Seaport Investment Management

April 2015

In our last note to investors we presented a cautious outlook for 2015 that called for modest positive returns from equities, for interest rates to trade in a range of 1.7%-3%, and for most commodity prices to remain under pressure, but show signs of stabilizing. We based this outlook on the belief that liquidity would remain positive, but that valuations across asset classes were expensive and that growth would slow.

We continue to believe that volatility cannot be suppressed indefinitely through monetary policy and that investors have grown dangerously complacent in the face of increasing leverage in the system. We have structured our portfolios to reflect these concerns and our belief that investors are increasingly not being adequately compensated for the risks they are taking.

A quick look at the table below shows year-to-date returns by region and asset class in three columns: first from the beginning of the year through the end of February, second from the end of February through the end of April, and finally year-to-date through April. We sorted them from high to lowest value by region and then by the results since February to highlight the changes from our last note to you.

2015 Period Returns by Asset and Region

region	asset	dec 31 to feb 27	feb 27 to apr 30	ytd
US	oil	-3.3%	10.8%	7.2%
US	high yield	3.0%	0.7%	3.8%
US	investment grade	1.8%	-0.1%	1.7%
US	US 10-year	1.9%	-0.3%	1.6%
US	S&P 500	2.6%	-0.6%	1.9%
US	Dow	2.2%	-1.4%	0.8%
US	gold	2.4%	-2.6%	-0.3%
Europe	FTSE 100	6.4%	1.2%	7.6%
Europe	Frankfurt DAX	16.3%	0.5%	16.8%
Europe	euro	-7.5%	0.3%	-7.2%
EMG	emg bonds	-0.0%	7.2%	7.2%
Asia	Hong Kong	5.2%	13.9%	19.8%
Asia	Nikkei	7.8%	4.5%	12.7%
Asia	yen	0.1%	0.2%	0.3%

The ultimate source of these returns is global growth and the two main engines of global growth today, the US and China, are both experiencing slowdowns. U.S growth at + 0.2% came to a virtual halt in the first quarter and growth in China dropped to its slowest pace since the depths of the financial crisis in 2009. Preliminary estimates show global growth at its slowest pace since 2001.

Market returns in the US have been anemic through April at 1.9% for the S&P 500 and 1.2% for the Barclays Aggregate, masking considerable volatility across asset classes. The decision of the Swiss Central

Bank to drop the peg to the euro resulted in a 30% overnight rise in the Swiss franc, which shocked currency markets and wiped out investors in one prominent hedge fund. Since the beginning of the year the euro has declined 7% against the dollar, oil has rallied on the decline in US production that began in early March, the Bank of China announced a monetary stimulus program, and Greece hasn't defaulted yet (but the specter of default remains). Over the same period the S&P 500 experienced numerous rallies and declines, but overall has made little progress.

The big winners, as you can see, have been Hong Kong stocks, oil, emerging market dollar bonds, which are essentially a derivative bet on oil and commodities, and finally Japanese stocks, which continue to respond favorably to Prime Minister Abe's program of monetary easing. Returns for every other asset in the table have been anemic or negative.

Where does that leave us? We'll reiterate a point we've made in the past that in our experience liquidity, growth, and value drive returns in financial markets. In the U.S, year-over-year growth in loans and leases outstanding (a measure of banking system lending activity) has increased from 4.8% to 9.5% over the past 12 months. At the same time, corporate profits have been essentially flat. The result is that leverage in the system is rising at the same time that corporate profit growth is slowing. Meanwhile, the European Central Bank and the Bank of Japan continue unabated with their experiments in quantitative easing.

At this juncture, we fear that rising leverage in the system (margin debt is at all-time highs) combined with the reduction of capital committed to trading markets due to regulatory capital requirements increases the threat of a significant rise in volatility across markets.

We expect the U.S to avoid recession and end the year with positive, but modest growth. The receding impact of cold weather together with lower gas prices, increased consumer net worth, and low single digit gains in wages should support consumer spending, while the manufacturing sector and exports will remain under pressure from the strong dollar. A reasonable forecast for global growth this year probably comes in around 2-3%.

Federal Reserve policy, specifically the timing of interest rate hikes, has become the dominant focus of market participants. We believe this is misguided. Whether the Fed raises rates in June, September, or not at all in 2015, it is likely that interest rates will be higher in 12-18 months than they were at the end of this quarter. What will matter most to investors is the path, the volatility, and ultimately the level of rates.

This has been an unprecedented experiment in monetary policy. Interest rates approaching zero and the Fed's monetary expansion have been a powerful force to push investors into risk assets. Six years of this policy has inflated valuations across asset classes, creating a buildup of speculative positions across investors' portfolios. We believe the Fed has brought us to a point where a smooth exit becomes increasingly unlikely. If the Fed raises rates too early or too aggressively, it risks ending the weakest economic expansion in post-war history, but if it holds rates at current levels too long, it risks fueling an asset bubble that potentially ends in another crisis.

The Fed professes to be concerned about inflation and has articulated 2% as a reasonable rate. While we are beginning to see early signs of a tightening labor market and wage growth, inflation remains constrained by lower energy prices and a strong dollar. Moderate inflation combined with recent evidence of slowed growth suggest the Fed will err on the side of delaying rate hikes. Over our cyclical time horizon of one year, there is little likelihood that this weakens the dollar sufficiently to accelerate inflation.

There is some irony that, left unchanged, these policies, which were implemented with the goal of raising inflation, may ultimately have deflationary effects. Purchases of longer maturity bonds by monetary authorities lower long-term rates, compress net interest margins earned by banks, and reduce the profitability of lending and the incentive to make new loans. At the same time, extended periods of artificially low interest rates will further fuel the growing bubble in debt markets. In the end, there is nothing more deflationary than a debt bubble that collapses after a broad base of investors has invested in it.

With negative real interest rates and poor returns for risk, value in the fixed income markets remains difficult to find. We are not surprised that returns since February have been so poor. The Quantitative Easing Program launched by the ECB will keep yields low in Germany and anchor yields in US Treasuries for the next 6-12 months. The Treasury market will benefit from capital flows seeking higher yields than those on offer in Europe and Japan, but they will only mask the intrinsic risk of a significant price shock when rates ultimately rise because of the extremely low yields across the entire Treasury yield curve.

We are equally cautious on corporate bonds, particularly investment grade, which in our opinion are overvalued and where fundamental credit is deteriorating. We have recently initiated a short position in investment grade corporate bonds as an overall hedge to rising interest rates and weakening credit fundamentals. Yield spreads in investment grade have held essentially flat since February, but have tightened by a quarter point in high yield and almost a full point in emerging market dollar bonds.

The sharp decline in oil prices has created opportunities with specific issuers in high yield. We have initiated positions in selected Latin American energy companies where we find attractive prospective returns with sound collateral. We have sized our positions at conservative levels as we typically do with new positions in our portfolio. We have also found attractive values in residential mortgage-backed securities with solid credit support and limited interest rate exposure.

As always, we continue to chart a conservative course in managing our portfolios. Our equity positions emphasize high quality, dividend-paying companies where we expect stable, predictable cash flows that support growth in dividends above the rate of inflation. Although we have increased our overall holdings in corporate bonds, our exposure to credit risk remains modest with our preference for issues that are senior in the capital structure and secured by assets. At the same time, we continue to search for favorable points of entry in other asset classes where we can plant seeds for attractive future returns.

We are appreciative of our Seaport clients who share our view of long-term, fundamental, value-driven investing, independent of short-term market moves. Our strategic focus on value for risk and our commitment to a disciplined investment process will continue to drive our investment decisions as we endeavor to protect and grow the wealth of our clients.

Thank you for your continued trust and support.

Sincerely,

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