COMMENTARY

August 15, 2014

Dear clients and colleagues,

What would you expect equity markets to do? If at the start of 2014 we predicted the following: The year will have to deal with geopolitical issues ranging from Russia and Ukraine to the Israeli-Palestinian conflict, from Argentinian debt default to the Portuguese bank failure - and let's not forget Iraq and Syria, and while we are at it lets also throw Ebola into the mix.

Our guess is most investors would expect equity markets to be down and not up. Yet as of writing, the MSCI World Small Cap is up 5.8%. It is also not a surprise that most market-watchers have been calling for a correction for quite some time now. But each time the market shows signs of even the mildest profit taking, we have buyers who jump in to take advantage of the opportunity.

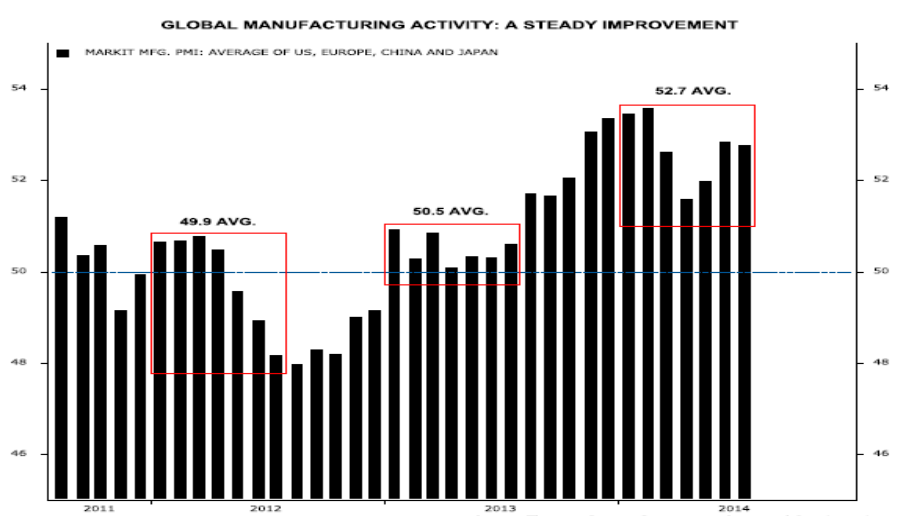
Let's just look at the performance for S&P 500, which since the lows on March 9, 2009 is up 150%. If one was to look at the numbers, it is easy to understand why there is skepticism. Some strategists say the correction has begun as S&P 500 is down from its high of 1,991 on July 24; others say the market will grind higher to 2,000. Some mention seasonality as a reason to sell and compare it to history to make their point, but the last time we checked they said sell in May.

What should you do?

Market timing doesn't work and the above is just an example of the same. After all, the US economy is improving. Economic data is positive. And if all this doesn't provide solid proof, take a look at the price of Gold since the end of 2012, or the VIX which is at its all-time low. Data like this suggests that people are not expecting an Armageddon.

Let's look at the positive for a change

Global manufacturing activity is steady and improving as shown in the chart below.



US economy

The Bureau of Labor Statistics' JOLTS (Job Openings and Labor Turnover Survey) report for June 2014 showed improvement in the labor market. The number of jobs opening reached a 13-year high, hiring also picked up after falling in May. The most interesting is the number of voluntary separations; which rose for a third consecutive month.

Let's think about it: if the job market is so bad why would you quit? We view it as a positive signaling worker confidence in finding better opportunities. You might ask why this report is important. This is the favorite of the Fed Chair Janet Yellen who considers it a useful measure of the U.S. labor market and it comes around the Jackson Hole meeting next week.

Europe

Things are improving slowly but surely. The skeptic in me points to the latest German ZEW indicator of confidence among professional investment analysts. ZEW is at a 20-month low in August. This cannot be a positive for the euro sentiment. As this means that German companies will reduce their investment.

But the optimist says is this really a surprise considering that the DAX is down 5% and let's not forget the sanctions against Russia.

Japan

Japan experienced a consumption tax hike from 5% to 8% in April. A lot of demand was pulled forward due to the upcoming increase in taxes. On the brighter side many Japanese companies announced wage increases earlier during the year. However in Japan the retroactive pay is made in June-July. Hence a weak 2Q GDP would not really be a surprise. But here are the two scenarios' that can occur going forward: 1) the economy improves 2) the economy remains weak and the BOJ begins QE again. No matter the end result, the Japanese economy should benefit.

We think the economy will improve based on our conversations with various Japanese companies who sound optimistic. For a generation that has seen deflation for as long as they can remember, this is a big shift in behavior. Even International companies are seeing growth in Japan, but are reporting weakness due to the currency. At this point all we can say is "in Abenomics we trust".

Does this mean we won't have a correction?

We will eventually have a correction, but when is next to impossible to predict. What is important is that market corrections are healthy. There are some red flags that indicate we might have one. Yield on a 10 year treasury has fallen to 2.46%. Let's not forget that if the economy improves interest rates would go up and this could be the start of a healthy correction.

How will your portfolio react in a correction?

No matter what view you have, one thing we can all agree on is that the global economy is improving. We think even if there is a healthy correction the case for additional gains is persuasive. Think of the market as climbing a hill - every now and then you need to pause to take a breath but at the end you finish on top of the mountain.

Similarly, distinction between a well-run company and strong management is increasingly becoming important. If you just look back in the spring of 2012 you saw quality outperform. We saw the same thing happen in May of 2013, and in 1Q14. What is more quality retains most of the gains.

Quality may be lagging again but will eventually take leadership. Another positive is that correlations are falling. All these are creating a perfect environment for active management as well as outperformance for small cap.

Quality will always outperform the flavor of the month when compared over a long period. The companies we own are growing 50% faster than the MSCI world Small Cap index and have better margins yet trading close to the same multiple as the index.

In conclusion, we cannot predict when the next correction will take place. However we are certain our portfolio will outperform the index when compared over a business cycle based on the defensive nature and quality of our holdings. In fact we can certainly say that there has never been a better time to own Global Small Cap.

Have a good weekend.

The Global Alpha Team