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MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date:	October 16, 2013
To:	Audit and Budget Committee
From:	Richard White, Retirement Administrator
Subject:	Audit and Budget Committee Report

Summary:

The Audit and Budget Committee met on September 18, 2013 following the regular meeting of the Board of Retirement. The focus of the meeting was to review the draft audit report prepared by the External Auditor, Gallina LLP. The agenda for the meeting is included in this report as are the approved minutes from their meeting of July 17, 2013.

The committee is scheduled to meet in the afternoon following the regular Board of Retirement meeting on October 16, 2013.

Mendocino County Board of Retirement
Audit and Budget Committee Meeting Agenda
September 18, 2013
1:00 p.m.

Roll Call

Public Comment

Members of the public are welcome to address the committee on subjects both on and off the agenda. The committee is prohibited from taking action on matters not on the agenda, but may ask questions and/or briefly answer questions. Public comment is limited to 5 minutes per person and not more than 10 minutes for a particular subject at the discretion of the Committee Chair. Please complete a speaker form, available at the entrance to the conference room and present to the Clerk. Public speakers are required to state their name before they begin. If you wish to submit written comments please provide 7 copies to the Clerk prior to the start of the meeting.

1) Approval of the July 17, 2013 Committee meeting minutes.

2) Discussion and Recommendation regarding the draft External Audit report for Fiscal Year 2012/13.

3) Schedule the next Audit & Budget Committee meeting.

Meeting Adjourned (Approximate Time 2:30 p.m.)

(Pursuant to Government Code Section 54954, this agenda was posted 72 hours prior to the meeting.)

Mendocino County Board of Retirement
Audit and Budget Committee Meeting Minutes
July 17, 2013

1:00 p.m.

Participants: Lloyd Weer, Committee Chair, Randy Goodman, Bob Mirata, Ted Stephens, Crystal Ekanayake, Gallina LLP, Scott German, Fechter and Company, Rich White, Retirement Administrator, and Judy Zeller.

Public Comment: None

1) Approval of the April 30, 2013 Committee meeting minutes.

Mr. Goodman motioned to approve the April 30, 2013 minutes. Mr. Mirata seconded the motion and the minutes were approved unanimously.

2) Discussion regarding the External Audit for Fiscal Year 2012/13.

Presenters: Mr. White introduced Mr. German, Fechter and Company, and Ms Ekanayake, Gallina LLP, to the committee and began discussion regarding the External Audit for Fiscal Year 2012/13.

Ms. Ekanayake referenced an auditor communications planning resource and our current letter of engagement which was distributed to the committee. She addressed areas of concern or risk to incorporate in the audit plan for this year. Mr. Stephens asked if an audit of actuarial figures would be done. Ms. Ekanayake mentioned that materiality is set at a very high level and an immaterial difference may be reported, but most likely would not be a concern. A new calculation to provide the amount of materiality would be done and approximately .03% to .04% of the total fund would be considered a material difference. Mr. Stephens stated that the Comprehensive Annual Financial Report (CAFR), Audit Report, and Actuarial Report figures should be similar without large discrepancy. He asked that Gallina also review figures provided by the County. Ms. Ekanayake stated that Gallina's job is to perform the independent audit of financial statements, not to make sure that the other service providers are doing their job.

Ms. Ekanayake stated that Gallina believes the correct figures to use in the audit are in the custodial records. She mentioned that some investment amounts might not be included in the audit report because they were not included in the information provided by the custodian, but these amounts may be included in the Callan report due to the timing of purchase or sale of investments.

Mr. Stephens asked about new Governmental Accounting Standards Board (GASB) reporting effective for fiscal years beginning after June 15, 2014 and whether Ms. Ekanayake had any comment so we can plan ahead. She replied that the Sensitivity Analysis is the biggest concern and to start planning now to make the most accurate disclosure. She suggested the start of a pro forma of what disclosures will look like in order to plan on the impact. If larger plans are adopting disclosures in the next year, then take a look at what they do and pro forma for our disclosures for the following year.

Mr. Goodman asked about timing and always getting the audit complete at the last minute. Ms. Ekanayake replied that it depends on when Segal gets their report to the Board and when the Board adopts the report. Mr. White added that the CAFR should be submitted no later than December 31. This is why timing of reports was brought to the Retirement Board's agenda and it is still a relevant discussion to have. If the Board had adopted the proposed policy change the same actuarial valuation information would be used for two audits. The data would be current for one audit and one year old for the next audit.

Mr. Goodman mentioned the State Controller's report is due on December 31 and we are always filing for extensions. Ms. Ekanayake stated that it is very common to do the audit either by quick reporting with year old actuary information or late reporting using the most current actuary information. Mr. Stephens asked Mr. White to check with Segal on getting their report completed in October. Ms. Ekanayake recalled a conversation with Segal and that they may be able to report to us very early if we can do interim work to close the books faster, perform field work faster, and get numbers to Segal much earlier. We would need final financial statements and census information as soon as possible. Typically, Gallina gets a report out three weeks after field work is complete for review and then the information could be sent off to Segal. If the audit report is sent for review the week of Aug 12, 2013 the Committee could review and meet to discuss in September following the Board of Retirement meeting.

Ms. Ekanayake inquired about the status of the Voluntary Correction Program (VCP). Mr. White said that Orange County should be close to completion. Recommendations will be made for all 37 Act Retirement Systems and individual system changes will have to go to the legislature. We do know that a complete rewrite of the 37 Act will not be done. The State Association of County Retirement Systems (SACRS) has a placeholder bill in the legislature in the event any of this is ready to go during this session.

Ms. Ekanayake mentioned that Gallina is in the 3rd and final year of the Request for Proposal (RFP). The audit this year will help provide an estimate for services for future years. Gallina has never billed for travel, but will bill for services performed outside of the letter of engagement. Both the Retirement Administrator and the Committee Chair will sign the engagement letter.

Mr. German mentioned that the last appraisal for Kings Court was done in 2007. He asked for establishment of a process for providing value to disclose in financial statements. There is no standard that requires appraisal for this type of asset for a retirement plan. The committee agreed to keep this item at a committee level and report to the full board in September. Committee members discussed the fact that commercial property has not come up in value and would a Commercial Broker provide a Broker's Price Opinion (BPO)? It was agreed that Mr. Mirata would contact a broker for a BPO. A value of $864,000 will be used for Kings Court unless the BPO is substantially higher or lower. If that is the case, the value should be adjusted accordingly.

3) Schedule the next Audit & Budget Committee meeting.

The next Budget and Audit Committee meeting will be scheduled September 18, 2013 following the Board of Retirement meeting.

MEETING ADJOURNED (2:27 P.M.)

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EMPLOYEES' RETIREMENT ASSOCIATION
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Date: October 16, 2013
To: Board of Retirement
From: Richard White, Retirement Administrator raw
Subject: Communications to the Board of Retirement

Discussion: Included are articles and items of interest which relate to public pension funds and are presented to the Board as informational items.

1. Detroit Paid Billions Extra From Pensions. Article authored by Mary Williams Walsh in the New York Times, September 26, 2013. Provided by Board Member Sakowicz.

2. Judge Rules Retiree Health Protected Like Pension. Article authored by Ed Mendel on the website CALPENSIONS.COM, September 23, 2013.

3. The Global View. Reset. Article authored by Michael J. Hood, Managing Director, Global Markets Strategist for J.P. Morgan Asset Management. September 30, 2013.

The New York Times
DealB%k
Edited by Andrew Ross Sorkin

SEPTEMBER 25, 2013, 3:08 PM

Detroit Spent Billions Extra on Pensions

By MARY WILLIAMS WALSH

Detroit's municipal pension fund made payments for decades to retirees, active workers and others above and beyond normal benefits, costing the struggling city billions of dollars and helping push it into bankruptcy, according to people who have reviewed the payments.

The payments, which were not publicly disclosed, included bonuses to retirees, supplements to workers not yet retired and cash to the families of workers who died before becoming eligible to collect a pension, according to reports by an outside actuary and other people with knowledge of the matter.

How much each person received is not known. But available records suggest that the trustees approving the payments did not discriminate; nearly everybody in the plan received them. Most of the trustees on Detroit's two pension boards represent organized labor, and for years they could outvote anyone who challenged the payments.

Since June, Detroit's auditor general and inspector general have been examining the pension system for possible fraud or misfeasance, and their report is expected to be released on Thursday. Among the findings is likely to be how much damage was done by the extra payments.

"It was like dandelions," said Joseph Harris, who served as Detroit's independent auditor general from 1995 to 2005. "You just accept them. They were there, something you've seen all your life."

When asked on what legal authority the trustees made the payments, Mr. Harris said, "My understanding was, it had to be approved by City Council, and council was under the belief that the money was there — that the pension funds were earning the money — with the consideration that in bad times the city would be making up the difference. I hate to say that. Ultimately the fund has to be funded by the taxpayers."

A spokeswoman for Detroit's pension trustees, Tina Bassett, said she thought the outside actuary's analysis, which concluded that the extra payments had cost the city nearly $2 billion over 23 years, was "not being fully straight with what happened."

She said that the trustees were administering benefits that had been negotiated by the city and its various unions and that they had established an internal account to set aside "excess earnings" that would cover the cost. She said it was appropriate for retirees to benefit from market upturns because they had paid into the pension fund, so their own contributions had generated part of the investment gains.

"People were having a hard time, living hand-to-mouth, and we thought we would give them some extra," Ms. Bassett said.

Of all the nonpension payments, she said, 54 percent went to active workers, 14 percent went to retirees and 32 percent went to the city, which used its share to lower its annual contributions to the fund. The excess payments were often made near the end of the year, when recipients needed money for the holidays, or to heat their homes.

Detroit has nearly 12,000 retired general workers, who last year received pensions of $19,213 a year on average — hardly enough to drive a great American city into bankruptcy. But the total excess payments in some years ran to more than $100 million, a crushing expense for a city in steep decline. In some years, the outside actuary found, Detroit poured into the pension fund more than twice the amount it would have had to contribute had it paid only the specified benefits.

And then the city's contributions were not enough. So much money had been drained from the pension fund that by 2005, Detroit could no longer replenish it from its dwindling tax revenue. Instead, the city turned to the public bond markets, borrowed $1.44 billion and used that to fill the hole.

Even that did not work. In June, Detroit failed to make a $39.7 million interest payment on that borrowing — the first default of what was soon to become the biggest municipal bankruptcy case in American history.

Detroit said at the time that making the interest payment would have consumed more than 90 percent of its available cash. And besides, the hole in its pension fund was growing again, and it needed another $200 million for that.

When Detroit went to the bond market, it acknowledged that it needed cash for its pension fund but did not explain its long history of paying out more than the plan's legitimate benefits, including the bonuses, known as "13th checks," which were reported this month by The Detroit Free Press. Nor did the city describe the pension fund's distributions to active workers, or that a 1998 shift to a 401(k)-like plan had been blocked and turned instead into a death benefit. In its most recent annual valuation, the plan's actuary said it was still trying to determine the "effect of future retroactive transfers to the 1998 defined contribution plan" without mentioning that it had been changed into a death benefit.

All of these eroded the financial health of the pension system, but neither the magnitude of the harm, nor its effect on the city's own finances, were disclosed to investors. German banks were big buyers of Detroit's pension debt; now they are complaining that they were told it was sovereign debt, as if it were issued by a national government.

Finally, in 2011, the city hired the outside actuary to get a handle on where all the money was going. The pension system's regular actuaries, with the firm of Gabriel Roeder Smith, would not provide the information because they worked for the plan trustees, not the city.

The outside actuary, Joseph Esuchanko, concluded that the various nonpension payments had cost Detroit nearly $2 billion from 1985 to 2008 because the city had to constantly replenish the money, with interest. It appears that Mr. Esuchanko could not get data for years before 1985.

His calculations included only the extra payments by Detroit's pension fund for general workers. Detroit has a second pension fund, for police officers and firefighters, which also made excess payments. Mr. Esuchanko could not get the data he needed to calculate those, either.

When he reported his findings in November 2011, Detroit's City Council voted to halt all payments except legitimate pensions. The police and firefighters' plan trustees appear to have discontinued excess payments earlier.

An investment banker now advising Detroit, Charles M. Moore, has said in a court declaration that the trustees of the general pension plan were "effectively robbing" the fund when they diverted its assets. He criticized in particular the transfer of money from the pooled pension trust fund to a group of individual accounts for workers who had not yet retired. The individual accounts had been established as a savings plan for city workers; the board credited them with interest at its chosen rate, often higher than what the fund's investments actually earned.

"This abuse of discretion was most egregious in 2009," said Mr. Moore, a managing director at the firm of Conway MacKenzie. He said the pooled pension trust had lost 24 percent of the value of its assets that year, but the trustees appeared to have credited the individual accounts with 7.5 percent interest.

"Hundreds of millions of dollars of plan assets intended to support the city's traditional defined-benefit pension arrangements were converted," he wrote, "to provide a windfall to the annuity savings accounts of active employees outside of the defined-benefit pension plan."

The actuarial firm of Gabriel Roeder Smith did not respond to an e-mail request seeking information about the excess payments and how they were disclosed in its annual valuations. The firm has already been dueling with a second actuarial firm, Milliman, hired by Detroit's emergency manager, Kevyn Orr. Milliman said the two city plans appeared to have a $3.5 billion shortfall, much larger than one previously disclosed by Gabriel Roeder Smith in its annual valuation.

Detroit's trustees say they think Milliman was told to come up with a big shortfall on purpose. Under Michigan's emergency manager law, a city's pension trustees can be dismissed if the fund under their care falls below an 80 percent funding level.

Unions fear the machinations are under way to reduce their benefits in the city's Chapter 9 bankruptcy case. They say this cannot happen because Michigan's Constitution explicitly protects public pensions.

James E. Spiotto, an expert on municipal bankruptcy with the firm of Chapman & Cutler in Chicago, said that if pension money was, in fact, misused, leaving an insolvency, it might affect the terms of an eventual settlement.

He said it was conceivable that the city might sue the pension fund, arguing it was unjustly enriched by the infusion of money from the bond market, because the city itself was misled about the size and causes of the pension shortfall. But that approach, if successful in court, would pose a practical problem: if the pension fund disgorged the bond proceeds, its own financial condition would just get worse. And it still has an obligation to pay the pensions.

Another approach might be for the city to try to claw back money from people who received more than they should have, using bankruptcy rules about fraudulent conveyances.

"A clawback is always hard," Mr. Spiotto said. Instead of trying to get back the money, he said, Detroit might try to reduce those people's future pension payments, to get back at least part of the overpayments.

"Somebody should be responsible for it," he said. "And I think the municipality may have a legitimate argument — 'We don't have to pay twice.' "

Judge Rules Retiree Health Protected Like Pension –CALPENSIONS.COM

By Ed Mendel

September 23, 2013

A superior court judge overturned a freeze on retiree health care for Los Angeles city attorneys this month, citing some of the same case law that made public pensions a vested right that can only be cut if offset by a new benefit.

The court ruling is a blow to the view that state and local governments, when looking for cost savings, may be able to make cuts in promised retiree health care that are not allowed for tamper-proof pensions.

The debt or "unfunded liability" for retiree health care promised state and local government workers rivals pension debt. But most employers make no annual pension-like contributions to a retiree health care investment fund to help pay future costs.

Los Angeles, a leading exception to the pay-as-you-go policy, had the best funded retiree health care among big cities in a national Pew*study issued* in January. The city pays a big price for the policy praised by many and practiced by only a few.

Making the actuarially required payments for retiree health care promised current Los Angeles workers in the future accounts for nearly a quarter of the soaring retirement costs former Mayor Richard Riordan warns are driving the city toward bankruptcy.

Los Angeles expected to save about $100 million a year with the retiree health care freeze, called *the "cornerstone"* of an attempt two years ago to curb soaring retirement costs and balance the city budget.

The freeze gave Los Angeles city employees the option of paying more for retiree health care or receiving a lower benefit, similar to the voter-approved pension option given San Jose workers now awaiting a ruling after a trial in July.

And as with the San Jose pension option, part of the legal rationale for the Los Angeles retiree health care option is a provision in the city charter that specifically reserves the right to modify retiree health care benefits.

Los Angeles gave employees an option in 2011 of earning a retiree health care subsidy frozen at $1,190 a month (for the non-sworn) or contributing 4 percent of pay to continue earning retiree health care with annual increases.

"The fixed and permanent $1,190 medical plan premium subsidy in the freeze ordinance constitutes an impairment of a vested right to a substantial or reasonable benefit," Los Angeles Superior Court Judge Luis Lavin said *in a ruling*Sept. 13.

The judge directed the city to provide a retiree health care insurance premium subsidy without regard to the freeze ordinance "since no new comparable advantages offset that impairment."

The city has not announced a decision about an appeal. The Los Angeles City Attorneys Association, which filed the suit, declined to comment on the broad impact of the ruling, saying its board had not yet been briefed.

A number of unions, including police and firefighters, agreed to give members the option and many chose to make the payment. A website, LAcityworkers.com, said the court ruling directly applies to two unions: city attorneys and engineers and architects.

"SEIU 721, AFSCME and other unions whose membership voluntarily entered into this agreement are not covered by today's ruling," *said the website*. "Only EAA MOU 31 and the LACAA as well as those units which voted NO on the 4 % are covered."

In brief, the city attorneys argued that the freeze impaired a vested right contractual obligation to a retiree health care subsidy. Los Angeles argued that employees do not have that right because the charter reserves a city right to change the subsidy.

Judge Lavin, a Harvard-trained lawyer, cited a state Supreme Court ruling in an Orange County suit in 2011 that said governments can create an "implied contract" for retiree health care, even if not specifically stated by an ordinance or resolution.

He said Los Angeles statutes that say a subsidy "will be provided" in exchange for a minimum of 10 years at age 55 demonstrate a clear commitment to give employees retiree health care.

"The city's reservation of rights to set the precise amount of the medical premium subsidy does not operate to defeat the finding that its employees have a vested right to a medical premium subsidy in the first place," the judge wrote.

Lavin found no vested right to a retiree health care subsidy that "perpetually" increases or is linked to medical cost increases. But the ruling that a vested contractual obligation is impaired still rests on the freeze of the subsidy.

The judge cited two landmark state Supreme Court decisions in suits over switching pensions that "fluctuate," based on the pay of current workers in the same job, to modern "fixed" pensions based on pay the retiree earned while on the job.

Former state Treasurer Bert Betts, who served from 1959 to 1967, did not retire before legislation in 1974 authorized fixed pensions. His right to a fluctuating pension was upheld in Betts v. Board of Administration (1978).

In an earlier case, a Long Beach charter change switched employees to a fixed pension and increased their pension contribution from 2 to 10 percent of pay. The charter change was rejected in Allen v. City of Long Beach (1955).

Judge Lavin said the state Supreme Court held in the two cases that a fixed benefit system is "disadvantageous" to a fluctuating or fluid benefit system, clearly so in inflationary times.

"For similar reasons, the court finds that the freeze ordinance impairs the vested right to a medical premium subsidy that covers all or part of the cost of medical coverage," Lavin wrote in his ruling.

The Los Angeles retiree health care subsidy, covering a retiree and one dependent, increased from $800 in 2002 to $1,187 in 2010. The judge said a benefit frozen at $1,190 a month likely would be "far outpaced" by inflation in the next decade.

Having determined that the freeze impairs a vested contract right, the judge's ruling moved on to whether the impairment is "reasonable" under standards set by the two high court decisions.

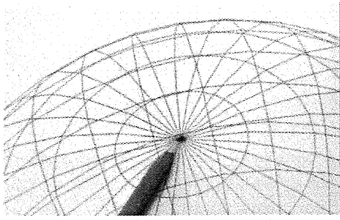
Lavin said the "disadvantage" of the freeze is not offset by a "comparable new advantage." He said giving employees who make the 4 percent contribution a vested right to a maximum subsidy only gives them what they already have.

On the requirement that an impairment bear "some material relation to the theory of a pension system and its successful operation" the judge also cited standards in a Court of Appeal ruling, Valdes v. Cory (1983), including that an impairment be temporary.

"Because the apparent goal of the freeze ordinance is to resolve the city's pending fiscal emergency, the ordinance is not materially related to the theory of a pension/medical subsidy system and its successful operation," Lavin wrote.

"Indeed, the economic viability of the medical subsidy system is quite robust given that it is pre-funded and its operation includes assumptions for increasing medical coverage costs and inflation."

Reporter Ed Mendel covered the Capitol in Sacramento for nearly three decades, most recently for the San Diego Union-Tribune. More stories are at Calpensions.com. Posted 23 Sep 13



The Global View

Reset

September 30, 2013

Connecting you with our global network of investment experts

IN BRIEF

- **Fed non-tightening has generated only moderate market effects beyond Treasuries**
- **Breakevens look fair, but bond volatility likely to normalize (again)**
- **Another impediment for the dollar strength story**
- **Stock-bond relative valuation still favors equities**

The Federal Reserve's (Fed) September 18 decision not to scale back its asset purchase program came as a surprise to markets and has produced a fairly significant drop in U.S. Treasury yields along the curve. Its effects elsewhere, however, have thus far proven ephemeral. U.S. equities, for example, have more than given up their Fed-announcement gains, probably in large part because investors have begun focusing on risks associated with fiscal-policy negotiations in Washington. Emerging market assets, which before the Fed meeting were recovering from a sharp slide in the previous couple of months, have essentially moved sideways since the news. In our view, while the Fed's choice represents not a cancellation of the "taper," but rather a temporary postponement (probably until December of this year), the overall *signal* from the Federal Open Market Committee (FOMC) meeting will likely reverberate for some time. In backing away from immediate tightening, and in forecasting a low level for policy interest rates through 2016, the Fed revealed itself to be carrying a somewhat stronger bias to support growth, and also to be more sensitive to the near-term data flow, than was previously thought to be the case. The seemingly probable nomination of current Vice Chair Yellen to succeed Chairman Bernanke would likely reinforce the former message.

Given the somewhat changed Fed outlook, here are four variables that merit particular attention as investors navigate the market environment in coming months (for the remainder of this note, we assume that U.S. fiscal policy negotiations generate only temporary disruptions to the economy and asset prices):

Breakevens. Other things equal, a dovish shift in monetary policy expectations raises inflation breakevens (the difference in yields between nominal U.S. Treasuries and TIPS). And some analyst commentary in the wake of the FOMC meeting highlighted a potential hit to Fed credibility. Breakevens did initially move higher after the FOMC announcement, but from low levels even by recent standards. After a few days, breakevens leveled off, and they have edged lower over the past week (Chart 1). They remain noticeably below the breakevens observed at the start of 2013, despite stronger U.S. GDP growth expectations than prevailed back then. It appears that the mere discussion of tapering, regardless of its lack of implementation, has if anything enhanced Fed credibility in recent months.

AUTHOR

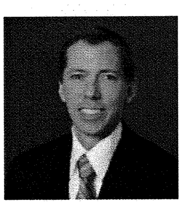


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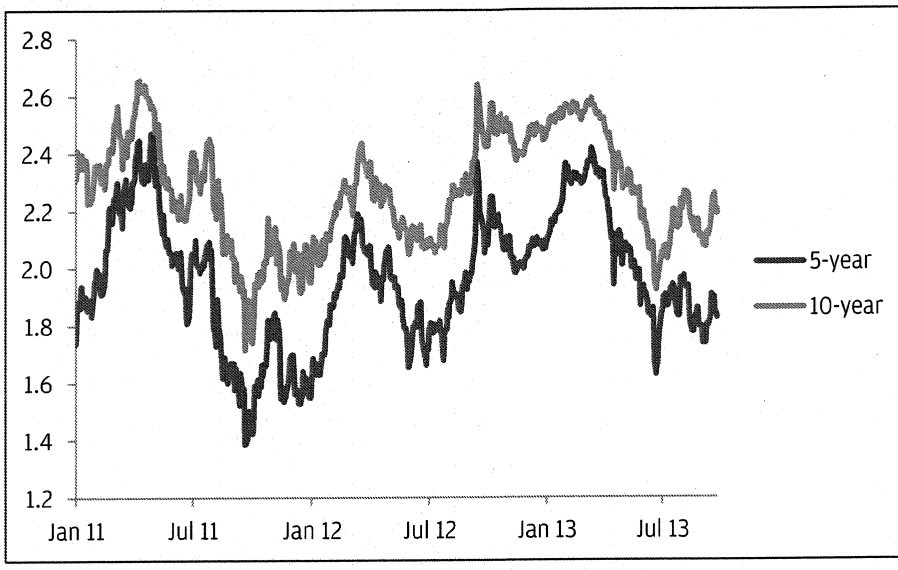
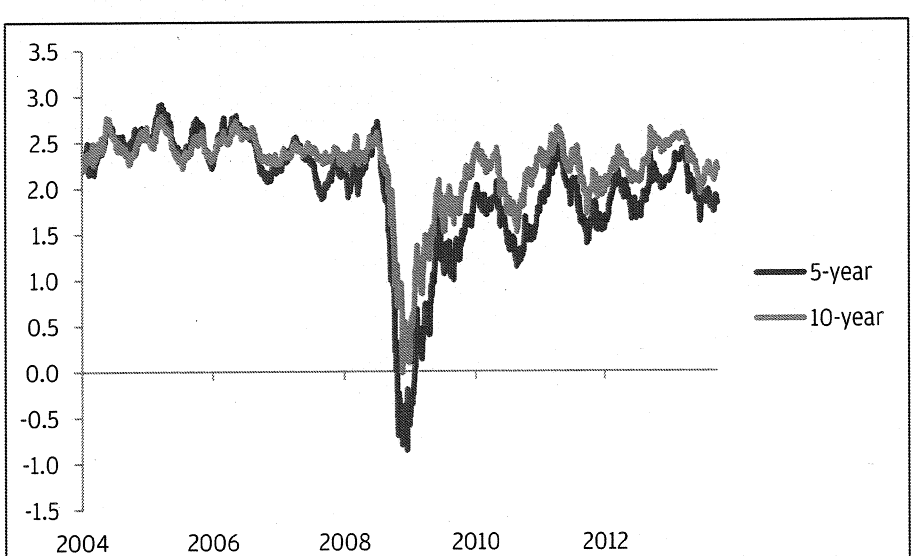
Chart 1: US inflation breakeven (yield of nominal Treasuries vs. TIPS, %)



Source: Bloomberg. Data as of September 27, 2013.

Looking at the medium-term context, breakevens look reasonably situated. The 5-year breakeven, at 1.82%, stands about 35bp below its average over the past decade (excluding the period of the financial crisis), consistent with the low current level of realized inflation. The 10-year breakeven, at 2.19%, is running 15bp below its own average (Chart 2). Assuming the Fed eventually succeeds in steering inflation back toward the 2% target, these measures will likely drift gradually higher over time. There seems little reason, however, to expect a sharp near-term move in either direction. In any case, the Fed will be monitoring breakevens and other gauges of inflation expectations for any signs - thus far not evident - that its policy stance is causing them to become less well-anchored.

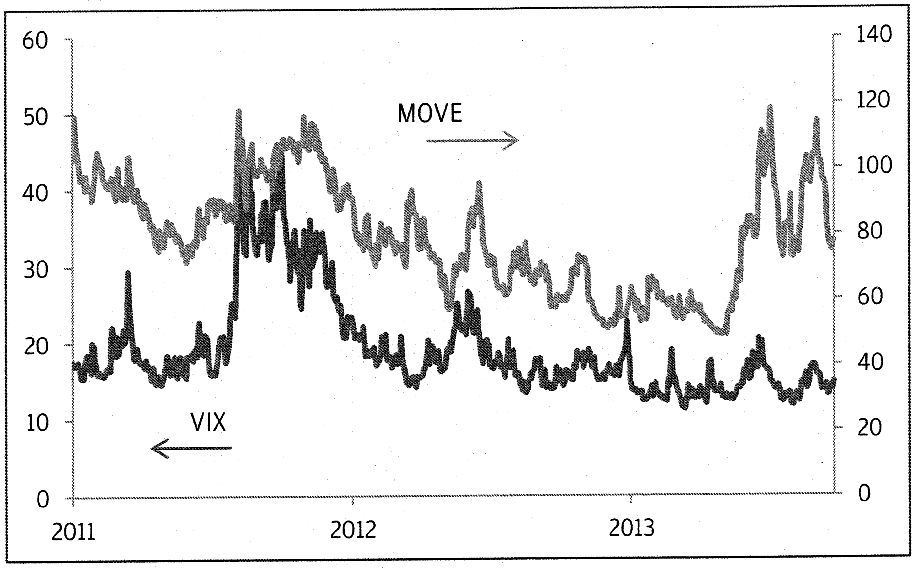
Chart 2: US inflation breakeven (yield of nominal Treasuries vs. TIPS, %)



Source: Bloomberg. Data as of September 27, 2013.

Volatility. Another strain of post-Fed commentary emphasized a likely increase in bond volatility, given greater uncertainty about the Fed's reaction function. While that line of thinking makes intuitive sense, implied volatility in the Treasury market (MOVE) has actually fallen significantly since the announcement (Chart 3). Indeed, bond volatility had normalized in recent months after a extended period at very low levels. The earlier drop in volatility, which occurred in 2012 and extended into early 2013, likely reflected in part the steady cushion underneath Treasury prices produced by the Fed's purchases, which have served to limit the range of likely outcomes in that market. Fed taper talk thus created upward pressure on implied vol, pushing it back to its longer-term average by the middle of the year. The prospect of asset purchases continuing for a longer period has served to dampen volatility again.

Chart 3: US equity (VIX) and Treasury (MOVE) implied volatility

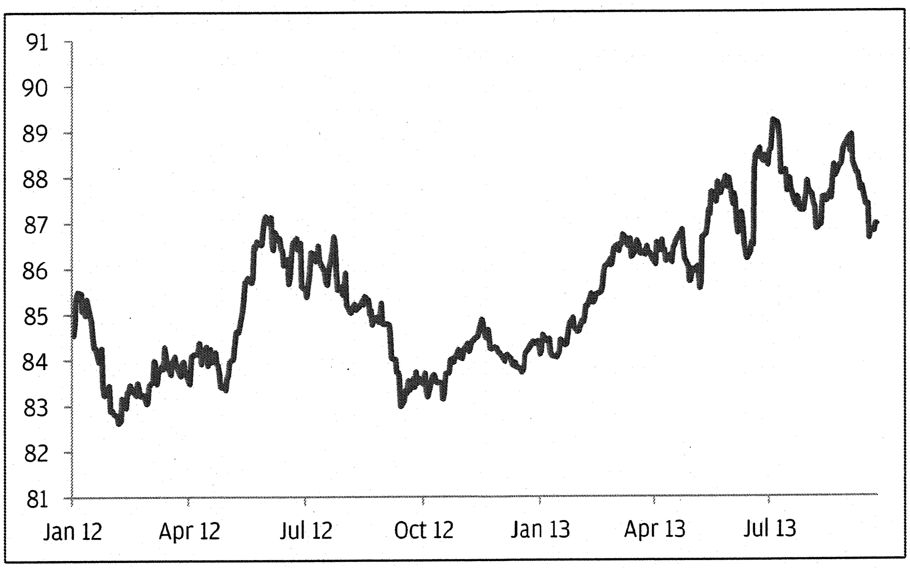


Source: Bloomberg. Data as of September 27, 2013.

Still, persistently higher volatility in the Treasury market over time appears probable. The Fed's playbook necessarily looks uncertain and subject to revision. And tapering will arrive fairly soon unless economic growth slows sharply. Meanwhile, implied volatility in the equity market has held close to the low levels reached last year. One factor that appears to be dampening equity volatility is the relative stability of global growth, albeit at persistently disappointing levels. On our forecasts, this smoothness will persist for a while, and equity volatility may therefore remain unusually low even as bond volatility returns to normal levels.

The dollar. Currency market conditions shifted in early 2013. In the previous several years, the dollar had traded as part of the overall risk-on, risk-off pattern, appreciating (on safe-haven inflows) when markets grew worried and drifting lower when volatility fell. Given the gradual healing in the global economy and the reduced frequency of risk-off episodes, along with an increasingly diverse monetary policy outlook, FX markets have returned to focusing on more traditional drivers, including interest rate differentials. As investors began pricing in earlier tightening by the Fed than other central banks, the dollar appreciated in the first half of this year (Chart 4). By the middle of 2013, though, this story stalled. To some extent, the dollar's recent stagnation reflects the behavior of interest rate markets. Government bond yields elsewhere in the world have displayed a tight connection to the Treasury market (and in the euro area, early bank repayment of long-term ECB financing has put additional upward pressure on money market rates). As a result, even with a more hawkish policy outlook in the US, interest rate differentials have not moved significantly in the dollar's favor. The advent of favorable growth surprises elsewhere in the world, especially in Europe, further dampened the dollar's rise. Additionally, markets have been paying attention to balance of payments fundamentals, which in the case of the US do not look particularly favorable, especially in comparison with the euro area.

Chart 4: US dollar nominal broad effective exchange rate (2000 = 100)

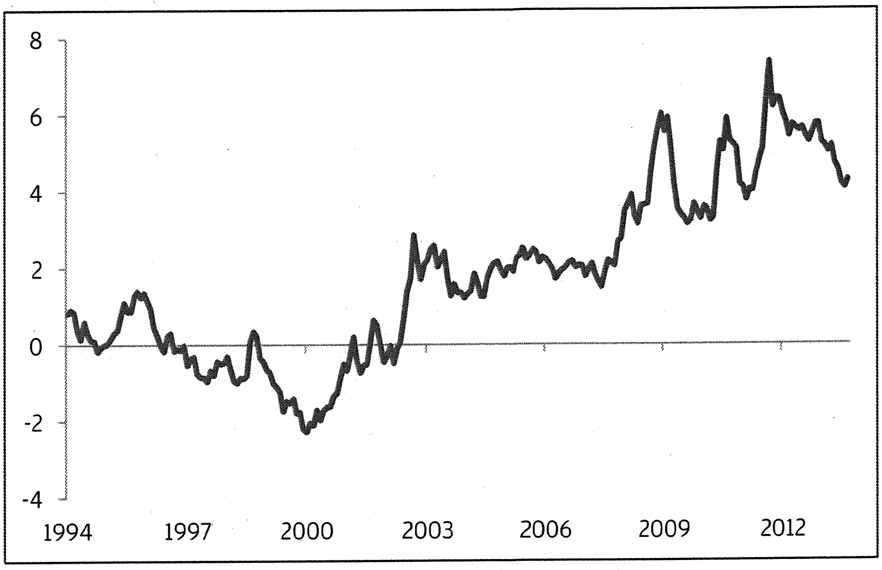


Source: JPMSI. Data as of September 25, 2013.

By delaying for now the prospect of tightening, the FOMC decision further damaged the dollar story. The dollar had already been declining in the two weeks prior to the announcement, mostly against the euro and the high-yielding EM currencies that had sold off sharply since May. It then dropped about another percent in trade-weighted terms on the news. Since then, however, it has broadly stabilized. From here, with the Fed still likely to taper fairly soon, the dollar may be able to hold its ground for some time against EM currencies (traditional sufferers in periods of Fed tightening), commodity-sensitive DM currencies, and the Japanese yen, with the Bank of Japan perhaps set to implement additional easing at some point during 2014. Across-the-board appreciation, however, seems less likely than before, unless the euro area growth data switch to delivering downside surprises. One complicating factor here is that high-frequency positions - sometimes useful as a contrary indicator - appear to have migrated significantly in recent weeks, with dollar longs becoming dollar shorts and traders the most upbeat about the euro in several years.

The stock-bond. In a broad asset allocation framework, the delayed taper and the prospect of a more lastingly dovish Fed represents only a small tweak to the basic overall story: a cyclical recovery in the US and elsewhere, leading eventually to reduced monetary stimulus. Neither have relative valuations changed significantly. The equity risk premium, while considerably narrower than it was in 2012, remains fairly high by long-run standards, with only a small shift after the FOMC announcement (indeed, toward a higher ERP, with bond yields falling and equities having declined slightly, Chart 5). Bond yields will very likely rise from here at a much slower pace than characterized the May-August period. Over the medium term, however, both the macroeconomic environment and relative valuations continue to favor overweight positions in equities and fixed-income underweights (concentrated in government bonds), compared with policy benchmarks. The abovementioned relative-volatility story reinforces that view. Again, we abstract here from the possibility of near-term distortions created by fiscal brinksmanship in Washington, as increased uncertainty about a debt-ceiling extension would likely push down both bond yields and equities temporarily.

Chart 5: US equity risk premium (forward earnings yield deflated by 10-year US Treasury yield, %)



Source: JPMSI, Standard & Poor's, Bloomberg, JPMAM. Data as of September 27, 2013.

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