MCS Update and Q2 2014 Outlook

WHAT'S IN YOUR WALLET?

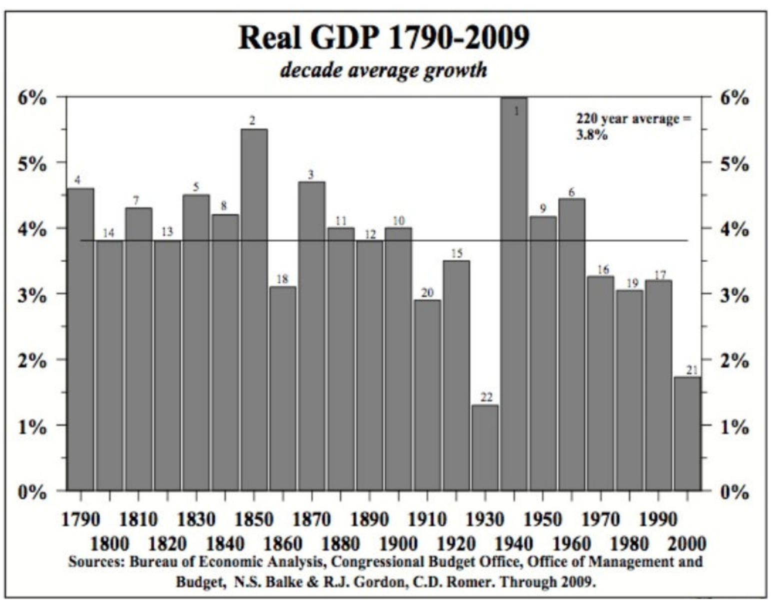
"Even if the Feds do not exit completely this year, the game is over one way or another."

Economic Situation

The Taper schedule, as it stands today (March 10, 2014) includes continued pumping of $65B March, $55B in April, $45B in May and June, $35B in July, $25B in August and September, $15B in October and $5B in November. Based on this schedule, additional liquidity will have been significantly reduced by the third quarter of 2014 and there could be a final drain in the fourth quarter. Should this occur, property prices, stock prices and thus net worth could begin to decrease. Another effect of the liquidity drain could be higher interest rates as early as the next quarter. To prevent some or all of these adverse effects, the Feds may be forced to reduce or suspend the tapering of QE. Therefore, all investors should keep a close eye on the Feds' future words and actions.

"Each time there is a wobble, the central banks turn on the taps. Either that works by creating growth with asset prices eventually coming into line with fundamentals or it doesn't and we're in for a massive fall. How massive? It would make 2008 seem like a walk through the tulips."

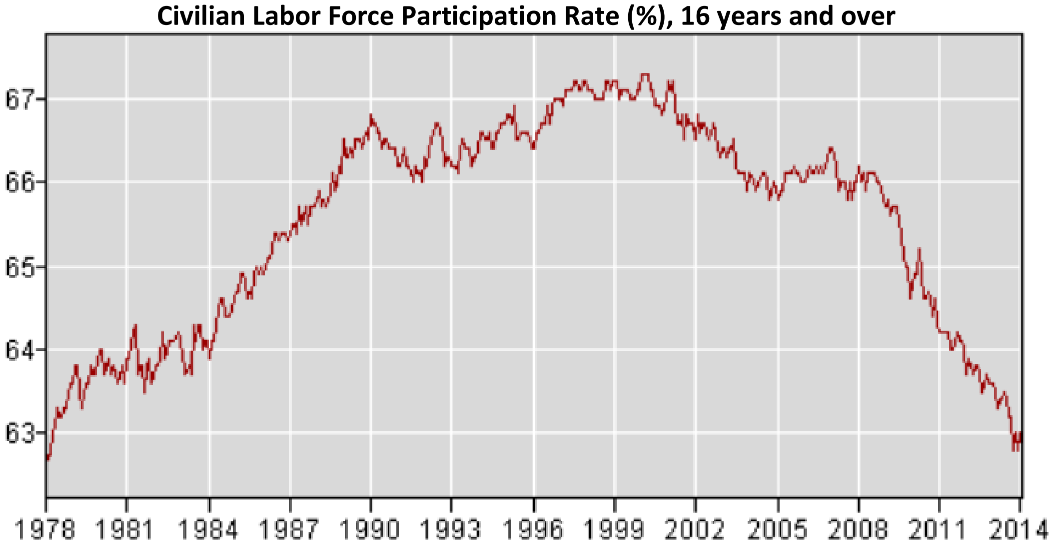
GDP – The total Q4 2013 results were reduced from 3.2% to 2.4% and prospects don't appear much better looking forward into 2014. Q1 2014 GDP should come in between 2.1% and 2.5%, and with that in mind we expect the entire year to average somewhere between 2.3% and 2.9%. Our forecast range for Q2 at this point in time, is between 1.8% and 2.3%, which continues the weakness and foreshadows a possible recession in the next few years. Recession is a relative term and just to refresh investors on terms, three consecutive quarters of GDP below 0% constitutes a recession and a depression is five consecutive quarters of below 0%. The US could experience a downturn and not meet these metrics, thus it would not technically be deemed a recession or depression, but it would still feel uncomfortable for most investors. The Real GDP 1790-2009 chart to is interesting as it reports GDP since 1790, and illustrates the current environment in a unique



Source: John Mauldin, *US Economy - The Erosion of Growth, Tax Consequences From Gain to Drain,* Jan 19, 2013 http://www.marketoracle.co.uk/Article38585.html perspective, possibly similar to the depression years.

Unemployment – continues to be a persistent problem, not just the actual number but for the real unemployed workers. The calculation of the actual unemployment number is not as useful to MCS at this time with so many workers falling off the rolls. As such, MCS uses the labor participation rate which is a percentage representing 16-64 year old potential workers. This percentage is just under 63% and is near its 35 year low.

Civilian Labor Force Participation Rate (%), 16 years and over



Source: Bureau of Labor Statistics Website

Most should understand the dynamics of the baby-boomer generation (which are individuals born between 1946 and 1964) encompassing approximately 78M Americans. Typically the average American worker retires at age 65. Current demographics indicate that the U.S. has about 10,000 people a day who turn 65; which is approximately 300K people per month, and 3.6M people a year. The U.S. will continue on that trajectory for about the next fifteen to twenty years. While not all of these baby boomers are employed, or due to drop out of the labor market, it is of concern to think about how that trend could affect our labor force. Even though the baby-boomers are beginning to retire, the older generation is doing better than the younger generation as far as employment. The chart below from the Bureau of Labor Statistics illustrates the labor force situation and all of the forms of unemployment today, not just the U-3 number touted by the media.

HOUSEHOLD DATA
Table A-15. Alternative measures of labor underutilization
[Percent]

MCS
METROPOLITAN CAPITAL STRATEGIES, LLC

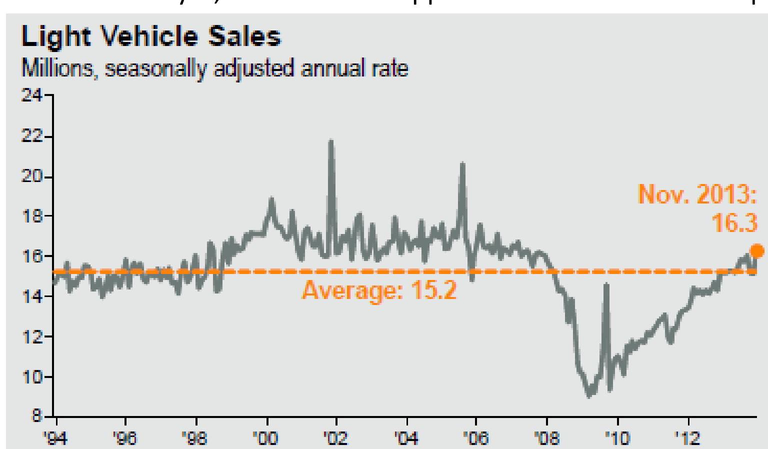
Measure	Not seasonally adjusted			Seasonally adjusted					
	Feb. 2013	Jan. 2014	Feb. 2014	Feb. 2013	Oct. 2013	Nov. 2013	Dec. 2013	Jan. 2014	Feb. 2014
U-1 Persons unemployed 15 weeks or longer, as a percent of the civilian labor force	4.3	3.5	3.6	4.2	3.8	3.7	3.6	3.4	3.5
U-2 Job losers and persons who completed temporary jobs, as a percent of the civilian labor force	4.6	4.0	3.9	4.2	4.0	3.7	3.5	3.5	3.5
U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)	8.1	7.0	7.0	7.7	7.2	7.0	6.7	6.6	6.7
U-4 Total unemployed plus discouraged workers, as a percent of the civilian labor force plus discouraged workers	8.6	7.5	7.5	8.3	7.7	7.4	7.2	7.1	7.2
U-5 Total unemployed, plus discouraged workers, plus all other persons marginally attached to the labor force, as a percent of the civilian labor force plus all persons marginally attached to the labor force	9.6	8.6	8.4	9.3	8.6	8.2	8.1	8.1	8.1
U-6 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force	14.9	13.5	13.1	14.3	13.7	13.1	13.1	12.7	12.6

NOTE: Persons marginally attached to the labor force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not currently looking for work. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule. Updated population controls are introduced annually with the release of January data.

Source: Bureau of Labor Statistics Website

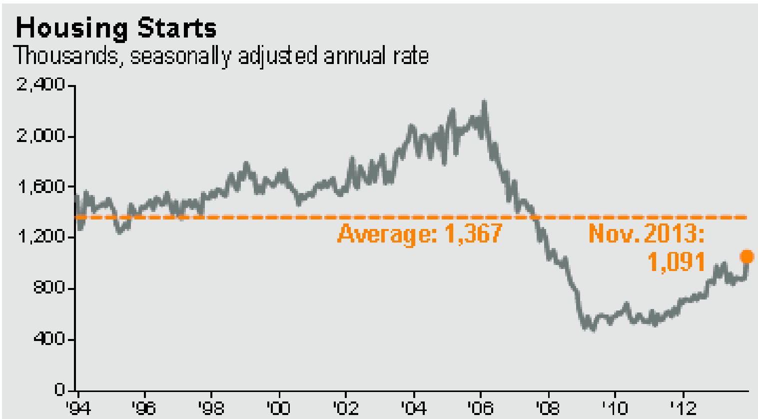
In addition to their effect on the labor markets, Baby-boomer Demographics are influencing the consumer today. As an example, let's explore four areas as examples: Auto Sales, Housing, Retail Sales and Consumer Spending.

Auto Sales – should be consistently growing on the basis of demographics alone. The American population is growing and once a car is purchased, one typically owns a vehicle until he/she dies. So unlike unemployment, drivers do not generally "fall off the rolls." Thus auto sales should be going up based purely on an increase in population alone. As yet, that does not appear to be the case. 16M per year for light vehicle sales is just near the mean level, yet this level needs to keep increasing to be meaningful to GDP growth. ***Dealership channels are over-stuffed with inventory and thus the automobile manufacturers may use incentives to move inventory off lots in the near future, which will temporarily mute the positive effect of any increase in sales due to squeezed profit margins.***



Source: Guide to the Markets® 1Q | 2014, J.P. Morgan Asset Management

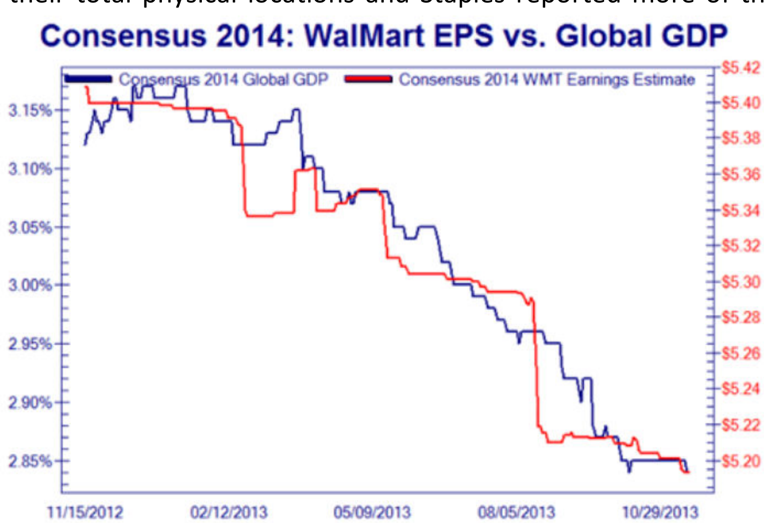
Housing – The average annualized numbers of New Home Sales since 1978 is 700K; these numbers have been as low as 400K and as high as 1.2M during that 35 year period, with the peak of 1.2M coming in 2005. The Jan 2014 New Home Sales numbers, reported in early March, "came in at" 468K annualized expected sales. The area with the highest increase in New Home Sales was the North East with a 73% increase month over month. If weather has been a factor in other "misses" this year how does one embrace this number (468K) as a positive?



Source: Guide to the Markets® 1Q | 2014, J.P. Morgan Asset Management

"Here is a recap of housing data points: Housing Starts (which is different than New Home Sales, in that housing starts are defined as "breaking ground" for a structure) fell 16% in Jan, the largest monthly drop since Feb 2011; existing home sales slid 5.1% to the slowest pace since July 2012; mortgage applications hit their lowest point since Sept 2011; the national association of home builders index fell 10 points; building permits fell more than expected; the housing industry is facing tight credit, limited inventory, higher average prices, and higher interest rates; approximately one out of every seven homes are still under water with their mortgage loans; shadow inventory (homes owned by banks that are not on the market for sale) is in the neighborhood of 7M homes. Therefore, inventory for sale is quite different than inventory per se. The data above begs the question on how the spin doctors can continue to say that the recent poor housing data has all been attributed to the weather when the new home sales number came in much stronger than expected and significantly better than even the most optimistic numbers. That said, if five and a half years after the financial crisis we have only 468K new home sales on an annualized basis, how does that translate into a strong recovery?" – from the MCS blog post February 16, 2014

Retail sales – are dismal and to some extent can be attributed to lower wages, the real unemployed and the realization that the baby boomers don't need a "new pair of shoes." How ugly can it get? It is already an anemic recovery for retail sales. Many retail experts are predicting the demise of Sears, JP Penney's, Barnes and Noble and other major chains that will at a minimum continue shuttering stores and perhaps even close entirely. Radio Shack, a store that has been around since 1930 just announced a closure of 1,100 stores, 20 percent of their total physical locations and Staples reported more of the same. Expect even more of this type of news from the retail sector. Walmart can't get shoppers to spend, even during the holiday shopping season. The poor retail sales negatively affected GDP which slowed significantly in Q4 and was not weather related. Our analysis indicates retail sales continue to struggle. The Consensus 2014 Chart of Walmart's decrease in earnings



Source: Gordon T. Long, *The Retail Real Estate Implosion: The Robotics Cometh!* Feb 17, 2014 Http://www.safehaven.com/article/32815/

per share/ overlaid with Global GDP is telling.

Consumer Spending – Q4 is normally one of the better quarters with the preliminary GDP consumer number at 3.3 but due to revisions dropped to 2.6 with momentum weakening and Q1 numbers will possibly be negatively affected by weather related problems. Another item negatively affecting the number is inventories; ***the lag in demand is keeping turnover stagnant with goods remaining on the shelf.***

Inflation – Currently the US is experiencing inflation below the Fed's target rate of 2%; official numbers are running between 1.5% and 2% annualized. Japan has been experiencing deflation over the past 25 years, and seems incapable of escaping its grasp. Now Europe is worried about deflation. The EU inflation rate is 0.7 and they are very concerned they could fall into a deflationary environment. This concern indicates a greater likelihood for an infusion of Quantitative Easing, (money printing) if the courts rule in favor of the legality of QE for the EU.

Fundamentals

The Fundamentals of US companies appear to be weak in Q1 2014 with the big story being Earnings versus EPS and also revenue growth. The earnings season doesn't appear to be as robust as what the media has been saying, but it's rather a" stellar EPS season." Are fundamentals really that good when EPS are improving primarily on cost cutting and buyback programs?

Since roughly 90% of the S&P companies have reported their EPS, adjectives such as "spectacular", "strong" and "surprise to the upside", one would think the major indexes would be up significantly. Actually, most indexes are flat, or slightly positive to slightly negative for the year.

The logical question to ask is: why is there a disconnect between a great EPS (roughly 70% of the companies reporting have beaten their EPS estimates) and a not so good earnings and revenue season? One reasonable explanation is revenue and earnings are not reflecting the EPS that the companies are reporting due to the stock buy backs and cost cutting mentioned above. Therefore, it appears the market may be changing course and locking itself into a channel for the next several years. This would be an ideal environment for those investors who are not in a buy and hold strategy or inflexible asset allocation position.

Here are a just a few companies that have had major decreases in revenue from 2011-2013: Bank of America's revenue has decreased 13.5B, Alcoa's revenue has decreased 2.0B, and Intel's revenue decreased 1.3B. There are many others, but you get the idea. IBM, as an example, needs to cut about 80K jobs to offset a loss of revenue and to become more competitive, however they are currently cutting only 17K.

EPS should continue to increase in 2014 as companies focus on additional cost cutting and stock buybacks that are expected to be in the$ 400B range; the peak for buybacks was probably in 2013 at about 500B. Earnings for Q2 on the S&P should range between $27 and $27.50 and the MCS full year projection at this point in time is $114-$117, while most professionals (at asset gathering firms) have a $119-$121 consensus. – from MCS blog March 4, 2014

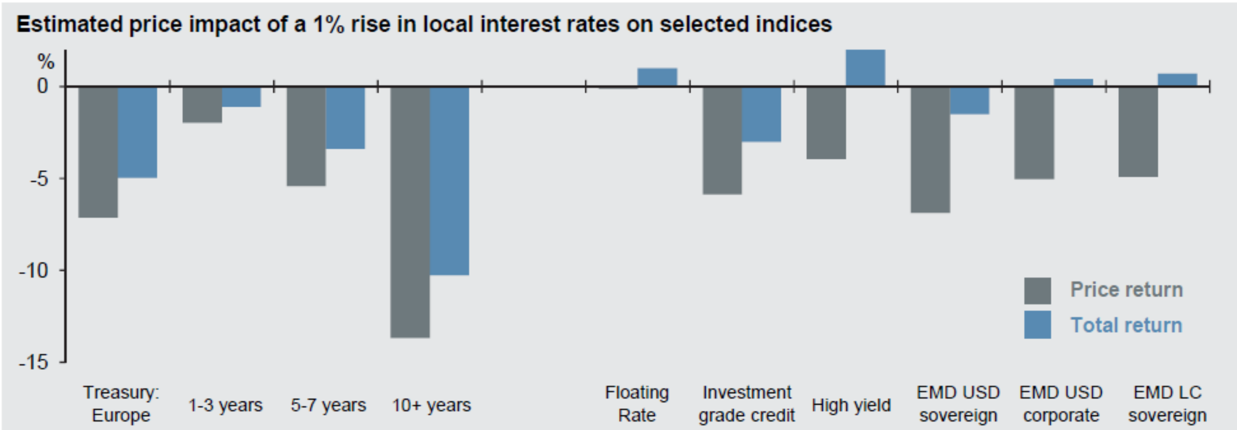
Potential 2014 Investments

Here are some potential asset classes for investment in 2014, and inflection points that could allow an entry point.

Gold is on our radar. Gold is a function of currency valuation, global uncertainty and inflation. As an investment opportunity in the near future gold could go significantly higher or lower depending on the aforementioned factors. It is currently in the upper end of the recent trading channel of about 1,350. MCS needs gold to make a significant indication of a move out of the current channel, in either direction to provide an opportunity for an entry point. That move could be sparked by either additional world unrest, inflation or a change in the US Dollar valuation. A change to the Fed's current tapering schedule that increases the speed of the tapering could also affect an increase in the price of gold (safe-haven.) Notwithstanding the events mentioned above, gold is still in a downtrend, and it is expected the range will continue this quarter.

Emerging Markets – the reduction in US monetary stimulus has had a profound negative effect on many emerging markets. In expectation of relatively higher yields and lower risk in developed countries and reduced available liquidity, capital will continue coming out of countries at a record rate and a short position would be the most likely investment in the near future this year.

Bonds – US Treasury interest rates on the 10-year currently are in a range from 2.4% to 3.2%. We are in the mid portion of that range and expect an upward move in yield perhaps as early as the second quarter. The chart below from JPM illustrates what a 1% increase in rates does to bonds one is currently holding in their portfolio.



Source: Guide to the Markets® Europe 1Q | 2014, J.P. Morgan Asset

China – has a major problem; the Peoples Bank of China indicates there are a lot of bad loans in their shadow banking industry and could experience a Lehman moment with their credit portfolios. China's exports dropped 18% year-over-year in February 2014 leading to concern about their ability to achieve their 7.2% GDP target. China is the second largest contributor to Global GDP and could therefore be used separately or in combination with an Emerging Market EFT investment. Currently, this asset class is in a downtrend and could continue on that trend.

US Equities - Finally, it appears we are entering a world where fundamentals can be analyzed with fewer distortions and temporary or artificial manipulations. This will allow the high risk associated with US equities over the last several years to dissipate. Once the risk can be managed under more "normal" environments one can easily identify investments that can be exploited to make and keep those investment profits. This year, and for the foreseeable future, US equities should provide opportunities for long and short positions, an array of low risk/high rates of returns for those managers and investors who have at their disposal the proper analytical tools and the unencumbered freedom to invest in any sector, industry or company at any given point in time.

Due to the nature of the Q2 calendar, this quarter generally has a lot of volatility. If the current situation on tapering remains the same going forward, there is a high likelihood of a 10% plus correction in US markets in the Q2 or Q3 timeframe, which could allow a short position and then a long play on the bounce. If the geopolitical situation heats up we could have an investment in the gold market. In addition, if the Emerging Markets fail in their attempts to stem outflow of capital we could short EM this quarter. Finally, if the US interest rates stabilize around approximately 2.5% yield and strongly move higher on the taper, MCS may get a short play on the 10-year plus bond as early as the second quarter.

While we do not expect all of these asset classes to present opportunities this quarter, being unconstrained in asset classes allows a manager the flexibility to exploit points in time to accumulate profits, and not ride assets classes up and down based on exogenesis market conditions. Remember, market investments over the last 14 years have resulted in anemic nominal increases for most investors- or worse.

MCS returns over the full investment cycle are above the 8% hurdle without any noteworthy losses.

MCS Portfolio Review

Metropolitan Capital Strategies' tactical portfolios performed as designed and shielded our clients' assets from the negative impacts of those market moves. Our Q1 2014 portfolio for Tactical Growth saw the closure of a Feb TLT call with profits intact, a new June TLT Call written and a MDY March put that is positive and expected to expire with profits. We continue to explore additional option positions in the portfolio to augment the portfolios short duration bond returns.

While our investment criteria allowed for option positions in our Tactical Growth composite and our hedge fund during Q1, we did not need to rebalance the portfolio. Thus the portfolios (Tactical Moderate and PKG TM) were not exposed to risk greater than short term bond funds and the iShares Floating Rate Bond ETF (FLOT) since our confidence criteria was not met. Those investments avoided the drawdown that many investors experienced.

In order to provide insight into the day to day changes of economic, fundamental and technical data in the global markets and how they impact our investment decisions, MCS posted a significant amount of commentary to our MCS blog (or investment diary) which began in November of 2013. We trust it has helped provide some understanding of why our portfolios were positioned as they were in Q1 and clarity about additional opportunities for further success in Q2 2014 and beyond.

MCS expects 2014 to provide lower-risk opportunities, primarily due to the planned exit of Quantitative Easing by the U.S. Federal Reserve and the return to less divergence and transparency distortion in Fundamental and Economic Analysis. ***Even if the Feds do not exit completely this year, the game is over one way or another and could expose asset classes to increased volatility for most other managers.*** Monetary policy continues to be one of the most important factors in the investment world right now. The US Federal Reserve is currently tapering $10B (Billion) per meeting; but they can change course at any meeting, moving forward with any one of three possible outcomes. The Federal Reserve can continue on the current course, delay or reduce the tapering, or increase QE.

The next Fed meeting (after March 18-19th) is April 29-30 and of the three possibilities - the most likely scenario is a continued tapering of $10B per meeting, which will still add about $500B of liquidity into the financial system this year. This is a vast amount of currency and at some point the central bankers will need to withdraw it from the system. Unfortunately, it appears that the Feds don't have a clue as to how this will end primarily because QE has never been attempted to this extent.   Each time there is a wobble, the central banks turn on the taps. Either that works by creating growth with asset prices eventually coming into line with fundamentals, or it doesn't and we're in for a massive fall.

"Our definition of risk is the permanent loss of capital"

As CIOs of our own assets, we have constructed a portfolio that can and has proven to protect investor capital no matter how severe these market dynamics.

What's in your wallet?