CapVisor Associates, LLC
Quarterly Newsletter

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Inside this issue:

With Quantitative Easing (QE) Officially Ended, What's Next?

As promised, the Federal Reserve ended the last of several quantitative easing programs which began in 2008 to provide liquidity and stability to the traumatized markets. Insurers have been anxious about how the markets would behave once this heavy dose of intervention was removed from the marketplace. And, a heavy dose it was!

As a result of the QE programs, the Fed's balance sheet has expanded multiples of its pre-crisis levels as indicated on Figure 1 on page 6.

Through these programs, the Fed had been buying treasury bonds and mortgage-backed securities, starting at a rate of $ 45B per month and rapidly increasing to $ 85B per month before gradually "tapering" since the beginning of this year.

As Figure 1 indicates, the rate of acceleration over the last year has been impressive and over the past 24 months the assets on

(Continued on page 6)

Economic Review

Markets: During the third quarter, storm clouds began to gather over risk assets. First, geopolitical risk flares (the Ukraine/ Russian conflict, western sanctions against Russia, and new and more severe disruptions in the Middle East) actually started to matter as the markets recognized the potential for their morphing into longer and more problematic affairs. Second, hopes for a sustained global recovery began to fade with disappointing growth and/or inflation out of Europe, Japan, China and the emerging markets. Finally, highly supportive technicals moved to a position somewhat out of sync as fund outflows and investor liquidations were met with a rather tepid bid from the street. As a result, the seemingly perpetual strategy of searching for yield, (the "carry trade") which had supported the risk-on view for most of the year, gave way to mounting concerns over valuations and risk, leading to the noticeable underperformance of lower-quality sectors.

Economic Review: Global growth is averaging 2.5-3.0% - rates generally considered to be the lines of demarcation between global expansion and recession. Behind these aggregate numbers, however, are increasingly divergent paths in growth, inflation and the pursuant monetary policies. The regional disparities are notable, with sustainable momentum in the US and UK, growing fears of recession and deflation in Europe, fading optimism for reflation and the full implementation of Abenomics in Japan, a surprising acceptance by Chinese authorities for more modest growth and finally, emerging market profiles highly susceptible to US monetary policy and downshifts in Chinese growth.

Interest Rates: As the Federal Reserve's normalization of monetary policy becomes a more proximate reality, short-term rates will be pressured higher. Longer-term rates will experience greater relative stability as inflationary expectations remain in check and the gravitational pull of

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Economic Review

(continued on page 3)

near-record low yields in Europe and Japan keep a lid on rates. 10-year Treasuries should trade broadly in the 2.5-3.5% range, with near-term overshoots to the downside presenting opportunities to become more defensive in interest rate exposures.

GLOBAL GROWTH and POLICIES:
In the US, the current cycle has now surpassed the 2001-2007 cycle and is bettered by only three others. It has been characterized by slower and sustained trend growth (centered on 2.0%) relative to past cycles, but it too has been void of the excesses which typically bring down a cycle. This lack of real excesses, the significant and advanced balance sheet repair across the consumer and corporate sectors and a highly accommodative Federal Reserve should allow this cycle to set more distance records. It should also allow for a modest inflection higher in trend growth (with our estimates still centered on 2.5%) but with risks skewed modestly to the upside. As this expansion marches on, it should be noted that business cycles do not pass simply from old age but tend to die from excessive consumer and corporate hubris coupled with a highly restrictive monetary response (all seemingly absent).

A sustained expansion will lead to further progress for the Federal Reserve in achieving its dual mandate of full employment and stable inflation. Whether full employment is 6.0% unemployment or more consistent with the Fed's 5.5% estimate, both will likely be achieved in the cyclical near-term. Consequently, modest wage pressures will arise, eventually feeding into broader measures of inflation. This fits well into the inflation bottoming process we have discussed. The balance of risk no longer supports a disinflationary bias, but instead, a modest inflection higher from 1.5% toward the Fed's 2.0% target – more of a "lowflationary" outcome. With this progress on the dual mandate will come a modest inflection higher or "normalization" in monetary policy, beginning with the end of quantitative easing and progressing to an actual rise in official rates. The timing of this shift in policy nears as we move through 2015. The pace should be measured (25 bps per FOMC meeting) with the eventual terminal rate centered on 3.50%. As such, this does not represent a shift to the more highly restrictive monetary responses usually associated with end-cycle excesses.

So, we have a series of likely inflections in growth, in inflation and in monetary policy albeit, each only modestly higher. This series pushes the medium-term balance of risks in favor of a higher rate structure across the yield curve with an accompanying shift in unsustainably low volatility. However, the front end of the curve is susceptible to a more meaningful rise as it bears the brunt of a Fed policy shift. Longer-dated rates will rise relatively less, held in check by a still "lowflationary" environment and the gravitational pull of near-record low yields in Europe and Japan. As such, the Fed will be engineering a continued flattening of the yield curve as we move through the fourth quarter of 2014 and into 2015.

FIXED INCOME: A Disciplined and Intelligent Approach to Risk

Duration and Yield Curve – With the Fed now in play for the process of normalization and an accompanying yield curve flattening

Economic Review

expected over the medium-term, we anticipate generally more defensive duration and "barbelled" positions in the intermediate-to-broad-market portfolios. This strategy will include a healthy exposure to floating-rate securities (as protection against potentially acute downside volatility at the front end) coupled with an overweight in 10/30-year maturities, all at the expense of underweighting 5-7 year intermediates. Short-term portfolios will be relatively more defensive with an even greater exposure to floaters. Our broad range on the 10-year Treasury remains at 2.5-3.0%, though we recognize the risks of an overshoot to the downside (2.375 -2.25%) due to technical and global relative value factors.

Risk Assets – We remain concerned about valuations as pockets of excess in late 2013 became more broadly systemic over the course of 2014. Investors have continually added to risk positions in credit (via the least overvalued sectors) with every minor bout of volatility, seemingly discounting any and all events as relatively insignificant. This parabolic discounting and buy-the-dip mentality have suppressed overall spreads and volatility. As a result, investors are "all in", many fully invested in overvalued, overowned and overcrowded positions. The market appears very aware of these skewed risk/reward profiles, nervously long and awaiting a catalyst to reduce exposures. However, any attempt at a quick and consensus exit is likely to be narrow and disorderly, given the mismatch of balance sheets between the investor base and the dealer community.
Therefore, we remain modestly defensive at this stage, choosing to participate in the credit sectors but leaning against excesses and more focused on liquidity and downside protection. That being said, when dislocations do occur and value is created, we will gladly add to exposures. We view this approach not as risk avoidance but as risk intelligence.

Sector Briefs – In the high-grade and high-yield sectors, we remain overweight on a proceeds basis but with a focus on short-to-intermediate durations. This allows us to capture attractive yield advantages while at the same time reducing potential downside spread volatility. Security selection is focused on liquidity and minimization of event risk exposures, particularly M&A and LBO activity.
We continue to recommend an underweight in mortgages given the limited potential for spread tightening from current levels and the headwinds from a higher rate structure and sustained spikes in volatility.

EQUITIES:
Stocks Remain Resilient In The Midst of Increased Volatility

After closing midyear near all-time highs, the S&P 500 resumed its ascension in July. This advance eventually culminated in the establishment of a new high of 1,988 on July 24th. From there came the anticipated "near-term pause". Although only a pullback of roughly 4.0%, volatility picked up considerably as the VIX rose from 10.3 to 17.0 in the span of just one month. Several factors helped to both limit the index's decline and to set the stage for the next move higher. First, the market still enjoys the presence of an accommodative Federal Reserve coupled with an improving domestic economic landscape and a scarcity of attractive investment alternatives. Second, the second quarter operating performance of the S&P 500 continued to impress with per-share increases of 7.9% on a year-over-year basis, again another new high.
Even more impressive was the fact that the just completed quarter produced the best top-line growth in over two years, pushing the S&P 500 index to a new record high (2,011 on 9/18/14), with an accompanying and notable decline in volatility as measured by the VIX. This latest move was short-lived, however, as investors adopted a more "risk-off" mentality. The S&P 500 ended the third -quarter with only a marginal advance, while the VIX approached its quarterly high. In our estimation, such swings in volatility should be expected over the remainder of the year as the market will have to digest third quarter operating results and further developments on the geopolitical front. Having said this, we continue to maintain a cautiously optimistic view on the domestic equity market and believe that any near-term pullback should prove to be fairly minor in both magnitude and duration.

Why Interest Rates Will Rise

Tom Krasner, CFA is Co-Founder and Principal of Concise Capital Management, LP, which manages short-duration, smaller issue high yield bond separate accounts and a hedge fund. Mr. Krasner has spent over 20 years in fixed income, distressed debt and high yield bonds, including extensive experience in corporate restructurings and workouts. Mr. Krasner holds a B.A. in Economics/ Mathematical Sciences and a M.A. in Economics from Rice University.

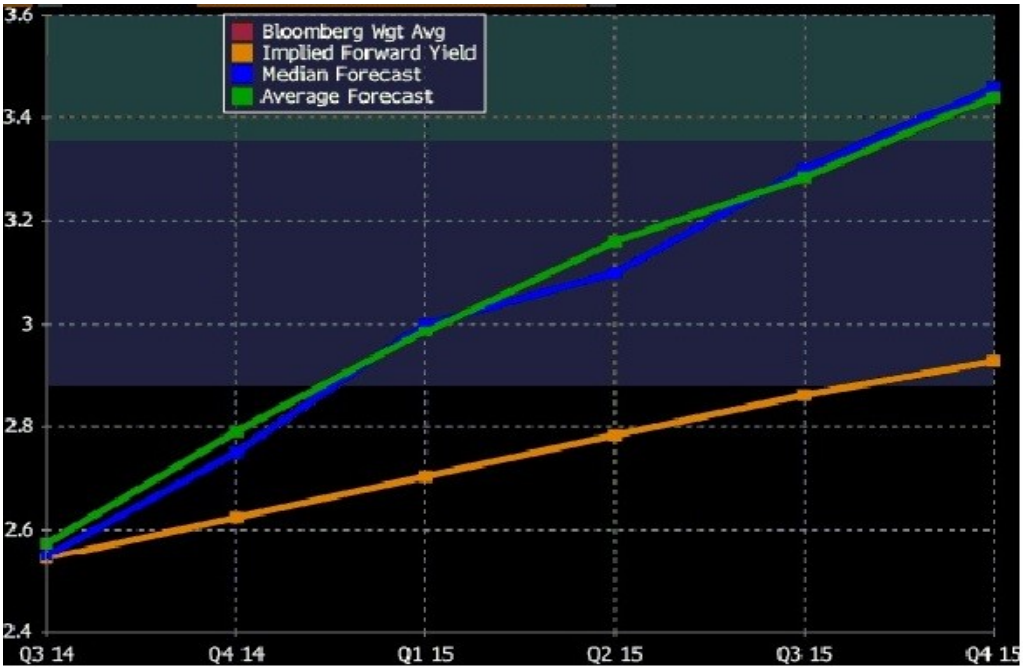
Aren't we in a new paradigm of permanently low interest rates? Don't believe it. The long-term direction of interest rates is up….The question is not whether interest rates will rise, but when.

Some strategists have argued that we are in a long-term period of low interest rates. The Fed has an incentive to keep interest rates near zero indefinitely. Unemployment and underemployment rates exceed historical norms. The national debt will keep the United States as a net borrower and gives the government reason to minimize its cost of borrowing. The pundits that have been calling for rising interest rates have erred for two years running. The predictions have been dead wrong. Interest rates have declined, not risen. Aren't we in a new paradigm of permanently low interest rates? Don't believe it.

The long-term direction of interest rates is up. The current interest rates for the 10-year Treasury and the 30-year Treasury are 2.37% and 3.12%, down approximately 65 basis points and 85 basis points from 3.02% and 3.97% on January 1st. The interest rates of the 5-year Treasury and short Treasury issues have changed little. The temporary declines in long-term interest rates have resulted from a change in perception, partly because of a harsh winter, which caused a seasonal drop in GDP. At the beginning of the year investors feared that the Federal Reserve would raise the Fed Funds rate in early 2015. The consensus expectation has now moved into the third quarter of 2015. The question is not whether interest rates will rise, but when.

Interest rate forecasts from major investment banks all indicate rising interest rates in 2015 and beyond. Economists surveyed by Bloomberg project the 10-year Treasury will reach 3.46% by the fourth quarter of 2015. Strategists at other investment banks agree. In August economists at Nomura and Barclays both predicted a rate increase by June 2015. Their colleagues at Merrill Lynch cited a similar time frame.

A naive forecast would expect the yield on the 10-year Treasury to at least remain close to 3.46%, if not significantly exceed it, in 2016 and beyond. The reason is that interest rates follow long-term, 25-year to 35-year cycles. We



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Why Interest Rates Will Rise

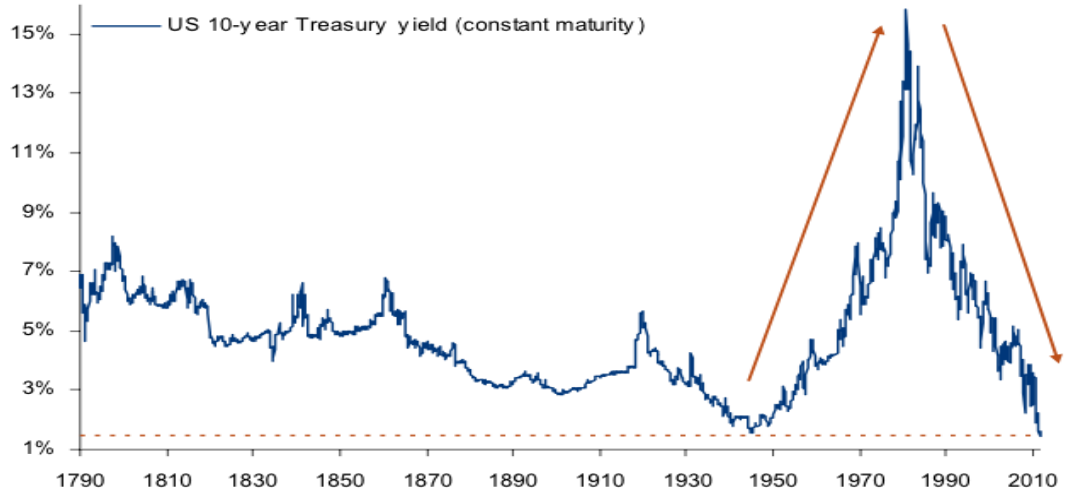
have been in a period of declining interest rates since 1981. Between 1946 and 1981 the yield on the 10-year Treasury rose from 2% to 15%. Between 1920 and 1946 the yield declined from 5% to 2%. As we seem to be at the end of a long-term period of low interest rates, it would be logical to expect interest rates to increase over the next ten years or so.

Within these long-term cycles the Fed manages interest rate policy over the shorter-term economic cycle. The boom-to-bust cycle usually lasts five to seven years. This present recovery is longer than most because of the depth of the 2008-2009 recession and the weakness of the ensuing expansion. Now the economy is finding its legs with GDP growth of4.2% in the second quarter. Once it starts to hike interest rates, the Fed is likely to continue to increase them. This pattern has prevailed throughout its history. No examples exist where the Fed increased interest rates only one time. The probable scenario is for the Fed to increase interest rates for two years or more. Economic necessity requires the Fed to manage inflation and to prevent labor markets and the economy from overheating. The impetus for the Fed to change course from its current zero interest rate policy to a non-zero policy would be a realization that stimulative monetary policy no longer serves the interests of the economy.

After six years of expansion we are close to that inflection point. Forecasts of economic growth and inflation suggest that the Fed will need to be wary. Consensus forecasts show an expanding economy and rising inflation. Economists at Barclays and BNP Paribas forecast that GDP will increase from 2.0% in 2014 to 2.7% and 2.8% respectively in 2015. The median forecasts of GDP growth among 78 economists in a Bloomberg survey are 3.0% in 2015 and 2.9% in 2016. Inflation is likely to increase too. Barclays forecasts the CPI will rise from 1.9% in 2014 to 2.1% in 2015. A strengthening economy and higher costs will put pressure on the Fed to act sooner rather than later.

According to most economists, the recent meeting of the Fed in Jackson Hole marked a turning point in Fed policy. Although her comments were balanced, Janet Yellen's speech indicated a shift toward policy normalization, an end of the low volatility policy framework, and an emphasis on data dependence. In short, if the economy expands, as most economists expect, the Fed will raise interest rates. The speech also suggests that markets should see increasing volatility in interest rates as the risk of a Fed hike has moved forward in time.

Treasury yields over two-years out have already widened by 10 to 15 basis points in September. I would expect the yield on the 10-year Treasury to keep increasing from now on. Given the recent GDP numbers, the speed at which interest rates will change could surprise people. I could easily envision the 10-year Treasury exceeding 4% by late 2015 and 5% by mid 2016. We have just begun a long, upward march that will continue for the next few years.



Monthly data
Source: BofA Merrill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

"an anouncement that the Fed would stop purchasing additional Mortgage-Backed Securities… However, continued reinvestment of the returns … will continue for the foreseeable future."

With Quantitative Easing (QE) Officially Ended, What's Next?

the Fed's balance sheet increased by 60% to 4.5 trillion dollars. The current Federal Open Market Committee Chair, Janet Yellen, who continued the easing policies of Ben Bernanke, her predecessor, to help stoke a rather lifeless US economy, is now satisfied that the economy's training wheels can be safely removed.

The Fed's QE programs were intended to keep interest rates low, lower unemployment and stimulate economic and investment activity. Alan Greenspan, Fed chairman from 1987-2006, was somewhat surprisingly outspoken on this topic at a recent speech before the Council on Foreign Relations.

He said that the QE program had failed to achieve its primary goals. "Effective demand is dead in the water" and the effort to boost it via bond buying "has not worked," said Mr. Greenspan. Boosting asset prices, however, has been "a terrific success." He also said, "I don't think it's possible" for the Fed to end its easy-money policies in a trouble-free manner.

"We've never had any experience with anything like this, so I'm not going to sit here and tell you exactly how it's going to come out," he continued. Past experience clearly indicates that market reactions to Fed policy changes are unpredictable and not entirely rational. For example, the end of the second quarter 2013, Fed officials hinted at a shift in policy by ending QE, unleashing significant volatility in markets, with bonds in particular taking a pounding. "Therefore, there is no reason to suspect that the actual process of boosting rates would be any different, "Mr. Greenspan said.

So where is the bond market's reaction to the end of QE? We did not see major movements in either the stock or bond markets that would be attributable to this turning point in Fed policy and its implications for future interest rates and the economy. A major reason is that the more communicative Fed that provides greater transparency of policy, a change introduced by Bernanke, has served to help the market more gradually "price in" expected Fed behavior reducing sudden reactions

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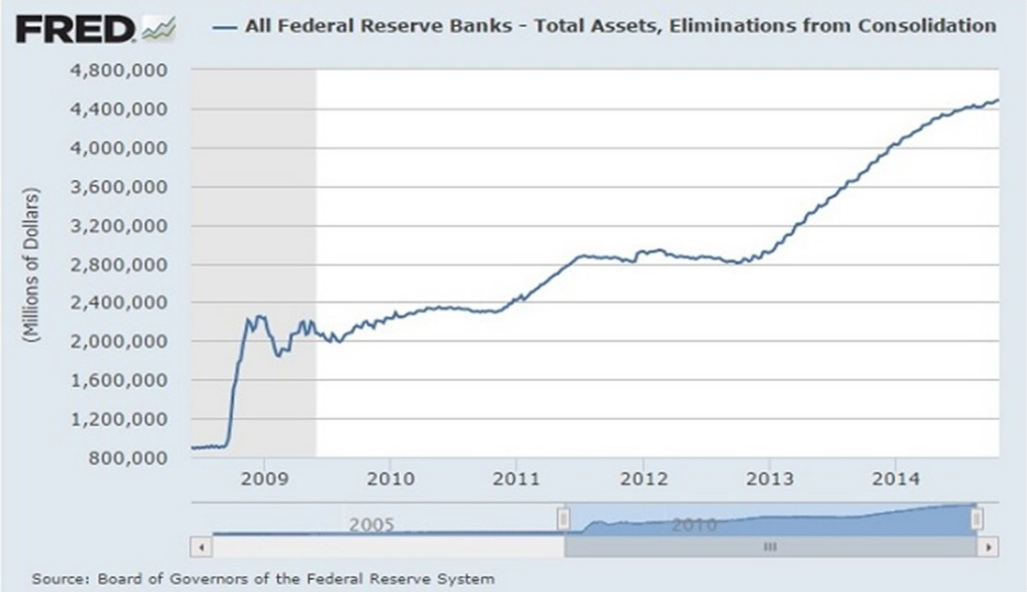
FIGURE 1



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and dampening volatility.

Even the reaction of gold prices was muted. Greenspan's speech also included advice, that under current conditions, an allocation to gold would be a wise and timely choice. According to *Wall Street Journal* reporter Michael S. Derby, "Mr. Greenspan said gold is a good place to put money these days given its value as a currency outside of the policies conducted by governments." (for more on this topic, please see Bradley Foster and Sargent's article circulated to CapVisor readers – Website archives dated March 2012)

There is another factor that should be considered when gauging the surprising calm in the markets. The end of QE was, more precisely, an announcement that the Fed would stop purchasing additional Mortgage-Backed Securities, specifically new investments paid for by freshly printed money. However, continued reinvestment of the returns on its $1.7 trillion dollar Mortgage-Backed Securities (MBS) portfolio back into the market will continue for the foreseeable future.

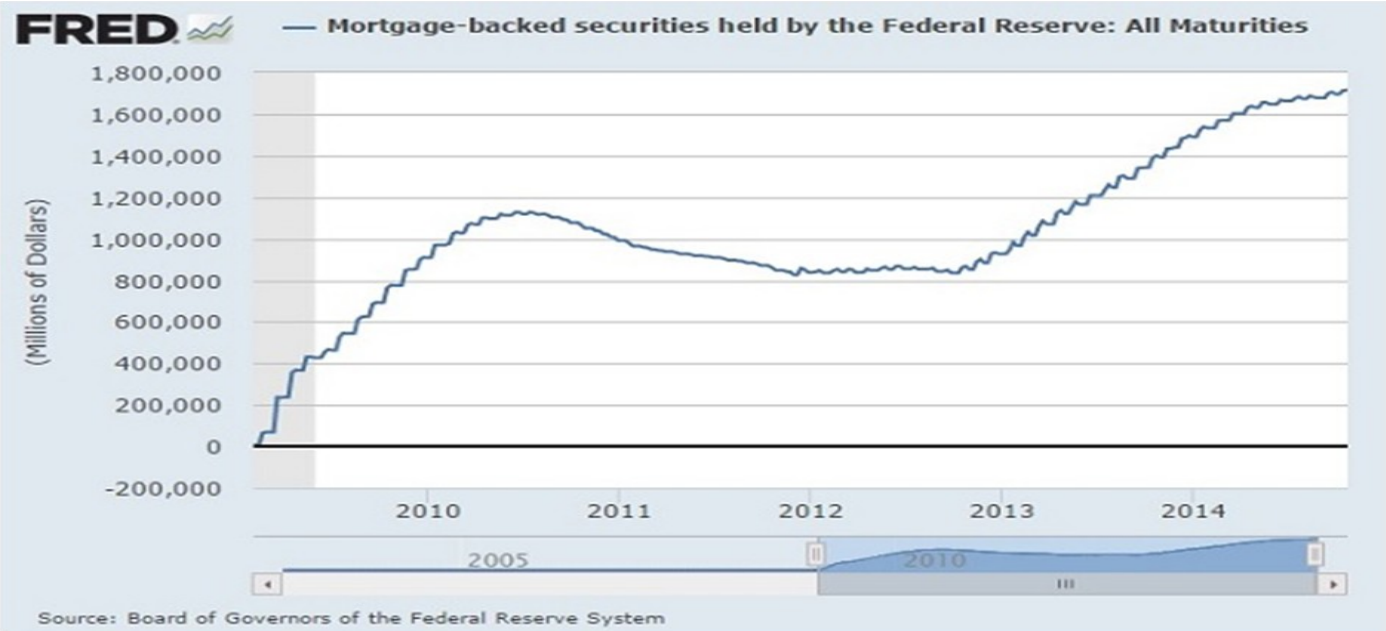
Assuming a return on the Fed's MBS portfolio of 2.75%, an additional $ 47B per year would flow into the Fed's treasury, and will very likely be immediately reinvested. So, stealthily an average of $4B per month in interest payments would continue to be invested in MBS, representing just a 20% decrease versus the official $5B per month number under the recently terminated MBS purchase program. There is no official mandate to take the money back out of the market when the MBS mature. So, this number will very likely be even higher, as it is also the Federal Reserve's intent to reinvest the principal amounts as well. Market analysts at Deutsche Bank, among others, expect the Fed to phase these investments out by 2017, although the central bank is under no real obligation to do so.

In short, the Federal Reserve will still pump in excess of $45B+ per year in the MBS market providing continued, but less blatant, support for the economy.

Figure 3 on page 8 demonstrates the effect of this disguised market support. Over the last month illustrated, the Fed had announced it would scale back the purchase of Mortgage-Backed Securities to just $5B per month at the previous meeting of the FOMC. Therefore the total amount of MBS on the Fed's balance sheet should increase by roughly $5B. The official numbers indicate that in just one month the total amount of MBS increased by not less than $16B.

The real 'credibility test' for the Federal Reserve will be twofold. Can it successfully manage the size of the balance sheet and manage interest rate increases in a manner

FIGURE 2



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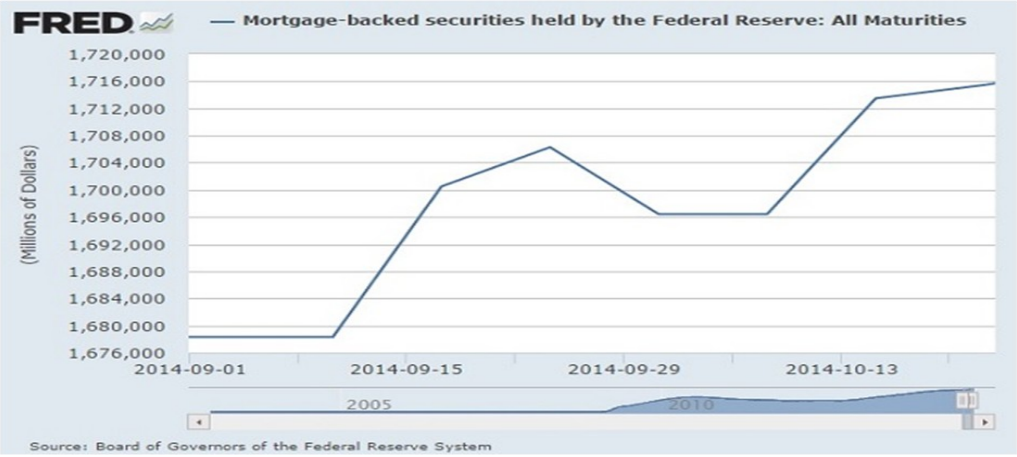
that avoids market turmoil and/or economic setbacks.

With regard to the balance sheet, it would be a good guess that it will remain at extremely elevated levels for the foreseeable future. With regard to a deliberate process controlling the rise in interest rates, the route may be challenging.

Greenspan believes that the Fed may not have much power over the timing of interest-rate increases. He identifies the problem as stemming from the interest rate the Fed pays on Reserves; the money banks deposit at the central bank. Fed officials plan to use their control over this interest rate as a tool and their primary lever for raising interest rates at the appropriate time. Greenspan warned that if bankers decide to put this money to work, creating inflation risks, the Fed may be forced to raise rates, even if the economy isn't ready for it. "I think that real pressure is going to occur not by the initiation by the Federal Reserve, but by the markets themselves," Greenspan said.

So, can we successfully get our economy and markets off the Fed's "juice"? We will have to wait and see but we choose to conclude our thoughts on this matter with a rather interesting and perhaps ominous comment: Mr. Greenspan said "gold is a good place to put money these days given its value as a currency outside of the policies conducted by governments. "

FIGURE 3



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