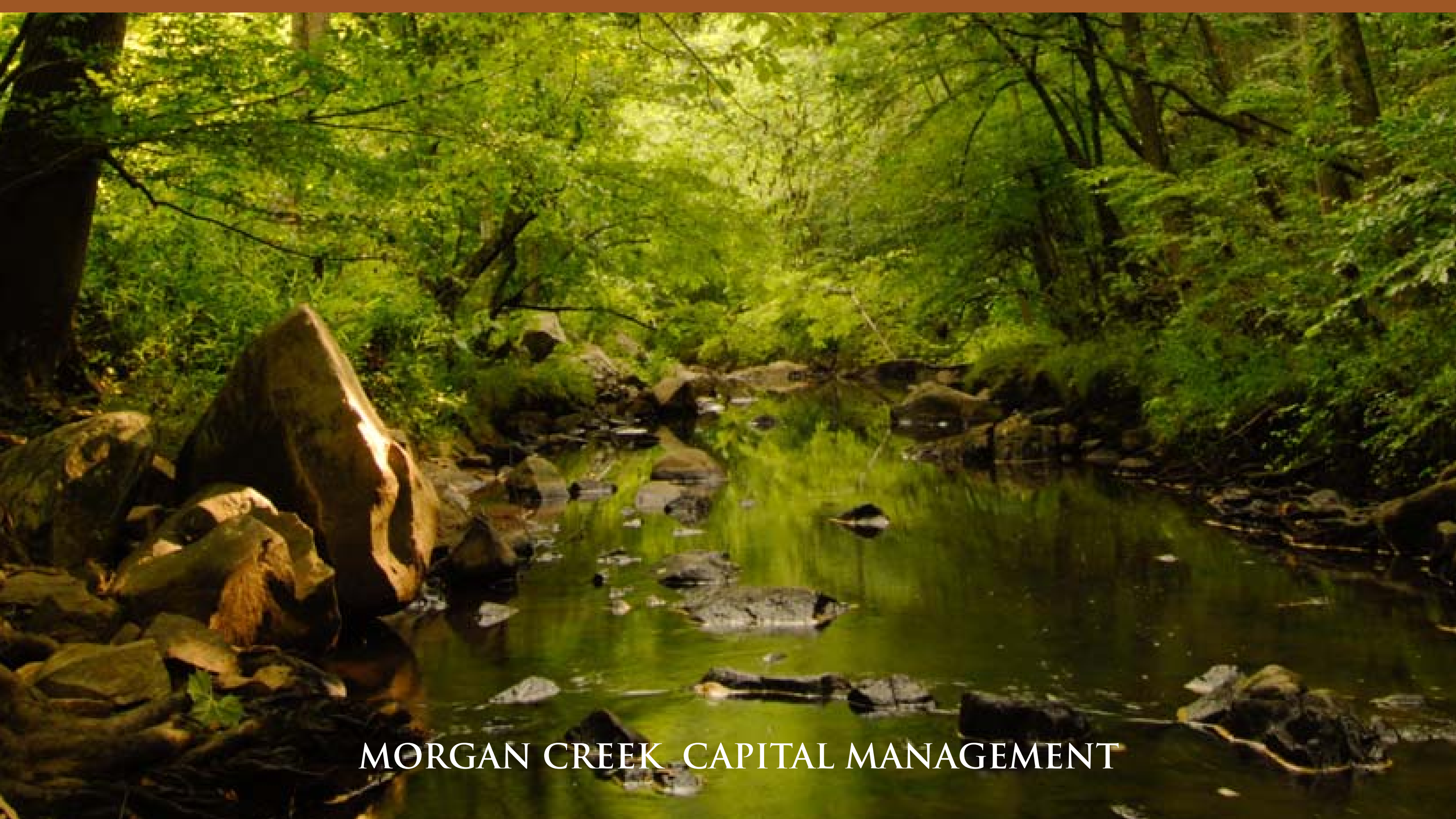
Q1 2015 Market Review & Outlook

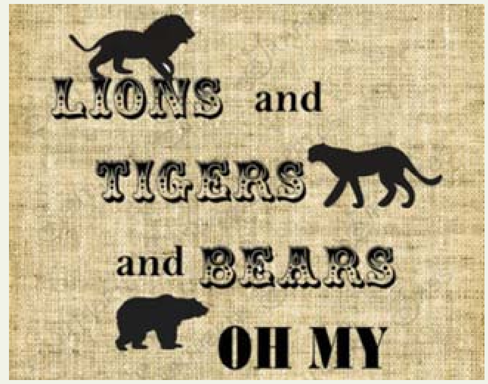
Morgan Creek Capital Management



MORGAN CREEK CAPITAL MANAGEMENT

Letter to Fellow Investors

Not Lyin', The Big Tiger's a Bear, Oh My!



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The father of the hedge fund was Alfred Winslow (A.W.) Jones. Jones was born in Australia, graduated from Harvard, was a U.S. diplomat and earned a PhD in Sociology from Columbia, before becoming a member of the editorial staff at *Fortune* magazine where he was inspired to try his hand at asset management while writing an article about current investment trends in 1948. He raised $100,000 (including $40,000 of his own money) and created a partnership that employed a long/short equity investment model where he combined leverage and short selling of securities, as a means to control risk and produce more stable returns. In 1952, Jones converted the fund to a limited partnership and added a 20% incentive fee as compensation for the general partner. The hedge fund concept did not catch on until 1966 when *Fortune* ran an article entitled *The Jones Nobody Keeps Up With*. That article showed that Jones' track record was superior to all listed mutual funds, had beaten them by double digits in the past year, and by high double digits over the past five years. Importantly, the article pointed out that the strategy was profitable in most Bear markets, including only a small loss in 1962, and that Jones himself had become rich as the manager. Suddenly, by 1968, some 150 hedge funds had been started, as many high profile investors were attracted to the lucrative compensation structure. However, in an effort to maximize returns, many managers turned away from Jones' original "hedged" strategy (the original fund name ended with a "d") and chose instead to simply add leverage to long positions. This long-biased positioning led to heavy losses in the downturn in 1969-70 and many funds never recovered and were forced to close during the Bear market of 1973-74. It has been estimated that 85% of the original hedge funds shut down during this period and the nascent industry was in a serious crisis. Even famed investor Warren Buffet shut down his investment partnership in 1969 to "pursue other interests" (turned out alright for him…). At the time, there were cries for more regulation of the industry, higher taxation on the incentive compensation structure and greater oversight by the SEC (which sounds eerily similar to today). With just a few handfuls of hedge funds left in the market and total assets estimated to have fallen to less than $1 billion, it seemed prophetic that *Fortune* had written another article in 1970 entitled *Hard Times Come to the Hedge Funds*.

Julian Hart Robertson Jr., was born in Salisbury, NC, graduated from Episcopal High School in 1951 and from the University of North Carolina at Chapel Hill in 1955 before serving as U.S. Naval officer until 1957. After the Navy, he moved to New York City where he worked as a stockbroker at Kidder, Peabody & Co. and was eventually convinced by his peers to run the firm's asset management division. Interestingly, despite his success at Kidder, in 1979, he moved his family to New Zealand for a year to write a novel. On his return, Julian launched a hedge fund, Tiger Management, with $8 million of initial investments from friends and family. Intriguingly, one of Julian's colleagues at Kidder was Robert Burch (son-in-law of A.W. Jones) and it is hypothesized that Burch and Jones gave him the idea of starting a hedge fund as they were among the first investors and because Tiger employed the Jones Model strategy (150% long, 100% short, 50% net) that A.W. had pioneered. Starting a hedge fund in 1980 was a daunting endeavor given that the industry had continued to languish and given that the equity markets were still locked in the grip of a grinding Bear market that had been going on since 1966 (and would not officially end until 1982). Julian said in an early interview that when he launched Tiger, his perception of the industry was that *"there* *was Soros and one other fund and I would estimate that there was less than half a billion dollars invested in hedge funds, total."* Perhaps it was being fresh from his time away in NZ, or perhaps it was confidence from his reputation on the Street for having the Midas touch in stock picking that no one could match, but whatever the reason, Tiger was formed and the hedge fund industry would never be the same. One interesting fact is that both A.W. Jones and Julian started their hedge funds at age 48 and one thesis for their great success starting funds so late in their careers is that they had developed an incredibly strong network of contacts where they could mine for investment ideas and that their seniority was a tremendous advantage in that regard (interestingly, Lee Cooperman was also the same age when he left Goldman Sachs to start Omega). In the early days of Tiger, Julian's stock picking prowess and his ability to attract incredible young analyst talent to the emerging firm led to outstanding results. The rapid rise of Tiger prompted a 1986 article in *Institutional Investor* touting the double-digit performance of the fund, which reversed the negative sentiment about hedge funds that had persisted for the previous two decades. Julian's investment acumen was so highly regarded, he became known as the "Wizard of Wall Street," hence the *Wizard of Oz* reference in the title of the letter.

In fact, there are few hedge fund managers who could be said to have had a greater formative impact on the industry than Julian Robertson (perhaps Soros and Steinhardt too). It might even be fair to say that were it not for the runaway success of Tiger in the 1980s, the hedge fund industry, as we know it today, would probably not exist. The incredible success of the Tiger fund is well documented and is truly impressive, growing from humble beginnings to become the largest hedge fund in the world in 2000, with $22 billion in assets (of an industry wide $300 billion at the time) and producing 25% compound returns for 20 years, handily beating the 17.5% gain in the S&P 500 and the 14.7% gain in MSCI World Index (an original investor in Tiger made 85 times their money vs. 25 times for the S&P 500 and 15 times for the World Index). Perhaps even more impressive, however, is the amazing cadre of Tiger alumni who currently manage hundreds of billions, known as the Tiger Cubs (those who worked directly for Julian) and Tiger Seeds (new hedge funds backed by Julian). Today, there are close to 100 hedge funds around the world with Tiger DNA and there is no other organization in the industry that has had this magnitude of success in producing talent. To that point, it was *Fortune* magazine again in 2008 that wrote a piece, called *Tiger's Julian Robertson Roars Again,* that discussed the incredible returns Julian had generated since closing Tiger in 2000, and I was quoted as saying that *"I think Julian is the greatest identifier, trainer, developer and backer of talent that our business has ever seen. He's also the most competitive guy I've ever met. The beautiful thing about his life now is he gets to cherry pick the very best ideas from the best guys on the planet."*

I first met Julian in my first month on the job as CIO at the University of North Carolina at Chapel Hill in January of 1998. I had met a number of the "Tigers" (those that worked at Tiger were affectionately called Tigers; in fact, the story goes that the reason the firm was called Tiger is that when he asked his sons what he should call his new business one said, "Tiger, because that's what you call everyone when you can't remember their name") over the years in my time managing the hedge fund portfolio at Notre Dame, but I had never met the "Big Tiger" in person. Julian is an incredibly charismatic person and a true southern gentleman who always makes you feel welcome and treats you like you are the most important person in the world. Perhaps that is the secret of his incredible global network; Julian has never met a stranger and everyone was his friend. Friends want to help friends and Julian amassed a virtual army of friends all around the world who were always looking for ways to help Tiger make money. I got to know Julian fairly well over the next couple of years and he became a friend and mentor to me, helping me immeasurably as I honed my investment philosophy. He was incredibly generous with his time and would always answer my questions on what really made a great investor great. Tiger is infamous for their incredibly rigorous process of identifying and screening talent to join the team. They have developed a proprietary set of tests that measure specific personality characteristics that they believe translate into investment success. The tests assess the applicant's honesty, intelligence, collaboration (ability to get along with co-workers) and, most importantly, their competitiveness. Julian says emphatically ***"to be a good hedge fund manager you have to be "absolutely" honest, intelligent and be able to get along with a team, but we found that true competitors are usually the best hedge fund managers."*** I had the privilege of really getting to know Julian well during the very difficult times around the closing of the Fund in 2000. We made a commitment to stay with Tiger through the wind down and held our residual position throughout the balance of the year, as I believed Julian's thesis in the overvaluation in the Tech Bubble was correct. That decision turned out great for us as after the Bubble burst in April; Value came roaring back into favor and the residual "old economy" stocks appreciated dramatically. They say character is how you act when no one is watching, but character is also how you act when things are extremely difficult and Julian taught me many great lessons about character, humility and loyalty during that challenging period.

Julian Robertson has gotten extremely Bearish three times since I have known him, once in 1999 leading up to the Tech Bubble in 2000, a second time in 2007 leading up to the sub-prime melt-down and Global Financial Crisis in 2008 and late last year (and becoming increasingly more concerned this year). In each instance, he started off mildly concerned about imbalances that were building and then he became increasingly vocal in his public appearances, as the situation grew increasingly dire. On each occasion he made significant adjustments to his portfolios that ultimately preserved capital and generated superior returns over the course of the entire event and we would all be wiser, and wealthier, had we followed his lead when the Big Tiger turned into a Bear. The challenging part of the story is that on each occasion he was early in his calls for caution and the funds experienced less favorable performance either in the form of actual losses or perceived opportunity costs (the dreaded Fear Of Missing Out) during the lead up to the actual event. The problem with the big crisis events is that you can be hours early, but you can't be one minute late on getting out of the way as the corrections happen too quickly and come at the precise time when everyone has convinced themselves that nothing bad could possibly happen. In 1999, and early 2000, Julian's bearishness was very costly as he continued to short stocks that he believed (incorrectly in the short run and correctly in the long run) were dramatically overvalued. Negative performance occurred, which led to client withdrawals, which then, reflexively (for a primer on Reflexivity see our Q4 2014 letter) caused more negative performance and more withdrawals in a vicious cycle. The short-term focus on returns clouded investors' views of Julian's core message of concern about valuations and the potential for a Recession and market collapse and ultimately led to Tiger having to liquidate the Fund at precisely the wrong time. People have a bad habit of selling what they are about to need and this bad habit caused significant damage as over the next three years the S&P 500 lost (40%) of its value while hedge funds, like Tiger, rose 10%.

Julian wrote about his fundamental investment beliefs and his grave concerns about the markets in his final letter to Tiger shareholders in March of 2000 (ironically within weeks of the NASDAQ peak, from which the tech heavy index would collapse and lose nearly 80% of its value over two years): ***"The key to Tiger's success over the years has been a steady commitment to buying the best stocks and shorting the worst. In a rational environment, this strategy functions well. But in an irrational market, where earnings and price considerations take a back seat to mouse clicks and momentum, such logic, as we have learned, does not count for much. Investors are rightly fascinated by the Internet, but wrongly they do not include price in these equations. It's going to end in a real blood bath."*** In another appearance, Julian referred to the Tech Bubble as an inadvertent Ponzi scheme that would eventually collapse under its own weight and allow the discipline of Value investing to come back into favor. He wrote ***"Life and investing are long ballgames. The people who were***

cynical and jumped in and played this boom are going to win this game. But to take the cynical risk against your fundamental belief, I wonder if in the long run that will work. I have great faith that this too will pass. The difficulty is predicting when this change will occur and in this regard I have no advantage." Importantly, Tiger was not the only Value investor to close up shop in the first quarter of 2000. Gary Brinson (Brinson Partners) and Tony Dye (PDFM) were both summarily relieved of their duties as heads of value-oriented firms that moved towards growth and Jeremy Grantham at GMO lost half his assets as clients lost their tolerance for missing out on the Great Bull Market. Some market observers considered (quite correctly) that Julian's exit from the hedge fund business was a signal that the long Bear Market in Value investing may finally be ending. Julian closed his letter with ***"I'm not capitulating. I'm not going to quit investing. But it will be nice to get out of the public eye. I don't mind people calling me an old-economy investor, but it doesn't go over well with the clients."*** We actually did a good job heeding Julian's warning in 1999 as we moved the UNC portfolio from a very net long equity portfolio at the end of the year to a nearly 50% weighting in hedge funds by mid-2000 and we were able to keep the portfolio flat over the three years from 2000 to 2002 while the average Endowment lost nearly (25%).

When I decided to leave UNC in 2004 to start Morgan Creek, I got an email that said simply, ***"Say it ain't so, Julian."*** I quip that I had not received a lot of emails from billionaires (one up to that point) so I got on a plane to go see Julian and explain why I was leaving his alma mater. On the way up, I thought that perhaps he was going to give me a "Nike Shoe Deal" (offer me something in addition to my salary like schools do with coaches to keep them around), but when he met me in the lobby of his office at 101 Park, he said **"Mark, I'm surprised you lasted this long. I like you, and I would like for us to work together."** I didn't have to think long on that offer, so we struck a deal on the spot. Julian would be a seed investor in Morgan Creek and we would develop a line of Tiger Hedge Fund of Funds. We developed an even stronger relationship over the years and we launched a Long/Short Equity Hedge Fund of Funds together, the Tiger Select Opportunity Fund ("TSOF") (what is today the Morgan Creek Opportunity Fund ("MCOF")). Julian invested capital in the Fund to get it started and we grew the business very nicely over the course of the next three years. As 2007 progressed, Julian became increasingly concerned about the Housing Bubble and the waning strength of the economy and he became quite Bearish for the second time in our association. In an October CNBC interview with Erin Burnett, he made a number of comments that turned out to be quite prophetic. In talking about the Fed policies that were encouraging imprudent leverage in the housing sector, he said ***"Chairman Bernanke is trapped in a situation created by the sins of his forefathers and he has no choice but to cut, cut, cut, print, print, print."*** He went on to discuss how the Fed was using a weak dollar policy to try and prop up growth through exports and why he didn't think it would be effective in saying ***"I think that the Federal Reserve will trash the Dollar until there is a turnaround in the economy. In the end, the policy is self-defeating, but it helps the exporters."*** He then raised the warning flag and spoke the unthinkable (given that everyone was convinced that home prices could never go down and the Fed had solved the business cycle) when he warned ***"The credit situation is much worse than people think and we are going to have a Doozy of a Recession."*** When Erin asked him to define "Doozy," he said that it would be a bigger than normal one. When she pushed him on whether he was Bearish on stocks too, he went on to say that ***"I am bearish on the economy and in stocks generally as well, but there really are some exceptions."*** True to form, being one of the most competitive people I have ever known, even in the face of the approaching Global Financial Crisis, Julian was always on the lookout for great companies to buy and for creative ways to make big returns. Another unique characteristic of Julian (and of all truly great investors, including Soros and Druckenmiller) is when he was convinced that he was "Right," he would "Bet the Farm" (similar to Soros' advice to Druck in similar situations to "Be a Pig").

We know now (with the benefit of hindsight) that the 2008 period did indeed produce that Doozy of a Recession and that we would have been wise to heed the warnings the Julian made in his October 2007 CNBC appearance. Interestingly, I wrote the following in our TSOF Q3 letter that October, *"there is an old saying in football that "defense wins championships" (obviously this has to be changed for baseball to "pitching wins championships" as the Red Sox swept the Rockies who were supposedly the best defensive team of all time in baseball) and I have long believed that this old saw was critically important in investing as well. Roy Neuberger, the founder of Neuberger and Berman, was fond of saying that there were three rules to managing money, "Rule #1, don't lose money, Rule #2, don't lose money, Rule #3, don't forget the first two rules." We have positioned the Opportunity Fund quite defensively during the past year as we felt that valuation in the areas where our investment themes were focused had become stretched."* Interestingly, we did follow many of the same paths as Julian during 2007 as we were heavily invested in the Tiger Cubs and Tiger Seeds and we had increased our hedging in the portfolio to prepare for higher volatility. We had also taken substantial positions in the short sub-prime trade (unfortunately not as substantial as Julian) in our other vehicles and kept moving up the capital structure in our underlying strategies (moving more toward credit vs. equity, taking less risk). The one place we didn't follow Julian (unfortunately) was when he liquidated all his investments that had any leverage (borrowed money), as he agreed with Warren Buffet that "any strategy that depends on the kindness of strangers will struggle in difficult times" (said differently, banks will change the rules and ask for their money back at the least opportune time during a crisis). We believed that with strong risk management in place, managers like Citadel, and many other absolute return and event driven strategies we had worked with for decades, would weather the impending storm well, just as they had done during the 2000 to 2002 period. As the year came to a close, I wrote in the Q4 TSOF letter *"2007 was, according to the Chinese Zodiac, the year of the Pig (the Golden Pig to be exact), but in reality, last year was definitively the Year of the Tiger. Managers linked to Tiger Management and its founder, Julian Robertson, put up astounding numbers across the board with Tiger Cubs like Steve Mandel, John Griffin and Lee Ainslee posting returns between 40% and 60%, the Tiger Seeds (those firms who cohabitate at 101 Park and were seeded by Julian) returned an amazing 55% as a group and it is has been reported that the Big Cat, Julian himself, had nearly an 80% return on his personal portfolio."* Our Funds did quite well that year as the combination of solid manager selection, prudent diversification and some very strong alpha production from the managers led to strong returns. TSOF was up 23.7% versus a 9% return for the MSCI World and a 5.5% return for the S&P 500. It is important to recall these strong returns in order to show how it is always at the times when things seem to be going nearly perfectly that heeding the cautionary call of a very seasoned investor is critical. Just because the rest of the market participants didn't see the dangers on the horizon that Julian did, and short-term returns were very strong, didn't mean that we shouldn't be more cautious (sounds similar to today).

Here is an excerpt from the 2008 *Fortune* article I discussed above that elucidates some of the points above. *"How are the subprime positions looking?" he asked excitedly. "Mm-hmm. Wonderful." He hung up and turned to me. "My gosh, this has been the most extraordinary period of my career as an investor," he said. The big short bet he had been riding - by owning credit default swaps on subprime debt - was suddenly paying off richly as values plummeted. As his mouth turned up in a half smile he added, "I think this is the best month I've ever had. It's got to be." Not bad for a "retiree" who was written off by many as washed-up when he stepped away from managing other people's money almost eight years ago. As I learned in a series of conversations with Robertson over the past six months, the man once known as "The Wizard of Wall Street" for the incredible success he had running his hedge fund firm Tiger Management has been on a magical run while most of the world wasn't watching. According to returns provided by Robertson exclusively to Fortune, he earned a stunning 76.7% return in 2007* *managing a portfolio of his own money. That rivals his best years running his flagship Tiger fund in the 1980s and 1990s, when he was an undisputed Master of the Hedge Fund Universe and grew Tiger from $8 million at its launch to over $22 billion at its peak in 1998. The investment reflects a negative outlook on the prospects for the U.S. economy that has been building in Robertson for years. He believes that the Federal Reserve will continue to flood the economy with money, weakening the currency and ultimately causing the Japanese and Chinese central banks to stop purchasing Treasuries, which will drive the price of 10-year bonds down. It's a macroeconomic hedging strategy that has already paid off handsomely. So far in 2008, the difference in the between the two bonds has already increased from 97 to 138 basis points. "I've made a big bet on it," he says. "I really think I'm going to make 20 or 30 times on my money." Considering the momentum he has, it wouldn't be a surprise.*

Looking back, I seemingly paraphrased Julian's October comments in my early February TSOF Q4 2007 letter saying, *"most likely we are already in a recession in the U.S., but what does that mean for the markets, both here and around the globe? U.S equities are falling despite significant rate cuts and it appears that Big Ben is pushing on a proverbial string."* The challenge was that Julian's Bearish call was about eleven months early (often called the euphemism for wrong in the marketplace) and it wasn't until his follow up CNBC appearance with Erin in October of 2008 that it was clear that things were going downhill fast. What was also unclear at the time was that the downturn was indeed going to be a "Doozy" (meaning bigger and badder than the 2001 downturn) and that the "normal" steps that an investor would take to prepare for a difficult investing environment would not provide the same level of protection during a true Financial Crisis. His genius was building essentially a barbell approach by raising the hedging in his equity portfolio (lowering the net exposure) and using cash as collateral to take very large positions in the derivatives trades that bet on the declines of economic growth, the sub-prime market and financial stocks. As I said above, we had some exposure to these trades, which was great, but we were not as aggressive as he was in eliminating the strategies that would be most negatively impacted by the economic downturn and Global Financial Crisis. While we were not alone in this positioning (and we actually fared better than many who did not have any hedging in place) we would have done better to heed Julian's Bearish call more fully. (As a post-script about our formal relationship with Tiger and Julian, in 2009 Julian wanted to have his son run an internal Fund of Funds program, so we executed a deal where we got our equity back and we relinquished our exclusive right to the Tiger name in the HFOF space and converted TSOF to MCOF)

So, now to explain the title of our letter, ***Not Lyin', The Big Tiger's a Bear, Oh My!*** The third time that Julian became Bearish occurred at the end of September of last year which was highlighted in another *Fortune* article entitled, *The Bubble is about to Bite,* and he has made a number of television appearances recently reiterating his concerns about the Fed policies and their potential impact on the economy and markets. In the article last fall he said, ***"I agree that the economy is recovering, but one of the biggest drivers of the recovery are bubbles in the financial markets. Those bubbles are eventually likely to bite us. The bubble will burst in a very bad way, they always burst, and that the reason bubbles form is because it's often hard to see why prices will go down. For example, the drop in 1987 came out of the blue."*** There is much wisdom in this short series of quotes, notably that governments and Central Banks can (and do) drive a recovery in an economy (or stock market) through the introduction of excess liquidity that overwhelms the market mechanism, but that process always leads to Bubbles. Those bubbles appear to help with the ongoing expansion, but in the end, all bubbles burst. The other wisdom is that it is the actual process of the bubble forming that prevents us from even considering that we might want to take a precautionary stance, because we are seduced by the rising prices of assets (another example of Reflexivity). Another characteristic of truly great investors is that they don't make the same mistake twice. All investors make mistakes (even the great ones), but what separates the great ones from the rest is the ability to learn from those mistakes and change their behavior in the future. The 1987 crash blindsided Julian (as well as many others). In fact, just two weeks before Black Monday, he wrote to Tiger investors saying ***"I do not see great danger of a drastic market decline until we all get a great deal more complacent."*** The important takeaway from that experience, reflected in the new quote above, is that bubbles end without warning and you have to move to the sidelines before the event actually occurs (reiterating here it is better to be a couple hours early, than a minute late, in these circumstances).

In a recent Fox Business appearance with Maria Bartiromo, Julian discussed why he has become so concerned about the economy and markets by saying ***"The thing that worries me the most are the twin bubbles that are developing, certainly the Federal Reserves of all the countries, the people that run their Treasury operations, are trying to really create a bubble in bonds and they're doing it and bond yields have never been anything like that."*** He made the point that this is a global phenomenon (and problem) and that it is not just the Fed that has been out of control with the bond purchase activity. Julian described the ECB actions and the creation of the new QE program as being very similar to the 2000 period where the Fed did everything they could to trash the Dollar. He said specifically, ***"I think the Dollar will continue to strengthen. I mean Europe needs a strong Dollar and I think they're going to do their best to cut the value of their currency."*** He then talked about how the resulting negative interest rate environment in Europe is creating all kinds of perverse incentives that will be bad for economies and markets over the long term. He said, ***"Well suppose you were a saver in Germany, you had to pay the banks to put your money in. And all this sort of creates a very difficult market to save in and a very easy market to borrow in and those two things are conducive to long term prosperity."*** The lack of savings and investment is a pandemic problem and we see it magnified by programs in the U.S. like SVM (Shareholder Value Maximization) which improperly skews management decision making toward short term stock price manipulation (through the financial engineering of stock repurchase) over long-term investment in activities that will generate future growth and cash flow.

In speaking about the U.S. economy generally, and the Fed policy actions specifically, Julian told Maria ***"I expect a rate increase this year. I think the economy warrants it and I think they're not going to be crazy enough just to let this thing boil over into complete explosion."*** He was saying that the Fed has held interest rates down too low for too long and that the cauldron was bubbling and was on the verge of boiling over. The conundrum that he sees is that there has been a concerted effort to inflate equity prices through the provision of excess liquidity (to stimulate a wealth effect) and that any tightening of liquidity conditions was likely to lead to pain in the equity markets. He made a bold statement when she pressed him on the size of the potential correction ***"I think the equity rally will be stalled by an increase in interest rates and I don't think it's at all ridiculous to think about a 2008 size decline."*** So here we are with one of the greatest investors of all time telling us for the third time in fourteen years (notice how that periodicity lines up nicely with the seven-year Kindelberger Cycle we have discussed in these letters in the past) that we need to prepare for a difficult, and potentially dangerous, investment environment. One point of clarification from our perspective is that we agree completely with the magnitude of the potential decline that Julian elucidates, but we believe there is much less leverage in the global financial system today and that the decline is more likely to play out like the 2000 to 2002 experience, down (9%), down (12%), down (22%) which produced a cumulative decline of similar magnitude (38%), to the 2008 crash, but was more manageable from an investment perspective.

So what is the plan from this point and how do we best heed the Big Tiger's Bearish call? Many of the things that we have been saying in these letters over the past few quarters still apply. Move capital from long-only into hedged strategies, reduce traditional fixed income exposure (other than long duration bonds which can be used as a Deflation hedge in the event that growth does not revive) and take advantage of the private markets where the valuations are often not nearly as extreme for comparable companies when compared to their public market counterparts. Julian often says that, ***"our mandate is to find the 200 best companies in the world and invest in them, and find the 200 worst companies in the world and go short on them. If the 200 best don't do better than the 200 worst, you should probably be in another business."*** We could not agree more and have long contended that the Jones Model Hedged Fund was the best way to gain long-term equity exposure as you get greater wealth creation by lowering the volatility of the return stream from the hedging. We believe that we have outstanding solutions for both developed markets and emerging markets investors in MCOF and BRIC Plus. Julian also said in the *Fortune* interview ***"I like the great growth companies and I think that's one of the great things about being older is you remember back what great growth stocks sold for in earlier times and I don't really think Google, Apple and Facebook have those valuations today. If those stocks had the 1980s and 1990s multiples, they would be double and triple their current prices. I like Biotech too, in the aftermath of the big blow up these stocks had an enormous rally, but still there is good value in some of those stocks."*** Again, we are in violent agreement and created the MC Direct (MCOF –Series B) product that follows this script in identifying the twenty best companies from what we believe to be our world-class group of hedge fund managers and provide access to these great companies. Even in challenging markets, there are good companies to own (and acquire at bargain prices during the drawdowns) and we believe that over the very long-term those best companies will generate superior rates of return for investors.

A side note is that Julian became bearish on Japan in 1986 (I had not met him yet, so I don't count it above) as Japanese companies traded to astronomical valuations because of the perception that Japan Inc. had the best operating businesses in the world (despite evidence to the contrary when comparing ROE to many U.S. companies). In a 1987 *Barron's* interview, he discussed NTT and Japan Airlines as two companies that were particularly overvalued and that Tiger was short. Julian was clearly early as Japan's Nikkei Index rose 70% from the time of the interview to the final peak on the last day of 1989. However, JAL was flat during that period and NTT peaked long before the Index so they were successful shorts (in that they allowed Tiger to finance better longs in the U.S. during the period). The point of bringing up this history is that even during the final stages of a speculative bubble top, it is preferable to follow a disciplined, hedged investment strategy in equities to produce strong long-term returns. There came a time to get very short in Japan in the 1990s and Tiger made lots of money shorting Japanese banks and the huge Keiretsu companies where cross shareholdings had artificially inflated prices by reducing free float rates (sounds vaguely similar to share repurchase programs). Even if the Big Tiger is early this time in his concern about the global bond bubble, we would all be wise to heed his warning and begin to realign our portfolios for a much more challenging environment than we have experienced over the past six years. The seven-year cycle works like clockwork and, as I like to say on Twitter (find me at @MarkYusko), it is #NotDifferentThisTime.

A final word about Julian is that he is not only one of the greatest investors of all time, but he is also one of the finest people I have ever had the privilege to know and it has been a great gift to have him as a friend and mentor for these many years. In speaking about what they looked for in the people Tiger believed would make great hedge fund investors, he always spoke about the four core characteristics of honesty, intellect, collaboration and competitiveness, but in a recent interview he also mentioned another characteristic in saying ***"I think there is something strange in that the make-up of the most successful hedge fund people. They have a real interest in making this world a little bit better than it was when they got into it."*** Julian has been as great a philanthropist as he is an investor and he has set up multiple Foundations and made myriad gifts to so many important institutions globally which are all doing wonderful things to make the world a better place. In the investment business, Julian's individual impact in leading Tiger was outstanding and led to outsized returns for his investors, but the multiplier effect created by his tutelage of the Tiger Cubs and Tiger Seeds is what will make an even bigger impact on the investing world over the long-term. Similarly, in the philanthropic world, his creation of the Tiger Foundation and his tutelage of legions of Tigers on how to think philanthropically and to start similar Foundations when they struck out on their own, has a huge multiplier effect and will help change the world. Following in that model, when we started Morgan Creek, we also started the Morgan Creek Foundation that makes grants to education programs in the communities where the Creekers live. We hope, that in some small way, we are also helping to leave the world a little bit better than in was when we got into it. We are very grateful for your support and partnership and please let us know how we can be helpful in any way.

First Quarter Review

For the past few quarters we have discussed a cyclical phenomenon that has developed in the U.S. equity markets which we described in the Q2 2014 letter as follows: *"there has been a very interesting pattern in each of the past four quarters, that equity markets fall for the first two to four weeks of the period and then turn sharply upwards when the Central Doctors (Bankers) agree to provide another hit of Monetary Morphine."* Q1 followed the pattern seven quarters in a row as the S&P 500 shed 3% in the first four weeks of the year, before rallying back 4.1% to finish the quarter up 1% after the Fed decided to keep the word "Patient" in the January minutes describing the timetable for a potential rate hike later in the year. The addiction to stimulus is so strong today that even the hint that the withdrawal of the monetary morphine may occur later, rather than sooner, is enough to stoke a stock market rally (or perhaps better described as a short-covering rally). In actuality, the Fed passed the QE drip line to the ECB in Q1 and watched from the gallery as the Europeans slashed the value of the Euro by nearly (12%) in the quarter (so all the talk about Dollar strength, might actually be foreign currency weakness...). The monetary morphine shunt connected to the dead parrot (an image from the commentary last quarter on the Economist cover showing Frau Merkel standing next to a moribund bird saying that the European economy was just resting…) produced the same result as in the U.S. as the Euro Stoxx 50 Index which had started down (4%) for the first two weeks of the year, surged back to life and finished up an astonishing 17.5% for the quarter. That said, investors who weren't paying attention to currency hedging were up "only" 5% in Dollars, as the race to debase continued unabated. We wrote last quarter that *"given the long-term track record of an inverse correlation between magazine covers and future performance, it made sense that perhaps Europe was due for a period of outperformance, yet we needed a catalyst"* and the announcement and implementation of the European QE Program was just what the doctor ordered.

We have discussed numerous times in previous letters how there was a correlation between the QE Programs in the U.S. and subsequent increases in the S&P 500, noting that "*historically every $100 billion of QE has translated into 40 S&P 500 points (calculated by Larry Jeddeloh at TIS).* There is likely to be a similar relationship between European equity markets and the ECB Program (we will talk to Larry about the precise calculation) and it appears that the equity markets may have surged ahead of the actual implementation of the $60B Euros a month of bond purchases, given that the Euro Stoxx 50 Index soared 550 points in the two months following the announcement. It would make sense to see a pause that refreshes in the short-term in Europe, but the infamous admonition of "Don't fight the Fed" can clearly be modified here to "Don't fight the ECB" in the coming year. Given the hand off by the Fed to the ECB, we noted last quarter that an important question was that *"if the markets have been driven by the QE equation since 2009, the cessation of QE this month does beg the question of what happens in 2015?"* We then discussed our concerns about downside risks to U.S. equities *"if the patient was forced to look at the MRI (valuation measures) without the soothing effect of the monetary morphine."* The problem was that every "marker" on the MRI was flashing brightly as the Yield, P/B, Market Cap/GDP, CAPE Ratio, Tobin's Q and P/E Ratio of the S&P 500 were now at levels only exceeded by the craziness of the Tech Bubble. Without QE to boost the markets and with the threat (now reality) of falling earnings thanks to headwinds created by the strong dollar and collapsing global growth, the question was how would stocks continue to rise? Given the meager 1% advance in the S&P 500 in Q1, we may have our answer, maybe they won't (in fact, MCCM Surprise #4 is that contrary to all the positive trend data, 2015 will be the first negative year since 2008).

Looking more closely at the performance in Q1, despite the lackluster results of the large-cap U.S. equity market, the overall equity market exhibited many of the characteristics of a healthy Bull Market as Small trounced Large (R2000 up 4.3% versus RTop200 up 0.5%), Growth pummeled Value (R3000G up 4.1% versus R3000V down (0.5%)) and the tech-heavy NASDAQ more than tripled up the S&P 500, rising 3.5%. Globally, International and Emerging Markets rebounded nicely from the drubbing they took on a relative basis in Q4. However, like last quarter, there were a few anomalies that left us puzzled as long bonds crushed stocks, rising another 4% in Q1 (creating a truly sensational trailing twelve-month return of 21.4% versus 12.7% for stocks), yield strategies were mixed as REITs surged again, up another 4.7% (a stunning 24.1% for the TTM) while MLPs got crushed (despite an slight recovery in oil), plunging (5.2%) which turned the TTM return to a negative (2.5%) and Utilities were smashed, falling (5.2%). Another anomaly was that three of the top five performing sectors in the S&P 500 were sectors that you would expect to see leading in an economic downturn with Healthcare up a very healthy 6.5%, Telecom up 1.5% and Consumer Staples up 1%. The surge in Consumer Discretionary, up 4.8%, makes sense given the decline in oil/gas prices was expected to put some extra spending money in consumers' pockets. We know that anomalies have great information content and since markets are leading indicators, the solid performance of the defensive sectors was likely signaling that the U.S. economy was weaker than the media would have us believe. To that point, the final estimate of Q4 GDP came in at 2.2%, far below the original estimate of 3% and well below the first estimate of 2.6%. Once again the economic growth for the year was disappointing and the four quarters of (2.1%), 4.5%, 5% and 2.2%, yield a Real GDP expanding at 2.4%, well below the 3%+ that the Fed (and everyone else) predicted at the beginning of the year. We wrote last time that, *"moreover, the number is being "bailed out" by an unusually low PCE Deflator (some would say manipulated…) that boosts the real number. The reality is that we have never had Nominal GDP growth this low without being in Recession."* Given that we are experiencing the worst decade of economic growth since the Great Depression, it seems unlikely that we are going to see a significant surge in growth, and hence profits, given the headwinds of Debt, Demographics and Deflation, don't seem to be yielding to the Fed's best efforts of stimulus. An argument could be made that we are in the early phase of a Recession and that the next few years could resemble the 2000 to 2002 period, which was not particularly hospitable for equity investors.

The U.S. Dollar went parabolic in Q1 and DXY surged another 9%. In looking at the currency issue, we wrote last quarter that *"much of the rally of the Dollar could actually be explained not by strength of the U.S. currency, but by the incredible weakness of the other global currencies, most notably the Yen and the Euro as the BOJ fired a huge bazooka in October by accelerating QQE and the Europeans inched ever closer to their own version of QE."* January brought the actual announcement of the European QE Program and the various Central Banks of the Euro Area began to buy government bonds on March 9th. The ECB move clearly furthered the ascent of King Dollar; however, something unusual happened in international equity markets. Whereas foreign markets had been punished in Q4 by the surge in the Greenback, most global equity markets held up fairly well in Q1 and there were some real standout performances around the world (aside from Latin America and Eastern Europe, which did get pounded by currency losses). We have said for the last couple of quarters that *"getting the Dollar right in 2015 may be one the most important portfolio decisions an investor can make"* and while we still believe that to be true, it appears that there has been some decoupling from the strong Dollar equals weak international equity performance. Looking at the broad indices, the ACWI ex U.S. jumped 3.5%, EAFE was up a very strong 4.9% and the MSCI EM Index rose 2.2%. Diving deeper into the individual markets, in a complete turnaround from Q4, the breadth of the positive returns was a mirror image of last quarter as only five of the twenty-two developed markets in the MSCI database had a negative return in Q1 and all of the positive returns were much better than the S&P 500. The strong returns were quite strong, particularly in Developed Europe, as despite the Euro's monster (12%) decline, Germany was up 8.3%, Italy was up 6.8%, Portugal was up 7.3% and Denmark was up a surprising 15.8% as their Central Bank surprisingly cut rates multiple times. In the Emerging Europe markets, the results were a little more mixed as Russia soared 18.6% (following the MCCM Surprises script nicely), while Turkey had current account problems and fell (15.8%) and Greece was pounded again, down (29.3%) on fears of debt default as negotiations with the Troika ebbed and flowed over the quarter (not following the MCCM Surprises script at all…). One thing Q1 showed us in Europe was that there will continue to be wide dispersion in the region and there will be both winners and losers as the ECB plan plays out, so we would expect to find some very attractive investment opportunities on the Continent in the coming quarters on both the long and the short side.

Perhaps our favorite developed market over the past couple of years has been Japan, and Q1 was again a very good place for equity investors as in the Land of the Rising Equities, markets surged 10.2%. The implementation of Abenomics has finally removed the specter of deflation after two long decades and has led to a virtuous cycle of rising inflation expectations, rising earnings and rising asset prices. The one-two punch of the Bank of Japan ("BOJ") monetary bazooka and the expansive fiscal policy has led to rapidly rising corporate earnings, allowing companies to begin raising wages which has led to increased consumption in a self-reinforcing process. The dramatic weakening of the Yen has also been a huge boon to the export-oriented companies, which showed significant strength again in Q1 with Toyota and Panasonic up 12% and Sony up 31%. Japan Inc. had to become incredibly lean during decades of a strong currency regime and the extremely high operating leverage in these companies means that even small downward moves in the Yen translate into large moves up in profits, and subsequently, stock prices. The one area of frustration within the Japanese market over the past couple of quarters had been the banks which we believed were extremely cheap and should have been benefitting from the lower Yen as well. We wrote two quarters ago that *"perhaps the most compelling opportunity, the banks (SMFG, MTU, MFG, Resona, Shinsei) have now bottomed and now have very significant upside (could rise as much as 60% to 100%) as their ROEs continue to recover and brokerage firms like Nomura and Daiwa should be very strong performers as domestic trading volumes increase and foreign capital returns to the Japanese market,"* only to watch these companies' shares languish over the past six months. We wrote again last quarter that, *"everything wasn't great in the Japan equity markets however as the other traditional beneficiary of a lower currency, the banks, ignored the conventional wisdom and continued to plumb lower levels. Like a coiled spring, these assets are becoming incredibly cheap, but we have been wrong in thinking that investors would seek out these undervalued assets and push prices higher."* Finally, toward the end of Q1, the Japanese banks joined the party and began to rally quite significantly. With April nearing an end, MTU is now up 30% YTD, SMFG and Shinsei are up 20%, MFG is up 15%, Resona is up 5%, Nomura is up 18% and Daiwa is up 10%. We think the party is just getting started in Japan and that there are more significant gains ahead. We wrote last quarter in MCCM Surprise #9 that Japan had No Way Out other than to weaken the Yen and drive up asset prices. We said that there would be some resistance along the way, but that the Yen would reach 140 by year end (from 120 today) and that the Nikkei would hit 22,000 (from 20,000 today, up from 17,500 when we wrote the Surprise).

Making a highly controversial call in Surprise #7, titled Water Finds Its Level, we wrote that "*Central Banks in the Emerging Markets are forced to stimulate their economies in response to the massive BOJ and ECB bond purchase programs and the resulting expansion of liquidity unlocks the extreme value in Emerging Market equities leading them to outperform the developed markets for the first time since 2012."* Given the cacophony of bad news around EM growth, currency woes in the face of King Dollar and the dismal results in EM and FM markets in Q4 (and 2014 as a whole), this was truly a Variant Perception. One further point of distinction was important in that we segmented EM into Service (current account surplus) economies and Commodity (current account deficit) economies and noted that with the rapid decline in oil prices the former would have additional tailwinds and the latter would have very robust headwinds. Looking at the Index numbers for Q1, the MSCI Emerging Markets Index had a solid quarter, rising 2.2%, while the MSCI Frontier Markets Index was down (3.1%) as there were more current account troubles in Frontier Markets than Emerging Markets. Digging deeper, many of the Commodity Countries continued to get hit with Brazil down (14.6%), Mexico down (2.0%), UAE down (5.8%), Qatar down (2.1%), Nigeria down (10.1%), and Columbia down (19.1%) and Turkey down (15.8%). We wrote last quarter that *"we think there were a lot of babies thrown out with the oily bath water in Q4 as investors sold everything in these countries despite the fact that many of the companies have very little to do with oil and, in some cases, will not be impacted by oil prices declines because the governments own the bulk of the natural resources and they have committed to funding the social programs (this is primarily true in the Middle East, but could also apply in some ways to Russia and Brazil) which will be paid to citizens regardless of the price of the commodity."*

As if on cue, a couple of Commodity Countries "got the memo" and turned around sharply in Q1 as Russia surged 18.6% (as we thought might happen in Surprise #5), Argentina soared 25% on anticipation of a new government in Q3 and Saudi rose 6.3%. We reminded everyone last quarter that *"the opening of the Saudi market to foreign investors should serve as a significant catalyst to move the market higher as capital flowing in from global institutional managers is likely to equate to a significant portion of the current Saudi market cap. Additionally, "opening" the market removes the primary hurdle that has historically prevented MSCI from including Saudi in their Indexes."* MSCI has announced that they will make the Index move in June, so we expect the Saudi markets to continue to be very strong. On the other side of the current account issue, the Services Countries were quite strong in Q1. Returns were led by China, up 8.1%, India, up 5.4%, Philippines, up 9.9% and Indonesia, up 2.4%. Two countries with unique stories that we highlighted last quarter were Kenya and South Korea. We wrote that *"Kenya is a great example of a market where innovation and rapid technology adoption in mobile payments (90% of Kenyans use mobile payments) has created an economic boom that is likely to persist for decades to come."* The Kenya market surged another 7.2% during Q1 raising the TTM return to a very robust 28.5% and has compounded over the past five years at 21.6%. We also noted that, *"if the Korean government can respond with some measures to weaken the Won, Korea could be a surprise winner in 2015 as expectations and prices are low and growth is solid"* and with some coordinated effort in the currency markets the Korean markets have turned nicely, rising 4.3% in Q1 and up another 6.6%% in April to be up 11.2% CYTD.

China has been one of the most over-analyzed markets in the world over the past few years as there has been a constant stream of reports about China in the media discussing and debating every shred of economic or financial information. We wrote last quarter that *"the combination of the Third Plenum Reform agenda beginning to be implemented, SOE reform, a change in position by the PBoC on liquidity (moved from tightening to loosening) and what appears to be a concerted effort by the new Leadership to shift assets from the property market to the equity market resulted in some spectacular performance in Chinese equities in Q4,"* and we argued that the Bull Market in China was just beginning. With the Shanghai Index up another 8.1% and the A-Share Index up 5.7% in Q1 (and an astonishing 16.7% and 18.2% in April for 26.2% and 24.9% respective CYTD returns), our instincts were right on the direction of the move, but we clearly misjudged the magnitude of the opportunity and while we did add exposure across many portfolios, we were too conservative in our allocation. To this point, there is a transcript of a speech that Stan Druckenmiller gave recently that has gone viral on the internet and one of the key takeaways of the speech was the lesson that Stan learned from working for George Soros (that we discussed at length in last quarter's letter on Reflexivity), that when you get something right, you need to "Be a Pig" and take big positions. We are improving in this area, but we need to keep making progress. We have discussed in previous letters how the managers who learned their craft under Julian Robertson said that what separated him from other investors was his uncanny ability to "Double Up." I have been tweeting (@MarkYusko) about this particular skill under the hashtag #WinnersPressWinners.

Two other lessons to learn from the recent rally in China are that when the leadership finally moves on one of their Reform agenda items, the response is swift, and the market reacts quickly, and that the second order effects that play off of the primary movements are important as well (e.g., build positions in Chinese brokerage stocks which benefit from the increased investment activity from the implementation of the Through Train Program). To the second point, we have discussed a basket of names that we thought would benefit from the increased local investment activity (there were 4.1 million new brokerage accounts opened last week…) and while we were a little "early" in Q3 call, this basket had a great Q4 and has surged again in 2015. We wrote about *"China Coal Energy, Great Wall Motor Co., China Vanke, China Overseas Land, China Resources Land and Poly Property Group (CN:601898, HK:2333, CN:000002, HK:688, HK:1109, HK:119 respectively) and a basket of China Banks"* and these stocks are up a remarkable 92%, 77%, 82%, 42%, 57%, 60% and 62%, respectively, over the past six months. We warned last quarter that *"there will clearly be some consolidation in these markets in the early part of 2015, but we believe that we have entered a new Bull Market in China and there are outstanding returns available for investors who are willing to ignore the "Noise" in the media about the slowing economic growth (quality of growth is more important than quantity) and focus on the "Signal" that is a the world's second largest economy in the beginning stages of an historic transition toward consumption and away from fixed asset investment"* and the China equity markets hovered between down (5%) and down (10%) until mid-March before surging the past six weeks, to finish up 26% for the first four months of the year. There has been an explosion of pundits calling the recent move in Chinese equities a bubble and not a day goes by without a discussion of the impending crash (comparing the current surge to 2007). In 2006 and the first ten months of 2007, the Shanghai Composite index ("SHCOMP") rose 440%, and then subsequently crashed (70%) over the next twelve months as the Global Financial Crisis struck. While the more than 120% increase in the SHCOMP over the past year has been sharp (compared to a 10% increase in the S&P 500), the current valuations are not stretched by any measure (particularly when compared to the nosebleed valuations in 2007) and while there are pockets of excess in places like the Shenzhen and Shanghai IPO markets (where limit up days have been the norm for months), the overall Chinese equity market is actually near the bottom (not the top like the S&P 500) of its multi-decade trend channel (shown in a great chart by Chris Kimble that I found on Twitter at @kimblecharting). As we said last quarter, there will be volatility and periods of retrenchment, but the Bull is loose in the China Equity Shop and he could run for a while.

Looking at the fixed income markets, we said at the end of this section last quarter that *"despite all the Fed jawboning, the newly created Fed Dots indicator, and the seemingly endless stream of hawkish Fed Minutes, rates continued downward and long Treasuries turned out to be one of the best performing assets in Q4, and 2014 (which we actually said would be the case last December)"* and we thought that it was likely that the trend would continue into the new year. The first quarter of 2015 turned out to be a lot like the last quarter of 2014 as bonds beat stocks as the Barclays Aggregate rose 1.6% and the Barclays Long Treasury Index was up another 4% (to bring the trailing twelve-month return to an astonishing 21.4%, nearly double the equity market return). The bond bears have been consistent in their chatter about better U.S. GDP growth, despite the Q4 number being revised downward to 2.2% (full year 2014 was a sub-par 2.4%) and the first estimate for Q1 coming in at a frighteningly low 0.2% (likely to be revised down to a negative number). That said, it was the release of that latter number last week that somehow triggered the long anticipated correction in bonds and rates actually rose after the terrible GDP print for reasons that seem to elude everyone we have talked to recently. The theory that we have heard is that the huge decline in GDP from an estimated 3% just six short months ago (and a consensus of 1% on the release date) was so bad that the Fed may as well go ahead and raise interest rates because "how much harm could she do at this point?" We will take the over on the amount of harm that will be inflicted on the economy, and financial markets, if Ms. Yellen decides to go ahead and tighten liquidity in an environment that is precariously perched on the verge of Recession. Last quarter we talked about *"one of my favorite charts, a sequential quarterly graph of the forward yield curve since 2009 showing a series of steep upward sloping lines between cash and two-year Treasury notes (implying imminent rate increases) and talked about how this chart "shows how the Fed has keep their finger off the trigger and maintained Fed Funds near zero (ZIRP, Zero Interest Rate Policy) despite the markets "knowing" that they would raise sometime "next year."* The Fed has been threatening to raise interest rates since 2009 and they have not (or cannot, depending on who you talk to) chosen to do so as of yet. However, every time someone hints that Lucy will actually pull the football away this time, the bond markets do their best Charlie Brown imitation and end up flat on their back. The past few weeks have been no different and the Barclays Aggregate gave back half of the Q1 gains, falling (0.4%) in April and the Barclays Long Treasury Index may need traction, after falling (3.1%) in April. We wrote in the 10 Surprises that the Fed would fool everyone this year and not raise rates as they had painted themselves into a corner, from which there did not appear to be any easy way to exit. The bond bears have had a couple of weeks in the sun this spring and they have been growling quite noisily in the past week, in particular, but we have heard this song before and it still sounds a lot like the Vapors' hit, Turning Japanese, to us so we will likely be tweeting about #LowerForLonger for a while longer and we will report on the Bull/Bear tug-o-war again in three months.

Looking beyond U.S. bonds, other fixed income markets also enjoyed a robust Q1 as falling rates triggered another global dash for yield. Bond investors piled back into all the assets they had shunned in Q4 and everything from high yield to emerging markets debt surged. The BoAML High Yield Index was up 2.6% as investors desperate for yield kept stretching ever further out on the risk curve again, just like they did right before the troubles in 2008. In a sign of just how crazy the yo-yo markets have become, the energy segment of the high yield market which was decimated last year (many bonds falling into the 70s and some of the worst credits falling sub 30), was the darling of the first quarter as investors went bottom fishing on the assumption that the BTD (buy the dip) model would work yet again. We wrote last quarter that *"there is a lot of concern that some large percentage of the massive $550 billion of debt issued by energy companies during the Shale Boom will default as oil prices have halved, but we expect that only a small percentage of issuers will go bust as many operators have done a good job hedging production and have bought themselves time to cut costs and restructure. One segment that is particularly vulnerable are the energy services companies as the E&P companies cuts in cap-ex are a cost reduction, but are a revenue reduction for service companies. We expect to see some tremendous opportunities to buy fantastic assets at fire-sale prices in the coming months."* It turns out that there were some great opportunities to buy, primarily because banks decided not to go hard line with most energy borrowers at the mid-year LOC reset period this April and many companies that should have defaulted got a free pass until October and their bonds (and stocks) surged. We expect that the banks were loath to enforce covenants because they would have to realize significant losses and they decided to "extend and pretend" like they did after the Global Financial Crisis (the logic being that it worked then, so why wouldn't it work now?). Time will tell if energy prices can hold their recent gains and if these overleveraged E&P companies can ever generate enough free cash flow to pay back the banks. Again, we will take the under, but you don't want to bet against the short-term momentum created by the ostrich approach to loan management.

Outside the U.S., government bonds yields continued their inexorable decline as the ECB began buying European government bonds and many investors trying to front run the Central Bank piled into these securities. The wall of liquidity into these markets should have raised prices and produced solid returns for investors. However, for U.S. based investors, the almighty King Dollar created a huge drag on performance and the Barclays Global Bond Index fell (2%) in Q1, a disappointing outcome given the dramatic fall in interest rates around the world. Emerging Market Debt proved once again to be a solid investment in fixed income land during Q1 as investors perceived that higher growth rates in these markets were more likely to support higher corporate cash flows to service debt. The JPM EM Bond Index rose nicely, up 2.1%, but local currency bonds were hit hard by King Dollar in Q1, falling (4%). The central belief in global bond markets is that inflation will not hurt bond returns as global excess capacity and low velocity of money supply are putting little, to no, pressure on inflation. With that in mind, we will continue with our Variant Perception that longer duration fixed income should continue to a very profitable investment as interest rates in the developed world should remain under pressure from the Killer D's of Demographics, Deflation and Debt. We will reiterate what we said the last two quarters that *"we know two awfully good fighter pilots who espouse that strategy today, Van "Treasure" Hoisington (who only owns long treasuries) and Russell "Horseman" Clark (who owns large positions in long-duration Bonds and Bunds), who would both say that they are staying with the Wingman Formation for the foreseeable future."* We will defer to the pilots with the most experience in these theaters and while we would expect that some anti-aircraft fire, in the form of Central Bank jawboning (and fixed income managers talking their book like Gross and Gundlach did recently saying to short German Bunds, after they were already short of course…), will continue to make the fixed income skies a little less friendly, we expect the volatility to be trumped by the strong returns from these assets in the coming quarter and years.

Just like the fourth quarter, Q1 was as divergent a period for other yield investments as we have ever seen. Investors continued to clamor for REITs (no matter how high the price rose) while concurrently shunning MLPs (no matter how low the price fell). These trends persisted despite the fact that cap rates in real estate seem irrationally low and the continued rise in hydrocarbon production should bode well for MLP cash flow. We all learned in school that a solid long-term investment strategy is one predicated on selling assets at premium prices and buying assets at bargain basement prices, but in Q1 investors decided to ignore that seemingly sensible advice, yet again. The S&P REIT Index surged 4.7% for the quarter (not quite as astonishing as the 14.4% in Q4) bringing the trailing twelve-month return to a "wow" level of 24.1% (tops among the broad equity and fixed income markets). In contrast to the continued mad dash for real estate, investors dumped MLPs for a second consecutive quarter and drove the Alerian MLP Index down (5.2%) in Q1. While this loss is not as dramatic as the (12.3%) decline from Q4, it was bad enough to push the trailing twelve-month return below zero, to down (2.5%), near the very bottom of traditional asset returns for the past year. There is something odd in the dichotomy between REITs and MLPs in the past few quarters and while we can offer no good explanation of why one yield instrument is preferred to another, perhaps there is information content in the expectations of future price stability in those two markets being created by the various security types.

In the commodity space, Q1 was challenging, to say the least, as the poor performance from 2014 continued into 2015. The continued strength of the Dollar and concerns about supply gluts in a number of commodities put continued downward pressure on prices. Everyone's favorite topic these days, oil, had another tough quarter as prices fell another (14.9%), on top of last year's (43%) trouncing, which brought the five quarter drawdown to a wallet-lightening (51.5%), as prices fell from the mid-June peak of $107.26 to $47.60. The quarter could have been worse as prices actually had fallen all the way to $43.46 on St. Patrick's Day for a peak to trough swoon of (59.5%). We discussed in last quarter's letter that *"there have been lots of pundits, media personalities and oil executives calling a bottom in oil since the mid-70s (quite unsuccessfully obviously as we sit at $48…) and there is unanimity in the investment community that there will be a sharp bounce in oil prices this year. The logic is that every oil price drop since 1995 has been followed by a sharp rebound, but the flaw in the logic is that all of those declines were demand driven (economic growth slowing leading to less consumption) and we have to go all the way back to 1985 to see what happened during the last supply shock."* From the low in mid-March, there has actually been a fairly ferocious rally in oil over the past six weeks as prices surged to $59.63 at the end of April, a stunning 37% move; however, the oil bulls may have gotten a little ahead of themselves reading too much into a very meager drop in U.S. production (which was offset 10X by an increase in production in Saudi). Moves of this magnitude are actually quite common in Bear Markets as big short covering rallies are precipitated by the perception of good news only to have fundamentals continue to be weak in the future. If the current oil correction turns out to be a Supply Shock like in 1986, then prices will hit an ultimate low sometime in 2016 before resuming an upward path and if the correction turns out to be a Demand Shock like in 1999, then prices will continue upwards from here. For now, we will stick with our MCCM Surprise #5 forecast of oil staying in the $40 to $50 range much longer than the markets anticipate, but we reserve the right to change our minds if the facts change, like if the export ban is lifted or GDP growth surprises to the upside.

Looking at other commodities besides oil, natural gas got smacked around again and was down (11%), bringing the peak to trough loss since February of last year to a whopping (55%). New fracking technology continues to drive production to record levels and there does not appear to be enough stress yet in the E&P space (banks aren't forcing the overleveraged companies to pay up) to reduce supply, so prices are likely to stay weak for a while. Just like Q4, the first quarter of 2015 was not muted in the precious metals as Gold fell only (0.2%) and Silver actually managed to recover most of the Q4 loss of (7%), by rising 6.1%. Industrial metals were weak, but not terrible as copper fell (3%) and aluminum fell (4.2%). While the Q1 losses were not huge, the continued weakness in the metals has some disturbing implications for global GDP growth as Dr. Copper is usually a fairly good indicator of future economic growth and copper prices have been falling steadily since 2011 when they peaked at $464 and are now at $293. One glimmer of good news is that most of the Q1 loss occurred during a free fall in January when prices troughed at $245, so they have staged quite a nice 20% rally off the bottom. The problem is that copper prices have made a series of lower highs and lower lows over the past four years, so we need to see a sustained breakout above $300 (and probably a move back above $340) before the Doctor's prognosis is positive. After an amazing Q4 for the Ags where wheat, soybeans and corn jumped 20%, 10% and 18%, respectively, Q1 was another difficult period for the grains as they gave back (13.2%), (5.4%) and (7.2%). We wrote last November that "*as we sit here today, the words of Sir John Templeton are running through our minds over and over to look for opportunities where things are the most miserable* *and on the TMI Scale (Templeton Misery Index) commodities look pretty interesting since the world is convinced that the Dollar is going to surge and that the Commodity Super Cycle is over. Conventional wisdom in investing is a very strong contrarian indicator, so we may find ourselves writing about better returns in these sectors in the quarters ahead."* Those better returns have been very elusive in the commodity space as the volatility has been extreme across the commodity complex and so far there has been more pain than gain in commodities over the past six months. That said, the upside moves in the recent weeks, along with the apparent topping in the Dollar, could portend more upside in hard assets as the year progresses.

Hedge Funds finally broke a string of quarters of negative relative performance versus equities in Q1. After a year of challenging performance in 2014 thanks to high volatility, broken merger arbitrage deals and another tough year for short selling, the stars aligned for hedged investing in the early part of 2015. M&A activity was high and several deals closed, so event driven strategies performed nicely and the HFRX Event Driven Index was up 1.4% and the Merger Arbitrage sub-Index was up a very nice 2.6%. The commodity moves continued to be very orderly (both down and up) and that was great news for the trend followers leading to the HFRX Macro/CTA Index to a very solid 3.4% return and the Systematic CTA sub-Index was up a very strong 4.6%. Those CTAs that make concentrated bets on commodities had another great quarter, rising 5%. As a reminder, there are a number of large, successful funds that don't report to HFR and thus sometimes the returns of the indices can seem out of synch with anecdotal evidence in the markets, which was true again in Q1 as a number of large CTAs produced double digit returns for the quarter. The HFRX Equity Hedge Index returned to winning form in Q1, as managers were able to take advantage of greater dispersion in equities and the Index was up 2.2%. Looking at a couple of the sub-Indices, the Energy related funds had very strong returns of 5.6% and the Multi-Strategy Funds produced 3.9% returns thanks to some well-timed balance sheet expansion (higher leverage). The ZIRP environment continues to challenge market neutral managers, but the HFRX Relative Value Index and Market Neutral Indices managed to rise 1.6% each. For the first time in a while, hedge fund returns outpaced both equity and bond markets. To that point, we continue to significant benefit in shifting from Bonds toward Absolute Return strategies (given their positive correlation to interest rates) in an environment where the potential for rising rates could wipe out fixed income gains quickly. We have been making the case for hedged strategies over long only strategies for the past year and while we were slightly early, we would expect to see the relative performance advantage of hedge funds continue to expand in 2015 as the valuation and growth concerns we have cited appear to be rising in importance in recent months.

We closed this section of the Q4 letter with *"as 2014 came to a close, we increased our focus on the theme of our Q3 letter, Highway to the Danger Zone, and prepared for the turbulence that we saw on the horizon. Last year was about dodging Alligators and 2015 may be more about combat and it may be important to remember the words of Viper's admonition to Maverick's class at Top Gun, "there are no points for second place."* The first quarter of 2015 was indeed a dogfight and the traditional markets in the U.S. produced sub-par returns (stocks 1% and bonds 1.6%) thanks to a high degree of volatility caused by increasing uncertainty about growth, profits and future Central Bank movements. One way to win in Q1 was to venture below the hard deck and look at small and midcap names in the U.S., which surged as money rotated into the laggards of 2014. The problem of flying below the hard deck is that the mountains are much closer and any small error can lead to real problems (fighter jets and earth don't mix well) and given the ridiculous valuations of small-caps (P/E ratios between 40 and 100+ depending on the methodology and whether you exclude companies with no/negative earnings) we think this angle of attack is fraught with peril (we are actually a little bit short here). Another way to win in Q1 was to venture overseas as Europe and Japan were both materially better performers that the U.S. (returns in Japan hit double digits and Germany hit high double digits if you hedged the Euro) and even Emerging Markets bested the S&P 500 despite the strong Dollar causing some currency woes in big Current Account deficit countries. To get the best returns, you had to exit the current theater completely, and go to the most unlikely places like Russia and Argentina and China, yet for most investors those have been (and unfortunately continue to be) restricted air space. An important question is how many investors had more Japan and China equity exposure than U.S. equity exposure over the past year? The answer is not many despite the fact that Japan is up 3X the U.S. and China is up nearly 9X (13% vs. 40% vs. 120%, respectively) over the trailing twelve-months. The performance at Morgan Creek was solid in Q1 as our Long/Short Hybrid fund again performed very well and our Developing Markets Hybrid fund again beat the EM indices (see sections below). Our private investment funds continued to post very strong returns and the convergence between the public and private markets continues to lead to a number of SPV opportunities like Alibaba that we expect will generate strong returns for our investors. We have stated in past letters that we believe that the 2015 to 2017 investment environment will be very similar to the 2000 to 2002 environment and that successfully navigating these challenging times will require an alternative flight plan to the traditional portfolio model. Q1 of 2015 was eerily similar to Q1 of 2000 and we expect those similarities to continue as the year progresses. We have seen this movie before when we were at UNC and we had a flight plan, based on the Endowment Model, that preserved, and grew, capital in that difficult environment. The combination of a global tactical approach, the integration of hedged strategies and the ability to capture the illiquidity premium are the core elements of a successful plan that will enable us to follow Julian's sage advice - when times get tough, always position yourself "to live to fight another day."

Market Outlook

We ended the Market Outlook section of the Q4 letter with the following summary: *"Surprises. We think 2015 is likely to be a year full of surprises as it continues to feel a lot like the last time there was so much "certainty" in the markets about New Paradigms and New World Orders, back in 2000. When investors have reached that reflexive maximum and are all leaning one way in certain markets, the impact of surprises is much greater. In 2000, everyone was certain that Internet valuations were reasonable, that Indexing was the only way to invest and that there would never be another Recession because the Fed had abolished the business cycle. Sounds familiar."* Interestingly, this commentary nicely foreshadowed the theme of this letter, that the Big Tiger is, to borrow a good Southern phrase, as nervous as a long tailed cat in a room full of rocking chairs, and that he wants to be certain that he isn't surprised like he was in 1987. The nature of tigers is to be aggressive, so when Julian gets cautious, we should indeed say "Oh My!" and pay special attention. Given our primary themes were already leaning on the cautious side last quarter, we will simply reiterate our views on the big portfolio decisions as they haven't changed; we favor Active Management over Passive/Index Strategies, favor Hedged Strategies over Long-Only in the U.S., favor Long-Biased Strategies in Japan and Europe over Hedged, favor Emerging Markets over Developed Markets, favor Private Investments over Public Investments whenever possible (emphasis on Small Buyouts, Growth Capital (with extra emphasis on EM), Energy and Direct Lending), and toward Real Assets over Financial Assets. We also discussed how *"if the 2015 to 2017 period does indeed follow the analog of the 2000 to 2002 period, there will be ample opportunities on the long side, on the short side and in the private markets, even if the overall environment turns out to be challenging for traditional assets."* If we go back to early 2000 (when Julian became Bearish for the first time), the next three years (and the next decade for that matter) were very difficult periods for U.S. and

International large-cap stocks, but there were plenty of places to not only preserve capital, but to make money. While the S&P 500 lost (38%) over the next three years and then fought back to "only" be down (1.1%) compounded over the next decade (ended up with 90 cents for every dollar invested) and EAFE managed only a scant 1% compound annual return (ended up with $1.10), you could have made double digit returns for the decade in Emerging Markets equities as they soared 10.5% per year (ended up with $2.71) or bought Emerging Markets debt and made 9.9% per year (ended up with $2.57) or you could have hid in REITs and made 9.8% compounded (ended up with $2.55, much of that from dividends). As we discussed earlier, Hedge Funds produced outstanding returns during the crisis and actually were up about 10% on average over the three years (with some of the best Tiger Cubs compounding close to 20%). Ultimately the future returns are determined often by the valuation you pay when you enter; if you buy things when they are super expensive like Japan in 1989, U.S. Tech in 2000, or U.S. Financials in 2007, you will lose money and when you buy things when they are super cheap like U.S. Equities in 1982, Emerging Markets Debt in 1998, Distressed Debt in 2009, you will make money. In every one of those situations there is a common theme; you had to have the discipline to break away from the herd and do the opposite of the consensus at precisely the time when it was most difficult to do so (high prices were telling you to buy or low prices were telling you to sell, hence the "price is a liar" mantra from Soros and Burbank).

So, speaking of Mr. Soros, in looking back at last quarter's letter, as I always do in thinking about how our ideas played out and what core themes still apply, I was struck by the similarity of a number of George's quotes to Julian's quotes (yes, great minds do think alike) and couldn't help myself from reprising a Top 10 list here that describes the current situation we find ourselves facing in a very similar manner to the Big Tiger. We start from the basic premise that Soros did not believe that the financial markets prices were a correct indicator of value, but rather the opposite in that they reflexively move to extremes of disequilibrium, driven by distortions created by the market participants themselves. ***"I contend that financial markets never reflect the underlying reality accurately; they always distort it in some way or another and the distortions find expression in market prices. Those distortions can, occasionally, find ways to affect the fundamentals that market prices are supposed to reflect."*** The second part of the quote is critical to the concept of Reflexivity and makes the point that as prices become extremely distorted, they can actually impact the underlying fundamentals. For example an M&A transaction can occur with inflated currency (overvalued stock) that would not have been possible at "fair value," but then actually leads to increased revenue or cash flow, which improves fundamentals. Positive deals aside, M&A always peaks at market tops; it did the last two times Julian was Bearish and it is peaking again. George also believed that "***stock market bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception. Every bubble consists of a trend that can be observed in the real world and a misconception relating to that trend. The two elements interact with each other in a reflexive manner."*** Essentially what is a Bubble? It is simply the overextension of a trend that has gone to an extreme. The extreme arises from the late stage participants forming a misconception that the current market prices are correct and they create new valuation tools (eyeballs, TAM) to justify those extremes and then push the bubble to its ultimate demise. Julian fought the extreme in 2000 (shorted the Internet companies) and learned, the hard way, that the "market can behave irrationally longer than the rational investor can remain solvent," where insolvent in this case meant more people wanting to withdraw from the Fund than enter. Today, you hear the same types of rationalizations for valuations in certain sectors that have gone to extremes like biotech and cloud as market participants justify sky high multiples because interest rates are so low. The real problem is that ***"unfortunately, the more complex the system, the greater the room for error. The***

hardest thing to judge is what level of risk is safe." Our global financial markets have grown exponentially more complex over the decades and that means each successive bubble bursting causes greater dislocations. Judging the balance between staying with the trend and protecting against the downside impact is one of the toughest decisions in investing.

George also makes a critical point about one of the most insidious causes of bubbles, credit (or leverage), when he said ***"I made two major discoveries in the course of writing: one is a reflexive connection between credit and collateral, the act of lending can change the value of the collateral, the other is a reflexive relationship between regulators and the economies they regulate."*** The problem is that when financial institutions extend too much credit, it reflexively raises the prices of those assets to extremes because those higher prices then are perceived as better collateral from which to extend more credit. Yes, this should remind you of the housing Bubble in 2007, but it should also remind you of the current situation in the global government bond markets that has Julian so concerned. When investors borrow money at cheap rates and buy government bonds (lending to the governments) they drive the prices up, and yields down, which reflexively makes other investors perceive that there has been an increase in quality (where none exists, in fact perhaps the opposite, as countries that issue more debt are less credit worthy than others) and demand for those bonds increases. George says it beautifully, ***"when interest rates are low we have conditions for asset bubbles to develop. When money is free, the rational lender will keep on lending until there is no one else to lend to."*** It has been said that when the cost of capital goes to zero, the return on capital goes to zero. Julian might say that it is worse than that and when lenders binge, bubbles occur and when they burst, the return on capital actually goes below zero. The problem is in knowing when the surface tension reaches the maximum tolerance and George says, "***The financial markets generally are unpredictable. So that one has to have different scenarios. The idea that you can actually predict what's going to happen contradicts my way of looking at the market."*** Herein lies the trouble with bubbles. Predicting is hard, especially about the future, so says Yogi Berra, so the better course is to form various scenarios and devise investment strategies that benefit in each of the outcomes. Like what Julian did in 2007 (and what he/we is/are doing today) where he took the net exposure in his long/short equity portfolio down (to capture alpha from the winners and the losers and remove market risk), raised cash to be opportunistic in the event that things got really ugly and utilized multiple capital efficient derivative strategies that win big in a certain scenario, but cost very little if another scenario plays out.

One of the challenges of spotting bubbles is that markets seem very calm right before they are about to get challenging, so most investors are caught off guard. George describes it as ***"short term volatility is greatest at turning points and diminishes as a trend becomes established. By the time all the participants have adjusted, the rules of the game will change again."*** Hyman Minsky described this phenomenon in saying that the absence of something creates it ultimate presence. Meaning that the longer we go along with the trend, the greater the misperceptions of safety and the lower the volatility will become, ultimately leading to a "Minsky Moment" where we get the unavoidable correction. To make matters worse the largest investors actually exacerbate the problem. George says ***"the trouble with institutional investors is that their performance is usually measured relative to their peer group and not by an absolute yardstick. This makes them trend followers by definition."*** So more capital moves from the sidelines into whatever asset is moving the most at precisely the wrong time. Today, massive amounts of capital has been moving into government bonds at astonishingly low yields which nearly guarantees a prospective loss over time. Julian described the problem with the government bond bubble and said that he expected things could get very difficult when the Fed raised interest rates and changed the liquidity environment. Julian took a line from George in ***"this line of reasoning leads me to look for the flaw in every investment thesis. I am ahead of the curve. I watch out for telltale signs that a trend may be exhausted. Then I disengage from the herd and look for a different investment thesis."*** The greatest investors know when to disengage and they are willing to be early (and be called wrong) because they are confident in their assessment that misperceptions have taken the trend to its illogical extreme. That instinct can really only come from experience and wisdom, so it is probably no surprise that the two people I am quoting here are over 80. One of my favorite Soros-isms seems like common sense, but it may be the very hardest thing to do in investing. He says, "***Markets are constantly in a state of uncertainty and flux, and money is made by discounting the obvious and betting on the unexpected."*** Sounds simple, but it's not. The obvious is alluring, it is popular, it is constantly in the news, you can't escape it unless you make the effort to disengage and take time away to really think and reflect. To truly bet on the unexpected, you have to think independently and have to have the courage of your convictions to go against consensus (not a popular thing in our society). Julian is warning us that something unexpected is on its way. We still have time to position accordingly. It is time to listen, read, reflect; it is time to form a hypothesis, implement the idea and let the reflexive nature of the markets tell you when you are right -- then really do something special, be a Tiger.

Something I wrote back in October in the Market Outlook section of last year's Q3 letter looks eerily similar to what I wrote in the Q3 2007 TSOF letter (that is included in the first section above) *"as we head down the Highway to the Danger Zone and anticipate an interesting (read challenging) year for investors in 2015, we are reminded of a couple of truisms in generating strong long-term investment returns; 1) Follow Roy Neuberger's three rules, i) don't lose money, ii) don't lose money and iii) don't forget the first two rules, 2) Invest without emotion and focus on eliminating unforced errors, and 3) You can't predict, you can prepare."* It is pretty interesting that I trotted out Roy's Rules precisely seven years apart (#SevenYearCycle) and that they align perfectly (coincidently) with Julian's becoming Bearish in October of 2007 and October of 2014. We know that if we take care of the downside, the upside will take care of itself and that the mathematics of loss are challenging to overcome, so avoiding losses in the first place is a far superior strategy. All that said, the hardest part of following those rules is knowing when the risks in the markets are greater than the reward and it would be advisable to play more defense and do more hedging or just head to the sidelines and go to cash for a while, let the speculative bubble burst and then go in and buy the best assets on sale. Like Julian, we have no particular edge on being able to determine exactly when the bubbles will burst, but we can heed his warning to increase our level of caution and position the portfolios with the barbell characteristics discussed above where we have less net exposure, more cash securing derivative positions that provide additional protection and can actually capitalize on drops in the most overvalued segments (e.g., being short government bonds with negative interest rates) and more exposure to the handful of places around the world where we still find cheap assets or high growth.

So let's take a quick Around the World tour and look at some of the things we like and some of the things we don't like. We will start in the U.S. where we wrote two quarters ago in *Highway to the Danger Zone "about how it might be time to play a little defense by going long IWL (large) and short IWM (small)."* There was no need for defense in Q4, so we updated that view last quarter saying, *"Given our history of being "early" on our defense calls, perhaps this would not be a bad idea for the coming months, but much depends on global liquidity."* For the first three and a half months of 2015, this was a bad idea as IWM surged 6.5% and IWL was only up 2%, but in the last couple of weeks that gap has completely closed and they are now both up only 1.5% and we reiterate that this is likely to be a nice market neutral trade for the balance of 2015. We also cautioned that biotech looked a little rich and that IBB could correct; that was a terrible call as it surged 20% through mid-April before finally succumbing to the law of gravity and dropping (10%) in the past couple of weeks (although still up 10% CYTD) and we do think that there could be some real downside here for those with a tolerance for volatility. We have written about the battle between the "*old tech names like MSFT, INTC, ORCL, HPQ and the new tech names like PCLN, EBAY, GOOGL, NFLX, FB and AMZN"* and it hasn't been much of a fight in 2015 as these names are up 2%, down (10%), flat, down (18%) for the old tech and up 4%, up 4%, up 4%, up 63%, flat, up 38% CYTD, respectively. We expect this trend to actually accelerate as fewer and fewer PCs are sold and it was just released that the 12 inch iPad (the laptop killer) is coming soon, so AAPL (up 15% so far this year) will continue to make life tough on the old tech guys.

Our view is that the "*big banks have been "Dodd-Franked" and have been turned into utilities as they can no longer lever up to levels needed to generate big returns in a ZIRP world.*" This view has been solid, as the banks have struggled with C down (2%), JPM up 3%, BAC down (8%), WFC up 2%, GS up 2% and MS down (3%). With restrictions on prop trading also hampering profits, if the one source of revenue growth, M&A activity cools in a Recession or market downturn, these companies could really struggle. Another important point that we brought up last quarter was *"the banks have huge derivative exposure and loan exposure to the energy industry that could cause some pain as the market begins to adjust around mid-year, so the swoon in bank stocks in January could be foreshadowing some interesting times ahead."* The banks chose not to "face the music in April" so they rolled over a bunch of LOCs to some very suspect borrowers (like they did with overleveraged REITs in 2007) and those will reset again in October (the cruelest month). Interestingly, right about the date Jeremy Grantham said eighteen months ago there would be a bubble top at 2,250 in the S&P 500. In the consumer space we have said that the lower gas prices equaling higher spending was unlikely to materialize (beyond mini mart fare and casual dining), but we did mention that companies *"like BBY, BBBY, JCP and SHLD could run on PE rumors,"* and 2015 has been a mixed bag with returns of down (9%), down (8%), up 30%, and up 26%, respectively. We have loved Airlines since October of 2012 and have mentioned that other travel related names could rally as well. The airlines had a great 2014, but have struggled so far in 2015 with AAL down (12%), DAL down (10%), UAL down (10%), LUV down (5%) and only JBLU has managed to buck the trend, rising 35%. Clearly investors are worried about rising oil prices, which while up 13% in 2015, are still down 40% from 2014, so we think they are missing the huge EPS boost coming from lower fuel costs. We expect the airline stocks will fly again as they are selling at way too cheap single digit P/E multiples and have strong growth prospects. We said last quarter that *"the cyclical stocks have been behaving as if growth were going to accelerate (hope springs eternal), so we will keep our eye on the semiconductors as they are a group that usually signals stronger growth ahead, so names like BRCM, KLIC, MRVL, LLTC, MSCC, NVDA, TXN, MU and QCOM will be bellwethers."* These names have mostly struggled in 2015 with returns of 5%, (6%), (5%), (1%), 15%, 10%, 1%, (20%) and (8%), respectively, so we that would point to economic slowing ahead. Finally, we said late last year that *"we expect continued strong growth in Defense as geopolitical tensions rise and countries like Japan and China increase military spending"* which played out well in Q4 and started strong in 2015, but has been weaker of late, leaving LMT down (3%), GD flat, BA up 10% and NOC up 5%. Overall, we find that U.S. equities will be a target rich environment on both sides, long and short, but we would expect to make bigger returns on the short side in the coming quarters if Julian's Tiger Sense is right again.

Heading across the pond to Europe, we mentioned last quarter that *"we have been cautious on building* *positions in Europe to date, but with Super Mario and Frau-Nein Merkel apparently on the same flight plan, we are now steepening the angle of approach and are beginning to build a meaningful overweight."* Looking at a basket of European ETFs for Germany, France, Portugal, Ireland, Italy, Greece and Spain, we see that has been a pretty good plan since the ECB announcement of a QE Program for Europe on January 22nd with EWG up 6%, EWQ up 8%, PGAL up 14%, EIRL up 15%, EWI up 8%, GREK down (7%) and EWP up 4% versus a rise of 1% for the S&P 500. The game plan in Europe is fairly clear; don't fight the ECB and stay long and strong so long as Super Mario keeps the member Central Banks buying government bonds. The recent Bear Raid by the big U.S. fixed income managers (taking a position short and then talking their book on TV and at conferences) has added a little wrinkle to the story as bond yields have blown out across the Continent. One can't help but be reminded of the days of QE in the U.S. where Ben the Babbler would jawbone about a big recovery and bond yields would surge, lowering prices nicely, so he could buy more bonds at better prices. If my job was to buy bonds, I might be tempted to "get some help from my friends" in taking prices down a bit every now and then. Perhaps this is too conspiratorial, but when you look back at the path of U.S. rates, it was like a rubber ball bouncing down a set of stairs, each bounce successively higher, but the end of the trip is lower than the start. Global investors clearly got out ahead of the ECB and pushed yields down to crazy levels (20% of European bonds have negative yields and aren't eligible to be purchased in the QE plan) so how might I expand my pool of available bonds, well I might encourage my friends to short those bonds with negative interest rates (and positive carry) and incite a price melt-down so I can go about my merry QE way. Perhaps Mr. Gundlach's comment the other day at the Sohn conference, "why wouldn't someone borrow infinite amounts of negative interest rate bonds," was just a coincidence. The other factor at work here is that there is a real economic recovery going on across Europe and that should create increasing opportunities for companies to increase profits. The wildcard here is that if Julian is right and the U.S. economy boils over, there clearly could be spillover effects into Europe, so some caution is still warranted in the long/short mix. Finally, there is the issue of the #Grexit. There will be none. That was easy. It would be too costly for the European Union to allow Greece to exit, so all the theater about the negotiations is, just that, theater. Germany is still the most mercantilist country in the world and they need a weak Euro to sell machine tools and cars, so the Euro is The Hotel California, "You can check out any time you like, but you can never leave." The only caveat on this hard line prediction is that if it is true that Russia is trying to create a regional currency block of their own (they have created a competitor to SWIFT already), then it is possible that Turkey and Greece (and a few other countries) will be drinking vodka instead of wine going forward.

Turning to our favorite developed market, Japan, we wrote last quarter that, *"while there has been a growing chorus of skeptics on Japan (and Abenomics in particular) we are emboldened in our positive view of the Japan market by Sir John Templeton's reminder that bull markets grow on skepticism."* And grow on skepticism this Bull Market has, as Japanese equities have been, Dare I Say, En Fuego (to quote Dan Patrick of ESPN). The monetary stimulus from Kuroda-sans big bazooka last Halloween pushed the Yen toward 120 which has helped drive record profits for the exporters (SNE up 37%, PCRCY up 25%), but the rest of Japan Inc. has joined in the profit party as overall Japanese corporate profits are at record levels. Even the one area that had continued to frustrate us, the banks, have finally begun to surge. We wrote in the Q3 2014 letter that *"perhaps the most compelling opportunity, the banks (SMFG, MTU, MFG, Resona, Shinsei) have now bottomed and now have very significant upside (could rise as much as 60% to 100%) as their ROEs continue to recover and brokerage firms like Nomura and Daiwa should be very strong performers as domestic trading volumes increase and foreign capital returns to the Japanese market,"* but no one else seemed to agree with our view and they languished for the next five months until February of this year. But surge they have with the Fab Five Banks mentioned above up 25%, 34%, 14%, 12% and 14% and the Brokers are up 21% and 11%, respectively. Kuroda-san was quoted this week saying he is not done yet with his bazooka and that the BOJ will achieve the 2% inflation target (long before the Fed or ECB comes anywhere close). This is great news for the Yen shorts and even better news for the Nikkei longs. There is no question that some of the rally in Q1 was the result of the giant pension fund GPIF raising their equity weighting to 25% (from 12%), but much of that money went into index funds and ETFs and pushed only the biggest names higher, so the next leg of the Bull Market in Japan will likely favor the small and mid-caps. Another interesting play in Japan is in technology names and the potential for new IPOs (and even Venture Capital) as Abe-san is committed to "bringing the Silicon Valley spirit" to Japan. Abe is the first PM to have a multi-year term in decades and he has a plan and is executing flawlessly so far. We will continue to be long Japan and will affectionately refer to it now as the Land of the Rising Stocks.

When we look at Emerging Markets we need to divide them into two groups, service-based economies like India, Taiwan and China and commodity-based economies like Russia, Brazil and Mexico. The global economic growth slowdown, the slowing of commodity demand from China as it shifts from fixed asset investment toward consumption, and the rapid decline in commodity prices (primarily iron ore and oil) are net negative for the commodity countries and are net positive for the service countries. We also have to factor in the impact of changing global liquidity on the EM currencies and how those FX fluctuations will impact our returns as U.S. based investors. 2014 saw some extreme moves down in EM currencies in places like Russia and Brazil and anyone invested in those markets that had to convert back to Dollars suffered huge losses. 2015 has been a very different story as some of the EM Central Banks fought back against King Dollar by raising interest rates (Russia, Turkey) and others began to lower rates as their current accounts came into balance with lower oil prices (India, China). We began to get excited about Russia in December and wrote in the Q4 letter that, *"since 12/15, Russian equities are a completely different story (a story we think extends throughout 2015, see Surprise #5 below)."* The returns on Russian equities since then have been spectacular with Lukoil up 28%, Gazprom up 49%, Sberbank up 60%, Yandex up 31% and RSX up 34% as the RUBUSD surged 38%. Russia is still incredibly cheap and we expect to see higher stock prices over the course of the year. One of our six Around the World favorites from last year was Argentina and we have discussed how *"we have played in three equities, Macro Bank, Pampa Energia and YPF as we think the rewards outweigh the risks at present, so we will continue to scale into opportunities as they arise."* With the election now in plain sight (October), investors are cheering the departure of Crazy Cristina sending BMA up 34%, PAM up 53%, and YPF up 30% and as impressive as those numbers are, PAM and BMA were up nearly twice that much through mid-March before some bond market stress triggered some profit taking. We expect that once the hedge fund holdout issue is settled (likely in May/June as a political move to win votes for the Peronista candidate) that Argentina will be a great place to make money as the capital markets open and corporate profits rise. We have liked India since it became clear early last year that Modi would become the new PM and we have been surprised that the market has been so moribund since for the last twelve months. While the short-term results have been disappointing, we see outstanding growth ahead and will continue to build positions in companies like Tata Motors and ICICI Bank. The India markets have sold off modestly in the past few weeks pushing EPI to a (5%) loss CYTD and TTM off (8%) and IBN down (15%). Another specialty area where we see significant opportunity is the generic drug industry where Sun Pharma (IN:524715) and Dr. Reddys (IN:500124) that were up 40% and 15%, respectively, in early April have sold off dramatically and we think these will prove to be solid buys looking back in a few years. Finally, we have talked a lot about the China market in the letter already and will just reiterate here that we expect that the Bull Market will run for a while (see Surprise #10 below).

Turning to commodities, we discussed at the end of last year how we had made *"an Energy shopping list of attractive names that we would want to own at certain price levels. EOG, FANG, CPE, WLL, PXD, RSPP and RICE."* Given our thesis that oil prices would stay lower for longer, we hesitated in buying into this sector and, with the benefit of hindsight, we may have made a mistake as these tickers are up 2%, up 31%, up 47%, up 10%, up 8%, up 10% and up 10%, respectively. While we may have missed the first leg up, there is more upside ahead as the energy markets recalibrate to a new price regime and we are not convinced yet that there won't be one more drop in oil prices as the excess storage is liquidated in the summer, so we may get another shot to buy our favorites on sale. We also mentioned last quarter that another way to play energy was *"Despite lower prices, U.S. production will rise in 2015 and all those hydrocarbons have to be transported, so pipelines will benefit."* We have liked ETE and PAGP (both of which we were involved in the private to public deals which were huge winners for our private portfolios) and they have started to perk up, rising 12% and 8%, respectively, this year. We started to look at the energy services companies last quarter, but we were convinced in talking to operators in the business (CEOs of our private companies and PE firms focused on energy) that the services companies' revenues would be under significant pressure as E&P companies cut their capex budgets. It appears the massive rush of money into energy ETFs as oil prices start to rise trumps the concerns of the experts (when money goes into an ETF, they must buy all the names regardless of differentiated prospects). The problem has been most of the money has gone into ETFs that aren't really exposed to oil itself, but instead into E&P companies, the integrateds, and the services companies. So, surprisingly, HAL/BHI (merging) is up 21%, SLB is up 8%, OIH (the ETF) is up 8% and the two sand companies (that are actually getting squeezed on price), SLCA and HCLP are up 35% and 5%, respectively. Even more surprising is something we discussed last quarter as well: *"another industry given up for dead is the offshore drillers RIG, DO, NE, EXXI, ATW, RDC and SDRL, so we will be looking for signs of a momentum turn to wade into the space."* These names have been incredibly volatile, but they appear to be bottoming as they have returned 5%, (6%), 5%, 18%, 22%, (4%) and 20%, respectively. We expect energy to remain highly volatile for the balance of the year and we will be spending a lot of time looking at opportunities in both the debt and equity markets for all of our portfolios.

Apart from oil and gas, we talked last quarter about how *"we continue to see the risks of deflation outweighing the risks of inflation, yet there still seem to be some attractive opportunities in real assets as we look forward. A few examples of companies that could be big winners if the commodity super cycle resumes are VALE, BHP and FCX and the steel companies like X and AKS (or if we want to get really fancy we can combine Surprises and go for a Russian steel company MTL)."* As if on cue the iron ore, copper and steel markets began to firm and these names started to recover, rising 11%, 6%, 24%, 4%, 25% and 6%, respectively. Clearly if Julian is right and we are headed into Recession, these stocks will suffer, but if commodity prices continue to firm, that should translate into some very meaningful EPS boosts for these market leaders who have punished the competition during this price consolidation and have gained market share. The key will be to watch Dr. Copper and see if that trend continues upwards (must break above $300) or rolls over as an early warning sign of lower growth ahead. We also noted last quarter that *"another area to think about is the public management companies of the private equity firms which will take advantage of the opportunities in distressed debt, energy and M&A and names like BX, OAK, KKR and CG could provide solid returns in an environment where the illiquidity premium continues to be rewarded."* These firms have raised tens of billions of dollars to buy distressed assets in the energy and commodity space and we would expect to see higher management fees boost earnings. In 2015, these companies have been mixed, with BX up 16%, CG up 14%, OAK down (2%) and KKR down (8%). We talked last quarter about how one of the biggest surprises of the year would be if commodity prices did not continue to be beaten down by King Dollar and real assets outperformed financial assets in 2015. There is unlikely to be a lot of clarity on this issue until we see if the negative growth surprise in Q1 was an aberration or the beginning of something more disconcerting. Speaking of surprises, let's take a look at our 10 Potential Surprises for 2015.

10 Surprises Update

Our January ATWWY Webinar was entitled *Channeling Byron: 10 Potential Surprises for 2015* (with a nod to Byron Wien, the former Morgan Stanley Strategist who originated the annual 10 Surprises idea). We recapped these Surprises in the Market Outlook section last quarter, as they seemed like a perfect baseline for our current view of the world. An important point about Surprises is they are intentionally non-consensus and have some reasonable probability of not occurring. The unlikely nature of a true Surprise fits in perfectly with the Soros quote above about discounting the expected and betting on the unexpected. Michael Steinhardt was famous for saying that *"we made all our big returns from Variant Perceptions that turned out to be right."* To that point, the definition of a Surprise is a Variant Perception (an idea that is materially different from consensus) that we believe has a better than 50% chance of occurring in the current year and the key is that it must be *materially* different. We discussed one other important point to be mindful of saying *"a year is a long time, things can change, sometimes dramatically and we need to remember the wisdom of John Maynard Keynes who famously quipped, "when the facts change, I change my mind, what do you do, sir?" We will remain vigilant during the year to track the progress of each of these Surprises and look for opportunities to capitalize on them in the portfolios, but also be ready to change our minds (and our positioning), should the facts change."* So the following are some quick updates on how the surprises are faring at the first turn (since the Kentucky Derby was on as I wrote this) with notes on places where we may need to change our mind as consensus is shifting (italics are from last letter and new commentary is regular font).

Surprise #1: The Lula Pivot. In a déjà vu experience harkening back to the 2002 Brazil elections, the radical Syriza Party wins the Greek Election (was still a potential surprise since wrote before election), but Alexis Tsipras turns out to not be as extreme to the left as expected (just like Lula) and the Greek equity market surges (just like Brazil did for next five years), turning out to be one of the best performing markets for 2015.

We believe that the rhetoric will continue to soften, both sides will compromise (just like they did in 2011, but likely not quite as extremely in favor of the EU this time, no more Austerity) and the markets will continue to recover as the uncertainty of the election is replaced by the focus on the work that has to be done. We see opportunities in both Greek Government Bonds and Greek equities (particularly the banks, where in full disclosure, we have been early/wrong so far…) and while the path will not be smooth, we expect that returns will be quite attractive over the course of the year.

To this point, we would have to say this surprise is not going according to script. Too much posturing and too little liquidity have led to some rapid deterioration in the GGBs, and while the equities had clawed their way back to even with the U.S. at the end of April, this first week of May has been tough and GREK is down 7% again and the banks are still down (20%) to (30%). The game of chicken between the new Greek government (and their not so tactful Finance Minister) and the Troika is nearing its end and we believe that when the drama is over, there will be no Grexit and stocks and bonds will surge.

Surprise #2: Turning Japanese, I Really Think So. Despite the BOJ and the ECB picking up the QE baton from the Fed and committing to purchase $80B and $65B of government bonds each month respectively, Deflation reemerges as the primary economic challenge in the developed world, GDP growth stalls and global interest rates continue to fall.

European bond yields are already at multi-century lows, with German Bunds now trading below JGBs, and a shocking 20% of European debt has negative yields today (that is $1.4 trillion worth). U.S. yields fell in 2014 contrary to all 67 economists polled to start the year, and yields have plunged again to start 2015. Almost no one believes that rates will keep falling, which can be seen in the massive short interest in Government Bonds, but the handful of people who have remained long (like our two favorite fighter pilots Hoisington and Horseman) continue to generate strong returns.

This surprise was going along like clockwork during the first quarter with global bond yields making new lows seemingly every day and even slipping into negative territory for large swaths of Europe. The German 10 year Bund yield had fallen from 55 bps to 5bps, but then in mid-April rates exploded higher as a number of large fixed income managers revealed they were short and yields bounced all the way back to 55 bps. Many investors who have lost a lot of money being short bonds over the past two years are now declaring victory (even though they are still down a lot…), but we remain in the #LowerForLonger camp for now as we expect more disappointment on the global growth front.

Surprise #3: Let's Do Limbo Now. Contrary to the Fed Dots (new, new thing), the preponderance of Economists' predictions (just like in 2014) and the continually upward sloping Fed Funds futures curves (since 2009), the Fed does not raise rates in 2015 and long bond rates take out the 2012 lows in yield.

Finally, there is no mistaking the long-term trend channels on the 10-year and 30-year Treasuries, so until such time as yields break out of those channels, it is tough not to see lower for longer as the mantra in the bond market. One real beneficiary of the lower rates has been the housing industry and the housing stocks have been looking good lately, so they could continue to shine in a lower for longer environment and the Index XHB will do well, but some of the components like LEN, PHM, KBH, DHI, TOL and RYL could do even better. Another beneficiary of this trend will be the asset managers who specialize in fixed income and names like BLK, BK, LM, FII, WDR and STT could continue to have tailwinds.

The U.S. 10 year had started the year at 2.2%, had fallen all the way to 1.63% in February, was hovering at 1.75 in April and has now surged back to 2.2% in a matter of weeks. Many investors burned by the sharp fall in rates over the past two years are saying the Bond Bull Market has officially ended, just like they have every year since 2009. We will take the under. Updating the housing and fixed income manager names, the housing stocks have returns CYTD of up 2%, up 4%, down (5%), up 20%, up 4%, up 4% and flat, while the asset managers have returns of up 6%, up 18%, down (2%), up 9%, up 7%, up 8%, all compared to the S&P 500 up 1%.

Surprise #4: Here's to You Mr. Kindleberger. Confounding the conventional wisdom that the convergence of the third year of a Presidential Cycle (average 21% return since WWII) and the fifth year of a decade (no down years since 1905) virtually guarantees a positive return for U.S. equities, the S&P 500 breaks the string of six consecutive up years and suffers its first losing year since 2008.

We discussed Charles Kindleberger's Cycle Theory earlier in this letter, but again quickly, he posits that the economy and markets follow a seven-year boom/bust cycle driven by repeatable investor behaviors. Given the last two cyclical peaks were in 2001 and

2008, we would be due for another peak in 2015 that would result in disappointing returns for U.S. equities. The S&P 500 has never been up seven years in a row. So as 2105 progresses we will see if the S&P 500 will be the anti-Craps game this year and roll a lucky seven or if it aligns with Mr. Kindleberger's periodicity.

Our thesis continues to be that 2015 = 2000, so we would expect a single digit negative return for the year and with four months in the book, a scant 1.9% return with a lot of negative momentum in the markets seems to be in striking range of our target outcome. With Julian sounding the alarm last fall, we expect some real fireworks in Q4 this year if history rhymes.

Surprise #5: TMI Writ Large. Despite an ongoing military conflict in Ukraine, the impact of coordinated global economic sanctions, rapidly falling oil prices, reduced government tax revenues, a collapsing currency and a looming economic downturn and downgrades of their government debt and consensus that Russia is simply "un-investable," Sir John Templeton turns out to be right that Bull Markets are born on Pessimism and Russian equities turn out to be one of the best global markets in 2015.

While not forecasting precisely the same kind of rebound as 2009 since there is not the same level of global stimulus from China and the U.S. this time around, but given the extremely cheap valuations, the potential for a meaningful positive surprise exists. So far this year Russia has appeared to decouple slightly from oil prices and the prospect for a true cease fire in Ukraine would be an additional tailwind to move from Pessimism to Skepticism, the state where Bull Markets really grow.

We couldn't have scripted a better first four months for the Russian Rebound sequel (just like 2009). Surpassing even our best expectations, the stabilization of the Ruble (up 20%), a recovery in oil prices and a general sense that things really had gotten too cheap in Russian equities have driven the markets up sharply from the lows of Maximum Pessimism on December 15th of last year. CYTD our favorite Russia names are up big, with RSX up 37%, LUKOY up 34%, SBRCY up 56%, OGZPY up 34% and VIP up 25%. We think there is a lot more to come here as we are still in the Pessimism phase and have yet to get to the growth stage of a Bull Market, Skepticism.

Surprise #6: All That Glitters. The acceleration of the Global Currency War reignites the demand for the ultimate currency, Gold, and the Barbarous Relic surges to new highs in 2015, carrying the miners along for the ride.

As the global currency wars rage and the QE baton is passed from the U.S., U.K. and Swiss Central Banks to the BOJ and ECB, it has been interesting this year to watch precious metals suddenly begin to trade like currencies again. One other interesting point is that the ratio of XAU (NYSE Arca Gold BUGS Index) to Gold Bullion reached the lowest level in history at the end of 2014 and given that gold had seemingly turned more positive, it appeared that gold miners were due for a rally.

Gold has been basically flat so far this year as the global currency wars have taken a little breather. Gold and silver have been acting more like currencies than commodities of late (usually happens around challenging times). The miners have been much more volatile and after being up 20% early on, they were hit, down (5%), before settling down in the past few weeks. CYTD the metals and miners are both mixed with GLD flat and SLV up 5% and GDX up 7% and GDXJ up 1%. Expect more volatility as the tug-o-war between Deflation and Expansion rages on.

Surprise #7: Water Finds Its Level. Central Banks in the Emerging Markets are forced to stimulate their economies in response to the massive BOJ and ECB bond purchase programs and the resulting expansion of liquidity unlocks the extreme value in Emerging Market equities leading them to outperform the developed markets for the first time since 2012.

We have seen a number of surprise rate cuts recently in places like India and China, where the majority of the CPI is food and energy as inflationary pressures have waned. Many things have changed in EM in recent years, but one thing that remained constant is the relative level of growth vs. the DM and while that growth has continued to be quite robust, investors' fears about Fed Tapering and slowing rates of growth (rather than focusing on rising quality of growth) has pushed prices down to levels where the valuations are extremely compelling. We think India looks very attractive, particularly given the momentum created by Modinomics and the surprise easing of interest rates by Central Bank governor Rajan.

Someone clearly forgot to send the memo to the Emerging Markets that they were all supposed to roll over and die as soon as the Fed stopped QE and turned off the liquidity spigot. Lo and behold the Central Bankers around the world stepped up and made the hard decisions to stem the FX declines and then began a measured program of expanding liquidity to the local markets. While most pundits were touting the continued dominance of Developed Markets over Emerging Markets in 2015, so far the true surprise is that it hasn't been close (the other way). EEM is up 10% versus the 1% rise in the S&P 500 and some of the components have been truly amazing with RSX up 37%, FXI up 10%, EWZ up 5% and only India has disappointed, with EPI down (5%). The Frontier Markets have been mixed, with FM up 2% and AFK up 3%, and we expect more good things out of Africa and the Middle East as the Saudi Market opens up in June. India has given back a little ground as the Modi honeymoon has waned and the real work has begun. We see this as a tremendous buying opportunity and see fantastic growth opportunities ahead as this Asian Tiger market modernizes and matures demographically.

Surprise #8: No Fracking Around. Contrary to the current consensus that Oil prices have bottomed and will rebound back to \$70-\$80 by year end, continuing liquidation of speculative long futures positions drives Oil down close to the 2008 lows (\$30) and prices stay in the \$40-\$50 range much longer than expected as structural challenges in the U.S. and OPEC make it difficult for market participants to move supply/demand back into balance.

So the bottom callers have come out once again saying that oil prices have seen their lows and that prices will rapidly recover to their 2014 levels. Why is everyone so sure this will happen? Why is there not one (not one…) Wall St. analyst with a year-end price target for oil below \$60? Primarily because everyone is looking at the data from 1995 on, that shows that each time oil prices have dropped precipitously, they have rebounded sharply, but the problem is that each drop since 1995 was a demand shock, not a supply shock. Demand shocks have been cured by the massive stimulus propping up consumption and encouraging speculation (the spec longs have actually increased again), while supply shock recoveries are measured in years, not months. So why are prices rallying in the past couple of weeks from the mid-\$40's to the mid-\$50's and why is the media trumpeting a new bull market in oil? Over the past couple of weeks, the oil markets have been very volatile, rising and falling more than 3% on most days, with more up days than down recently, resulting in the move upwards. Soros says that volatility always increases at turning points, so perhaps the trend is about to change back to positive and oil will surge for the balance of the year. We remain skeptical and continue to believe that the consensus for a steep rebound will be proven wrong as the fundamentals trump the recent speculative activity.

Early in the first quarter, this surprise was looking good as a continued slide in oil prices knocked another (16.5%) off the already low price of \$53.27 at year end and WTI hit \$44.45 on the second to last day of January, before a vicious rally on the last day of the month trimmed losses to only (8%). Oil headed back down as supply data got worse and worse and WTI touched a new low of \$43.46 on March 15th. From that point, something (what, we are not quite sure yet…) materially changed in the oil markets as prices have staged a very strong rally over the past six weeks, rising a stunning 38% to $60, to now be up 7% for the year. We said we reserve the right to change our mind about a surprise if the facts change and therein lays the conundrum. Seemingly, the fundamentals of the market have actually gotten a little worse as the small drop in U.S. production (60k bpd) was more than offset by a huge production increase by Saudi (800k bpd) and while demand has ticked up at these lower prices, it doesn't appear to be enough to move supply/demand back in to balance. Add the overhang of record stored oil that will come back into the market and you get less balance, not more. For now, we are sticking with the view of the smartest oil trader we know, Pierre Andurand, who thinks we see lower lows later this year, but we are mindful of the fact that no one is right all the time (and he may change his mind, after all he is a trader…) and sometimes you need to just listen to what the markets are telling you.

Surprise #9: Only Way Out. Kuroda-san and the BOJ pull out the bazooka again in 2015 taking aim at a USDJPY level of 140 in an attempt to stimulate profits of Japan Inc. so they will raise wages, triggering a virtuous circle to break deflation and achieve the 2% target inflation rate. Japanese equities tag along for the ride and the Nikkei reaches 22,000 by year-end.

Corporate profits at Japan Inc. continue to set new records and the shares of export oriented companies continue to make new highs, on top of very robust advances in the past two years. A bonus here is that, surprisingly, Japanese equities are actually cheaper today than before the rally started because the earnings growth has been so robust. Our expectations are that the BOJ will continue to remain accommodative and provide liquidity to fuel continued margin expansion, further increases in ROE and higher stock prices. At the core of Abenomics is a commitment to continued weakening of the Yen and we would expect to see 140 on the USDJPY by the end of 2015. This move will not be linear and we do see some resistance at 123 (and correlated resistance for the Nikkei at 18,400), but once those levels are cleared, we expect to see the 140 and 22,000 levels of surprise #9 achieved later this year.

This surprise is going pretty much according to script as the Yen did indeed encounter resistance and has essentially remained flat over the course of the first four months of the year around 120. The Nikkei also hit some resistance at 18,000 for a few weeks before surging over the past couple of months to finish just under 19,500 (almost halfway to the target). As we have discussed in the sections above, there have been a lot of places to make really strong returns in Japan this year, like the banks and exporters, but the indices themselves have been solid with NKY up 12% and DXJ up 13% versus the 1% gain in the S&P 500 and the 5% gain in the MSCI ACWI Index. We expect that Japan will continue to be one of the best places around to own equities over the next few years and should also be much more resilient in the event Julian is right and we get a meaningful correction in U.S. equities, due to relative valuations and the fact that there are many overleveraged U.S. companies and many net cash Japanese companies.

Surprise #10: Goats Climb Mountains. In spite of the cacophony of bad news about slowing GDP growth, an impending economic hard landing, a potential currency collapse, a looming banking crisis and a pervasive real estate bubble, coupled with fears that huge returns in the Shanghai market in 2014 have pushed equity markets too far, too fast, China officially enters a new Bull Market and equities (both Hong Kong and Shanghai) rally strongly again in 2015.

We believe that this Reform Agenda has set the stage for a powerful, and long-lasting, bull market as the reflexive synergies between global market participants and the Chinese economy fuel a virtuous cycle of development in the years ahead. The tremendous success of the Through Train Program that has increased equity activity is just one example of how the New Leadership is pushing the economic model beyond the property markets into other asset markets. In

2014, it was the A-Shares market that led with spectacular gains of 53%, but so far in 2015, it has been time for the H-Shares and SOEs to play catch-up. We would expect to see strength across all Chinese equity markets in 2015 and there is some possibility that the virtuous cycle could produce the type of robust bull market that we saw in the U.S. in the mid-90s. To that point, we continue to see the best opportunities in five sectors, Internet, e-Commerce, Consumer Staples, Healthcare and Alternative Energy.

When the Chinese Leadership set their mind to something, they usually get their way and the recent shift of assets from property toward equities is no exception. From increased liquidity from the PBOC to the development of the Through Train Program and expansionary regulations on trading, the message has been clear for Chinese investors to start consuming stocks, now. The result has a been a very powerful move in equity markets over the past year (SHCOMP up over 100%) and our surprise looks pretty darn good at this juncture with the SHCOMP up 27%, FXI up 18%, ASHR up 23% and EWH up 15%. The global financial media has come out in force calling the rapid move a bubble and predicting an immediate crash. The facts are quite different from the reality as valuations for the broad markets are still cheap (not even average, let along expensive). Yes, there are a few pockets of extreme valuation in some of the small/micro-cap markets and most of the new IPOs have been rocketships, but the total market cap of these high fliers is relatively small. The rest of the year is likely to see some meaningful volatility, but we would expect Chinese equities to keep rising on the back of the Great Wall of Money moving into the markets.

Bonus: Surprise #11: Little Luxuries Not Enough. In contrast to the powerful narrative, the huge windfall for U.S. consumers from lower gasoline prices fails to materialize as some of the savings are applied to reduce debt and increase savings and the loss of jobs from the economic downturn in the Oil States counteracts the positive impact of the balance. U.S. Real GDP growth hovers around 2% (for the 6th consecutive year) and talk of QE4 begins in the fall.

When I was creating the 10 Surprises, I got on a roll and actually came up with an extra one that originated from all the hoopla around the consumer windfall that was coming from lower gas prices. Numbers were being thrown around in the media of $200 billion to $300 billion and expectations were very high that all this money would immediately flow into consumption and boost GDP. But a funny thing happened between the gas pump and the mini mart. Consumers did buy a few extra packages of cigarettes, a few more bottles of beer, but the overall retail sales figures actually fell, showing that consumers held on to some of those savings, perhaps to pay down some debt or maybe sock away some savings in the event that the low gas prices were fleeting (wholesale gas prices have now doubled since bottoming on 1/13). As the surprise title implies, an extra lottery ticket, or cup of coffee at Starbucks, won't juice GDP enough and we don't expect to see U.S. GDP hit the 3% level in 2015, for the seventh year in a row.

There is no question that as gas prices tanked (couldn't resist) last year, consumers had a few extras dollars in their pockets at the gas station and they did indeed buy more stuff at the mini mart (MO went up 5%) and they did stop at more casual dining restaurants on the way home (DRI went up 9%), but the overall impact on the economy was very muted based on the Q1 GDP number of 0.2%. The real problem is that with the newly released trade numbers that include info adjusting for the CA port closures, that GDP number is going to revised down to a negative number. Surprise! That performance in Q1 almost guarantees that GDP has no chance of hitting 3% for the year. Worse yet, the Atlanta Fed GDP Now forecast (which was the only forecaster to have Q1 below 1%, they were right on at 0.2%) has Q2 GDP at 0.8%, which would mean we are only a little bit of bad weather away from two negative quarters of GDP, the old school definition of a Recession. That said, after spending the last few hours in the Atlanta airport, we are not in a Recession yet (and we believe our airline investments are going to soar…), but all the talk of resurgent growth seems misplaced given the data.

Update on Morgan Creek

In closing, many of you know that we lost our good friend and partner, Peter Gutrich to a brain tumor recently. We held a memorial at the Creek to celebrate his life and to share stories of how Peter had touched all of our lives. We affectionately referred to PG as The Most Interesting Man in the World and, more importantly, he was the most optimistic person I have ever met. One of my favorite thoughts about him is that "he never met a stranger," he engaged with everyone as if they were the most important person in the world. Peter was a true friend to us all and we will miss him dearly. RIP My Friend. Peter often talked about the Magic Circle, that group of people that you interact with to exchange ideas, discuss strategies and who make you better by being around them. I have been very lucky in my life and career to have some truly extraordinary people in my Circle and the opportunity to learn from Julian Robertson over the years has been a great gift. When people with great experience and wisdom share something important with us, all we have to do is listen, so we will end this letter the way it began, Not Lyin', The Big Tiger's a Bear, Oh My!

With warmest regards,

Mark W. Yusko

Mark W. Yusko
Chief Executive Officer & Chief Investment Officer

General

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Russell 3000 Index (DRI) — this index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Definition is from the Russell Investment Group.

MSCI EAFE Index — this is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. Morgan Stanley Capital International definition is from Morgan Stanley.

MSCI World Index — this is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. Morgan Stanley Capital International definition is from Morgan Stanley.

91-Day US T-Bill — short-term U.S. Treasury securities with minimum denominations of $10,000 and a maturity of three months. They are issued at a discount to face value. Definition is from the Department of Treasury.

HFRX Absolute Return Index — provides investors with exposure to hedge funds that seek stable performance regardless of market conditions. Absolute return funds tend to be considerably less volatile and correlate less to major market benchmarks than directional funds. Definition is from Hedge Fund Research, Inc.

JP Morgan Global Bond Index — this is a capitalization-weighted index of the total return of the global government bond markets (including the U.S.) including the effect of currency. Countries and issues are included in the index based on size and liquidity. Definition is from JP Morgan.

Barclays High Yield Bond Index — this index consists of all non-investment grade U.S. and Yankee bonds with a minimum outstanding amount of $100 million and maturing over one year. Definition is from Barclays.

Barclays Aggregate Bond Index — this is a composite index made up of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index, which includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $100 million. Definition is from Barclays.

S&P 500 Index — this is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is a market-value weighted index – each stock's weight in the index is proportionate to its market value. Definition is from Standard and Poor's.

Barclays Government Credit Bond Index — includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries and agencies. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specific maturity, liquidity and quality requirements.

HFRI Emerging Markets Index — this is an Emerging Markets index with a regional investment focus in the following geographic areas: Asia ex-Japan, Russia/Eastern Europe, Latin America, Africa or the Middle East.

HFRI FOF: Diversified Index — invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets. Definition is from Hedge Fund Research, Inc.

MSCI Emerging Markets Index — this is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of November 2012 the MSCI Emerging Markets Index consisted of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.