funds from the troika, which consists of the European Commission, the ECB and the IMF. Greece's lack of progress with economic reforms and its waning austerity measures have been a key point of contention in the negotiations. To make matters worse, the anti-austerity Syriza party is in power, reflecting the economic frustrations felt by most Greeks.

A real Greek Tragedy is playing out before our very eyes. And we see a failed deal as a "lose lose" situation by most standards.

On the one hand, the euro zone, particularly Germany and France, cannot really afford Greece to exit the union. Their banks hold a lot of Greek debt and would likely suffer should the drachma reappear. In addition, a "Grexit" would likely bring into question the euro zone's viability as other "frustrated" countries like Spain and Italy could seek to lessen or reverse their austerity measures. Meanwhile, the Greeks have shown unwillingness to make the sacrifices necessary to reform their economy.

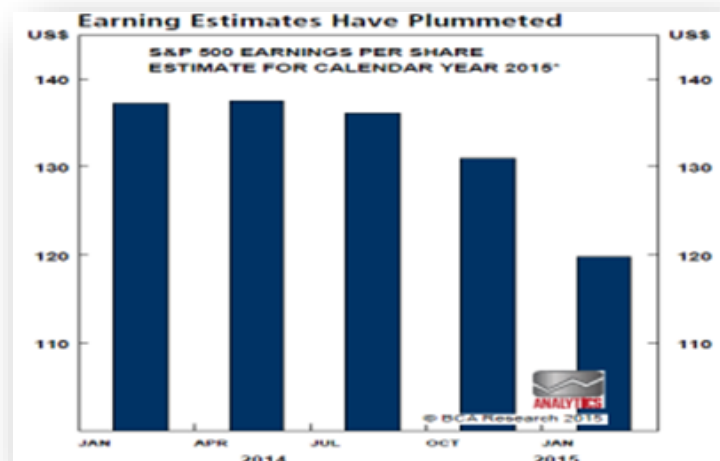
With the apparent impasse, the question now becomes how Prime Minister Alexis Tsipras might maintain

credibility with both the troika and his countrymen? His tenure may be short-lived as he may not be able to deliver on his campaign promises and has placed Greece in an untenable position. They could start selling assets to raise the needed cash but that takes time. We think an agreement will eventually be reached as both parties have a fairly strong incentive to work things out. A "Grexit" would only worsen the economic perils facing the average Greek and it could have large consequences for euro zone economies. We expect somewhat of a bumpy ride for world equity markets as Tsipras's Greek Mythology gives way to the proverb that states: "the borrower is slave to the lender."

The Earnings Squeeze

With U.S. markets at all-time highs and European markets at multi-year highs, what could investors possibly be worried about? In a word, earnings. We are more than half way through Q4 earnings and the early results are not as promising as the market highs would portend. By some measures, forward-looking earnings metrics are worse than we have seen in decades.

More than 4 out of 5 companies providing forward earnings guidance lowered future expectations. Analysts are tripping over themselves to reduce their estimates for 2015 earnings at a faster rate than has been seen in a long time. Consensus earnings estimates for the S&P 500 in the summer of 2014 were \$138. This figure was lowered to \$131 in December of last year and just recently fell to \$120, essentially flat with 2014 results. As forecasted earnings are getting squeezed, the stock market is making new highs, the perfect illustration for the efficiency (or lack thereof) of the markets.



We see two culprits for the downward revisions of earnings. First, the strong U.S. dollar is clearly taking its toll on companies that do business overseas. Exports account for only 13% of GDP but represent approximately 33% of revenues for S&P 500 companies. The dollar has increased in value 14% since last summer reducing profits

when converted back to USD and making American products less competitive in terms of price. This impact is best illustrated analyzing the earnings of consumer discretionary stocks. Domestic companies (less than 30% of sales overseas) have reported +19% year-over-year earnings growth while Multi-National companies (over 30% of sales overseas) have experienced -10% earnings growth. The trend higher for the dollar may taper in 2015 but is very likely to continue its upward trajectory.

The second factor leading to an earnings squeeze is falling oil prices. Low gasoline and heating oil prices are like a tax cut for consumers but there tends to be a 6 to 8 month lag before spending increases. Energy production represents only 1.7% of GDP but 8% of the S&P 500 market capitalization. Energy sector earnings are 11% of the S&P but only 3.3% of the economy as a whole. Finally, and most importantly, energy represents nearly 33% of non-residential investment (capex) of S&P 500 companies even though only 10% for the economy as a whole.

Falling earnings are making stocks less correlated and turning this into more of a stock pickers market. Portfolio managers adept at screening for strong fundamentals who follow a disciplined, rules-based approach should shine in this market environment.

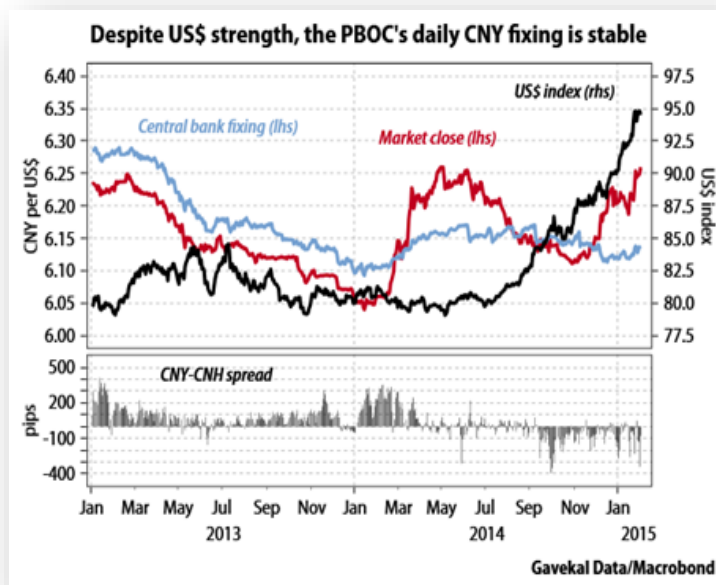
Currency Winners and Losers

There are a couple questions that must be addressed when determining which currency is the winner and which one is the loser during a period of heightened deflationary pressures. First, is victory only found in the near term or is it sustainable? Second, when a currency finds itself in the grips of deflation, how does the corresponding central bank respond? Currency is a zero sum game. There are winners and losers. Unlike youth sports, everyone does not receive a trophy.

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Currency and monetary policy can drive short term and long term success of a nation's economy, and then ripple into impacting the global economy. Deflation is currently not only a predicament in the US, but in the Eurozone, China, and Japan. The ECB and BOJ have made it clear that they will continue aggressive QE with the expectation that a devalued currency will help eventually fend off deflation. This expansion of the balance sheet is likely, in the immediate term, to benefit equities. The case can be made, though, that yen and euros find their way towards

the less risky of the risk assets, specifically US equities. The liquidity out of Japan and Europe may also look for a safe harbor, likely US treasuries and the greenback. This may create an interesting result in driving up the price of short term treasuries while rates remain muted. Over the long term, the yen and euro face an uphill battle. Japan has demonstrated this for the past 25 years. To emerge from the depths of deflation, Japan and Europe must address the issues that extend far beyond monetary policy. In the short term, the U.S. dollar will win over the depreciating yen and euro. This may create headwinds for U.S. growth, but over the long term, a strong local currency often translates into a strong economy.



China makes for an interesting case study in the currency race as they attempt to maintain a balance between a state run economy and the allure of capitalism. The PBOC is in tune with the impact the renminbi and U.S. dollar has on their exports. Financial stability and the internationalization of the Chinese currency are important moving forward, and may be hindered given a renminbi devaluation relative to the dollar. The chart above shows the stability in the renminbi relative to the appreciation of the dollar. Gavekal Research points out that Chinese companies are heavily exposed to the U.S. dollar but have very little exposure to other currencies. More than 80% of China's registered foreign debt is either in U.S. dollars or Hong Kong dollars, whereas only 10% is in euros or yen. At the same time, 75% of China's foreign trade payments are in U.S. or Hong Kong dollars (and a further 22% in renminbi). Only 3% are in euros or yen. Therefore, China landing on the winning side of the currency "war" is based heavily on the success the PBOC has in creating stability and continuing to show prominence in the global economy, all without an appreciating home currency.

Macro View

Real estate and housing are key factors associated with the health of the macro economy in the US. Housing has been a missing piece of the recovery coming out of 2008. Analysts are receiving mixed signals from commercial and residential real estate.

Existing home sales fell 4.9% in January to a seasonally adjusted rate of 4.82 million, according to the National Association of Realtors (NAR). U.S. housing starts fell 2% over the same time period. Existing home sales, which make up 90% of all purchases, fell slightly from 2014 and are well below prerecession levels. NAR Chief Economist, Lawrence Yun, commented on the recovery and housing stating, "I would say the initial phase of the price recovery was good news for the economy but now that prices are easily outpacing people's income and consumer price inflation, I would say it's less healthy."



The chart above tells a different story, though. The Dow Jones Home Construction iShares ETF (ITB), depicted in the bottom half of the chart, is breaking to the upside of a nearly two-year trading range. ITB is at the highest level since 2007 when the housing market was in total collapse. The ratio of home construction to the S&P, shown in the top half of the chart, is also turning up after nearly two years of underperformance. This is likely attributable to the combination of lower mortgage rates and a better job market. To further support evidence of a potential recovery in housing, Home Depot and Toll Brothers both surprised on the upside with their most recent earnings report.

Commercial real estate fundamentals showed improvement in the fourth quarter. Most notably, commercial rents were driven higher across major property types. The NAR commented in their 2015 outlook that employment gains are expected to continue into 2015, which will further expectations for the commercial space. Office vacancies remain elevated as a result of efficiency in space utilization. The NAR forecasts rents to rise 3.3% in 2015.

Taking Stock

The market fundamentals do not look as strong two-thirds of the way through the first quarter as they did at the beginning of 2015. As documented earlier, there is an earnings squeeze occurring that is hurting valuations. The economy does not appear to be growing as robust as many expected as seen by the consensus of Blue Chip Economists lowering their growth targets for the year from 2.9% to 2.7% in the last month. The Federal Reserve Bank of Atlanta publishes a real-time growth model called GDPNow that indicates the current growth rate may be as low as 1.9%.

Without strong earnings growth, the market looks pricey to us and becomes vulnerable for a sharp correction. It can be very deceiving to analyze the market in aggregate without breaking it down into its individual components. For example, buying domestic consumer discretionary stocks look attractive based on earnings growth while multi-national firms appear poised for correction.

If you measure the Price-to-Earnings ratio of the S&P using the median instead of market capitalization, the market looks significantly overvalued. More than 50% of the S&P 500 stocks are trading at more than 20 times their trailing earnings. This measure is higher than at the market peak in 2000 when the high P/E was the result of the largest companies sporting high multiples.

2000		2015	
Company/Ticker	P/E*	Company/Ticker	P/E*
Microsoft	57	Apple	15
Cisco	127	Google	19
Intel	43	Microsoft	16
Oracle	103	Facebook	39
Sun Microsystems	85	Amazon.com	717
Dell Computer	57	Intel	14
MCI Worldcom	22	Gilead Sciences	11
Chartered Semiconductor	53	Cisco Systems	13
Qualcomm	123	Comcast	17
Yahoo!	418	Amgen	17

* Next 12 months

Sources: Fidelity, Nasdaq, FactSet, Barron's Research

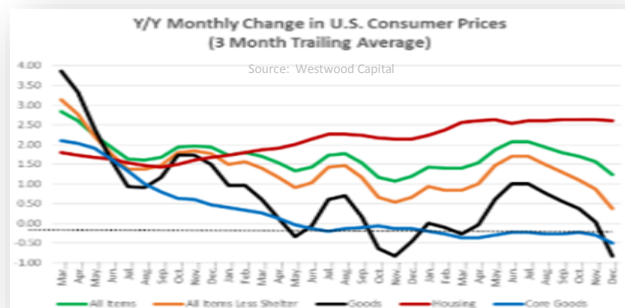
Where we do see value is in the Nasdaq. You read that right, we are now proclaiming the Nasdaq to be the new value index for investors. As the Nasdaq approaches a new all-time high just above the 5,000 level, its valuation does not appear to be as stretched as the S&P 500. Fifteen years ago the P/E of the Nasdaq was astronomical with only 2 companies having a P/E below 50 and half the firms trading at triple-digit multiples. Today, 8 of the top 10 companies have multiples below 20 with only Amazon trading above 40 times earnings.

Stocks may be trading at elevated levels but with bond yields so low it is likely Mr. Market continues to get large amounts of new dollars flowing in.

Income Unconstrained

The fixed income markets saw a surprising upward move in yields during February even though the economic data questioned the strength of the recovery. Inflation remained extremely tame with January PPI falling slightly as energy prices continued their path lower. Bond traders remained fixated on the Fed with careful scrutiny of the release of the Fed's latest meeting minutes and Chairwoman Yellen's two day testimony before Congress.

Our reading of the minutes from the Fed's January meetings (instant cure for insomnia) did lead us to the conclusion that the Fed is highly unlikely to raise short-term rates at their June meeting. We noted that "several" members voiced concerns about the risk of waiting too long to hike rates while "many" believe the greatest risk remains to derail economic recovery and job growth. Since the Fed still votes on policy changes (we assume), the many are likely to prevail over the several postponing the first rate increase. We expect August to be the earliest the Fed will act.



With economic growth potentially slowing and inflation still trending lower, we are taking advantage of the bump up in yields to extend durations in our tactical bond portfolio. Current economic data convince us that long-term rates will not be significantly impacted by at least the Fed's first two rate increases. If the economy were to drop below stall speed, yields on long-term bonds would come down and lead to large profits. The chart above shows inflation broken down by category. Strength in housing is the only thing keeping CPI from following PPI into negative territory.

Getting Technical

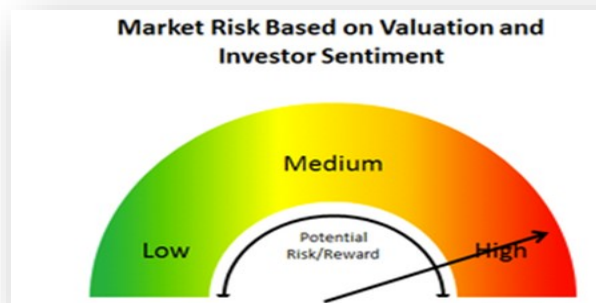
For traders whose sole focus is on change in price, not fundamental valuations, the market continues to provide a green light. We are seeing a much larger dispersion in returns so far in 2015 but the underlying technical strength demonstrated by stocks remains high. While many analysts have raised caution flags during the first two months of 2015, downside risk has yet to materialize for the major market averages.

Sentiment readings, while off their multi-year highs, continue to show confidence in the economy, the markets, and a lack of fear. We believe we are seeing the initial signs of confidence waning in many emerging markets and Europe. Capital flight is beginning to accelerate and a large majority of capital fleeing countries experiencing economic chaos will find its way to the U.S. markets.

Another driver of growing demand for domestic stocks is endowments and other large institutional portfolios. The last couple of years hedge fund returns have greatly trailed the

returns of the broad U.S. indices and many endowments are reducing exposure to alternatives in favor of public stock funds.

Negative divergences often signal market tops but can be difficult to see except in hindsight. The market breadth has always been an important measure as it shows how many stocks are participating in a rising market (new highs) compared the number of stocks not participating (new lows). The A/D line, as it is known, has failed to break out to a new high as the S&P did and is worth watching to see if market breadth begins to deteriorate.



Steve Blumenthal of CMG publishes a weekly sentiment-driven gauge of overall market risk in his Trade Signals blog. His indicator suggests caution for investors at this time. We remain more than 75% allocated with nearly 25% in cash as a hedge. If earnings continue to show modest contraction in both prior and forecasted quarters it may actually be getting close to the time when profit taking makes sense.

Currency and Commodities

Commodity prices continue to struggle, and, by some estimates, are in bear market territory. It is difficult to make the case for appreciation in commodities in a slowing global economy, rising deflationary pressures, and a tightening monetary policy in the U.S. Industrial raw material prices have plunged over recent months. Both iron ore and copper have dropped over the past year. The Baltic dry shipping index is at levels not seen since the mid-1980s. Gold and Silver continue to attempt to gain their footing. Year to date for both precious metals are in single digit positive territory but remain lower from year-ago levels. Gold is down over 10% while silver is lower, down by more than 24%.

Much of the struggle in commodities can be directed at China, which has been the world's largest consumer of commodities. Their economic growth in 2014 slowed to 7.4%, which was below government targets of 7.5%.

The U.S. dollar has appreciated about 4.75% year to date and over 16% over the past year, as measured by the Invesco PowerShares ETF, UUP. Historically, there is an inverse relationship between the dollar and commodity prices.

The glimmer of hope for commodities may be in the luster of gold and silver. Low interest rates and depreciating currencies force precious metals to become attractive placeholders for short term fixed income. There is also a trifecta occurring that potentially benefits precious metals: the combination of a rising dollar, deflationary pressures in the global economy, and terrorist concerns are causing volatility across many assets classes. We think volatility will persist among commodities, requiring investors to be agile. As a result, a more active approach to commodity investing seems more appropriate to us.

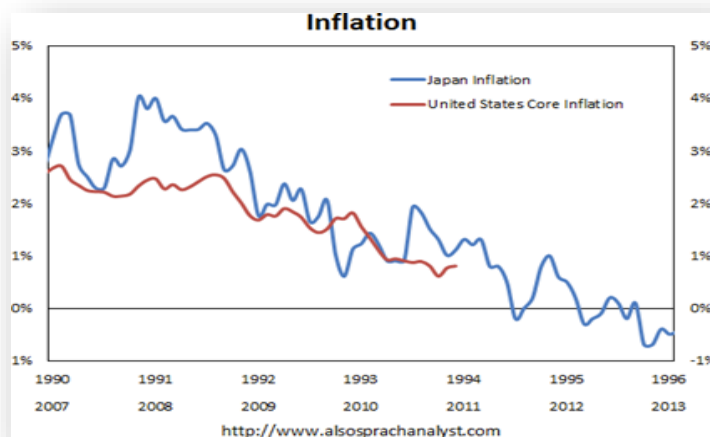
Q : Are we turning Japanese?



We clearly are not referring to the 1980 song by the Vapors but to the deflationary spiral the Japanese economy has been engulfed in since the late 1980's. While it is easy to find parallels between deflationary pressure in the U.S. and Europe and the Japanese experience of the last 30 years, I do not believe the U.S. will experience the long-term stagnation of the world's third largest economy.

My reasoning is based more on cultural influences than economic policy or performance. Having spent time in Japan, there is a deep sense of honor and conformity within society. There are very positive social aspects of this but it also results in sweeping problems under the carpet and not publicly admitting mistakes and taking corrective action. Loans, for example, are kept on the books of banks at artificially high asset levels instead of being written down to actual current values.

In the U.S., issues are openly talked about and debated which forces governments (and companies) to address imbalances more quickly. The sub-prime mortgage debacle is a great example. In the span of 10 years a new lending product was created, marketed, abused, and corrected and most housing markets are back near or above previous highs.



I believe the U.S. economy has, and will, experience many of the economically debilitating effects of deflationary pressure but we will not remain mired in those effects for decades.



This is an interesting question to contemplate. Its main premise refers to the spreading deflationary pressures across the globe. China's growth could surprise to the downside, suggesting tepid or falling demand for raw materials. We've already seen a decline in commodity prices and slowing growth in China has played a key part. Europe is fighting growing deflationary pressure with its version of quantitative easing. Is it too late for them? Maybe. They need some serious structural reforms in my view to avoid a similar fate to that of Japan's 20-year struggle. The over indebtedness and generous employment benefits are part of the problem as is an aging population. Japan has faced very similar challenges unsuccessfully. So, the risk of a prolonged period of deflation plaguing Europe is quite real in my view.

Could this deflation spread to the U.S.? It's entirely possible and I think the risk is elevated at this time. But, even though we too have an aging population, we currently have more favorable demographic trends than most of the developed world and

China. And our economy is more versatile and open in most respects, though the trend has worsened since the "Great Recession." Nevertheless, I think we will see continued deflationary pressures in the U.S., which likely means the Fed will be quite measured in normalizing interest rates. I'd look for wage increases and rising participation rates before inflation becomes a greater concern.

Q : Is India the new China?



Fifty years ago economists questioned whether India or China would emerge as a world economic power, and the answer seemed uncertain. Today, while India has the 10th largest economy in the world, it is only slightly more than 20% of the size of the Chinese economy. I do not expect we will see India surpass China in terms of economic influence in our lifetimes.

I do believe, however, that India may be poised to become the "growth leader" of the emerging markets. New Prime Minister Narendra Modi, who was elected with record-breaking levels of support, has promised to reform India's economy and is targeting 7% GDP growth. The government recently changed the way they calculate GDP in an obvious attempt to boost economic performance.

While India has many economic attributes in its favor, there remain cultural concerns that will limit their progress if not addressed. Inequality in opportunity, education, healthcare, and basic living standards is as high in India as any country in the world. India increased their number of billionaires by nearly 40% last year and now ranks only behind the U.S. and China in the number of super-wealthy. Sadly, the number of Indian citizens mired in extreme poverty and who have no access to education has also dramatically increased. The world's largest democracy can do much better at helping all citizens benefit from economic prosperity and when they do, they will surpass but the largest of the economies of the world.



I think India's prospects look more favorable than China's at this point. They are a freer society with more domestic consumption than China, which means they are less dependent on exports for their growth. And though high inflation and poor economic performance in recent years has plagued India, the country appears better positioned to deliver more consistent growth than China in my view. India's new leader, Narendra Modi has promised a number of reforms to attract more investment to the country. Modi heads what has been called a more business-friendly government with the goal of improving India's infrastructure and lessening its regulatory constraints. Plus, the head of the Reserve Bank of India, Raghuram Rajan, is a very capable economist who so far has been very instrumental in taming the country's rampant inflation. So, it would appear India's economy is in good hands.

Still, it may take some time before India is on the same level as China in terms of its infrastructure development, but it has a lot going for it in my view. Like most developing countries, corruption is a concern but its large population and more favorable demographics are more appealing to me than China's. While the size of India's economy has a long way to go before it catches up with China's, I think the ingredients are there for India to deliver more stable economic growth going forward. Of course, things can change quickly if Modi fails to deliver.

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