MainStay Investments® | Marketfield Asset Management

June 2015

MainStay Marketfield Fund

Fund Overview

Objective

The investment objective of the Fund is capital appreciation.

Strategy & Process

The Fund seeks long-term growth of capital above that of the broad equity market over a full market cycle, with volatility that is lower than that of the broad equity market. Correlation between the Fund and the broad equity market may vary considerably over a full market cycle. The Fund has a broad investment charter that allows it to utilize equity securities, fixed-income instruments, commodities, futures, and options. Additionally, with respect to 50% of the Fund's net assets, the Fund may engage in short sales of securities to profit from an anticipated decline in the price of the security sold short. The use of short selling could result in increased volatility of returns.

Fund Facts

Fund Statistics

CUSIP: ....Class A: 56064B878
.... Class I: 56064B852
.... Class R2: 56064B845
Inception Date 7/31/07
Benchmark ....S&P 500 Index
Net Assets .... $5,039 M
Number of Holdings....................................... 101

Top Ten Long Holdings (Excluding Cash) (As of 6/30/15)

HSCEI Index July 2015 Futures* (China) 4.9%
iShares China Large-Cap ETF.......................4.5%
Merlin Properties Socimi SA (Spain)............3.2%
iShares MSCI Japan Index ETF.....................3.0%
Bank of China, Ltd. Class H.......................... 3.0%
Kennedy Wilson Europe Real Estate Plc UK... 2.5%
iShares MSCI Hong Kong Index ETF............2.3%
iShares MSCI Emerging Markets ETF...........2.0%
Bank of Ireland... 1.8%
China Life Insurance Co Ltd. Class H...........1.7%
TOTAL: 28.9%

Portfolio Allocation (As of 6/30/15)

Equity Long 84%
Equity Short .... -12%
Equity Index Futures Long*.......................... 5%
Equity Index Futures Short*.........................-11%

Option delta not reflected.
**Notional Value*

Fund Performance

Quarterly Average Annual Total Returns as of 6/30/15

	Tickers	YTD	One Year	Three Years	Five Years	Inception
Class I (7/31/2007)	MFLDX	-1.97%	-10.91%	1.60%	5.96%	6.14%
Class A (Max. 5.5% load) (10/05/2012)	MFADX	-7.43%	-15.96%	-0.50%	4.53%	5.14%
Class A (NAV) (10/05/2012)	MFADX	-2.04%	-11.07%	1.39%	5.72%	5.89%
Class R2 (10/05/2012)	MFRDX	-2.11%	-11.20%	1.25%	5.59%	5.77%
HFRI Macro Discretionary Thematic Index (12/31/2007)	N/A	2.37%	-0.01%	1.68%	1.09%	0.59%
S&P 500® Index (7/31/2007)	N/A	1.23%	7.42%	17.31%	17.34%	6.81%

Performance data quoted represents past performance. Past performance is no guarantee of future results. Due to market volatility, current performance may be less or higher than the figures shown. Investment return and principal value will fluctuate, so that upon redemption, shares may be worth more or less than their original cost. Performance figures for Class I shares reflect a contractual fee waiver and/or expense limitation agreement in effect through 2/28/16, without which total returns may have been lower. This agreement shall renew automatically for one-year terms unless written notice is provided prior to the start of the next term or upon approval of the Board. For performance information current to the most recent month-end, visit our web site at mainstayinvestments.com.

Total Annual Fund Operating Expenses are: Class A: 2.73%, Class I: 2.47%, and Class R2: 2.84%. Expenses include *Dividend Expense on Securities Sold Short and Broker Fees and Charges on Short Sales* for each share class, without which, the total net expenses are as follows: Class A: 1.86%, Class I: 1.61%, and Class R2: 1.96%.

Average annual total returns include the change in share price and reinvestment of capital gains and distributions. Effective 10/5/12, Marketfield Fund became MainStay Marketfield Fund. At that time, the Fund's existing no-load shares became Class I shares. Performance for Class I shares reflects the historical performance of the then-existing shares of Marketfield Fund (which were subject to a different fee structure) for periods prior to 10/5/12. Performance for Class A shares includes the historical performance of Class I shares, adjusted to reflect the differences in fees and expenses. Class I shares are generally available only to corporate and institutional investors. Class R shares are available only through corporate-sponsored retirement programs.

Equity allocations may include fixed-income exposure.

Top Five Sectors–Net

Sector	%
Financials	22.6%
Consumer Discretionary	13.3%
Information Technology	8.1%
Materials	6.8%
Industrials	5.8%

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security. Current and future portfolio holdings are subject to risk. There can be no guarantee that investment objectives will be met.

Management Team

Michael C. Aronstein
President, CIO, and Portfolio Manager

Michael C. Aronstein is President, Chief Investment Officer, and Portfolio Manager of Marketfield Asset Management LLC. He was one of the founding partners of Marketfield, which was created in 2007. In 2004, Mr. Aronstein joined Oscar Gruss & Son Incorporated, where he held the position of Chief Investment Strategist. Prior to joining Oscar Gruss, Mr. Aronstein was Chief Investment Strategist at Preservation Group, a provider of independent macroeconomic and strategic advice to professional investors. Mr. Aronstein began his investment career in 1979 at Merrill Lynch, serving positions as Senior Market Analyst, Senior Investment Strategist, and Manager of Global Investment Strategy. Mr. Aronstein spent six years as President of Comstock Partners, a diversified investment advisor, and left to found West Course Capital, a discretionary commodity management firm. Mr. Aronstein graduated from Yale College with a Bachelor of Arts degree in 1974. His views on macroeconomic and strategic issues are regularly sought by and disseminated through the financial print and visual media. Mr. Aronstein manages $5,039 million in MainStay Marketfield Fund, $401 million in MainStay VP Marketfield Portfolio, and $140 million in Marketfield Fund Dublin; total assets under management are $5,580 million.

David C. Johnson, Jr.
Principal, Director of Research

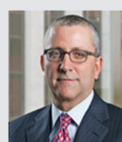
Mr. Johnson joined Marketfield Asset Management LLC as Director of Research in April 2011. Mr. Johnson is a graduate of the University of North Carolina at Chapel Hill. He received his MBA in 1984 from Darden School of Business, University of Virginia. Prior to joining Marketfield, Mr. Johnson was an Investment Analyst, Portfolio Manager, and Head of Business Development at Wilkinson O'Grady & Co., Inc. He spent the first 10 years of his career in the fixed-income department of Salomon Brothers, where he managed one of its primary sales groups. Mr. Johnson was President of Preservation Group, where he worked closely with Mr. Aronstein.

Michael Shaoul
Chairman and CEO

Michael Shaoul is Chairman and CEO of Marketfield Asset Management LLC. Mr. Shaoul is one of the founding partners of Marketfield, which was created in 2007. In his role at Marketfield, he helps formulate the top-down insights that inform the firm's investment decisions and authors a daily commentary that communicates these ideas with clients. He is a frequent contributor to the financial media, which values his views on economic cycles and investment markets. In 1996, Mr. Shaoul joined Oscar Gruss & Son Incorporated. He became its CEO in 2001 and held this position until 2014. He is Treasurer of American Friends of Tel Aviv University and a member of the Board of North American Friends of Manchester University. He was awarded a PhD in Accounting and Finance from the University of Manchester (UK) in 1993.

Myles D. Gillespie
Principal, Senior Trader

Myles D. Gillespie joined Marketfield Asset Management LLC in 2007. Myles is a graduate of The Hotchkiss School and holds a Bachelor of Arts degree from Franklin and Marshall College (Class of 1983). From 1983 to 1986, he worked as a Stock Index Futures Trader with Henderson Brothers and in 1986, became a NYSE Specialist at Quick & Reilly. He was appointed Executive Vice President of JCC Specialist Corp., the successor firm to Quick & Reilly, in 1989. In 1999, he became President of Fleet Specialist, Inc., the successor firm to JCC Specialist Corp., retiring from this position in 2004. During his time at the NYSE, Myles served as a NYSE Floor Official (1993-1999) and NYSE Floor Governor (2001-2004).



Andrew Lyss
Principal, Senior Trader

Mr. Lyss joined Marketfield Asset Management LLC in 2012. He was previously Executive Vice President at Oscar Gruss, which he re-joined in 1997. Mr. Lyss previously worked for Oscar Gruss from 1993 to 1995. Mr. Lyss specializes in special situations, including merger arbitrage, spinoffs, bankruptcy, and post-bankruptcy valuations. Prior to re-joining Oscar Gruss in 1997, Mr. Lyss was employed by Arnhold & S. Bleichroeder from 1995 to 1997 in institutional sales and by Prudential Securities from 1983 to 1989 in varied positions. Mr. Lyss received a BS/BA from the University of Denver in 1982.

MainStay Investments®

MARKETFIELD
ASSET MANAGEMENT

June 2015

Before You Invest

The Fund regularly makes short sales of securities, which involve the risk that losses may exceed the original amount invested. The Fund may also use options and futures contracts, which have the risks of unlimited losses of the underlying holdings due to unanticipated market movements and failure to correctly predict the direction of securities prices, interest rates, and currency exchange rates. However, a mutual fund investor's risk is limited to the amount invested in a fund. Investments in absolute return strategies are not intended to outperform stocks and bonds during strong market rallies. The Fund invests in smaller companies, which involve additional risks, such as limited liquidity and greater volatility.

The Fund invests in foreign securities, which involve greater volatility, and political, economic, and currency risks, and differences in accounting methods. These risks are greater for investments in emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the Fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. Investments in asset-backed and mortgage-backed securities involve additional risks, such as credit risk, prepayment risk, possible illiquidity and default, and increased susceptibility to adverse economic developments. The Fund involves the risk that the macroeconomic trends identified by portfolio management will not come to fruition and their advantageous duration may not last as long as portfolio management forecasts. The Fund may invest in derivatives, which often involve leverage, may increase the volatility of the Fund's NAV, and may result in a loss to the Fund.

MainStay Marketfield Fund is subadvised by Marketfield Asset Management LLC and distributed by NYLIFE Distributors LLC, 169 Lackawanna Avenue, Parsippany, NJ 07054, a wholly owned subsidiary of New York Life Insurance Company. NYLIFE Distributors LLC is a Member FINRA/SIPC.

MainStay Investments® is a registered service mark and name under which New York Life Investment Management LLC does business. MainStay Investments, an indirect subsidiary of New York Life Insurance Company, New York, NY 10010, provides investment advisory products and services.

Neither New York Life Investment Management LLC, its representatives, nor its affiliates provide tax, legal, or accounting advice. Please consult your own advisors on these matters.

Notional value is the total value of a leveraged position's assets.

The S&P 500® Index is a trademark of the McGraw-Hill Companies, Inc. The S&P 500® Index is widely regarded as the standard index for measuring large-cap U.S. stock market performance. The securities holdings and volatility of the Fund differ significantly from the stocks that make up the S&P 500 Index.

The HFRI Macro Discretionary Thematic Index is a broad-based hedge fund index, consisting of strategies that are primarily reliant on the evaluation of market data, relationships, and influences, as interpreted by an individual or group of individuals who make decisions on portfolio positions. These strategies employ an investment process most heavily influenced by top-down analysis of macroeconomic variables.

An investment cannot be made directly into an index.

"H" share refers to a share of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange. H-shares are still regulated by Chinese law, but they are denominated in Hong Kong dollars and trade the same as other equities on the Honk Kong exchange.

Obtain the Prospectus

For more information about MainStay Funds®, call 800-MAINSTAY (624-6782) for a prospectus or summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus or summary prospectus contains this and other information about the investment company. Please read the prospectus or summary prospectus carefully before investing.

Commentary

Chairman's Report

2015 has been a mixed year so far for the Fund, with some of our core assumptions being recognized within financial markets, while others remain more controversial. We are yet to reach the point that our portfolio is firing on all cylinders, but there has been a movement of market sentiment back towards a number of our core beliefs and positions, which are outlined below.

The U.S. Equity market is now in a mature bull market.

There is little macro controversy left regarding the U.S. economy or the attractiveness of its equity market, which is now widely held by both U.S. and foreign investors. Gains are increasingly concentrated in a limited number of sectors (most notably health care, consumer discretionary and media) where valuations are now much higher on an absolute, relative, and historic basis than they were one or two years ago. In addition, monetary conditions have started to tighten, with the Federal Reserve Board no longer purchasing local fixed income and we assume about to increase interest rates. For the above reasons, while we do not believe that the U.S. bull market has ended, our view is that more attractive destinations for capital exist elsewhere. We have maintained exposure to housing-related equities and a number of smaller allocations to sectors such as defense, technology, and large financial institutions. The modest performance of the U.S. equity market in 2015 matches our expectations, and we are comfortable with our decision to keep a light overall exposure.

The U.S. Housing market has started a second leg of recovery.

The one part of the U.S. economy that still attracts some controversy is the housing market, where consensus still assumes that only a modest pace of improvement can take place going forward. Given that new home sales are still around 50% of "normal" activity and around a third of the peak 2005 activity, we believe this to be a substantial underestimation of the potential strength of housing-related activity going forward. The overall balance of economic and corporate data during the spring selling season suggests that a second leg to the housing recovery is underway. We, therefore, have a meaningful exposure to homebuilders and housing-related equities. The homebuilders themselves remain at the top end of a two year range, but if activity and earnings start to accelerate there is meaningful upside in these positions.

The U.S. interest rate cycle has bottomed.

We believe that long term U.S. interest rates bottomed early in 2015, while intermediate-term rates bottomed over 2 years ago. Income-related equities reached their cycle peaks early in 2015 and are vulnerable to further correction. The Fund maintains short positions in both long term Treasury instruments and income-related equities such as utilities and Real Estate Investment Trusts (REITs). Interest rates have been trending higher for several months, but have yet to provoke the sort of capital flight that took place in 2013.

European commercial real estate is enjoying a strong recovery.

Europe's real estate markets have continued to recover in 2015, and this is particularly true in peripheral markets such as Ireland and Spain, which account for the majority of our exposure. We have maintained positions in European REITs and other entities with substantial exposure to real estate loans and lending activity.

Japan is an attractive destination for investment capital.

Our Japanese allocation has been the standout performer in the first half of 2015, reflecting the strong performance of the local equity market, which led USD returns for developed markets over this period. It is worth remembering how unlikely this outcome would have seemed a year ago, when the dominant view was that the hike in the sales tax had dealt a body blow to the economic recovery.

In fact, not only is Japan's domestic economy enjoying a steady recovery in activity, but its corporate sector is posting record profits. The local equity market is enjoying its strongest three year period since 1989, and yet most global investors remain underweight Japan and have not substantially increased allocations during 2015.

Commentary (continued)

China's economy is bottoming and its equity market is improving.

China has dominated the portfolio's performance in recent months, generating strong gains in March and April, and losses in May and June. Our exposure to China is only to large-cap, high-quality entities listed in Hong Kong, at the level of index futures, Exchange Traded Fund (ETF) exposure, and individual issues. Valuations in the "H" share market are currently at an average Price/Earnings Ratio (P/E) of 8.5, compared to their 2009 low at 7. This clearly represents the most volatile portion of our portfolio, but it is arguably also the one with the greatest potential reward. We view the purpose of our Fund as being willing to take exposures that our clients find difficult to stomach, be this U.S. equities in 2009 or European equities in 2012, or on the short side emerging markets in 2011. Our China-related exposure certainly comes into this category.

The portfolio manager's report below outlines our thinking regarding China in some detail, since not only is this the key issue for our own portfolio, but also likely to be the key determinant of global performance in the coming quarters.

In summary, the Fund has de-emphasized the U.S. equity market and made something of a "pivot to Asia" in recent months. Although the recent decline in China has been costly, we do expect the offshore "H" share market to find its footing in the coming weeks and start to make progress. Japan obviously is an easier market to justify exposure to at present, but this would have been less true 12 or 15 months ago. Overall, the Fund gives exposure that it somewhat outside of consensus thinking and, therefore, can be expected to have a low correlation to most equity benchmarks at the current time.

July 23, 2015

Michael Shaoul
Chairman, CEO

Portfolio Manager's Report

In the years since the panic of 2008, we have wrestled with the implications of official policy initiatives designed to address deficiencies in markets and economic activity.

The focus of action has expanded immensely during the seven years since the Federal Reserve stepped in and restored liquidity to funding markets in 2008-2009. Their expansionary forays were gradually expanded and joined by similar efforts from the Bank of England, the European Central Bank (ECB), the Bank of Japan, and the Peoples Bank of China.

Not to be outdone by the central bankers, politicians joined the fray and have elbowed their way onto center stage. From the relatively limited aims of Troubled Asset Relief Program (TARP) in 2008, regulatory and legislative exertions keep coming faster, more furiously, and with ever increasing size and scope. No macroeconomic problem is deemed too large or intractable for official intrusion.

After a decade and a half of monetary integration, economic turmoil, and political volatility, events are forcing European leaders to confront fundamental issues of sovereign power, fiscal latitude, free markets, and political control of economic life. Mistaken notions of these and the consequent distortions of economic function lie at the heart of the crisis in Greece and the struggles of most of Southern Europe.

At the same time, China is continuing its attempts to reconcile a nominally socialist ideology with the reality of markets that obey economic laws rather than the dictates of Marx and Mao. Their success in this endeavor is probably the single most important variable in determining global growth over the next decade.

Slightly farther east, Japanese leaders are intent on provoking a radical transformation of the social attitudes that underlie commercial and financial life.

Commentary (continued)

Their early efforts appear to be succeeding, but the process will be gradual and complex. We have taken the view that the old quasi-feudal model of business organization and management will give way to more contemporary leaders willing to emphasize profitability and the creation of lasting shareholder value within the many first rate companies already there. We continue to hold meaningful positions in a diversified mix of Japanese equities.

In the U.S., the dominant theme of political discourse revolves around how best to address the spectacular accumulation of wealth among those who directly benefit from historically low borrowing costs and inflating asset prices.

The common backdrop for all of these political endeavors is the aggressive monetary ease being brought to bear by all major central banks. All instances of sub-normal economic activity or market stress are now addressed according to the "Bernanke Doctrine," which holds that a central bank should always err on the side of generosity. This is something of a penitential response to the failures of the Federal Reserve between 1930 and 1932, when their tendencies ran toward tighter policy despite the collapsing markets, banking system, and economy. In contemporary central banking circles, this constitutes original sin.

The mixture of regulatory and administrative interventions in a monumentally expansive monetary environment has produced a strange brew of macroeconomic effects. The benefits of suppressed interest rates and accommodative capital markets accrue almost exclusively to the portion of the economy that can be thought of as the balance sheet, and this is where the monetary inflation is apparent. Credit and liquidity-fueled purchases of productive assets (corporate equity, debt, and commercial real estate) have accelerated as returns on cash savings and high-grade fixed income have dwindled. The utilization of depressed long-term interest rates as discounting factors greatly increases theoretical present values for streams of future output, and has also led to a revaluation of assets assumed to provide stores of value (high end real estate, contemporary art, and gold until 2011).

By designating monetary expansion as the root cause of the accelerating price of capital assets, we are clearly at odds with the stated views of most central bankers, for whom, even now, there is no admission that the real estate mania of 2001-2007 had its basis in the expansion of mortgage credit underpinned by a federal funds rate that remained at 1% during the first three years of the process. Nominal Gross Domestic Product (GDP) was expanding 7.1% on an annual basis before the first hike in the federal funds rate to 1.25% in June 2004. By that point, property speculation was well beyond control and destined to end badly.

The current inflation of existing wealth contrasts with the grudging progress of the economy's income statement, as expressed in popular measures of output and cash flows. This is where the burdens of ill-considered political intrusions into economic processes take their toll. The contrasting fortunes of northern and southern European nations correspond closely with the varying political burdens imposed in the two regions. Greece is an extreme, but edifying example of the economic harm inherent in government run wild. In the U.S., the contrasting fortunes among various states and regions highlight the real burdens of over-reaching government. The demise of Puerto Rico's finances and prospects is the latest example, with Detroit having been forgotten and Illinois still hanging on by a few threads.

The mixed condition of accelerating wealth amidst slow growth in incomes is a condition that we call "stagmania." In contrast with traditional inflation or stagflation, stagmania occurs when clear excesses in certain parts of the economy do not prompt monetary authorities to adopt restrictive policy. It is the opposite condition that arose following the stock market crash in 1929. When Britain abandoned the gold standard in 1931, dollar holders, fearing that the U.S. would follow, began to aggressively withdraw gold. The seeming need to preserve domestic gold supply provided rationale for the Federal Reserve to raise rates, even as the economy and money supply collapsed.

To this day, there are serious debates as to whether the sequence of events leading to and through the Great Depression was prompted by inappropriately easy or tight monetary policy. Without reiterating the full range of argument (a book-length project), we will simply offer our opinion.

This writer believes having seen similar sequences time and time again, that the Federal Reserve's aggressive response to the recession of 1927, and the deflation of a speculative boom in Florida land provided the credit background that allowed the entire nation's speculative energy to focus on stocks during the next two years.

Commentary (continued)

This sequence, where monetary balm is intended to fix one area of distress but instead migrates to another, untainted realm of speculation where it intensifies to dangerous levels, is identifiable over and over in modern economic history.

The Federal Reserve Board (FRB) responded to the crash of 1987 and two years later the Nikkei was at 39,000. The Asian currency crisis and the demise of Long Term Capital Management prompted easing in 1998 and by March 2000 Nasdaq reached 5000. The technology liquidation of 2001-2002 brought the Fed into full support mode. WorldCom and its brethren did not revive, but house prices more than made up for the destruction of wealth in technology stocks.

Returning to the era of the Great Depression, the great policy error following the crash of 1929 resulted from the failure of the FRB to recognize the degree to which stocks had become the main collateral form behind the expansion of credit in the last part of the bull market. Shares were bought on 90% margin, much like houses ten years ago.

Banks were aggressive competitors for margin business and once the liquidation began, forced selling became the order of the day. The banking system was fatally impaired, failures ensued, deposits evaporated, and M2 (a measure of money supply) eventually fell by more than 30%, ensuring more widespread deflation.

The existence of the Federal Reserve as a lender of last resort should have allowed the necessary liquidation of excess to proceed without the destruction of the banking system and an acute decline in money supply. The failure to fulfill this function led to a systemic deflation that resulted in damage that was catastrophic in economic, societal, and geopolitical terms.

Managing the liquidation of credit bubbles without allowing their demise to destroy the entire structure of banking and finance is the great conundrum of modern central banking. Although it can be argued and argued persuasively that rises of large-scale credit excesses in the first place are attributable to fractional reserve banking and the central banks that accommodate it, both are facts of current economic life.

Our challenge is to consider the various policy responses to financial market conditions and determine those likely outcomes that are not already incorporated into security prices.

Understanding the implications of policy failures after 1929 is fairly simple with the benefit of hindsight. The extraordinary complexity of a current world in which monetary, political, and market forces collide like particles in an accelerator is a good deal more difficult and uncertain.

For two years we have been of the opinion that asset inflation would begin to migrate to aspects of the real economy that were accepted as components of more traditional measures of inflation. Thus far, the relentless decline of commodity prices, culminating with oil prices falling by half in 2014, has kept all traditional measures of inflation near zero.

The fundamental correlate of the weakness in commodity prices and those of globally traded goods has been the dramatic slowdown in the Chinese economy. After decades of expansion fueled largely by excessive and inefficient investment, they are attempting a transition to more market-directed, service, and consumer growth that increasingly reflects preferences of the population rather than just those of the state.

Success or failure by the Chinese in accomplishing the evolution of their economy to a more stable and self-sustaining footing will determine the general tone of the global economy for the remainder of this decade.

Explicit in both our portfolio and our macroeconomic analysis is a belief that the transition of China's economy will be generally successful, in spite of the large and daunting array of risks that attend.

China, like the U.S. in the late 1920s, is full of excesses in need of liquidation. We are of the view that the outcome will be very different. This is with full awareness that the excesses present in the Chinese banking system are of a scale that would normally foreshadow crisis. The collateral basis of the credit excess is property, despite the recent expansion (and subsequent decline) of margin debt.

Commentary (continued)

Why, one might ask, do we think that China can avoid its own version of the 1930s given the excesses that have built up in finance and in the real economy?

Our answer goes back to the discussion of the Federal Reserve's responses in the early years of the 1930s.

We have been critical of the policy inertia that allowed a bear market to proceed throughout the structure of bank credit, bank solvency, and confidence to a point at which a good proportion of the deposit base and money supply was destroyed. After that point, deflation and depression were inevitable.

The Chinese authorities have both the means and the will to preempt the monetary and credit deflation that would prompt a 1930s style depression.

In terms of means, almost $4 trillion of reserves and a savings pool about 5 times that size allows for the People's Bank of China (PBOC) and the executive branch to marshal adequate resources to address deflations of bank credit that might present systemic threats. Private savings are growing at close to $4 trillion per annum and the Chinese consumer is underleveraged.

Questionable assets in the banking system are concentrated in a half dozen state sponsored entities. Rules concerning the pace at which loan impairments must be recognized or capital raised are almost wholly crafted at the discretion of official overseers, none of whom have the slightest incentive to provoke crisis. If it proves convenient, accounting adjustments can be taken over many years. There is no funding crisis over the horizon that might compel immediate recognition of losses.

In contrast with the U.S. and Europe, there is no political constituency that has revenge on bankers and the dismantling of their institutions as a core platform. The Chinese (and the Japanese) would actually like to see their financial institutions become more successful. This creates a structural advantage as they begin to compete globally.

The monetary argument is based on the idea that China, like nearly every sovereign nation, has the latitude to create enough central bank money to back its local currency obligations. They also have sufficient reserves and real economic productivity to prevent a collapse of the Yuan and the severe inflation that would follow. In fact, like the European Central Bank, the Federal Reserve and the Bank of Japan, their wish is for more rather than less inflation to diminish the real burdens of their internal debt.

We are fairly certain that China has the means to manage banking system stresses and prevent acute liquidity crises from destroying the monetary base. Whether they will, in an appropriate timeframe and with sufficient force, is an open question.

The nature of the Chinese political system leads us to believe that they are likely to respond forcefully to the threat of any general crisis. They might be late in responding, as was the Federal Reserve in 2007-8 and the ECB in 2011 and again in 2014, but they will be, if anything, too intense in response. At the heart of the matter, however, is the primary objective of the leadership to maintain absolute political authority. There is a willingness to cede some measure of economic control to markets and individuals, but relinquishing some portion of political power is an entirely different matter. It is a non-starter.

With that in mind, it is highly likely that any crisis with the potential to undermine the political legitimacy of the current leadership will be addressed with every tool available. In the same way that Ben Bernanke stated that dropping as much currency as demanded from the sky could arrest any generalized deflation, it is our sense that a widespread loss of savings resulting from institutional crisis would, if all else failed, be met by the government simply replacing the lost money in everyone's account with a series of keystrokes.

The Chinese leadership is willing to allow losses in speculative endeavors so long as these do not threaten to engulf millions of citizens. This accounts for the very slow pace of capacity closures in heavy industries that are clearly loss making and heavily destructive of the environment. Sudden, large-scale unemployment is to be avoided at almost all costs.

Commentary (continued)

Indeed, this process is already underway, and after deliberately tightening monetary and regulatory policy in 2011, the Chinese authorities abruptly changed course in 2014. Since then the PBOC has cut the policy rate 4 times from 6.0% to 4.85% and lowered the bank reserve requirement on three occasions. Substantial injections of liquidity into the interbank market have caused short term rates to decline far more than the policy rate (a key divergence with the experience of the U.S. and Europe in recent crises).

Although this represents clear progress, the balance of PBOC policy is still inappropriately tight. We suspect that the explosive move higher by the local equity market accounts for some of the reticence and the recent sharp decline may allow a more rapid pace of monetary policy easing.

The troubled housing market (which accounts for around 60% of household wealth) has seen the macroprudential constrictions on mortgage credit and home ownership removed, with banks now encouraged to increase mortgage activity. The large concentration of distressed credit at local authorities (much of which had been issued to allow speculative development) has been the subject of a 2 trillion Chinese Yuan (CNY) debt swap program. There are signs that these measures have taken effect, particularly in China's largest cities where both sales activity and prices are now moving higher.

To make matters more confusing the attempts to stimulate the economy come at the same time that China has embarked upon a package of regulatory reform aimed at increasing the role of private sector markets and the convertibility of the local currency. To the extent there is a clash between the need for financial and economic stability and the wish to reform, it is now apparent that the former will drive the policy decision, as was made abundantly clear in the recent equity market rout. Although we certainly would like to see a freer, less regulated, and state controlled economy ourselves, our willingness to invest in China is predicated much more on our expectations for monetary loosening than any process that involves the reduction of the state's role in the domestic economy.

The mix of transitional political initiatives and generous monetary support is one that we have identified and invested toward for seven years. The major venues where policy was brought to bear began with the U.S. in 2008 and spread to Britain, Europe, then Japan and finally, in the past year, China. Of all of these, China seems to be moving more explicitly toward free markets as arbiters of relative value within their economy. They do have the farthest to go, but the direction of travel is encouraging nonetheless.

In all of these cases, we have counted on continued monetary fuel at any point where the initial reflationary impulse runs into trouble. This has been our expectation during the Greek crisis, and we assume that China will not be timid in the monetary response to recent sharp declines in local equity markets. Our substantial exposure to Chinese stocks remains a key driver of portfolio results.

Our core macroeconomic perspective anticipates a continuation of global liquidity expansion as a means of ameliorating stresses that arise in real economic activity, credit quality, and government finances. Thus far, most of the obvious effect has been confined to the inflation of productive and investable asset prices. We anticipate the spread of effects to begin appearing in more transactional elements of the real economy from which current production and income arise. We have, of course, been waiting for quite awhile, but signs suggesting the beginnings of reflation in the real economy continue to arrive.

July 23, 2015

Michael C. Aronstein
President, CIO & Portfolio Manager

The information provided herein represents the opinion of the Chairman & Portfolio Manager and is not intended to be a forecast of future events, a guarantee of future results, or investment advice.