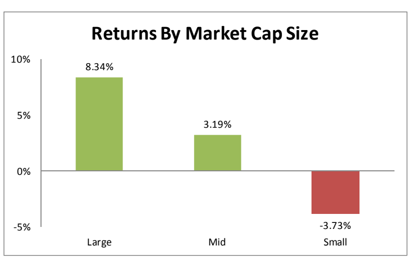
NOTTINGHAM ADVISORS
ASSET MANAGEMENT

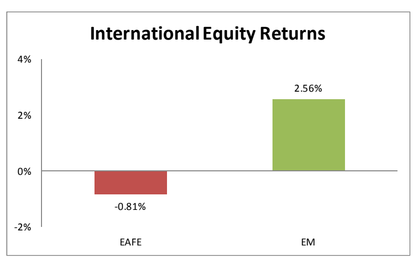
THE SONG REMAINS THE SAME

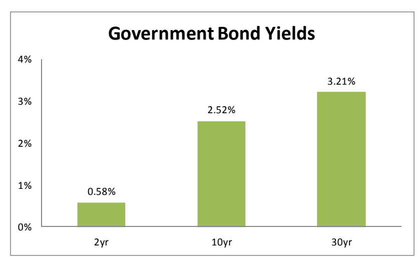
"The only way to deal with an unfree world is to become
so absolutely free that your very existence is an act of rebellion."
-Albert Camus

Anyone looking at the overall third quarter return metrics for equity and bond markets could be forgiven for thinking that nothing of real consequence occurred over the past 90 days. The S&P 500 rose a scant +0.62% on the quarter while the 10yr Treasury Note saw its yield migrate a mere 3 basis points from 2.52% to 2.49%. Single period return optics can often be very deceiving, especially over short periods, and this time was no different. As our last note to you indicated, financial markets, in general, are enduring a period of heightened uncertainty, and daily swings in price merely reflect the fact that no one has a really good handle on where things are headed over the next 6-12 months.

That said, Nottingham's diversified strategies fared well through the increased volatility that we experienced and are well positioned for whatever may come our way over the coming year. There's a certain beauty to adopting and maintaining a long-term outlook as it helps an investor work through (though not ignore) much of the daily noise that the markets generate. The decisions we've made over the past several months, admittedly few in nature with respect to your portfolios, were made with our client's **time horizon** and **risk tolerance** clearly in mind.







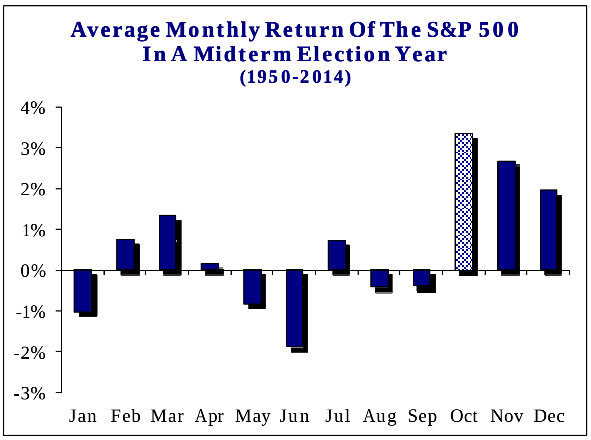
2014 equity total returns and government bond yields as of 9/30/14. *Source: Bloomberg*

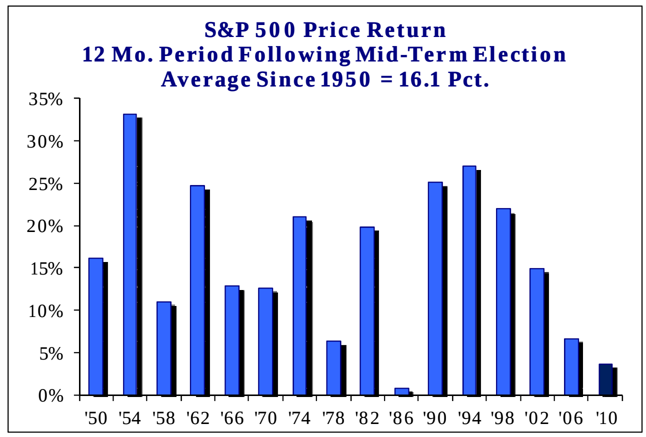
Central banks remain the principal driver of market gyrations, with the Federal Reserve winding down QE and preparing for outright rate hikes, while their counterparts across the pond at the European Central Bank are finally backing up earlier "whatever it takes" talk with actual QE implementation. The divergence in economic condition is marked and reflected in recent equity market returns shown above, with international returns trailing domestic.

With September unemployment at 5.9%, Q2 GDP growth of 4.6% and inflation running 2% per annum, the United States is clearly further along the road to recovery following the 2008 recession. Europe, meanwhile, is struggling with 11.5% unemployment and GDP "growth" of a meager +0.7%, and, perhaps most alarmingly, battling outright deflation. The August reading on consumer prices showed an annual increase of +0.4% YoY while producer prices actually declined at a -1.4%

annualized rate. The ECB is only now embarking on a bond buying campaign and the hope among investors everywhere is that they didn't wait too long. Although we've been optimistic with respect to Europe's recovery, the deliberate and measured approach being taken by the ECB seems increasingly inconsistent with the deteriorating economic condition of the Eurozone member countries.

Before we go further, however, we must first pause and offer some thanks – and although it involves turkeys, it doesn't involve Thanksgiving. The thanks we give is directed towards the upcoming November elections, which have forced politicians (the turkeys) of all stripes, colors and credos to cease their senseless bickering in order to focus on the glad-handing and baby-kissing that comes with the campaign trail. Remarkably, with our esteemed politicians away from Washington, our republic is still thriving and we the people don't have to watch/listen/read about career public servants carrying on like children (trust me, I get enough children bickering at home!).





Historically, markets have reacted positively following mid-term elections. *Source: Strategas Research Partners*

The election is important on a number of levels, but in the interest of brevity I'll focus on just two. First, there are enough seats at stake to shift the balance of power in Congress, which could meaningfully alter the remaining two years of the Obama presidency. Secondly, Election Day once again stands as a referendum on policies such as bigger government versus smaller, more regulation versus less, and international leadership versus isolationism, among other things. As unsavory as some of our electoral choices may be, and they seem to deteriorate every election, please remember to vote.

Now, let's get back to the main point of this letter, our take on the financial markets. The 3rd quarter saw a rise in geopolitical tensions that helped drive investors away from risk assets into the safety of Treasuries and large cap U.S. equities. Uncertainty around the prospects for global growth only seemed to grow throughout the quarter, which culminated with the IMF issuing its 2015 outlook, slashing global growth estimates and warning about geopolitical tensions and somewhat elevated valuations in equity markets. All in all, a dour assessment for investors – however, the IMF's track record doesn't necessarily correlate strongly with investment success.

We argued towards the end of last year that we felt the equity market had likely pulled forward some of 2014's gain into 2013. Certainly this can help explain some of the lackluster performance of small and mid cap stocks thus far. As of this letter, U.S. small caps are down over -5% in 2014, trailing their larger brethren by nearly 1200 basis points. Small caps entered 2014 with decidedly stretched valuations and are currently trading at roughly 24x trailing year earnings. And although we like the prospects for many of these less levered and domestically oriented companies, we would like to see better value before we add to our exposure.

Market valuation has become something of an issue of late with the S&P 500 trading at nearly 18x trailing year earnings and mid-cap and small-cap at 21x and 24x respectively. In a low interest rate environment, we would consider these to be full but not frothy valuations. Should corporate earnings for 2015 land anywhere near analyst estimates, we would be looking at forward market multiples of 14x and 16x each respectively for large, mid and small caps. These are fair multiples by any measure and would imply 10%+ upside for equity markets over the coming year.

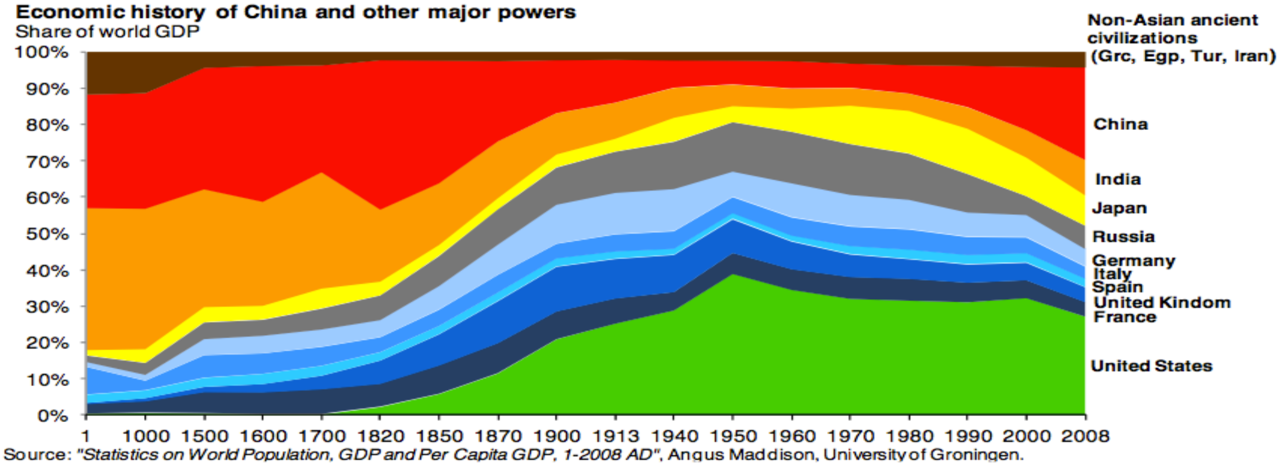
International equities on the other hand continue to struggle, despite multiple attempts at a rebound by emerging markets, which have lagged developed market returns over the past 5 years. The sticking point with both sectors remains growth, with the Eurozone battling deflation and China and Brazil readjusting to lower nominal growth rates. A lot of faith went into Mario Draghi's pledge to do "whatever it takes" to preserve the Euro and the follow through from the ECB has fallen a bit short. Europe appears closer to recession than not, with low interest rates offset by lack of demand due to high unemployment and restrictive bank lending. Although international equity valuations remain favorable versus their domestic peers, they aren't yet cheap enough to move to an overweight position.

As the title of this missive implies, things haven't changed noticeably – yet. Equities remain the only viable asset class for growth in the face of meager bond yields, fairly to fully valued real estate and declining commodity markets. Our asset allocation models didn't change much in Q3 – in fact it may have been the lowest quarterly portfolio turnover we've ever had. This doesn't imply complacency but rather a comfort level with our portfolio positioning given today's investment climate and overall economic and political situation. Every effort continues to be made to find attractive risk-adjusted returns for our investors and we'll be making several portfolio changes in the near future.

October should prove a pivotal month within the realm of fixed income as the Fed's bond buying program is poised to end by the time of their next meeting in two weeks. With the Fed no longer pursuing *expansionary* monetary policy, bond market investors will be positioning for the inevitable rise, or *normalization*, of interest rates. Nottingham has maintained a relatively <u>short duration</u> across its client bond holdings and the impact of interest rate hikes on current bond prices shouldn't be severe. We have also clung, somewhat doggedly it seems, to <u>high quality credits</u> and thus wouldn't expect to see too much damage to our portfolios from any credit spread widening. We feel the risk/reward trade-off within fixed income currently favors lower-yielding, higher quality bonds rather than high yield, bank loans or emerging market debt.

Exposure to commodities, real estate and cash substitutes remains fairly muted across our strategies. Slowing global growth, especially in China, along with a rising U.S. Dollar has put tremendous pressure on commodities. Already we're seeing the price of oil drop precipitously while gold and silver are both marking levels not seen since 2010. Real estate investment trusts (REITs) have performed admirably over the past year despite modest yields; however, we would expect this trend to reverse once interest rates begin to rise. As for cash, all that can be said is its liquid and aside from losing purchasing power to the tune of about 2% per annum, you know it'll be there when you wake up in the morning.

Despite today's investment uncertainty, we're beginning to see a pickup in both equity and bond market volatility. This usually creates opportunities for investors as prices stray from fair value. At Nottingham, we like to look for growth on a global level. In that vein, we find the following chart of significant interest. It's not often one can look back to the year 1 A.D. and try to measure anything with a high degree of confidence, but this chart attempts to do just that!



Two things are particularly interesting to us: first is the historically significant role China and India played in world economics, dominating the first thousand years; second is the rapid rise, plateau and steady decline of the US share of world GDP. To be fair, it's not just the U.S. but rather all the developed market economies shown above – Germany, Italy, Spain, France, U.K. and Japan. They are all in decline in terms of their share of world output. China, India and other emerging market economies are playing an increasingly large role and it's our bet that these countries will dominate the next 200+ years. Despite tepid investment returns of late, the case can still be made for long-term investors (okay, by "long-term" I'm not implying 200 years, but 15-20!), maintaining decent exposure to these countries and we are closely monitoring opportunities in this space.

The economic, demographic and political shifts in both China and India are increasingly compelling from an investment standpoint and will likely reward patient investors with handsome returns. As with many things in life, timing is everything. We suspect the timing is getting near when an overweight position in emerging countries will make a lot of sense. Until then, we'll favor the good old USA, reluctantly moderating our enthusiasm for continental Europe while still holding out hope that Abenomics will prove triumphant and Japan will thrive once again. Diversification isn't always rewarded in the short-run, but over time it remains the only "free lunch" in investing. As we head into the final quarter, don't forget to think about IRA distributions, capital gains liabilities and year-end charitable giving. Let us know if we can help you with any of these things. In the meantime, we wish you a peaceful and enjoyable Autumn and thank you again for your business. It is most appreciated.

Lawrence Whistler, CFA
President/Chief Investment Officer
October 2014