First Quarter 2014

US Economy:

Last year, the US economy grew 4.0% nominally. After subtracting inflation, the real rate of growth was 2.5%. We have written extensively about the positive impact the Federal Reserve's Quantitative Easing (QE) has had on the stock market. By purchasing a majority of US treasury and mortgage supply over the past few years, the Fed forced investors into riskier assets while reducing the overall market volatility.

So what should we expect now that the Federal Reserve is reducing its bond purchases? Beginning late in 2013, the Federal Reserve began reducing its asset purchases by $10B per month. This reduction has occurred after each of three meetings. Their stated intent is to end new bond purchases by the end of 2014. A year ago when QE tapering was rumored, stocks and bonds tanked. Now that tapering is occurring, the capital markets have been relatively flat.

Perhaps the US economy is indeed getting closer to the point where it can stand on its own and not require increasing doses of stimulus. Although the Federal Reserve is reducing the latest QE effort, even after tapering, the Fed will still be extremely accommodative as the proceeds of maturing treasury and mortgage debt from their $4 trillion balance sheet will be used to purchase additional bonds. So QE really isn't going away - new money is not being added. In addition, the Fed stated it intends to keep short term interest rates low for the foreseeable future. These rates are key to capital allocation decisions. As long as rates stay low, corporate debt is inexpensive and profit margins can remain high. As long as rates stay low, savers holding cash are not rewarded and capital will tend to flow to stocks.

Capital Markets:

The US stock market continues to advance even though to begin the quarter it was the second most expensive stock market in the world. The S&P500 declined 6% to begin the quarter, but ended the quarter up 1.8%. After the challenging 2013, US bonds matched the SP500's first quarter return of 1.8%.

Given the Fed policy (QE) appears to have been the key driver of US stock market gains over the past few years, how does the changing Fed policy affect our investment decision making? We continue to believe the US stock market is significantly overpriced. The current Shiller PE of 25+ supports our contention as indicated in the chart below.

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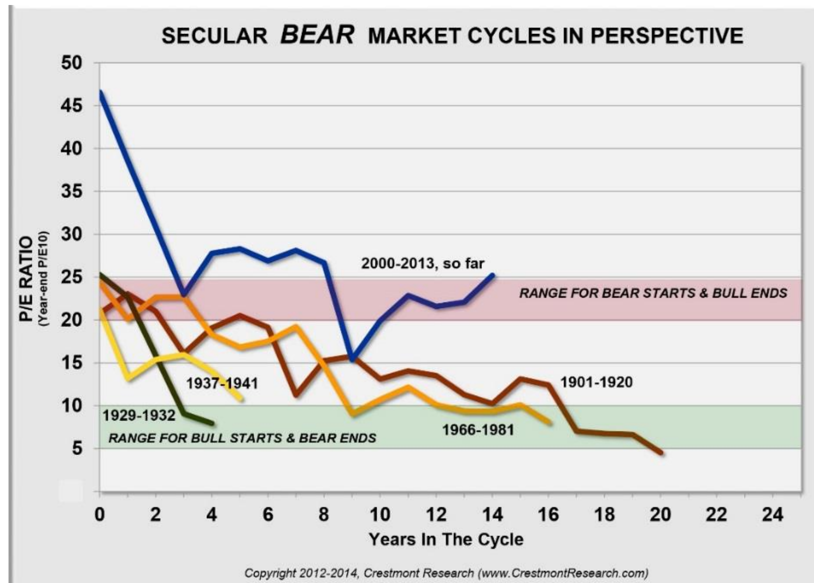

If history provides a roadmap and perspective, bear markets usually began at these current valuations. We have written many times over the past few years about the dangers of buying an overpriced, over-bullish stock market but as the saying goes, "markets can stay irrational longer than investors can stay solvent".

As long as the market demonstrates a desire to advance, our risk management tools will guide us to allocate capital to equities. If and when our indicators tells us that price trends are breaking down, we will mitigate risk and move out of stocks. Of our four primary risk-on/risk-off metrics, two of the four have continued to be risk-on and the two shorter term metrics have vacillated of late. These primarily trend-based indicators have kept us in stocks through Q1 and into Q2. If we experience a significant market correction, our portfolios will be overweight bonds and underweight stocks and along with our managed futures positions, downside risk will be well-mitigated.

Portfolios:

Our primary bond fund, Doubleline Total Return, was up 2.2%. Every year since inception, it has outperformed the bond market. The cheap country allocations (Greece, Ireland & Italy) each performed exceptionally well during the quarter collectively gaining approximately 8%. The natural resource investments (Sprott Resources, Toscana, platinum & palladium) also had a good quarter gaining 3.5% to 10.5%. Holdings uncorrelated to stocks and bonds had mixed performance with 361 Managed Futures up 3.1% and Longboard down 3.7%. The biggest detractors for the quarter were Japan, down 7%, and emerging markets. Our sector model investments were flat for the quarter.

Gold stocks began the year with a 28% gain. After they retreated to a gain of only 18%, we reduced the position. The valuations here are compelling and we still have conviction for gold stocks to be very profitable over the next few years. We will buy again when we see confirmation of an uptrend in price.

Thank you for your continued trust and support.

Trevor Holsinger, Steve Small & Darrin Wolff

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