Two Important Conversations
April 16th, 2014

Dear Clients and Friends,

There are two very important conversations that I would like to discuss with you regarding the health of the U.S. economy and its financial markets:

1) **Federal Reserve Omnipotence**
2) **China's changing economic dynamics**

Federal Reserve Omnipotence (?):
Ben Hunt (Harvard PhD) is considered somewhat of an expert on game theory and its application to economic/market analysis. In his fantastic blog --- Epsilon Theory --- he describes among other things the power of "Common Knowledge". Essentially he makes the point that there is immense power in "the Crowd" and in a common knowledge that binds a crowd together. Knowing what the crowd thinks is very useful in predicting market behavior.

Since the end of the Great Recession, the entire world has been operating under the Common Knowledge that the Federal Reserve is omnipotent. Markets around the globe have paid homage to this creed as they have continually marched higher. HOWEVER, this same Crowd is now seemingly hesitating to genuflect. Markets have gone essentially sideways so far this year. The quintessential question is: WHY?

There are two possibilities:

1) The Crowd is changing its mind and beginning to think the Federal Reserve is NOT omnipotent. If this is truly the case ---- run for the hills! Markets will be very bloody for an extended period of time. Long durated U.S. government bonds and gold will be your best store of value.
2) The Crowd is actually affirming that it still thinks the Federal Reserve is omnipotent. However, it now sees that omnipotence as being applied elsewhere. Said another way, the Federal Reserve is still seen as having the power to control markets --- but is considering discontinuing the use of said power. If this is the case ---- markets will likely still experience far greater volatility per unit of return on a go-forward basis.

It is my opinion that option number 1 is not currently a legitimate explanation. Federal Reserve omnipotence is still intact. For now. Thus, we are left with option 2 which still implies a more difficult market than the one we have witnessed over the past five years. The best possible outcome in this scenario would be an anemic growth story here in the U.S. Why is anemic growth good? Because growth needs to be strong enough to avoid an outright recession --- but weak enough to keep the Federal Reserve in play with its stimulative monetary policies. Sadly, we are still stuck in a world where bad economic news is ironically good for the markets --- as it insures a stimulative economic policy from the Fed. And good economic news is bad --- as it threatens a removal of stimulus.

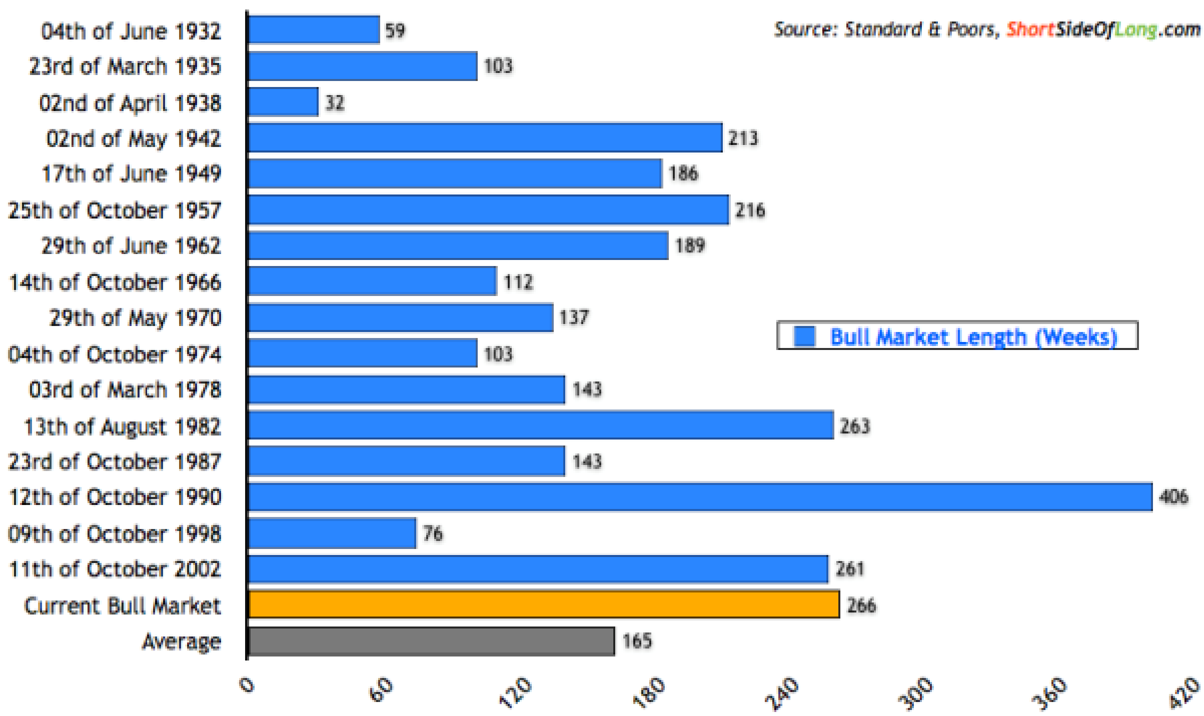
LAUREATE
WEALTH MANAGEMENT

China's Changing Economic Dynamics
GaveKal Research is one of my favorite sources of information for solid global economic research. They are truly thought leaders in an industry full of copycats. According to Louis Gave, a GaveKal partner, China has assimilated 200 million people into its labor force over the past decade. To put that number into perspective --- the entire U.S. labor force is only 158 million people. During that same decade there has been massive balance sheet expansion in all sectors of the Chinese economy: state owned enterprises, private individuals and corporations, and various government entities.

Both of these trends have now stopped --- and in some cases reversed. This is perhaps the largest shifting tectonic plate in the world economy that no one is talking about. To put it bluntly, it is unlikely that China will be the growth engine for the world over the next 10 years. I am uncertain what affect this will ultimately have on the U.S. economy and markets. It is certainly something to watch closely. (You can watch Louis Gave's entire 6:38 interview here. Push forward to the 4:40 mark for China-specific data.)

Ominous Chart of the Year (so far):

80 years of bull markets! Hmmm…



Conclusion:

By way of review, I thought it might be interesting to highlight the positive economic dynamics I discussed in my last commentary (approximately 7 months ago). I re-list them here with a few updated comments:

1) **Manufacturing on-shoring trend continues**
2) **Housing rebound continues:** This one has admittedly waned since last Fall.
3) **Energy revolution continues:** Shale oil and gas continue to increase.
4) **Shrinking federal deficit**
5) **Labor unions are getting crushed**
6) **What if the consumer does finally re-emerge?** This one is definitely gaining momentum since last Fall.
7) **A Yellen Fed:** Early returns on Yellen's leadership are not instilling confidence in the markets. It is my opinion that this has more to do with a change in Common Knowledge surrounding go-forward Federal Reserve policy --- than with the personal leadership of Janet Yellen.

In spite of the Common Knowledge headwind discussed at the outset of this letter…
In spite of the significant macro-economic shifts in the Chinese economy…
In spite of the ominous 80 year bull market chart above…

I believe the U.S. stock market will likely:

- end the year higher than where it started.
- experience increasing volatility this year.
- perhaps experience a 10%+ correction during the interim.

Accordingly, it will be as important as ever to focus on finding asymmetric risk/reward opportunities throughout the alternative investments universe to compliment allocations in traditional asset classes. As always, please don't hesitate to reach out with any thoughts or questions. Thank you.

By Jeremy Boynton, CFP ®
Founder, Laureate Wealth Management