JSB Capital Management, LLC

“Predictions are very difficult, especially when it’s about the future.”

Niels Bohr, Physicist, 1885 - 1962

At the beginning of 2014 Wall Street’s “top” forecasters predicted that the average closing price of the most widely followed stock market index, the S&P 500 index, would be up just a few percentage points, at best, and close the year at around 1950. Only one analyst predicted it closing higher than the actual close. It actually closed at 2058. As 2015 begins, every “big strategist” predicts the S&P 500 will finish the year higher. Many of them are double digit forecasts. It’s important to note that when everyone is on the same side of a trade, the most likely outcome is to disappoint the consensus.

This document provides our best forecast for the markets in 2015 including discussions in areas such as interest rates, precious metals and some of the most significant global events.

The two dominant themes for 2015 are:

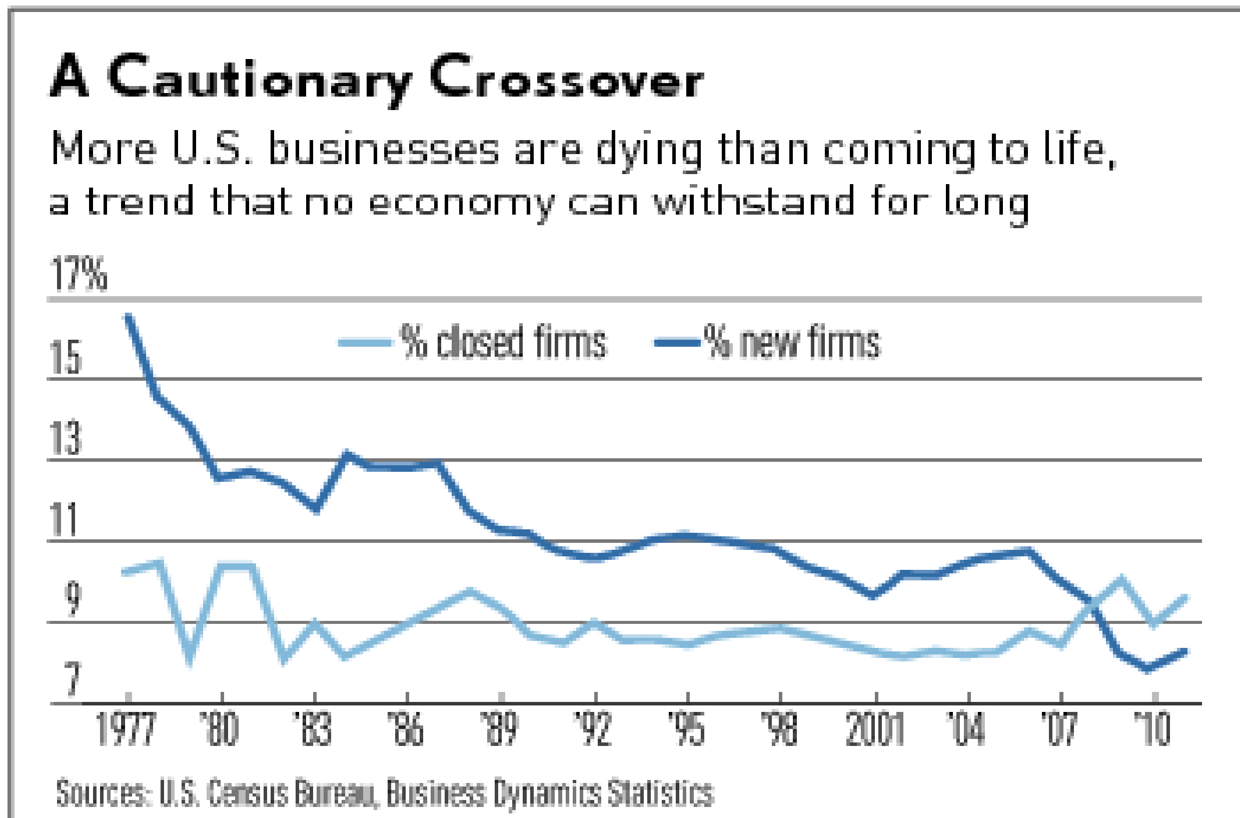
(1) When will the Fed begin to raise interest rates, and by how much before the year ends; and

(2) How will the sustainably low price of oil positively and negatively impact all sectors of the economy? Our investment plan for 2015 will focus on the highest probability outcomes from these two enormously significant factors.

Potential Outlier for 2015

A third factor which could dramatically impact investment results this year could be something known as a “Black Swan,” or an event that is highly impactful globally, but that can’t reasonably be predicted currently. This expression came from the title of a blockbuster book by esteemed author Nassim Taleb. Today what appears to be the stealth destruction of the entrepreneurial spirit and process in America is occurring for the first time in U.S. history. In recent years, there are more businesses that are closing

or “dying” than there are being created or “born.” This birth/death ratio as it is known is graphically depicted below:



The U.S. currently ranks 12th among developed nations in terms of business start-up activity. Italy and Hungary have higher start up rates. Recent data show that in the U.S. 400,000 businesses were born while 470,000 per year are dying. This is critically important since smaller businesses and start-ups account for more than 80% of new job creation. A record 93 million of the available U.S. workforce are **not** participating. Only about 63% of available working age Americans are participating, the lowest rate since 1977!

The significance of the above information lies in the fact that about 2/3rds of the U.S. economy (GDP) is based on consumer spending. Without newly created jobs and increased labor participation, it is unlikely that GDP can

grow sufficiently, if at all, from these current anemic levels. A Pacific Research Institute paper published in 2013 revealed that each job created by a start-up company increases a state's economy by nearly $1.2 million per year. No one is really talking about the economic impact of this dire birth/death situation (which is what makes it a "black swan type of situation), but it could be a major factor in determining economic prosperity this year and beyond.

The Role of The Federal Reserve Bank

Since 2009, virtually the entire rally in the stock market is attributable to the actions of the Federal Reserve Bank (The Fed) through their intervention primarily in the interest rate structure by cutting interest rates, printing money out of thin air, buying bonds (known as "Quantitative Easing" or "QE"), or by just promising to do more in the future. Their actions have not only pushed investors into risk assets (stocks), but they have also provided a virtual guarantee against any significant drop in asset values thereby giving confidence to investors to "buy the dips" anytime there was even a relatively slight market decline.

For more than five years over 90% of global stock markets price action was based on investors' perception of what the (global) Central Bankers would do rather than fundamental factors. Any bad news was perceived as positive rationale for continued central bankers' intervention and any good news was confirmation that stocks were still a good investment.

What Happens If Investors Lose Faith in Central Banker's Omnipotence?

The early signs of this loss of faith are emerging. Specifically, the following recent actions support this thesis:

A. The Fed has definitively signaled that they will begin to raise interest rates (they use the term "normalize") sometime this year. Taking away the punch bowl as the party seems to be nearing the end could

dramatically and negatively impact stock market participants' confidence.

B. Just a few days ago the Swiss National Bank (SNB) announced that their three year "peg" of their currency (the Franc) to the Euro (at 1.2 Franc/Euro) is dissolved and along with that announcement, billions of Euro's worth of investments was decimated. This was significant.

C. The Bank of Japan (BOJ) has for years attempted to jump start their economy (a process dubbed "Abenomics") using Quantitative Easing techniques, interest rate cuts and idle promises of future actions. The dismal failure of these attempts at stimulus (Japan has been in a two decade recession) completely eroded investor confidence in the BOJ's Governor Kuroda and Prime Minister Abe.

D. The European Central Bank (ECB) has for years used mostly jawboning techniques by President Mario Draghi in an attempt to shore up investor confidence in the European Union and the Euro currency. The resulting years of economic stagnation and historically high rates of unemployment are testimony to the failure of this policy. On January 22 it is very likely that the ECB will perform another futile attempt at stimulus by announcing their first round of Quantitative Easing (buying sovereign European debt). The likely utter failure of this policy will complete the erosion of confidence in this Central Bank and its President Draghi.

All of the above indicated that Central Bankers were just making it all up on the fly for the last five years. It wasn't until January 15, 2015, a day that will live in economic infamy, that the Swiss National Bank broke an outright promise, broke their currency peg, AND lost $60-$100 billion in a single day, that things really got ugly. The follow-on effects of this action are too numerous, too extensive and too detailed for this report, however there will be numerous bankruptcies and fund closures as a result.

Conclusion:

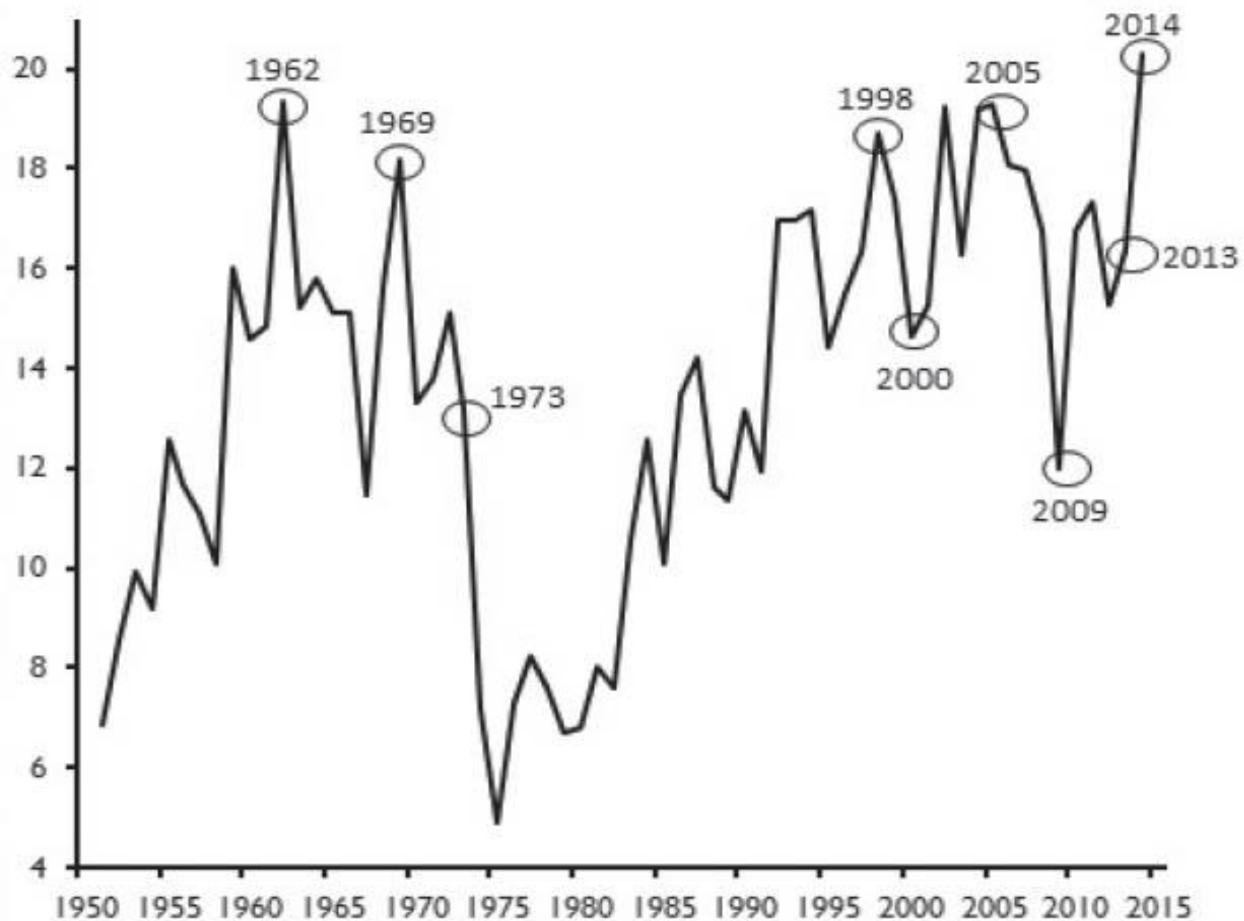
The resulting loss of confidence in the global Central Banker's ability to come to the stock market's rescue (including other assets such as real estate) will likely lead to a "normalization" of asset values and true price discovery where asset prices are determined by market forces and not

Central Banker's hubris. Overvalued assets will decline toward their intrinsic values all over the world. Gold will increase in desirability.

What Does This Mean For The Stock Market?

It was almost exactly one year ago, on January 11, 2014, when Goldman Sachs stunned its bullish fans that "The S&P500 Is Now Overvalued By Almost Any Measure" adding that "***the current valuation of the S&P 500 is lofty by almost any measure, both for the aggregate market as well as the median stock***."

Part of their analysis was based on the following graphical data:



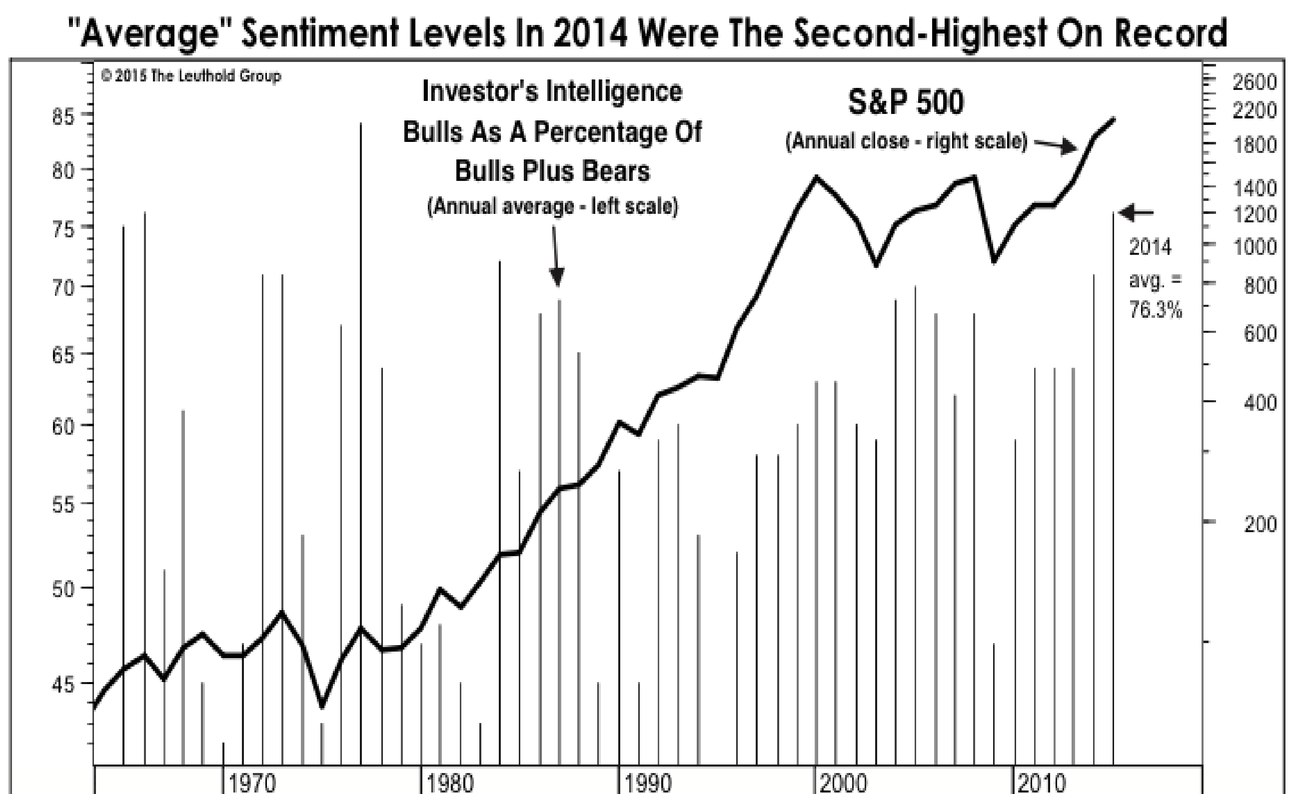
As the above graph indicates, the S&P 500 begins 2015 with a price/earnings (P/E) multiple of about 18 times trailing 12-month earnings per share. This represents a valuation higher than about 74% of the time since 1945.

Then, in the early summer of 2014, Jim Paulsen, widely known as a "permabull," wrote in a letter to Wells Capital clients titled "*Median NYSE Price/Earnings Multiple at Post-War RECORD*", admitted that the market is about as overvalued as ever, based on numerous criteria but mostly due to the median (not average) P/E multiple surging to fresh all time highs.

Over the last year the larger stock market as represented by the NYSE Index which contains 2000 stocks has actually shown clear signs of weakness and a technical break down. The graph below shows the NYSE Index as a thin blue line which exhibits lower high's while the more publicized S&P 500 (represented by the blue/red bar chart below) makes a series of higher highs. At the risk of sounding too geeky about this, the interpretation is that many if not most of the stocks on the NYSE are struggling while the larger, more well publicized stocks that inhabit the S&P 500 Index give the impression of a very strong market overall. This is known as "divergence" in technical terms and it is often a very significant signal for an impending market correction.

<u>NYSE Index vs. S & P 500 Index</u>

One last observation of how the U.S. stock market might perform this year entails a look at a very important and valuable indicator: Investor Sentiment. The graph below depicts the average annual value of an Investor's Intelligence indicator which compares survey participants who indicate they are "bullish" (believe the market will go higher) vs. those who indicate they are "bearish" (looking for a down market). The solid black line is the actual S&P 500 Index value (representing the largest stocks in the U.S. economy) for the period of the survey going back over the last 60 years.



Taking the ten highest years of investor sentiment (more bulls than bears) depicted in the table below we see a remarkable correlation between those years with very high percentage of bulls and the subsequent annual return in the stock market the following year. While there were two "good" years the average annual return after a high sentiment reading was 0.1%!

High Sentiment Years & Subsequent Market Action

Ten Highest Average Sentiment Years	Average Sentiment Reading	Subsequent Year Gain Or Loss In S&P 500
1976	83.7 %	-11.5 %
2014	76.3	?
1965	75.6	-13.1
1964	75.0	9.1
1983	72.3	1.4
2013	71.0	11.4
1972	70.8	-17.4
1971	70.5	15.6
2004	70.3	3.0
1986	68.9	2.0
	Average Return:	**0.1** %

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Taking the ten lowest years of investor sentiment, more bears than bulls, yields the following results:

Low Sentiment Years & Subsequent Market Action

Ten Lowest Average Sentiment Years	Average Sentiment Reading	Subsequent Year Gain Or Loss In S&P 500
1994	41.4 %	34.1 %
1969	42.4	0.1
1974	42.7	31.5
1982	42.8	17.3
1988	44.7	27.3
1968	44.8	-11.4
1981	45.2	14.8
1990	45.4	26.3
1970	47.0	10.8
2008	47.2	23.5
	Average Return:	**17.4** %

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What was the investor sentiment reading in this survey at the end of 2014? It was the second highest value ever at 76.3%.

Trying to time the end of an asset bull market is very difficult at best. Investors are optimists by nature and it doesn't serve the business interests of Wall Street analysts to forecast a decline in the value of the product they sell. At the very beginning of this report there were statistics showing the overwhelming bullish nature of market forecasters, which was the case even in the years of "the Great Recession." Rapid credit growth, artificially lower interest rates (set by The Fed), and lowered risk premiums (taking more risk that costs less) have dominated the finance-driven economic cycle for the last five years. However, there comes a time when common sense overcomes a "mania" environment and this year may be the beginning of that occasion.

ENERGY

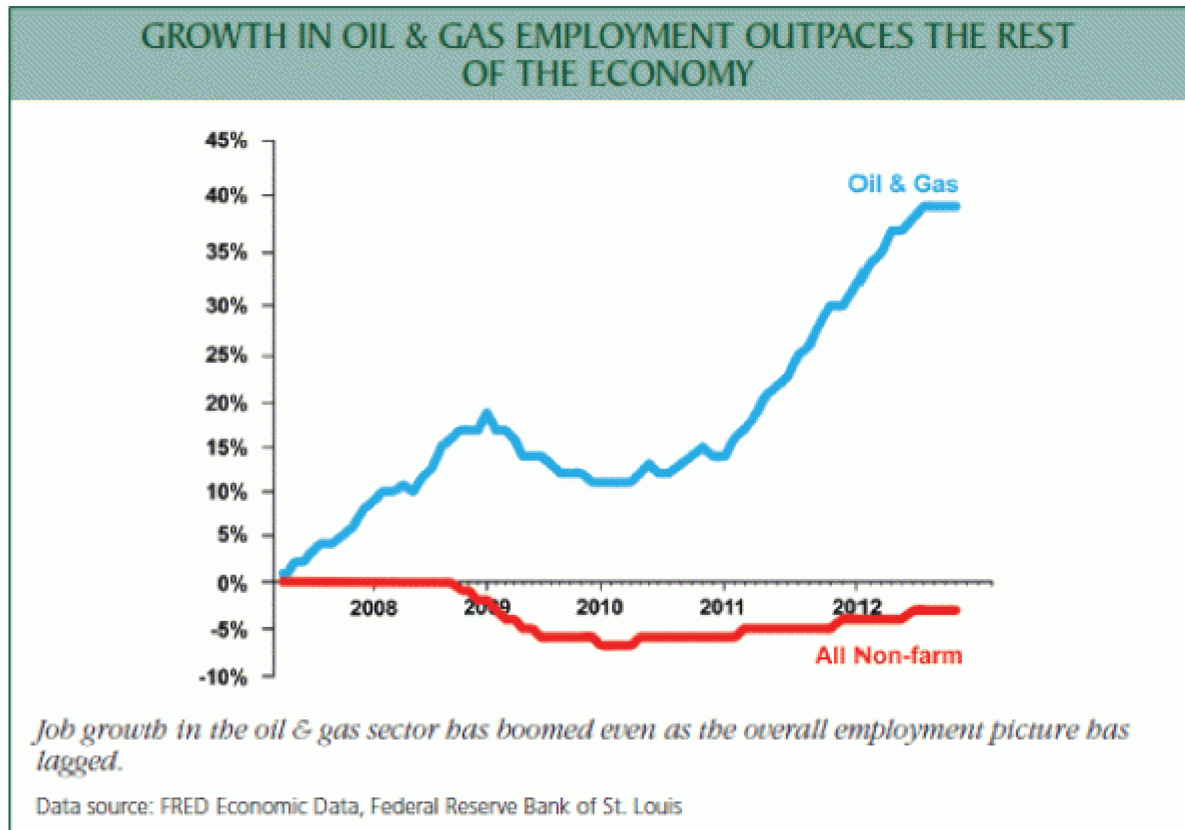
The price level of oil, and the subsequent pricing of its distillates like gasoline, will be a dominant theme in 2015. Taking a look at the price movement of oil over the last 7-plus years there is a lot of volatility:

The precipitous plunge in the price of oil from the middle of last year until now has had the following immediate effects:

1. Major oil exporting countries such as Russia, Venezuela, Iran and Norway, the most oil export-dependent, have experienced extreme declines in national income that has severely strained their budget deficits and drawn down their reserve currency deposits substantially.
2. Market prices for all of the energy related companies have plummeted in sync with oil's decline. Estimates as high as a loss of $2 TRILLION in market value globally have been forecast.
3. Numerous plans for capital expansion in the energy industry have been cancelled amounting to hundreds of billions of dollars of spending lost. Just a few examples:
    a. Goldman Sachs cut its long term forecast for oil prices adding that $2 trillion of oil projects globally are at risk, up substantially from a recent forecast of about $1 trillion.
    b. Chevron cancelled plans to drill in the Canadian Arctic.
    c. U.S. shale oil companies have dramatically slashed capital spending plans and many land rigs have been shut down.
    d. Brazil's Petrobras (national oil company) announced plans to dramatically cut back its $220 billion exploration project off its coast.
4. Exploration and Production (E&P) companies were the first to be severely impacted by oil's plunge. Top tier companies such as Schlumberger, Apache and Halliburton have already laid off thousands of employees and have dramatically lowered earnings estimates.
5. Royal Dutch Shell cancelled plans for a $6.5 billion petrochemical plant in Qatar.

These are just a handful of the consequences of the over 50% plunge in oil prices over the last six months or so.

While the overall U.S. employment picture appears to have brightened recently, a look at the composition of the current work force reveals a very interesting statistic. The chart below breaks out the energy related jobs from the rest of the economy (known as the “non-farm payrolls”):



Job growth in the oil & gas sector has boomed even as the overall employment picture has lagged.

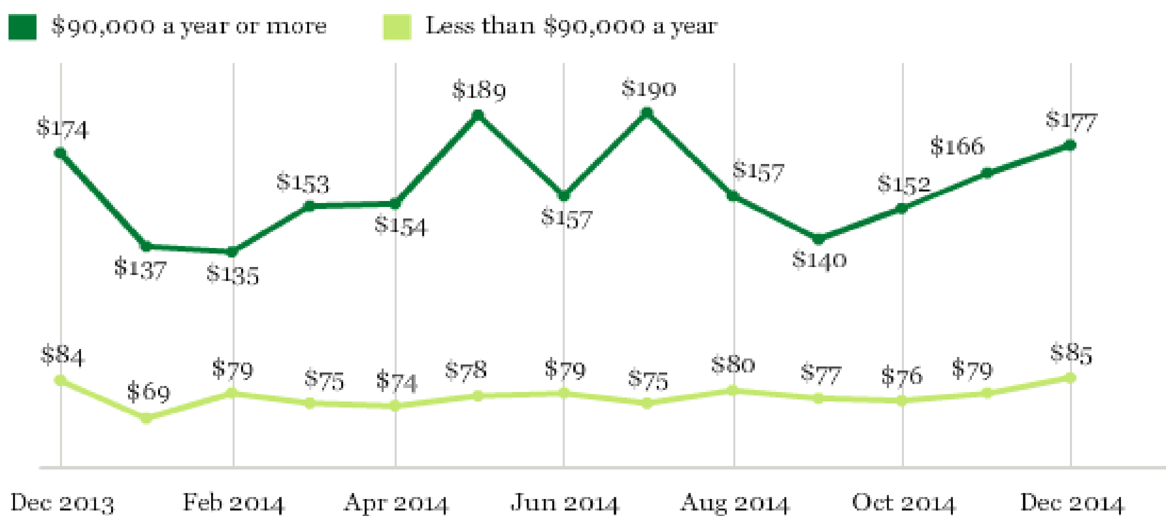
Data source: FRED Economic Data, Federal Reserve Bank of St. Louis

Not only has the oil and gas industry employment picked up substantially since 2011, but those jobs are also typically very high wage and benefit jobs thereby adding more substantially to the economy and, therefore, consumer spending than many of the retail, healthcare and service sector types of jobs. A significant decline in those oil and gas related jobs, such as we’re seeing right now as a result of sub-$50 per barrel oil clearly will result in a decline in consumer spending this year. As of the end of last year, oil and gas companies employed 543,000 people across the U.S., a number that’s more than doubled from a decade ago. However, tens of thousands of energy industry workers are now getting their pink slips.

In a particularly bearish note to clients just a week ago, Goldman Sachs lowered its forecast for oil stating it will plummet to $42 per barrel and then average $50.40 (how did they get 40 cents??) for the rest of the year. This is in line with many other forecasters and in many ways it mirrors our own view except that we believe oil could easily see $30 something before it bottoms later this year.

With that in mind, what are the best actions to take for the short-term?

1. It appears that the decline in oil prices will persist longer than years past because shale oil extraction is significantly different than conventionally drilled projects. There can be a five year or more lag between exploration and actual drilling in an offshore rig whereas with shale extraction there is typically a 12 month lag. Once oil bottoms, the best play will be to invest in the domestic shale oil producers.
2. Oil service companies are beginning to charge less for rigs and workers for the shale based drillers thus shifting the break-even cost of shale drilling to the mid-$50 per barrel and this is likely to decline even further in the short-term. Eventually, the oil service sector will be a very attractive investment once these costs stabilize.
3. It is widely thought that consumer spending is positively impacted by lower gasoline prices and that the drop in oil, according to some, amounts to “a $100 billion tax cut” for the typical consumer. However, the chart below seems to contradict this widely held belief:



Consumers with incomes less than $90,000 annually are believed to be the biggest beneficiaries of lower gas pieces. However, as the above chart depicts, these consumers began the year spending about $84 per day on discretionary purchases. In the middle of the year oil began its decent from over $100 per barrel to around $50 per barrel at the end of the year when they averaged $85 per day. So despite what the headlines predict, lower gas prices apparently do not translate into greater personal consumption which leads to more robust growth. On the contrary, lower gas prices tend to intensify deflationary pressures and reduce consumer spending activity which is a damper on growth.

A recent report stated that each job created in energy related areas has had a "ripple effect" of creating 2.8 jobs elsewhere in the economy from piping to coatings, trucking and transportation, restaurants and retail. The plunge in oil prices and the corresponding loss of revenue will lead to cuts in oil production, declines in capital expenditure plans (which comprise almost 25% of all capital expenditures in the S&P 500), freezes and/or reductions in employment, and declines in revenue and profitability.

Conclusion:

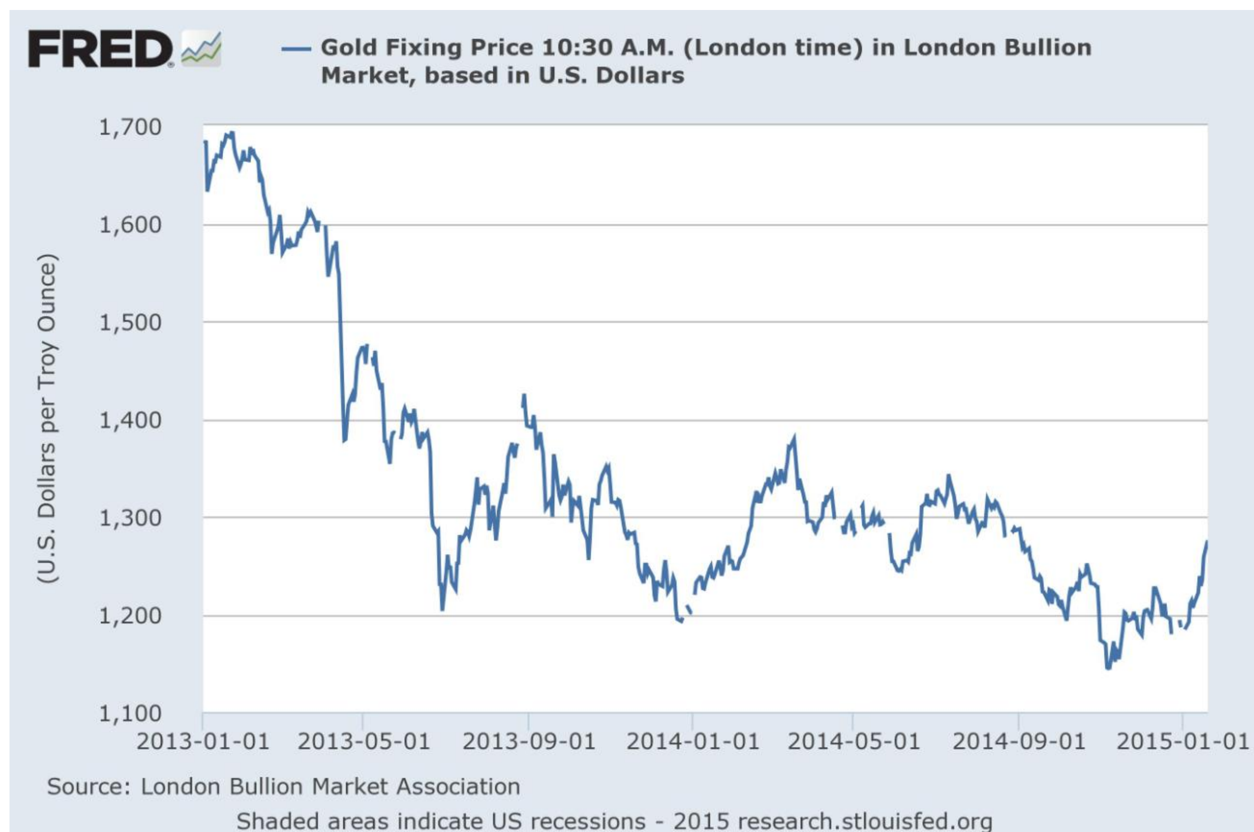
For now we will avoid investments in the energy sector itself as well as consumer discretionary stocks that are directly related to the drop in oil prices as described above. Also, many industrial sector stocks will decline for now as will cyclic resource stocks.

GOLD and Precious metals

As stated above, many market participants globally are losing confidence in the global central bankers' ability to produce economic prosperity using

ineffective financial policy tools. Over the past six years, central bankers have continuously promised "growth within six months" using their anointed powers to control interest rates and wantonly purchase public debt. Their credibility is waning if not completely gone in some economies (see: Japan and nearly all of the southern EU countries).

People understand now that the banks were the only real beneficiaries of Central Bankers financial fiddling (particularly the Quantitative Easing operation) as the ratio of banks' profit to economic output (GDP) is the highest since WW II during a period when we are experiencing the highest amount of unemployment over the same period. Simultaneously, most of the West (especially Japan and Europe) is experiencing near zero growth while being way over-indebted, and there are few growth prospects on the horizon.



In this environment the U.S. dollar has emerged as the pre-eminent currency investment globally and gold has surged from a low of around $1150 per oz. (in late 2014, as you can see in the chart above) to its current level of about $1300. As global investors flee their domestic, fiat

currencies, largely brought on by their growing loss of confidence in their Central Bankers, gold has emerged as the "currency" of choice for many.

Our holdings of gold companies have experienced a tremendous spike of around 30% over the last four or five weeks and they are likely to continue this trend for awhile. We will hold those positions for now.

EUROPE

As stated above, it is very likely that the European Central Bank (ECB) will announce on Thursday that they will implement their first round of Quantitative Easing (QE) beginning with an investment of 550 billion Euros ($630 billion). Without getting into a technical discussion of whether they can legally do this (some still believe it is against their charter), it will likely turn out to fail to raise economic growth or increase inflation near to their target of around 2%. It will however allow many of the European banks to slough off their toxic waste (bonds) in much the same manner as the U.S. banks did. As usual, the tax payers of each sovereign nation in the EU will be responsible (through their respective governments) for at least half of

the losses suffered by the ECB from taking on this toxic waste (details to follow).

As depicted above, the Euro is back to where it was when it first launched 16 years ago and it is also likely to continue the downward trend shown above to a point where it is at least at parity to the U.S. dollar. This, by the way, was one of the primary reasons that the Swiss decided to abruptly remove their own currency peg to the dollar (as described above): they would have gone broke holding their Euros as the Euro sank further against the dollar. For now Europe is likely to struggle and their markets are overvalued.

This concludes the analysis of 2015. Please contact us with any questions or comments.