Verity Asset Management

Market Commentary and Outlook

Core Allocation June 30, 2013

INDEPENDENT ADVICE ACTIVE MANAGEMENT

Three Card Bernanke

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Target Allocation by Asset Class / Strategy	
56.5%	Equities
20.0%	Commodity Related
11.5%	Cash
4.0%	Equities - Short
5.0%	Merger Arbitrage
3.0%	Bonds

If you are a tourist visiting New York City, and you find yourself at an outdoor venue populated primarily by other tourists, you have likely been exposed to the confidence/deception game (or scam) known as three card monte. The proprietor, who holds himself out to be operating solo, has usually set up on an easily movable table and is generally surrounded by throngs of observers. The nature of the game is a continuous face down shuffling of three playing cards on the table, with the operator occasionally exposing the queen of hearts so onlookers may attempt to follow that card while the shuffle continues. Periodically, the face down shuffle stops and someone from the crowd confidently bets a significant amount of money that they correctly know where the queen is. They are virtually always correct, and they always get paid. The pattern repeats until at some point someone bets a much larger amount of money and of course, loses, since the operator is always quite adept at sleight of hand. Sometimes the game ends abruptly as law enforcement arrives and everyone scatters. In some sense therefore, three card monte may at least impact positively on the employment of local crowd control professionals.

As the tourists usually comprehend shortly after observing the game, the only people benefiting are the operator and his paid shills, who of course were not really on the up and up when "winning" those bets. After witnessing and coming to understand the true nature of the game, no rational person ever again believes that any three card monte game is anything but a confidence/deception scam.

It has been more than four years since markets bottomed following what is known as the "financial crisis". During this time the monetary policy practiced by central banks throughout the developed world, known as quantitative easing (QE), has escalated in size and scope. A stated purpose of this bond buying program by the central banks, which makes its purchases via money they simply create, is to keep longer term interest rates low in the name of stimulating certain aspects of the economy, which it has been asserted is also in the interest of job creation. Concurrent with the policy as implemented by our Federal Reserve, the U.S. stock market has produced one of the truly impressive rallies in history.

But, is the rally in its more recent stages even remotely related to the genuine anticipation of an improving economy, or is it more about liquidity that has been forced into the system and the resultant capital flows that move to preferred nations whose central banks--for the moment at least—have instilled confidence in their countries' credit and currency markets? It is easy to find analysts who contend that the U.S. economy is about to really pick up steam--in fact if you turn on financial television those analysts virtually fall over each other as they jockey for position in front of the camera. Unfortunately however, all sorts of number crunchers are now downgrading GDP estimates for the quarter, some to under 1% and less--in other words we are still in the throes of anemic growth.Chairman Bernanke himself, in a widely publicized statement, asserted that the employment situation is significantly worse than the 7.6% unemployment rate suggests, which is probably an acknowledgment that recent job growth has been predominantly an expansion of part-time positions. In addition, industrial production and personal consumption expenditures have declined after post-crisis peaks mid 2010 to early 2011 and have flatlined or worse over the past year and a half. And there is growing concern as to whether, over the next couple of quarters, corporate earnings will be able to grow via top line revenue growth as opposed to continued cost cutting.

If one believes the markets' movements are currently dependent to any great extent on economic fundamentals, these could be very important concerns. If however, as markets have strongly suggested, the key factor is the Fed, then continued support of and belief in the efficacy of its policies becomes a most import bellwether in determining the likelihood that confidence in our credit markets and the dollar keeps capital flows moving toward the U.S.

2013 has been a year in which the U.S. Treasury market has experienced very significant volatility. After witnessing 10 year rates making a significant low in early May at 1.62%, yields rose to over 2.70% shortly before the end of Q2. If the economy were expanding robustly, such a move might be expected. Many fund managers and commentators suggest that is what is about to happen. Chairman Bernanke and the data suggest otherwise. And, based on the Fed's stated objective of keeping interest rates extremely low, it is inconceivable that such a precipitous move higher in rates is something about which Fed governors are pleased.

In the meantime, one inarguable result of the Fed's policy has been to increase the reserves of major banks from $9 billion in September 2008 to $2.07 trillion currently. Another result has been to keep interest rates to this point so low that savers, who at retirement may have expected to live off fixed income, are unable to do so. Given these and other concerns, it has appeared that the Fed's policy is facing at least incrementally increasing scrutiny from many directions. Notably, based on recent Fed meeting minutes it is clear there is also considerable internal debate at the Fed as to the prudence of cutting back on the QE program. The cumulative result of it all is that the crucial issue of confidence in the credit markets gets more uncertain. This is not to say that the stock market cannot continue to rally in such conditions, but ultimately there may be no more important factors dictating what befalls the real economy than issues of credit and related moves in currency markets.

To understand how completely dependent on the confidence in central bankers the markets have apparently become, one only has to tune in to financial television each day and listen to the commentators attempt to explain market movements. The complexity and uncertainty imposed upon financial markets by central bank actions worldwide is far beyond what a casual observer would imagine. Outside of U.S. and Japanese stocks, it is remarkable how poorly so many asset classes have performed so far in 2013.

Given these conditions, the past two quarters have probably been two of the most difficult in memory for us as investment managers. In the environment just described, we consider it imperative that investment themes be fundamentally sound for the longer term, while at the same time being consistent with the ultimate implications of what we see as an unfolding global monetary scheme that shows no signs of abatement. Under such circumstances, what is most important to us is that, whether market confidence wanes and investors scatter, or in the alternative the investment environment "normalizes", we are confident that the investments we hold have been selected on a disciplined basis for the right reasons, providing investors sound opportunity for growth as conditions evolve.

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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 .