CURRENT STATE OF SOLUTIONS

February began with a continuation of the sharp increases in both expected and realized market volatility that began in late January. Over the balance of February, however, much of that volatility spike subsided and in developed equity markets that trend gave way to expanding valuations. Emerging market equities have not fared nearly as well as have developed equity markets as concerns over growth and geopolitical risks continue to dominate. Domestically, the S&P 500 has returned to its previous all-time-high levels. Curiously, despite the return of equity valuations to previous highs, forecasts of economic growth have not become increasingly rosy, and, in fact, many recent data releases are consistent with fundamental weakness in the economy. Meantime, global political instability remains extremely elevated.

DOMESTIC U.S.

The leadership transition at the Federal Reserve is complete, and during this past month incoming Chair Janet Yellen gave her first semi-annual congressional testimony on monetary policy. Scripted from Bernanke's castings, her comments provided apparently needed assurance to investors that economic data support the continuation of the Fed's tapering of asset purchases.

The balance of the month has been littered with, at best, mixed economic data. Recent releases have included declines in existing home sales for January, disappointing housing starts and building permits and higher-than-anticipated initial jobless claims. The soft economic data have led market commentators to question whether the numbers reflect fundamental weakness in the macroeconomic landscape, or are merely a blip on the screen attributable to prolonged and severe winter weather across much of the country. Indeed, markets are now using the weather to defend valuations. Next will be the "dog ate our homework" excuse. In her latest prepared remarks, Chair Yellen gave a much anticipated nod to the idea that the weather plausibly may be to blame for the recent soft data releases. Importantly, she described the tapering of asset purchases as not being on a "pre-set course."

While we remain generally negative on the U.S. equity market, we continue to maintain three small beta exposures in the sector portfolios. These positions were established in the prior month and include the following sectors: Financials, Industrials and Materials. At this preliminary stage in these sectors' emergence in the framework, we continue to maintain small positions. Our quantitative framework remains positive on those particular U.S. sectors with solidifying fundamental support for current valuations. As earnings season progresses, we will continue to monitor the dynamics of the fundamental metrics as we look for further clarification as to whether the underlying fundamentals continue to support current valuations.

We also note two recent trends that have received attention in the financial press. The first trend is the emergence of large net short positions by hedge funds and futures market speculators. While the role of these investors is not entirely clear (e.g. do the large short futures positions reflect bearish bets or are they merely part of a broader strategy?), they are noteworthy as historically large short positions by these "sophisticated traders" have tended to precede equity market declines. Additionally, we note the uptick in trading activity among small and retail investors. Almost always late to the party, heavy trading and large margin positions by these traders are noteworthy as such activity historically precedes equity market declines. It is worth noting that margin debt (leveraged buying of stocks) is at historical highs relative to GDP. Overall, such anecdotes are consistent with the quantitative framework and recent macroeconomic data releases, each suggesting domestic equity beta is unattractive relative to the return opportunities in a well-diversified fixed income portfolio. There continue to be nascent signs of emerging support to valuations in select sectors, and we continue to monitor those sectors for further directional indicators.

EUROPE

Turning our attention across the Atlantic to Europe, after a dip in European equities at the end of January, valuations mostly have recovered over the course of February. The economic outlook for the Eurozone remains divided. A positive signal is that economic growth has picked up in most Eurozone nations. But, levels of growth remain very low. And debt levels in some countries remain high and corporate earnings remain sluggish. Unemployment levels in the Eurozone periphery remain extremely high, especially youth unemployment, at around 50% in some countries.

Recently released are the realized Eurozone economic growth numbers for Q4 2013. The Eurozone economy grew by an anemic 0.3% over the fourth quarter last year, a value that exceeded expectations and that also is higher than economic growth for the previous three months, which was a paltry 0.1%. The year 2013 concluded with three consecutive, quarters of growth within the Eurozone. Economic growth has been relatively broad based with most Eurozone member countries (both the core and the periphery economies) achieving positive growth numbers. France, Germany and the Netherlands achieved economic growth rates of 0.3%, 0.4% and even 0.7% over the last quarter of 2013, respectively. Over that same period, some of the countries that were most affected by the crisis, namely Portugal, Italy and Spain, posted growth numbers of 0.5%, 0.1% and 0.3%, in that order. All these growth numbers were higher than expected by market participants, but remain well below historical standards for robustness.

Yet, the modest macroeconomic growth rates have not translated into higher corporate earnings. The lack of corporate earnings growth is concerning, since earnings growth and interest rates together comprise the ultimate drivers of equity market valuations. For those European companies that already have announced fourth quarter 2013 results, earnings surprises relative to analyst expectations mostly have been on the negative side. These disappointing earnings results have come after Q3 earnings already turned out to be exceptionally poor. The current corporate earnings environment in Europe looks grimmer than at any time since 2011, near the peak of the Eurozone crisis.

The disappointing earnings news mostly has been driven by disappointing top-line (sales, revenue) results, rather than increasing costs, as is also true globally. One of the factors hurting many Eurozone companies' sales has been the strong Euro. During 2013, the appreciating Euro has made exports to non-Eurozone regions more expensive. On the cost side of the equation, the picture looks more promising. On average, European corporations have been successfully cutting costs, and have had particular success in cutting labor costs. While this is encouraging, cost cuts have not been sufficiently high in most cases to improve profit margins, which remain depressed and far below their long-term averages. Analysts also have seen a divide between European companies that are exposed to emerging markets, versus those that are more exposed to Europe itself. The former set has performed relatively worse from an earnings point of view, due to continuing difficulties and uncertainties on the emerging markets side.

Some analysts believe that corporate earnings in Europe have now bottomed out and that the marginally improved macroeconomic environment in the region will soon show up in companies' bottom lines. It remains to be seen whether those expectations are going to materialize. In our framework, extremely preliminary evidence that fundamental support is gaining a foothold to support valuations emerged early in 2014.

Most of the headlines on Europe over the last few weeks have focused on the political developments in Italy, where a new prime minister, Matteo Renzi, has just been sworn in. He is the youngest prime minister in Italy's history. His government is dominated by center-left democrats with only a few government members that one would classify as center-right. Mr. Renzi was forced to rely on these members as coalition partners in order to secure a majority in parliament. Mr. Renzi faces huge challenges and will have to climb a steep learning curve since, as a former mayor of the city of Florence, he does not have any political experience at the national or international levels.

Italy faces monumental challenges. Compared to other members of the Eurozone periphery, Italy has made relatively little progress in response to the crisis. The country is just starting to emerge slowly from its longest post-war recession and continues to suffer youth unemployment at record levels. Moreover, Italy's debt remains burdensome, at 133% of its gross domestic product, which is the second-highest level within the Eurozone after Greece. Despite this astronomical debt level, Italy's borrowing costs recently have fallen to an eight-year low, as the rating agency Moody's dropped its negative outlook for the country. One needs to keep in mind that, despite this being a positive sign, Italy's low borrowing costs are mainly a reflection of the fact that the European Central Bank (ECB) stands behind the country with a guarantee to provide whatever emergency support might be needed. Among all the positive rhetoric that has resurfaced recently with regard to the Eurozone periphery, the region's critical dependence on ECB guarantees cannot be stressed enough. ECB guarantees are not going to be sustainable for the indefinite future.

Will Mr. Renzi be able to turn things around in Italy? In our opinion the chances of that happening are extremely slim. Despite his youth and goodwill, Mr. Renzi has very little relevant political experience. Moreover, he is a left-leaning social democrat, a background that one would not commonly associate with the tough economic reforms needed to revive the economy. One of Italy's first and foremost problems remains the reduction of the country's massive debt level. This objective is very hard to reconcile with socialistic values. Another problem in Italy is that archaic industry and labor structures need to be broken up. At the top of that list is curbing the demands of labor unions. Again, we remain highly doubtful whether the current prime minister has the credentials and the political will to credibly pursue these necessary tasks.

Pivoting to Spain, we recently liquidated the small equity exposure to that country's equity market established last month in our Country Rotation Portfolio after realizing a significant profit. Spain has made considerably more progress in resolving the current crisis than Italy. The country has regained access to global financial markets and, in fact, corporate bond issuance in the country in 2013 had been up to a four-year high.

Even so, we believe that the progress Spain has made on the road to recovery now mostly has been priced into its equity market. The country is expected to see its budget deficit rise next year to 6.5%, rather than fall. It therefore is very unlikely that the country will reach the 3% limit by 2016 mandated by EU rules. In a sign of desperation, the E.U. is now contemplating easing these rules. There is a tiny bit of good news in Spain, in the sense that employment figures have just risen for the first time since 2008, but the increase has been very small and it will take a long time for the country to return to normal employment level given that overall unemployment remains near 25% and youth unemployment approximates 50%.

Also reflected in recent portfolio activity, on the back of strong gains in the equity market there we liquidated our U.K. equity position, also at a significant profit. In general, Britain's economic recovery remains on track, despite a few slight disappointments that just came out over the past week. Retail sales in the U.K. were down January, the government surplus fell, and the unemployment rate rose slightly over January from 7.1 to 7.2%. While these developments have been relatively minor and are unlikely to put the economic recovery at risk, they remind us to retain a sense of caution. Although the European economy is gradually recovering, progress is unlikely to prove steady. There will be many bumps in the road ahead and considerable risks remain as myriad fundamental issues have not been resolved. We continue to monitor the region for attractive beta exposures, and to ascertain whether recent trends in fundamentals evident in our framework transition into solid support for valuations.

EASTERN EUROPE

Eastern Europe has proved a hotbed of geopolitical activity as Ukraine has become a battleground between Western and Russian influences. Events continue to unfold at a fast pace, but the Baltic country continues to be on the brink of collapse. Developments over the past month have included the ousting of former president Viktor Yanukovich, the appointment of Arseniy Yatseniuk as the new president, the overtaking of the Crimea region capital by pro-Russian Separatists, and the surprise of Russian military exercises in the region.

While, economically speaking, Ukraine is of marginal importance, the spill-over effect of uncertainty throughout the region has been significant. Potential impacts to the E.U. include increased oil prices, since Russian oil flows through the Ukraine to Western Europe. Additionally, escalation of the tension could disrupt regional trade, which could have significant impacts on growth. We continue to monitor the events and assess their capital market implications, especially in light of the beta exposure we maintain to Russia. Political risk is always an exogenous factor that cannot be modeled. Many countries are more prone to these kinds of risk, a long list that includes Russia, Egypt and Israel. Some of these political events also have a global effect.

Additionally, we maintain emerging market debt exposures that are impacted by these events. In the context of our quantitative framework, Russian equity markets continue to be attractively valued. As they have been impacted adversely by the situation in the Ukraine has further compressed valuations, but the underlying fundamental support remains. Although we not see neither a quick nor an easy solution to the unrest, at current levels this continues to be an attractive exposure, despite the geopolitical risk.

ASIA PACIFIC

The major themes we have highlighted in recent months continue to dominate the investment landscape in China. The systemic risks posed by the shadow banking system remain of major concern. Local governments and infrastructure investments both heavily depend on these trusts for financing. Chinese equity markets reacted negatively to news this week that the PBOC continues to drain liquidity from the lending market, increasing concerns of a crisis. Across the country, signs of tightening credit conditions are evident as mainland banks reportedly are scaling back on loans to property developers.

The Yuan has come under pressure this month, ending the perception that the currency is a one-way bet. In fact, during this past week, the Yuan experienced its largest one-day decline since 2008 as speculation runs rampant that the currency will no longer exhibit unidirectional volatility, meaning that depreciation is a possibility. Although the official story from the PBOC is that “market forces” are behind the currency fluctuations, manipulative actions by the PBOC are behind these currency moves. The PBOC, it is widely reported, has orchestrated these currency moves through state-owned banks, which it directed to purchase dollars. Such a move could have the effect of introducing volatility, which would alleviate upward pressure on the Yuan if traders change their expectations such that they believe the Yuan depreciating relative to the dollar is a possibility. The reaction to these events has been muted, since market participants largely believe the PBOC remains in control of the currency and the impact of a wider trading range to be minimal.

Recent data releases indicate China’s property values, although exhibiting nearly 10% year-over-year increases, may be coming under pressure. First, January one-month appreciation came in below expectations, with the rate of gain slowest in large cities. Second, many areas, primarily smaller cities, continue to face excess supply and there are cases where developers are cutting prices in attempts to move their inventory. Third, multiple sources have highlighted that mainland banks are dramatically reducing their lending to property developers, a further sign of trouble ahead for this sector. It is reasonable to expect these price cuts to put downward pressure on other similar properties. Together, these present significant headwinds to the property market, a significant part of the domestic investment component that has been such a critical component of economic growth.

The transformation of China’s economy from one driven by and highly dependent on investment to one that is more balanced and in which domestic consumer demand plays a larger role has yet to gain momentum. This fact, combined with concerns over the sustainability of growth that is tied to investment results in heightened concerns about whether the projected rate of economic growth is achievable. According to the Politburo, the economy remains on track to match current economic growth forecasts, despite the numerous concerns regarding the ability of the economy to sustain those elevated growth rates. Given the lack of domestic consumption growth, the impact of tighter lending on the construction and property sectors, growth expectations fall squarely on the shoulders of exports. This remains a tall order given the low levels of income growth seen in China’s trading partners.

Overall, the Chinese macroeconomic backdrop supports the view of our quantitative framework. A potential exposure to the Chinese equities at current levels does not appear favorable, although this is an exposure we monitor closely and the framework's score is in the neutral zone. Overall, the framework's neutral to negative scoring combined with the uncertainty posed by the many systemic risks facing China's economy lead the Investment Committee to require more evidence that China will be able to avert economic crisis and achieve sustainable growth before adding this exposure to the portfolios.

We continue to hold Japanese beta exposure in the Country Rotation Portfolio. February was a volatile month for Japanese equities as valuations initially came under pressure, along with virtually all equities globally. Japan, in particular, was hurt by a larger-than-expected trade deficit and currency fluctuations. Japanese equities also have come under pressure this month on concerning news flows from China, one of Japan's largest trading partners, as summarized above. Even so, our quantitative framework remains favorable toward the Japanese equities market, as the levels and dynamics of fundamentals remain strong. In light of this support, we took advantage of recent volatility to increase our allocation to this market.

Japan's increasing trade deficit at first glance is surprising given the extensive quantitative easing under-taken by the Bank of Japan (BoJ) at the direction of Prime Minister Abe with the intent of devaluing the Yen and benefitting exports. Japan, however, still suffers from structural issues in the energy sector following the nuclear disaster. Although Japan is in the process of reviving nuclear energy as a major source of electricity, the country has been forced to rely on imports of oil and natural gas in its absence. In fact, annual increases in Japan's imports of both oil and natural gas have exceeded 20%. Thus, the dependence on energy imports has made imports highly inelastic to the Yen's depreciation, which has the impact of widening the trade gap. However, there is growing domestic interest in lowering Japan's dependence on nuclear energy. Should such sentiment gain traction, it has the potential to be a drag on economic growth through exports, unless export growth is somehow not reliant on energy as a factor input. In our view, increasing domestic nuclear power to pre-Fukushima disaster output levels is critical to Japan's economic growth.

With Japan's controversial sales tax increase scheduled to take effect on April 1, the Bank of Japan is in a holding pattern regarding whether additional monetary easing efforts are required. Although policy makers estimate the sales tax will not have a meaningful impact on consumer spending, and thus on economic growth, its actual impact remains to be seen. Additional stimulus efforts are unlikely until the effects of the sales tax increase become apparent.

A significant event in Australian capital markets during the past month is the end of nearly two years of monetary easing by the Royal Bank of Australia (RBA). Through several rate cuts, the RBA had lowered the benchmark rate to 2.5%. This policy decision had been directed primarily at spurring the domestic housing and construction industry, as well as providing assistance to the country's manufacturing sector. The mining and natural resource sectors of the Australian economy have been the primary engine of economic activity over the last decade, benefitting tremendously from emerging market, predominantly China, demand for raw materials. The appreciation of the Australian Dollar has been adversarial to other sectors of the Australian economy, hurting manufacturers and leading to job losses at economically important multinationals. Analysts had expected the RBA to end its bias towards easing, but did not expect the RBA to drop language referencing an "uncomfortably high rate of exchange" for the Australian dollar. That they chose to note that the depreciation of the Australian Dollar relative to other major currencies has brought it into a comfortable range amenable to balanced growth, is significant and shifts expectations away from further easing toward a stronger Australian dollar and stronger growth over the medium to longer horizons. In light of these important developments, we continue to monitor the Australian equity market for opportunities. Thus far, our quantitative framework remains negative on Australia's return prospects compared to opportunities in fixed income markets. Despite the policy stance, and the more favorable exchange rate, current valuation levels remain too elevated relative to the underlying fundamental support.

We continue to expose the Country Rotation Portfolio to the Singapore equity markets. Our quantitative framework remains positive on Singapore, where solid fundamentals support current valuation levels. This exposure has withstood the recent market volatility, and continues to offer attractive risk-adjusted returns. Singapore's impeccable sovereign credit rating and enviable positioning to benefit from, but not be grossly dependent upon, growth throughout other Asian economies makes this an attractive exposure.

We eliminated Hong Kong from the portfolio during the past month. We added a small allocation to Hong Kong early in the month during the intense sell-off in global equity markets that was lead primarily by emerging markets and concerns over political unrest throughout many developing economies. In the view of the Investment Committee, and supported by the quantitative framework, the declines in the Hong Kong equity market were unjustified and the fundamental support underlying valuations remained solid. Over the course of the month, we saw Hong Kong valuations return to more normal levels as volatility subsided and global equity markets recovered. Thus, toward month end, the framework began reflecting that the valuations had expanded to the point where locking in the gain became prudent as the return to risk profile was no longer superiorly attractive compared to the opportunities in fixed income markets.

LATIN AND SOUTH AMERICA

Valuations in many of the equity markets in this region have endured sustained pressure during this past month. In addition to the global economic issues outlined above, this region faces its own set of concerns ranging from the devaluation of the Argentinian Peso to the protests that divide Venezuela.

Until recently the regional model of Marxism, Venezuela is mired in political unrest. The population of Venezuela is heavily polarized and violent protests rage. Despite resorting to violent tactics, President Nicolás Maduro has been unable to quiet the unrest. Venezuela faces high inflation, in excess of 60% annually, and a governmental default is becoming increasingly likely. On the social and humanitarian side, the situation is increasingly dire as medicines and supplies are in short supply. As the situation there grows increasingly critical, the region seems to be shifting in ideology away from the socialist model towards more centrist models.

Despite the situations in Argentina and Venezuela, there are bright spots across the region. The more moderate countries and those having market-oriented economies are better positioned, both politically and economically. In fact, there have been positive regional developments, including the Pacific Alliance trade pact. Such developments, which are focused on the region's mutual interest in trade and investment, are part of why we maintain exposures in the Country Rotation Portfolio to Peru. Our quantitative framework continues to view this exposure favorably. Despite the regional volatility and the volatility seen across all emerging markets, the Peruvian market has not seen the same valuation declines and has exhibited lower volatility, consistent with the framework's assessment that current valuations present attractive opportunities.

The largest economy in this region, Brazil continues to be mired in low economic growth of approximately 2%, struggle with high inflation and suffer domestic unrest. Despite compressed valuations, the framework remains negative on the Brazilian equity market at present. Across the board there have been negative headlines on the Brazilian economy, including warnings from major automakers that sales will come in under expectations, weakness in China's manufacturing sector, which impacts Brazil's exports of raw materials, as well as very dry conditions during January that have had deleterious impact on Brazil's economically vital sugar and coffee crops. Given the high level of volatility in this market, we continue to monitor the framework for signs of fundamental support.

As events unfold across this region, we expect significant market volatility to persist, and we continue to monitor these events for attractive opportunities. This is especially true for markets such as Peru, which may become undervalued and present attractive opportunities as they suffer from the negative externalities associated with the turmoil in neighboring countries.

FIXED INCOME

Our investment framework compares the attractiveness of equity beta exposures to the risk-adjusted return opportunities in fixed income markets. During market periods such as the present when our portfolios are positioned heavily in fixed income exposures, our decisions to allocate within the fixed income space become even more important. We continue to position the portfolios defensively relative to the duration exposure of the benchmark index. This decision reflects the Committee's view that benchmark rates, and particularly key rates on the longer end of the term structure, will increase over the course of this year. Such a view is consistent with the reduced demand for longer-term bonds due to the Fed's tapering of its asset purchases, the eventual inflationary effects of balance sheet reduction by the Fed, the incredibly high amounts of money in the reserve system, and the continued need for the U.S. government to finance its debts.

Our Fixed Income Portfolio is diversified across sectors, both domestically and internationally. The portfolios are lighter on duration relative to the benchmark, but we have enhanced the portfolio yield by under-weighting low-yielding U.S. Treasury bonds and increasing allocations to carefully selected credit sectors. Our recent analysis highlights that the yield-to-duration trade-off is most attractive toward the shorter end of the curve.

Taking advantage of opportunities when they arise requires the ability to liquidate portions of our fixed income allocations quickly. For this reason, another facet of our decision making considers the liquidity of our Fixed Income Portfolio. To ensure we have the flexibility to capitalize on tactical opportunities, the portfolio includes highly liquid fixed income positions that trade easily and provide us the needed liquidity in virtually all market conditions. Two such exposures include short-term corporate bonds and short-term floating rate bonds.

The investment team continually scours the ETF product space for new fixed income exposures. Each new ETF is thoroughly vetted for liquidity, yield and risk. We consider each fixed income ETF in the context of our current portfolio and evaluate that ETF's contribution to the portfolio yield (net of expenses), duration risk, credit spread exposure and liquidity.

CONCLUSION

Recent global equity market volatility brought significant opportunities for us to add beta exposures to the portfolios. A slew of global economic growth concerns from China to the U.S., in addition to exogenous geopolitical events continue to dominate the investment landscape. In such market environments, tactical opportunities will continue to present.

Our quantitative investment framework captures the fundamentals and risk characteristics of equity markets. While this framework is adept at identifying attractive capital market environments, geopolitical risks are impossible to model and are unpredictable. Avoiding geopolitical events entirely is impossible. In some cases, our portfolio positions are exposed directly to these events, as is the case of our Russia exposure. In other cases, geopolitical events may impose externalities on our portfolio holdings, such as is the case for Peru given its proximity to Venezuela and Argentina. When these events transpire, understanding the capital market implications is critical to ascertaining whether or not the disruptions they impose on markets are opportunities for gaining exposures at attractive levels. In both of these cases, we remain confident that current valuations present opportunities for superior returns and continue to expose the portfolios to these positions.

Looking ahead, we continue to monitor the global investment landscape, responding tactically to opportunities that arise. Opportunities could arise in Europe on a very selective basis. In cases where valuations are over-extended, a correction that is not accompanied by deterioration in the underlying fundamentals would present opportunities for additional beta exposures. Such examples include Germany, France or Sweden in the Eurozone. In other cases, as current exposures continue to emerge in the framework, we expect to increase our allocations. In Latin America, some of the ongoing turmoil from which even the more politically stable and market-oriented economies continue to suffer will likely create investment opportunities going forward.

IMPORTANT INFORMATION

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