Seaport Investment Management

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Our goal at Seaport Investment Management is to build wealth after inflation, fees, and taxes. Our outlook for 2015 calls for mid-single digit returns from equities, interest rates to trade in a range of 1.7%-3%, the yield curve to flatten, and most commodity prices to remain under pressure, but show signs of stabilizing.

We remain skeptical of forecasts despite having just provided one. Our investment process weighs potential outcomes, valuation, risks and prospective returns in order to construct portfolios that will yield positive real returns across the broadest range of possible outcomes. At this point, we'd like to lay out the framework that will guide how we will position our portfolio over the course of 2015.

We believe that liquidity, growth, and value drive returns in financial markets. Liquidity takes many forms including money supply, corporate cash and undrawn borrowing capacity, investors' cash balances, and the general availability of credit in the economy.

The general availability of credit is a major driver of economic growth. This is reflected explicitly in loans and leases outstanding in the economy, which have grown at an annual rate of over 13% since the Fed began its quantitative easing policies ("QE2" and "QE3"). This tailwind will subside as the Fed winds down this unprecedented policy, so the question becomes whether private sector growth and quantitative easing by the European Central Bank and Bank of Japan will be sufficient to replace it. For our part, we do not believe that monetary policy alone will overcome the demographic, structural, and political impediments to growth across developed economies.

The Chicago Fed National Activity Index serves as a useful measure for evaluating economic growth and it tends to lead growth in earnings for the S&P by 1-2 quarters. Currently, it confirms that the U.S. has been experiencing a slowdown since the third quarter of 2014, although growth remains positive. We expect continued modest growth in consumer incomes, corporate earnings, and GDP over the next 6-12 months as the positive effects of sharply lower gasoline prices, which are equivalent to a 1.6% raise for an individual earning the median wage, offset the headwinds of a strong dollar and a retrenchment in the energy sector.

There are a number of threats to the sustainability of this growth, however. They include inventory destocking across numerous industries, weaker growth in China, the specter of Europe falling back into a recession at a time when the Eurozone appears to be fragmenting politically, and upheaval in emerging markets from the collapse in commodity prices, and dramatically higher volatility in currency markets.

Over the past two decades China has accounted for as much as half of global GDP growth. The inevitable slowdown that follows an investment-driven growth strategy has already been felt broadly across commodity markets and is a trend that is likely to continue for some time as China transitions from an investment-driven to consumption-driven economy. In the past, almost 45% of China's GDP came from capital investments.

Europe is struggling to contain a major contraction in credit coming from a Russia coping with sanctions and a collapse in oil revenues, which account for 60% of the government's budget. The implementation of quantitative easing by the European Central Bank should mitigate the impact of the credit contraction in the Eurozone for a year or more to judge from the experience we have had with quantitative easing by the Fed, but the outcome remains highly uncertain. We don't believe that monetary policy will be sufficient to overcome demographic and structural impediments to growth.

Experience and history have demonstrated that valuation is a powerful indicator of future returns, although a poor predictor of their timing. Equity markets appear expensive by many measures of value, and while they may appear less expensive in the context of today's extraordinarily low interest rates, we do not believe interest rates at current levels will continue indefinitely. Markets trading at high valuations generate weaker returns in subsequent periods, which is why we believe that equity returns will remain modest over the next 3-5 years.

Value in the fixed income markets is equally difficult to find. Across developed markets, real yields after inflation are negative out to three-year maturities and in some instances five years. Without a full-fledged episode of deflation (unlikely in the U.S in our opinion), we believe government bonds at best will offer low single-digit returns with a decent probability of producing losses over the same 3-5 year horizon.

Yield spreads in corporate bonds have widened over the past quarter, largely in response to turmoil in the energy sector and the knock on effects of lower oil prices in emerging markets. However, yields have not reached levels that, in our opinion, provide sufficient compensation for the risk, especially for taxable accounts. We consider yields on mortgages and municipal bonds the most attractive among fixed income securities in relative if not absolute terms.

We find ourselves in an environment of unprecedented monetary policy with at best an uncertain outcome. Monetary policy alone will not be sufficient to drive growth back to historic norms without substantial structural reforms in taxes, regulations, and the labor market for which the political will is lacking. Economic growth will be further restrained by the demographics of an aging population in developed economies and by high debt levels across the globe.

We will 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. In fixed income, we have limited our exposure to rising interest rates. Mortgages continue to offer attractive yields on a relative basis, but future appreciation will be limited. Our exposure to credit risk remains modest.

The equity market has sustained an unprecedented run without a 10% correction. While we expect volatility to be higher in the future, we continue to search diligently for attractive points of entry 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,

Ben Trosky, Chief Investment Officer
Charles Wyman, Portfolio Manager

Seaport Investment Management
New York, NY 10024
+212.877.2330office
844-249-9453 toll free
+212.877.6249 fax

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