Verity Asset Management

Market Commentary and Outlook

Core Allocation

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INDEPENDENT ADVICE | ACTIVE MANAGEMENT

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It was a wonderfully dramatic story, terrifying to investors and citizens alike. A deadline at the very last minute of 2012, for which lack of resolution would most certainly mean doomsday--the imposition of draconian measures that would imperil the economy and send us into a catastrophic tailspin.

Never mind that the draconian measures were mandated by an agreement made last year by politicians who anticipated that their collective inability to grow spines virtually guaranteed they would not come up with any other plan to cut government spending prior to the "deadline". Never mind that this notion of cutting the rate of annual increases in government spending (let's not be fooled that there have ever been actual decreases in spending agreed to by any plan) was presumably made in 2011 based on the politicians' acknowledgment of the future unsustainability of the fiscal mess that they have created.

Target Allocation by Asset Class / Strategy

56.5%	Equities
22.0%	Commodity Related
8.0%	Cash
5.5%	Equities - Short
5.0%	Merger Arbitrage
3.0%	Bonds

So this, then, was the all encompassing, banner headline grabbing, nightly lead news story of Q4. The commentators were in agreement--the longer the mess dragged on, the more the markets would plummet. Could the politicians possibly save us from themselves, demonize their former agreement, convince the commentators that more fiscal imprudence absolutely needed to be agreed to before the deadline? I for one could recall only being as terrified as this just prior to the nightmare of Y2K.

And the markets said: "Ho-hum!" They really never doubted for a second that the politicians would immediately dishonor an agreement for government to spend less, for the markets are much smarter than the average journalist or politician. And so the "panic of Q4" was merely a 0.97% quarterly decline in the S&P 500, before apparently resuming the long entrenched uptrend early in 2013.

So what else was of real economic or market importance globally in Q4?

Certainly notable was the continued ascent of the Euro currency. Q4 saw another 2.6% rise against the dollar, extending the dramatic increase that began in July. Is everything peachy keen in Euroland, or are things just continuing to decline structurally in the U.S.? Unfortunately, the world's dirty little secret may be that, to a large extent, all out currency wars have begun, and the primary goal of many developed world central bankers and policy makers is to aggressively devalue their own currency to protect export trade as well as cushion their potentially devastating sovereign debt problems (and maybe elevate local stock markets?). Fundamentals are fundamentally irrelevant. And of course, the currency markets will continue to be of prime importance to nearly every other market in the world.

So strike fundamental analysis from the currency markets and it all becomes--more explainable, or at least it does in the case of Japan for Q4. New prime minister Shinzo Abe makes no bones of his efforts to create massive quantities of new yen. The result was a Q4 yen decline versus the dollar of 13.8%, leading to a 22.5% rise in the Nikkei (the Japanese stock market). Not bad for a country that is an unqualified economic, demographic, debt-laden basket case.

Logically, the upshot of all this money creation along with unsustainable sovereign debt must be imminently higher interest rates and inflation, correct? Well maybe, but let's pause to dwell briefly on Spain, where 10 year note yields have fallen from over 7% in July to close 2012 at 5.26%. How? By assuring the bondholders that they will be paid, even via shaky agreements that provide borrowed money, appears to make everybody "happy"--even in a country with astronomical unemployment and plummeting real estate prices.

The perspective that policies may be constructed primarily to satisfy the sovereign bondholders, who are typically other sovereigns and large banks, can put a very different spin on the macroeconomic situation. In that regard, some background among the monetary movers and shakers of the world is worth mulling over. Mario Draghi, head of the ECB, was at one time a managing director at Goldman Sachs International. Jack Lew, the presumed next U.S. Treasury Secretary, served at Citigroup, while his predecessor Tim Geithner, was the protege of Robert Rubin, the former head of Citigroup. Masaaki Shirakawa, governor of the Bank of Japan, was at one time the bank's general manager for the Americas, based in N.Y., where he obviously dealt regularly with the aforementioned U.S. banks.

Connect the dots and you may ultimately see policies of extensive global money creation pursued simultaneously with widespread European-style austerity, with a primary purpose of benefitting bondholders, rather than getting any fiscal houses in order—and connecting those dots results in an investing environment that is foggier than San Francisco Bay on a July morning.

But the beauty of this all is that by focusing intently on the changing nature of the markets and investing in a disciplined manner in themes that make sense for a variety of macroeconomic outcomes, it is possible to extend one's relevant time frame and use the intermittent periods of confusion and volatility to potential advantage.

Our tactical maneuvers in 2012, and specifically in Q4, were largely an extension of themes and tactics that have been well documented in our commentaries over past quarters.

--- Early in Q4 we incrementally added to our water related position, which proved to be an area of strength during a relatively flat quarter for the overall domestic equity market.

-- While grains were down substantially in Q4, we continue to see the longer term picture as extremely favorable for the continuation of the uptrend in place since 2005. Over the course of the year the strong general rise in grains compared very favorably to the Reuters Continuous Commodity Index, which was down for the year at - 1.99%.

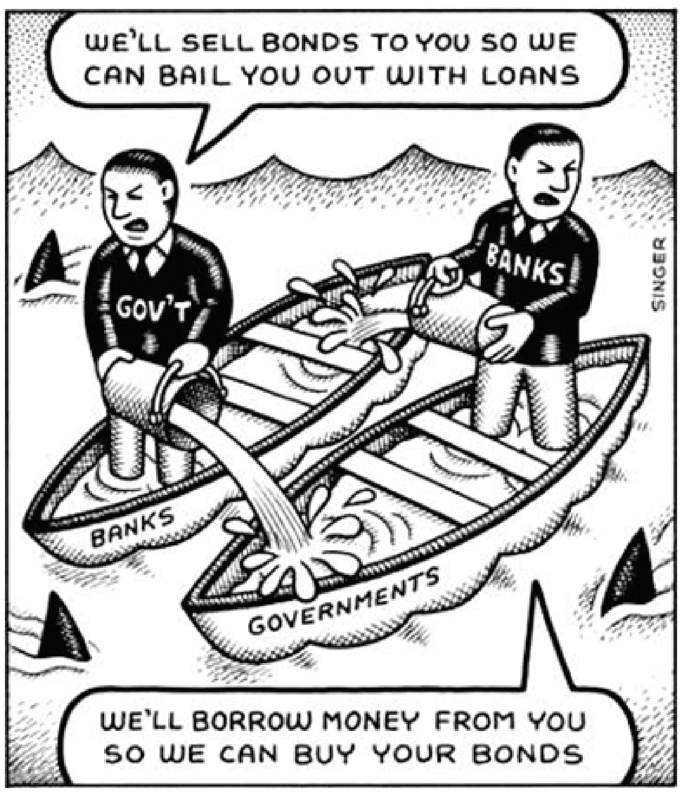
-- After 13 consecutive up years for gold, we see little reason to believe hyperinflation, or some catastrophic economic event, is necessary to justify that gold is worth holding as both an insurance component and legitimate 'hard asset' investment in one's portfolio.

--- In keeping with our strategy of investing in emerging markets with diverse growing economies and relatively sound fiscal and debt structures, we added an equity position in Peru just prior to Q4.

--- And some time around mid year, as the Chinese market declined in response to a very popular belief that China was about to experience a severe economic downturn, we incrementally increased our China holding.

One may further note that amidst all the negative China talk, in a world of near bankrupt developed nations, the latest news from China reports that in 2012 they quadrupled their imports of rice, amassing stockpiles, although they are not suffering from any food shortages. Hmmm.

In closing we'd like to pictorially include the best explanation we have seen this quarter of the current operating policy of the largest developed nations of the world.



We encourage you to review earlier editions of our Market Commentary, which may be found on our website at http://verityinvest.com/investment_management/commentary. Please feel free to contact us for more detailed information and insight into our process and our current thinking about market risks and opportunities.

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