



Forecast 2014



About the Author

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Mr. Crespo has over thirty years of experience developing real estate, structuring innovative funding strategies and building complex infrastructure, commercial, industrial, and institutional projects. He is a Florida State Certified General Contractor and has developed over 18 million square feet of commercial and industrial facilities in 17 countries. He developed the financial model for the first airport privatization project in the world based on the concept of build, operate, and transfer.

Mr. Crespo holds a Bachelors of Science Degree and a Masters of Science Degree in System Development and Integration from Indiana University at Bloomington, and a Masters of Science Degree in Financial Management from the University of London. He is an active member of the Charter Financial Analysts Institute, the Associated General Contractors of America, and the Construction Management Association of America.

***"It was the best of times,
it was the worst of times..."***

Nothing describes the binary performance of markets in 2013 and the expectations for 2014 like the opening sentence to Charles Dickens' ***A Tale of Two Cities***. This was a terrific year for equities and one of the worst in 40 years for bonds. But as the stock market blazed along, the economy did not come close to realizing the expectations of over 3% growth forecasted by the Federal Reserve and most analysts. The euphoric cries from Wall Street were not heard elsewhere.

The optimists claim it was the best of times and point to favorable economic data:

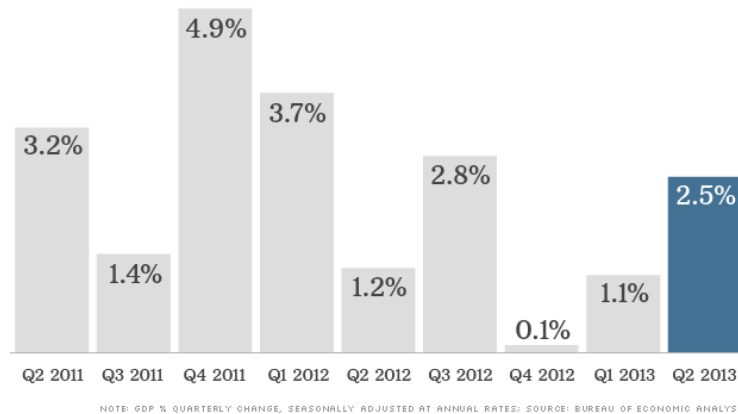
- The economy is growing
- Stock markets are at record highs
- There is practically no inflation
- Interest rates are low and the Fed will continue its accommodative position
- Unemployment is down to 7%
- Housing is recovering

Indeed, all these claims are true and positive, so what is the problem with the other half? We will look at each topic with a more in depth analysis of what the data really tells us.

Economic Growth

The economy grew at an annual real rate (after inflation) of 1.1% in Q1, 1.7% in Q2, and 2.5% in Q3. On average, this represents a real annual growth rate of 1.77%; almost half the expected rate of growth by the Federal Reserve and grossly below trend of 3.0%. While it is expected that Q4 real GDP will be higher (some predict as high as 4.0% growth on annual basis), the preliminary results from Christmas retail sales are not that optimistic. My expectation is that Q4 real GDP after revisions will be in the 2.8 – 3.0% range, making the real GDP for 2013 a menial 2% at best.

A 2% real GDP growth is perhaps the best rate of growth in developed economies, but it is not enough to improve our economic condition and reduce the real unemployment rate and the country's deficit. When you consider that the Fed has injected \$1.04 trillion into the economy in the form of Asset Purchases alone (Long Maturity Treasuries and Mortgage Back Securities), the equivalent of 6% of the total annual GDP, and all that liquidity can only produce 2% growth, you can see how many people will be uncomfortable with the growth figures. Is this economy strong enough to maintain or increase this rate of growth without Fed support? I don't think so, yet the Fed has little choice but to continue to taper the purchases of long-term bonds (see my Brief on The Fed and Janet Yellen dated Dec/13/2013), increasing the burden on economic growth.



average. The down side of this argument is that the markets should be discounting future earnings to reach fundamental valuations and these earnings figures are suspect.

While public companies have, by and large, met or exceeded earnings expectation in every quarter, two issues cause concerns: earnings expectations have been consistently lowered every quarter, and while

they have met or beat earnings, they have mostly failed to grow revenues. The earnings have been achieved by corporate austerity measures and demanding higher productivity from the workforce. Earnings increased by 9.6% in 2013 while revenues increased by only 2.7%. You cannot sustain 30% growth in S&P 500 Valuations in a 2% GDP growth economy by cutting costs without increasing revenues, and global demand is weakening.

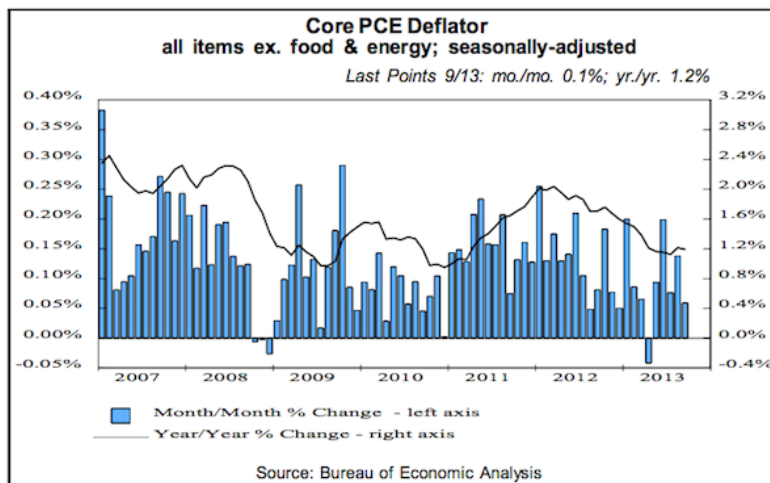
Stock Markets are at Record Highs

There is no question that the equity markets have exploded. This was the only possible outcome to the Fed buying 90% of all government treasury and the GSE's (Fannie, Freddy, and FHA) Mortgage Back Securities (MBS). They pushed the yield on the bonds to negative real rates, forcing all investors to move into higher risk equities whether they can afford the risk or not. But, do these valuations make sense? Are they sustainable?

The stock markets have been propelled by higher earnings, and if you look simply at the markets' price to earnings ratios (PE) the case can be made that the market is fairly priced at approximately 16.5 times 2014 earnings, close to the historical

It is my belief that unless we can increase economic growth and sales revenues, the S&P earnings have peaked and will drop, raising the PE ratio and forcing the revaluation equities lower. CEO's are preempting this effect by increasing dividends and buying back stocks. Increasing dividends help support stock prices as shareholders at least receive some compensation while they wait for better times, and reducing the number of shares outstanding will increase the earnings per share and support

the PE valuations. However, these actions have limited impact and duration as it is strictly financial engineering and not better performance. In fact, it bodes negatively for future expectations since it indicates that executives cannot find investment opportunities that can exceed their current



extremely low cost of capital, opting to return money to their investors in lieu of investing for growth.

The Lack of Inflation

This is a phenomenon that must keep the Fed Chairman awake at night. How is it possible that after injecting over \$3 Trillion into the economy inflation, as measured by the Fed's preferred PCE method, continues to track below target at 1.7%, with core PCE at barely 1.2%. The reason is lack of velocity of the money supply.

According to the tenant of Monetarist Economist developed by Milton Friedman, The Theory of Quantity of Money, inflation is strictly a money supply issue. This is expressed by his classic formula:

$$(Money) (Velocity) = (Inflation) (GDP)$$

Since GDP is not influenced by the supply of money or its velocity [GDP = Consumer Spending + Investments + Gov. Spending + (Exports - Imports)] then the impact of the increase in the money supply and velocity will be directly on the rate of inflation.

With \$3 trillion in additional money supplied to the economy you would expect increased inflation, but it has not happened. The reason is that lack of confidence, uncertainty about fiscal policies, and taxation makes investment outcomes unreliable and the risk premium required for investments much higher; thereby reducing the pool of potential projects that can pass the threshold of required returns.

The increased regulatory environment on the banking sector has created a similar condition for banks, who favor only the safest investments, in essence, rationing credit. The result has been that banks prefer to keep their funds deposited with the Federal Reserve earning a low rate of return but requiring no

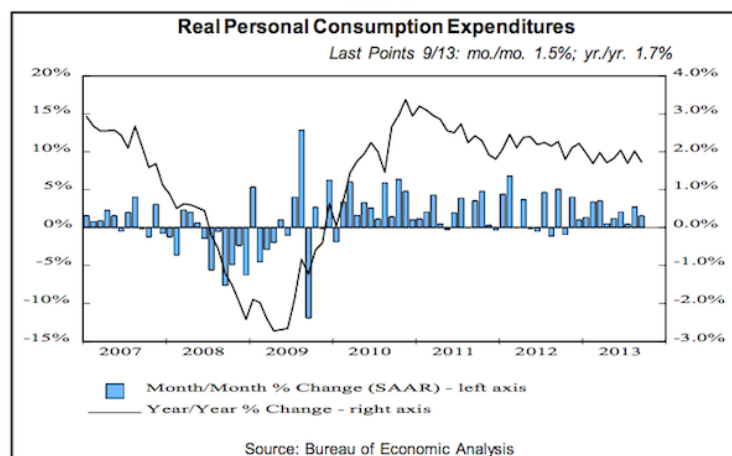
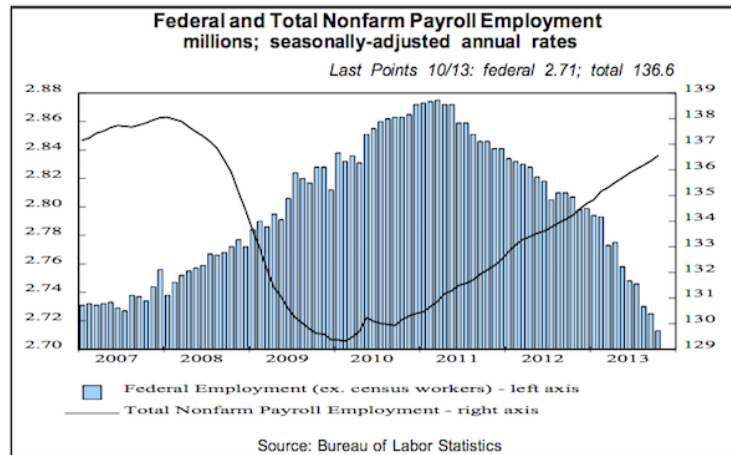
reserves and with zero risk. Consequently there is no monetary velocity; money is not moving throughout the economy.

Low rates of inflation can be a good thing at certain levels and a bad thing at others. Too low an inflation rate runs the risk of a recession or a depression resulting from any economic shock. High rates of inflation are detrimental because they reduce the purchasing power of currencies, increases the tax burden on society and forces the Fed to tighten monetary policy, restricting economic growth.

The Fed will be forced to continue an accommodative monetary policy to overcome the lack of proper fiscal policies to fix our structural economic problems but these policies come with a high level of risk. At some point all the money printed will gain velocity

and the Fed will have to start removing all those trillions of dollars from the economy, causing a contraction. The faster the rate of increased money velocity, the more drastic a policy change will be required by the Feds, leading to drastic volatility and instability in the markets and the economy.

Another possible outcome is that the rest of the world loses confidence in the value of the US Dollar



and starts dumping dollars and investments denominated in dollars in favor of other currencies, including gold. In this latter case you could have massive inflation even without money velocity. None of these outcomes are positive for the economy.

Interest Rates are Low and the Fed Continues Its Accommodative Policy

The Fed already started tapering their purchase of government securities and the long end of the curve is rising. The 10 year bond rate has already climbed to 3%, leading to the collapse of mortgage applications. As the Feds continue tapering, we will see where the real rates are and all financial valuation will reset accordingly.

While interest rates are low now, the Fed has insisted that their policies are data dependent, meaning that they can reverse that policy at any time. Certainly, that also means that they could go back to unconventional policies, like buying long term bonds again, if economic conditions warrant it; but the long-term consequences of that are dire. There simply is no free lunch. What you gain today with these heroic policies you pay with greater risk for the future. So the question becomes one of proper valuation of the risk and what risk premium to demand from investments. In other words, more uncertainty and less economic activity.

Unemployment is Falling. Currently at 7%

This statistic is fraught with spurious correlations and misleading information. The way the unemployment survey is conducted leads to many

inconsistencies and wrong assumptions. While the rate has been dropping, it has not been because of more people being employed, but rather more people leaving the work force, either

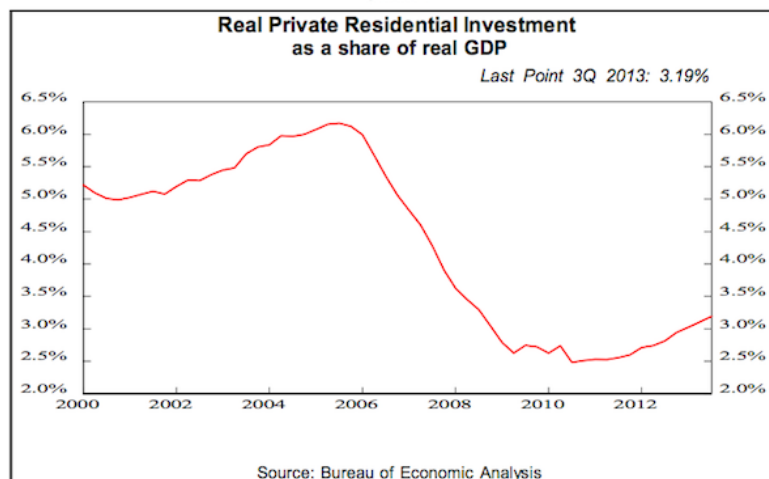
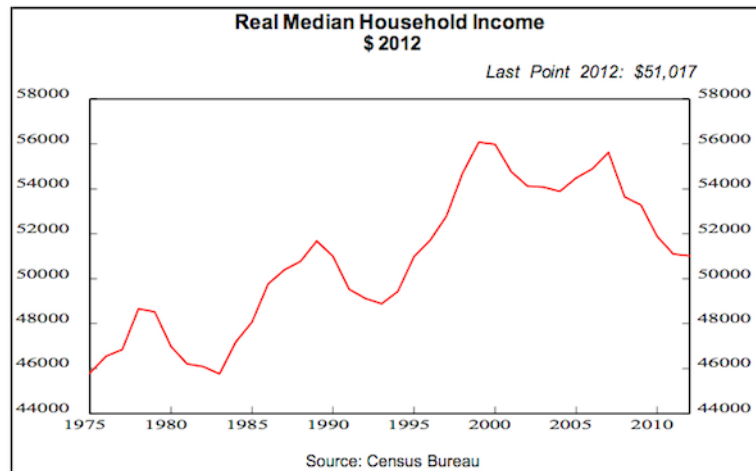
through retirement, claiming disability, or flat out frustration in not finding a job. Since 2009 thirteen million workers have claimed disability; roughly twice the number of jobs created in the economy since. Our population increases by 3 million every year, requiring a minimum of 2.6 million new jobs just to employ the new entries to the work force. However, new workers looking for jobs are not counted as unemployed because they must have

lost a job first before they can be counted as unemployed.

The weakness in the job market is amplified by the fact that the majority of the jobs created over the last 4 years have been in low wage industries such as hospitality, fast food, and retailing.

Three quarter of the populations thinks we are still in a recession; this is perhaps due to the fact that while the average income of the top 20% by income has risen 6% since 2008 in real terms, the middle quintile gained just 2%, and the bottom 29% are still below their pre-recession peak. In the decade from 2002 to 2012 the bottom 90% of income earners lost 10.7% of their income in real terms.

While there are many structural issues at the foundation of this issue such as globalization, demographic shifts, and skill gaps, we cannot fail to accept that we face a global competitive environment that pits US labor against machines and workers from developing economies, at a far lower cost. Still, U.S. fiscal policies continue to worsen the situation. An example of this



fiscal policy drag on employment is the impact expected from Obamacare on employment, which will force small employers to reduce employment below 50 workers, or depend on a part-time work force.

The data that best capture the crisis nature of the unemployment issue is the labor participation rate which currently is at 63%, the lowest since 1979. This is the reason why Janet Yellen has said that she will continue monetary accommodation beyond the announced 6.5% unemployment subject to the total resource utilization, meaning the participation rate. The low participation rate swells the welfare rolls, increases government spending,

and reduces government revenues as fewer workers are paying taxes. This leads to a bigger deficit and the call for either reducing welfare spending or increasing taxes, both politically difficult decisions especially in a mid-term election year. Increasing taxes in a fragile economy reduces economic growth and reducing welfare spending could lead to social instability. Again, there is no free lunch.

Producers compete in a global environment and have a duty to stay in business, for which they have to remain competitive. The higher marginal tax rates, expensive regulatory system, fiscal and monetary uncertainty, and high cost of production demand that employers look at forms of labor substitution through, automation, outsourcing, or flat-out foreign production in order to survive. The net result of these survival options is an extreme bimodal distribution of income, where you only have winners and losers. The winners get all and the losers resort to the government to support them.

The Housing Recovery

While the price of existing homes has risen, mostly due to lack of supply as investors bought thousands of foreclosures, and sellers are waiting for price appreciation to match their mortgage balance, total housing sales are slowing down.

A true housing recovery depends on increased jobs, higher wages, and lower interest rates. While unemployment rates have dropped, the employment reality, as discussed earlier, is

not positive.

Particularly impacted are the Echo boomers and millennials who are saddled with high educational debt, a poor job market and wages that are not rising. As we start to see the long-end of the yield curve steepen in response to the tapering, we can

only expect it to have a negative effect on housing affordability.

Not only are mortgage rates going up but they will be harder to get. FannieMae is changing their policies starting in 2014 and they are not just lowering the maximum price of home mortgage that qualifies for Fannie's mortgage, but they are increasing the underwriting standards. Bank do not issue mortgages for their own account since the long term interest rate risk is too high. But Dodd-Frank and

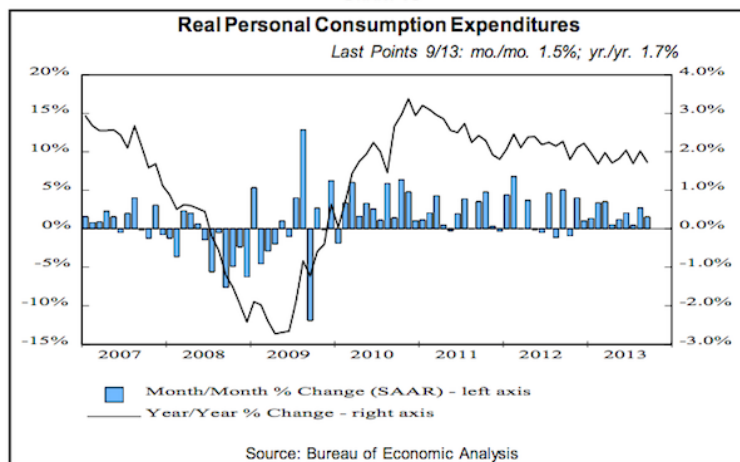
Basel-III increases the banks' cost and risk of issuing mortgages. The result is a major head-wind for housing in spite increase demand.

What to expect for 2014

Contrary to the political rhetoric, we are still deleveraging, especially in the global financial sector and among the US consumers, evidence to this regard is the lackluster GDP growth following the Global monetary expansion. We still have another 4 to 5 years of deleveraging to go. Until then, annual economic growth in the 2% range is all we can expect.

Small business sentiment has fallen recently. The percentage of companies expecting economic improvement dropped from -2 to -10 from August to September, and reached a lower rate of -17 in October, as reported by the NBSB. Companies expecting higher sales dropped from +8 to +2. All other components of the NBSB survey; investment climate, hiring plans, capital spending intentions, inventories, inflation, and plans to raise wages and prices also dropped.

The slow growth rates are not unique to the US; they are global. The International Monetary Fund issued its sixth consecutive global economic forecast downgrade recently to 2.9% in 2013 and to a meager 3.6% in 2014. Hardest hit were developing economies whose 2013 growth forecast was reduced to 5%, stating as the reason the drying up of years of cheap liquidity, competitive constraints, and slowing investments. The IMF cut



its 2014 forecast for China from 7.8% to 7.3% and for the US from 2.8% to 2.6%. On a fundamental analysis basis, given the information at hand today, the IMF forecasts seem more realistic than those of the Federal Reserve.

For the economy to grow faster than 2% a year, I believe that we need to incentivize industry to invest. Of all the components of GDP, investment is the only one that is capable of improvement.

Consumers are deleveraging; their share of GDP has dropped from 68% to 65% in 2013, and for next year they face higher taxes, and a potential increase in the cost of living of as much as 20% just from Obamacare. Consumer spending cannot be the catalyst for growth.

Government spending cannot increase either. In fact, it is dropping and needs to drop further. With a \$1 trillion yearly deficit and an \$18 trillion debt, government cannot be the source of economic growth.

Exports cannot increase enough to surpass imports, so net export will always be a negative on the GDP ledger.

The only possibility for real growth is corporate investments. Fortunately, corporations have over \$4 trillion in cash earning zero returns right now. Imagine the impact of this amount of money coming back to the US, investing in plants, equipment and R&D. With a multiplying effect of 2 or 3 times, it would explode GDP, lower unemployment, balance the current account deficit, and lower the national debt in a very short time. Unfortunately, this strategy has limited probabilities of success due to politicians' focus on wealth distribution rather than wealth enhancement.

Investment Outlook for 2014

Due to all the monetary manipulation taking place globally, I have devised models that no longer are based strictly on mathematical, economic and financial fundamental. The reason is that the massive intervention of the global monetary authorities has completely distorted any semblance of fundamental valuation and rational decision making. Much of what you see today can be construed as completely irrational behavior which is a tenant of fundamental valuations. However, shorting these markets and betting against Bernanke has proved to be suicidal. Therefore, I have developed expectations based on both rational financial expectations as well as behavioral based expectations.

The case for Equities

Fundamentally speaking, based on the analysis stated above, the equity markets have to correct. This correction could

be significant, in the 10-20% range. However, in the words of Richard Yamarone of Bloomberg, the current condition resembles an overweight man on a street corner drinking and smoking. You know this condition will not end well, but you can't predict when he will drop dead. I would add that this gentleman is also being administered IVs, and medications by the Feds to keep him standing; in essence simply postponing the inevitable.

The only case for jumping into this equity market, in my view, can only be justified on a behavioral basis. Opportunity cost is basically zero, Yellen will keep liquidity flowing, and most of the money managers are bullish and putting money in. I must add that money managers are paid to invest, not to sit on money, so they have little choice but to invest in something. There also is tremendous amount of cash earning nothing that could come into the market from retail investors, partly because, as we know from Tversky and Kahneman, investors facing losses become risk seekers. Add to this the frame dependence being promoted by the financial media and you have a powerful behavioral catalyst in the form of an investment bias that can push the markets higher short term. The problem is, what happens when the Fed's music stops? Will you be able to get out the door fast enough? If you chose to follow this approach I would watch the long-term interest rate like a hawk, because as it climbs the risk of a correction will increase. You can also buy put options for protection.

Still, there will be winners as well as loser in the stock market this year. My preferred sectors are energy, MLPs, Midstream Oil companies, and Industrials. However I emphasize the need for in-depth research before buying because even among these sectors there will be big losers as well.

I am not a believer in the "buy and hold" strategy under these conditions. Portfolio managers will use the excuse that they are focused on the long-term so a short term correction of this magnitude would not affect them. I differ. Just imagine the impact it would have over the next 10 or 20 years if you are able to capitalize and purchase the same shares at a 10-20% discount today.

I do not see the current equity market as a market for retailers buying mutual funds or ETFs. Some stocks will still do well but the market as a whole will have a correction and could end 2014 with a minor gain or a loss. You would need to be very selective and buy individual stocks based on in depth analysis, and if possible integrate a hedge strategy using options. These strategies are beyond the capabilities of the typical retail investor so they need to return to using active money managers; of course the problem here is that 85% of money managers underperform their own benchmarks.

Long-short hedge funds should do very well in the coming year since they are very sophisticated and will usually outperform in down markets. Naturally, one issue here is the requirement to qualify as an accredited investor to participate.

The Case for Commercial Real Estate Investing

I can't remember a time when economic fundamentals were more positive for commercial real estate investments. Interest rates are historically low, certain sectors of the market enjoy large unsatisfied demand, there are little if any new products coming into the markets, and we know that when we come out of the deleveraging phase we will see significant inflation pressures.

Additional opportunities can be found among some \$1 trillion in commercial mortgages due to reset over the next few years, many of which are still underwater and not stabilized. Many of these properties could be bought for 50-70% of reconstruction cost. All these conditions are extremely bullish for real estate. The problem is that to enjoy the benefits of the current low interest rates you need a very strong balance sheet. Leverage is limited to 50-65% of the property value and financing for development is practically non-existing. It is no surprise that the ones reaping the benefits of these opportunities are the large REITs and Hedge Funds like Blackstone Group, KKR, Blackrock Investments, Starwood, etc.

Nevertheless, many smaller real estate private equity groups are issuing private placements and raising funds to take advantage of these opportunities, us included. Returns on opportunistic funds have been extremely attractive running an average of 20% Internal Rate of Returns.

I have always looked at real estate as a local phenomenon that behaves like Swiss cheese, meaning that there are a lot of holes in it. Success depends on proper valuation, analysis, modeling and identifying the highest and best use for a property.

Recently multifamily housing has been hot and the prospects for the sector are positive overall but care must be exercised in each market as a lot of capacity is coming on line in many places like South Florida.

Similar to the case with the equity markets, real estate success will depend on identifying the right opportunities and proper execution. The least amount of risk, in my opinion, is targeting opportunities in areas that are demand driven with inelastic demand curves. These are places where jobs are abundant and wages are high and rising. Other opportunities exist in distressed properties, infill, and longer term industrial facilities.

Today, the only sector that I feel comfortable buying and holding for the long-term is commercial real estate in targeted markets.

2014 will be a challenging year, but those challenges will present unique opportunities to those who act rationally and carefully value risk. No longer can you expect the high tide to raise your ship.

Best wishes for a successful and prosperous 2014,

Carlos Crespo