DoubleLine Multi-Asset Growth Strategy: 2013 Review and 2014 Outlook

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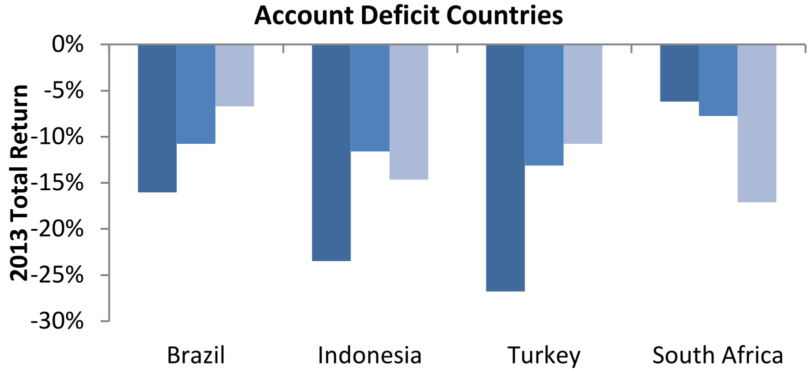
2013 Year in Review

In 2013, financial markets continued to be driven by central bank policy. The Federal Reserve (the "Fed") was a main market driver with the announcement of its intent to "taper" monthly asset purchases by the end of the year, data permitting. For the majority of the year, investors were left wondering when the Fed would eventually dial down its Large Scale Asset Purchase Program and by how much. As a result, U.S. Treasuries (UST) sold off as investors tried to reduce interest rate risk with yields on the U.S. 10-year Treasury rising 140 basis points (bps), finishing the year at 3.02%.

Emerging Markets (EM), which have become somewhat dependent on cheap funding, sold off precipitously as investors unwound their "search-for-yield" trades. EM countries with current account deficits were hit the hardest including Indonesia, Brazil, Turkey, and South Africa. See Exhibit 1.

Exhibit 1. 2013 Total Return for Selected Current Account Deficit Countries



Source: DoubleLine, Bloomberg

During the year, investors substituted interest rate risk with credit risk, as spreads on high yield bonds tightened to pre-crisis lows. With default rates near an all-time low, high yield bonds, floating rate debt, and convertible bonds were some of the top performing fixed income assets in 2013. Global government bonds, as measured by the Citigroup World Government Bond Index (USD) posted a total return of -4.00%. EM fixed income, as measured by the JPMorgan Emerging Markets Bond Index (EMBI) Core, posted a total return of -6.45% in 2013.

Developed Market (DM) equities performed extremely well over the course of the year as improving economic data and accommodative monetary policy helped to buoy equity prices. U.S. equities, as measured by the S&P 500 Index, rallied +29.6% (the largest annual return since 1997). Japanese equities, as measured by the Nikkei, rallied 56.72% (the largest rally since 1972). Japanese equities were supported by unprecedented quantitative easing (QE) from the Bank of Japan (BOJ) and promising developments from Prime Minister Abe's "Abenomics." EM equities, as measured by the Morgan Stanley Capital International Emerging Markets Index (MSCI EM), underperformed developed markets in 2013, posting a total return of -4.98%.

Although it is often inaccurate to group all commodities together, they performed poorly as a basket in 2013. The S&P Goldman Sachs Commodity Excess Return Index (SPGSCI ER) posted a total return of -1.28%. Of the five sectors represented by the SPGSCI, only Energy had positive returns for the year. The Precious Metals sector was the worst performing sector returning -29.8% for 2013. It was the first calendar year that gold suffered a negative return since 2000. Industrial metals and agriculture were also negative, as measured by the SPGSCI Industrial Metals and Agricultural Indices[1], down 12.92% and 18.05%, respectively.

In currencies and against the U.S. Dollar (USD), the Japanese Yen, Australian Dollar, and Norwegian Kroner were the weakest performers in G10, while the Euro and British Pound strengthened as data improved across the eurozone. In EM currencies, current account deficit countries (Indonesian Rupiah, Turkish Lira, South African Rand, and Brazilian Real) were the weakest performers, as investors pulled money out of carry trades as funding costs increased.

2014 Outlook and Themes

DM to outperform EM

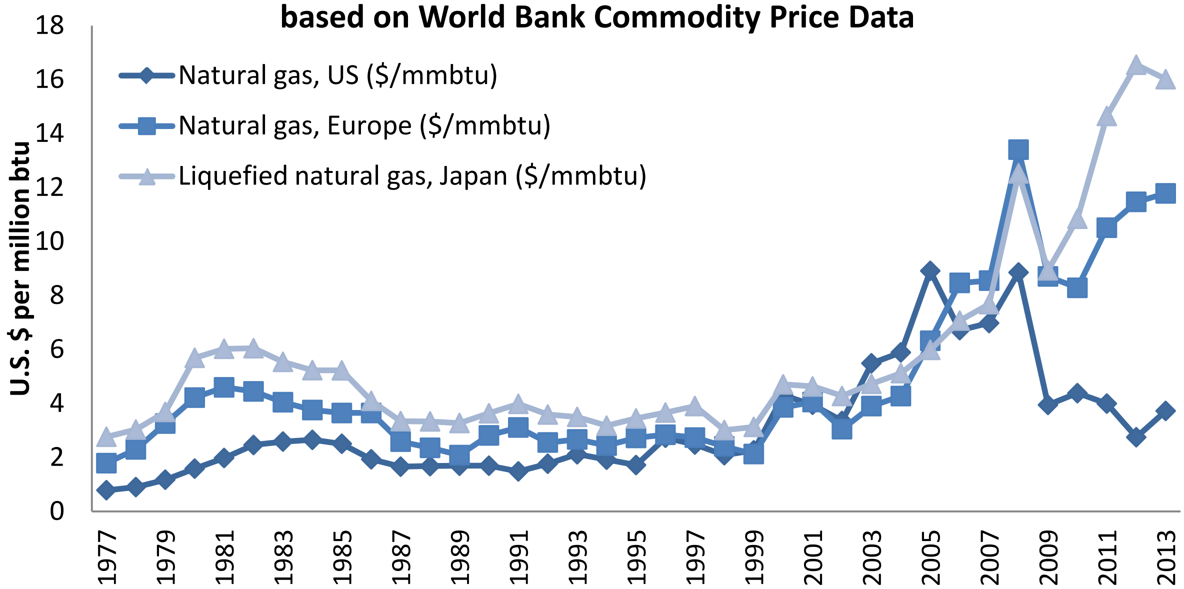
Continuing the themes from 2013, DM are considered more likely to outperform EM in 2014 at this point. Growth in most DM is forecasted to pick up while the growth outlook is revised downwards in many EM countries. Unlike 2013, we should expect more dispersion of performance among EM assets: countries with sound fundamentals should avoid a sell-off while countries with poorer fundamentals will likely continue to be a concern for investors; the ability to access global funding and the risk for severe volatility and social unrest.

The premise of this outlook hinges on U.S. growth outpacing current estimates and commensurate withdrawal of monetary stimulus by the Fed. This seems to be a scenario that could occur in 2014 due to

[1] Industrial Metals and Agriculture are commodity sectors within the SPGSCI and are subsets of the Index. Please see the Definitions section of this piece for Index Definitions.

the following expected tailwinds: 1) the fiscal drag witnessed in 2013, which cut an estimated 1.5% from real GDP, could diminish in 2014 with an estimated impact of between 0.25% and 0.5% to real GDP in the U.S.[2]; 2) consumer spending could pick up in 2014 as there is pent-up demand from tax increases in the previous year, and capital spending could improve in the coming quarters; 3) the upward trend in housing activity could continue in 2014, albeit at a more moderate pace; 4) the U.S. is benefiting from low energy costs compared to historical levels and other countries. See Exhibit 2.

Exhibit 2: Natural Gas Price in U.S., Europe and Japan (1977-2013) based on World Bank Commodity Price Data



Source: World Bank, DoubleLine

In addition, low commodity prices across the board will increase profitability and benefit consumers; and 5) while the Fed will be reducing QE stimulus in 2014, monetary policy is likely to be highly accommodative over the course of the year. While this improving growth story is positive, it highlights one of the key risks in our view: for the potential for the Fed to lose control of the short end of the curve, as forward expectations of the first round of rate rise begins becoming unanchored, and as the market begins questioning whether the Fed is behind the curve in the tightening cycle.

As for Europe, the eurozone should continue to crawl its way out of recession but with some risk of a severe turbulence, and loss of confidence should policy makers make a misstep, or external factors pull down economic growth. The region should benefit from stronger external demand, especially from the U.S., reduced fiscal drag, and a European Central Bank (ECB) that is likely to remain highly accommodative in an effort to stimulate growth in the eurozone. One of the key risks to the eurozone

[2] Goldman Sachs, "10 Questions for 2014"; U.S. Economic Analyst; Issue No 13/52; 12/27/2013

recovery is France and its looming structural primary deficit[3] which should be watched closely this year. It will also be important to watch the European parliamentary elections in late May, which could act as a sounding board for anti-Euro political parties.

As for Japan, Abenomics and the BOJ will be the center of attention once again. The central bank is expected to increase the pace of its Large Scale Asset Purchase Program in an effort to offset the effects of fiscal tightening. The BOJ may also increase its purchases of ETFs as well as various risky assets. This could weaken the Yen further and support Japanese equities. While inflation in Japan has risen to multi-year highs, the rise is largely the effect of the weaker Yen and higher import costs. One way to promote sustainable and healthy inflation is for Japan to increase wages. While wage inflation has not been showing up in the data as of yet, there is anecdotal evidence that Japanese firms are beginning to increase salaries and bonuses. This development would boost consumer spending and could lead to the next leg up in Japanese equities. Japan should also benefit from lower commodity prices which will counterbalance some of the effects of Yen devaluation. Here too, we must highlight an admittedly low probability event but real risk for markets: should Abe change policies for any number of reasons and back down, or pause his initiatives? Any significant unwind of the Yen carry trade could have severe implications for global markets and serve as a source of major volatility.

On the other hand, EM countries with high external financing needs, low real policy rates, high foreign holding of local debt, and structural budget deficits are likely to feel pressure and underperform this year. Countries that fit this description include Turkey, South Africa, Brazil, and possibly India. If the U.S. and other developed markets began to overshoot growth expectations, interest rates in the U.S. could have the potential to normalize further, with the short-end of the curve perhaps the most vulnerable this time around. If this scenario unfolds, these aforementioned current account deficit countries could find themselves cut off from external funding as funding costs increase and carry trades continue to be unwound. Things could get worse in these countries before they get any better as they are *all* facing national elections in 2014. This could delay any productive political reform until after the elections when political parties are safely in control.

Bullish USD

The potential acceleration of growth in the U.S. in 2014, along with the Fed reducing stimulus, should support the USD over the course of the year. As the Fed becomes less dovish relative to other DM central banks, yield differentials should continue to move in the USD's favor. Contrary to 2013, the gradual rise in rates with lower interest rate volatility should be a tailwind for the USD. On the other end of the spectrum, the ECB and BOJ will likely maintain their highly accommodative policies and may loosen further. The ECB is looking to stimulate a faltering labor market and boost household credit

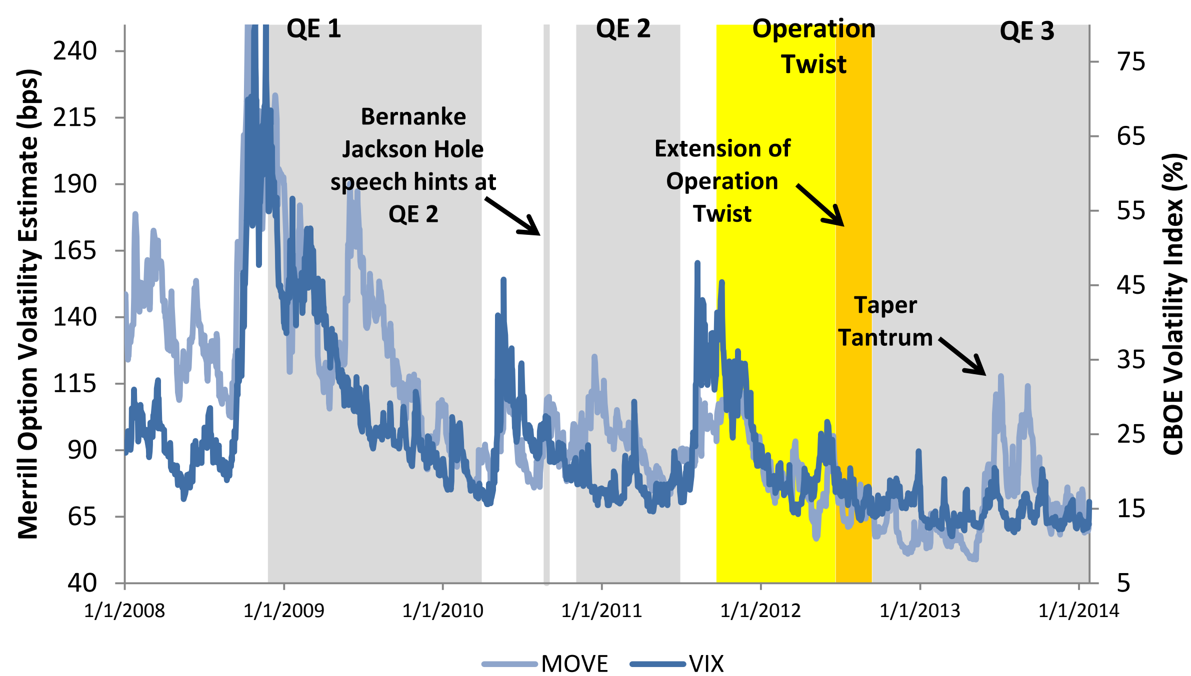
[3] The primary deficit is the budget deficit less interest expenses.

growth, and the BOJ is looking to do whatever it takes to climb out of the multi-decade period of deflation. We will see whether or not Japan will pass the deflationary baton over its European counterparts. While being bullish on the USD is a consensus view, there is much disparity on which currencies the dollar should perform strongest against. The USD looks like it could outperform commodity-based currencies as commodities will likely remain suppressed, as China is transitioning to a domestic consumption based model. The Canadian Dollar, Australian Dollar, Norwegian Kroner, Chilean Peso, and Brazilian Real are a few currencies that are vulnerable to these dynamics. Each of these countries could be vulnerable as their business cycles moderate due to their overheated housing markets and overleveraged households.

Volatility Likely to Pick Up Next Year

Since the global financial crisis, volatility across most asset classes has been trending lower as it is suppressed by global central bank intervention. See Exhibit 3. The "Bernanke Put," has propped up risk assets and has essentially removed two-way risk from the market. Easing Fed policy has caused investors to move further out on the risk spectrum, taking on more credit and interest rate risk, stretching for yield.

Exhibit 3: QE, The "Ultimate Volatility Suppressor"



Source: Bloomberg, DoubleLine

Currently, forward guidance has become the policy of choice for many central banks. While there have been obvious benefits from such an unconventional policy, it is not without risk. At the top of the list are risks stemming from complacency in the reform agenda, financial stability, and central bank credibility.[4] A major problem with forward guidance is that it assumes the central bankers can accurately predict what is going to happen in the future. However, empirical evidence shows that central bankers do not have a very good track record when it comes to prognosticating (e.g. housing bubble, dot-com). When it comes to tightening cycles, the Fed has historically been behind the trend. In a situation where U.S. growth surprises to the upside (or downside) and the unemployment rate moves well below the Fed's 6.5% threshold, the market may start questioning the Fed's credibility and its commitment to maintaining zero interest rate policy under such conditions (or tapering in the opposite case), causing short term rates to sell off. The knock-on effects of higher short term rates would be felt across many asset classes, particularly assets that are dependent on cheap funding as previously mentioned; e.g., current account deficit EM countries. But, would a major undershoot on U.S. growth open the door for more QE? Or has the Fed become more reluctant to embark on another QE program as many members have started questioning the efficacy of additional QE? A scenario such as this could be significantly worse than the growth overshoot scenario as there are fewer available options. It is hard to believe that volatility would not pick up under this scenario. It is clear that the Fed does not have much room for error. Oddly enough, equity volatility is trading near a multi-year low, illustrating some complacency in the market. Market participants seem to believe the Fed is clairvoyant and knows how to react accordingly - but from where we sit those goal posts look narrow.

Summary

We admit that most of the observations and views mentioned previously are consensus and have noted that consensus thinking at the beginning of this year is more pronounced than anytime we can recollect. This being the case, we remain focused on watching for signals that can serve to challenge market sentiment and reverse concentrated positioning, such as a series of disappointing data in the U.S. Hence we remain flexible in our thinking and approach this year respective of the relatively higher level of downside risks in the market this year versus the recent past.

Positioning in the Multi-Asset Growth Strategy is reflective of the aforementioned view of the macroeconomic landscape. In fixed income, over the intermediate term we prefer shorter duration assets including floating rate and Collateralized Loan Obligations (CLOs), yet we still own some long duration assets to protect against the U.S. economic growth scenario underperforming expectations. Conversely, we want to avoid the bonds of EM current account deficit countries. In equities, we are

[4] IMF Policy Paper: Global Impact and Challenges of Unconventional Monetary Policies; October 7th, 2013; http://www.imf.org/external/np/pp/eng/2013/090313.pdf

overweight developed market equities with a bias towards long U.S., Europe, and Japan. When the opportunity presents itself we will look to tactically short EM equities, as both a directional view and hedge to our long equity exposure. We will also look to tactically engage in long equity volatility positions in a low cost manner. In currencies, we prefer to be long the dollar against Japanese Yen and a basket of commodity-based currencies, and long low beta currency volatility. We also plan to use currencies to engage in cheap tail-risk hedges, including going short currencies that are vulnerable to a global slowdown and potential EM weakness. In commodities, we will continue to allocate capital to our systematic long/short commodity strategy.

Definitions

G10
G10 is a group of eleven industrial countries including Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

JP Morgan Emerging Markets Bond Global Diversified Index (EMBI)
This index is uniquely-weighted version of the EMBI Global. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by EMBI Global.

Morgan Stanley Capital International Emerging Markets Index (MSCI EM)
The MSCI Emerging Markets Index is a float-adjusted market capitalization index designed to measure equity market performance in global emerging markets. It consists of indices in 26 emerging economies, including but not limited to, Argentina, Brazil, China, India, Poland, Thailand, Turkey, and Venezuela.

S&P 500 Index
Standard & Poor's US 500 Index, a capitalized-weighted index of 500 stocks.

S&P/Goldman Sachs Commodity Excess Return Index (S&P GSCI ER)
Standard & Poor's/Goldman Sachs Commodity Index, or GSCI, is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures. The index's components qualify for inclusion in the index based on liquidity measures and are weighted in relation to their global production levels, making the Index a valuable economic indicator and commodities market benchmark. The S&P GSCI Excess Return Index (SPSCI ER) is one of the three S&P GSCI Indices published, measuring the return accrued from investing in uncollateralized nearby commodity futures. This Excess Return Index includes an Energy component, which was referenced in this commentary.

World Government Bond Index (WGBI)
The World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indices are available in any combination of currency, maturity, or rating.

An investment cannot be made in an index.

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