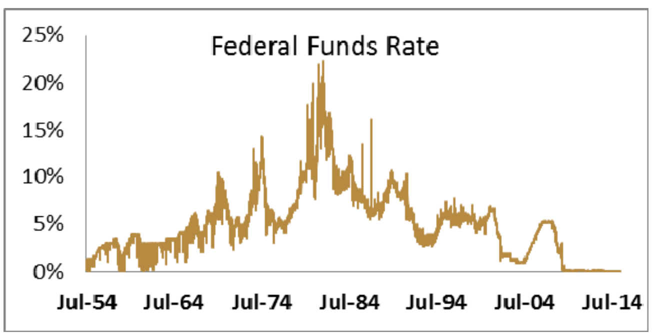
NOTTINGHAMADVISORS
ASSET MANAGEMENT

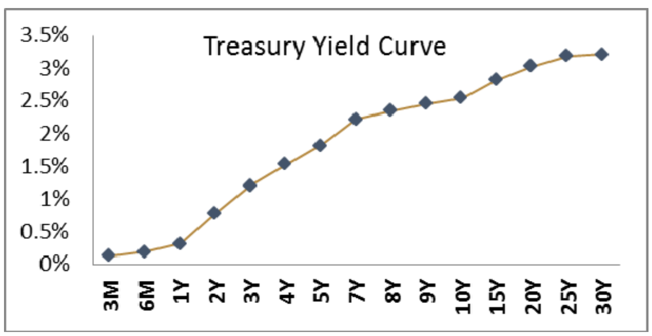
SAYING SO-LONG TO THE LAKE WOBEGAN MARKET
(WHERE ALL ASSET CLASSES ARE ABOVE AVERAGE)

"Sometimes you have to look reality in the eye, and deny it."
-Garrison Keillor

For any of you that may have caught one of Garrison Keillor's monologues on NPR over the years, you'll know all about the fictitious town of Lake Wobegon, "where all the women are strong, all the men are good looking, and all the children are above average." The same descriptor might be used in the investment arena these days, except *all the returns over the past 6 years have been strong, all risky asset classes were good looking, and all asset classes in general were perceived to be above average*.

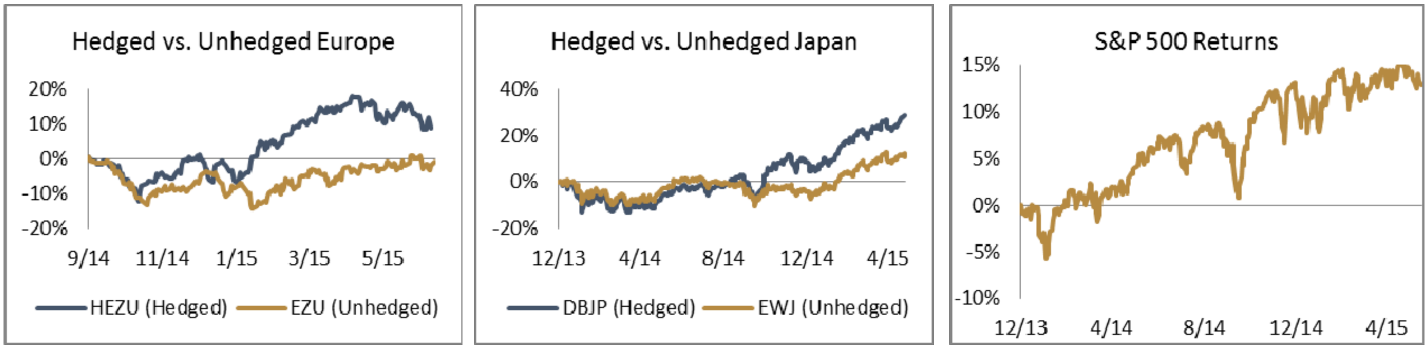
The culprit, of course, for this goldilocks scenario is our very own Federal Reserve. And with the official start of summer just around the corner, the clock is ticking rapidly, counting down the days until the Fed's largesse of the past 6+ years vanishes into the night. Yes, an honest to goodness Federal Open Market Committee hike of the Fed Funds rate appears imminent. The last time this happened was nearly 10 years ago, so you might be forgiven for not knowing that **central banks can actually raise interest rates, and not just lower them – or that the short-term interest rate might actually be something other than zero!**





The Fed's intention with respect to the loose monetary policy post-crisis has been well-documented in past missives. The Lake Wobegon effect, if you will, is that all asset classes, in our eyes, appear "above average" in terms of valuation. In business school, one of the basic tenets is that lowering the discount will increase the present value of future cash flows. Raising the discount rate will have the opposite effect. By driving short-term interest rates all the way down to zero, the Fed has succeeded in boosting the asset values of nearly all asset classes (except money markets of course).

(This is the point in the letter where I could get really wonkish and show you the formulaic beauty of the above paragraph. In that I want you to actually keep reading all the way to the end, just take my word for it that the math works.)



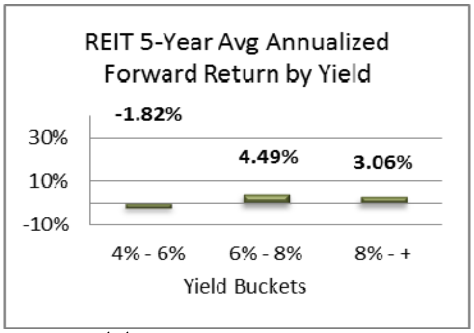
Europe and Japan have been very attractive markets – if you've hedged out currency risk! The ever-evolving ETF market is making this increasingly easy to do.

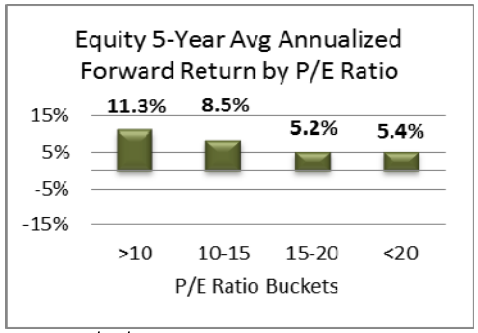
An exhaustive and ongoing survey of the global investment landscape reveals very few pearls, but an excess of flotsam and jetsam. The areas of interest to us, and we've shared this with you in many of our publications, involve geographic regions where central banks are either beginning (Europe) or are accelerating (Japan) quantitative easing programs. Despite strong year-to-date returns in these markets, we suspect there is quite a bit of room left to run. Just make sure part of your trade involves currency hedging.

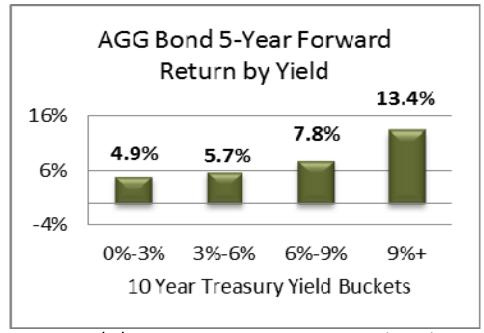
We're somewhat less sanguine with respect to U.S. markets as we think the Fed will begin the normalization of interest rates come September. What does "normalization" mean? It means that Fed Chair Yellen will slowly, and likely begrudgingly, return control of the interest rate setting process back to the market, out of the hands of central bank luminaries. The process is bound to take some time, as the risks of a 1937-like policy mistake remain a concern at the FOMC (and here at Nottingham for that matter).

One of Nottingham's basic investment tenets is that **starting price matters**. What this means in practical terms is that the price you pay today for an investment asset has a great deal to do with both your expected and actual subsequent rate of return. If $10 bills were selling for $6.50, one need not be a CFA to surmise that that represents a pretty compelling return on investment. If those same $10 bills were going for $9.90, however, return expectations would likely be seriously diminished. At the same time, if $5 bills were selling for $5.50, and $20 bills were selling for $22, investors might actually think they were getting a good deal on the $10 bills at $9.90 each. That's the kind of market we're in right now.

From a historical perspective, nearly all asset classes – domestic and international equity, domestic and international investment grade debt, high-yield debt, MLP's, REITs, private equity – are trading at the north end of fair value. This makes sense in light of central bank monetary policy (remember, lower discount rate = higher present value of future cash flows). And despite what we would consider "full" valuations, we wouldn't consider them alarmingly full valuations (otherwise we would have pared back exposures and retreated to cash proxies). In a low interest rate environment, valuations can remain elevated in the absence of a clear alternative. The downside is that expected future returns are likely to be lower – again, <u>price matters</u>.







From: 12/1/1971 From: 1/29/1954 From: 1/1/1976 Source: Bloomberg

So, what do investors do when nearly all asset classes are above average (and expected future returns are by definition likely to be below average)? First off, don't panic. Whistler's corollary to Keynes' observation that *markets can stay irrational longer than investors can stay solvent* is that market's can stay fully valued but worth investing in longer than would seem prudent (see the 1990's U.S. equity market if you don't believe me!). It's really important at times like this to remain focused on your long-term plan. Markets could correct over the summer, dropping maybe 10-15%. This would actually serve to bring valuations more in line; however, as our prior missive alluded, we're more than likely going to see a sideways (or *sidewards*) like market over the near term.

The continuing saga around Greece has generated considerable turmoil within the European Union; however, it has also created opportunities for investors. As we go to press, the Greeks are in the 11th hour – actually it's more like 2 minutes til midnight – before a deal must be struck with its creditors in order to avert defaulting on their debt. The endless back forth between debtor (Greece) and creditor (the IMF and EU banks – mainly German ones), has caused wild moves in European bond markets. Equity markets have done fairly well as money has flowed into the Eurozone from U.S. investors looking for cheaper markets. The trick has been to hedge out exposure to the Euro, which fell from $1.40 U.S. to as low as $1.05 U.S., before bouncing back to $1.12 U.S. today. We've had positions on for some time now that are benefiting from this dynamic.

The same case can be made for Japan, as we enter year 3 of *Abenomics*. After decades of sluggish growth and deflationary pressure, green shoots of GDP growth and inflation are finally emerging. As with the Euro, the Yen has fallen from 80 per USD to 123 as the Japanese central bank has rapidly increased its quantitative easing program. Our hedged Japan trades have done very well and we remain bullish on Japanese equities over the near term. These currency hedges come despite an outright long position in the U.S. Dollar that we continue to maintain.

Despite our affinity for international developed markets, we remain somewhat leery around the prospects for emerging markets, with much of our exposure here of the low-volatility variety. China's A-share market has been red-hot, with the Shanghai Composite up nearly 60% YTD. Needless to say, the speculative fervor gripping those markets is immense and reminiscent of our own equity bubble from the 1990's. Like that one, this is bound to end badly. Brazil, Russia and India too are struggling, for different reasons, but for the once mighty BRICs, the luster is surely off in 2015. Despite favorable demographics and above average growth rates, EM countries continue to struggle with the strong U.S. Dollar and their own debt challenges. We're optimistic long-term on EM but remain cautious for now.

Looking at our domestic exposures, healthcare, tech, financials and energy remain our best bets. All but energy have paid off handsomely, yet we think oil will end the year higher as the global economy improves, giving a boost to energy related stocks in the fourth quarter. Our growth over value bias has paid off as well, with the S&P 500 growth sector outperforming value by 267 basis points thus far in 2015. Ironically, defensive sectors appear the richest right now. Despite an unsettled economy, hiding out in utilities, telecoms and staples appears a bit risky to us.

Turning to fixed income, our foray deeper into the international sovereign arena paid off nicely in Q1, but has since given back some of those gains as bond markets in the Eurozone grow uneasy over the fate of Greece. We've pared back a little on that trade, booking some profits and we remain optimistic it will work out for over the balance of the year. Short duration high yield continues to crank out decent equity-like returns, while our newer position in TOTL, the SPDR DoubleLine Total Return ETF, should outperform the broader bond market as rates drift higher.

Our income strategies have held their own in the face of rising rates here in 2015 and our early bets on shortening duration, or the interest rate sensitivity of the portfolios is paying off. With interest rates backing up thus far in 2015, traditional higher-yielding equities such as utilities and real estate are faring poorly. The good news is that the opportunity set for yield is expanding rapidly. As the Fed begins the process of normalizing interest rates, fixed income should come under pressure from a total return perspective. Ultimately however, higher rates will benefit savers of all stripes and the days of finding value in traditional bank CDs will return.

In summary, despite full asset class valuations, punk economic growth and a Federal Reserve poised to raise interest rates, we don't feel any sort of market crisis is imminent. The noise level around impending doom is increasing, both here and abroad, but we're not buying into it. The U.S., European and Japanese economies continue to improve while both corporate America and the US consumer are in far better shape than at any time since 2007. We'll admit we get uncomfortable when the ratio of the U.S. stock market value to U.S. GDP rises above 150%, where it's at right now, but we don't believe it's time to sell or be overly alarmed. Again, absent viable and attractive alternatives, equities will remain the asset class of choice for some time to come. If anything bonds are more likely to drop out of the "above average" camp in this Lake Wobegon market. Ultimately, valuation usually wins out in time. The Fed could help expedite this by beginning the interest rate normalization process in September.

Happy summer,

Lawrence Whistler, CFA
President/Chief Investment Officer
June 2015