Observations and Outlook

April 18, 2016

Selected Index Returns 1st Quarter/ last 12 months

Dow Jones Industrials 2.2%/ 2.08% S&P 500 1.35%/1.78% MSCI Europe -2.51%/-8.44%

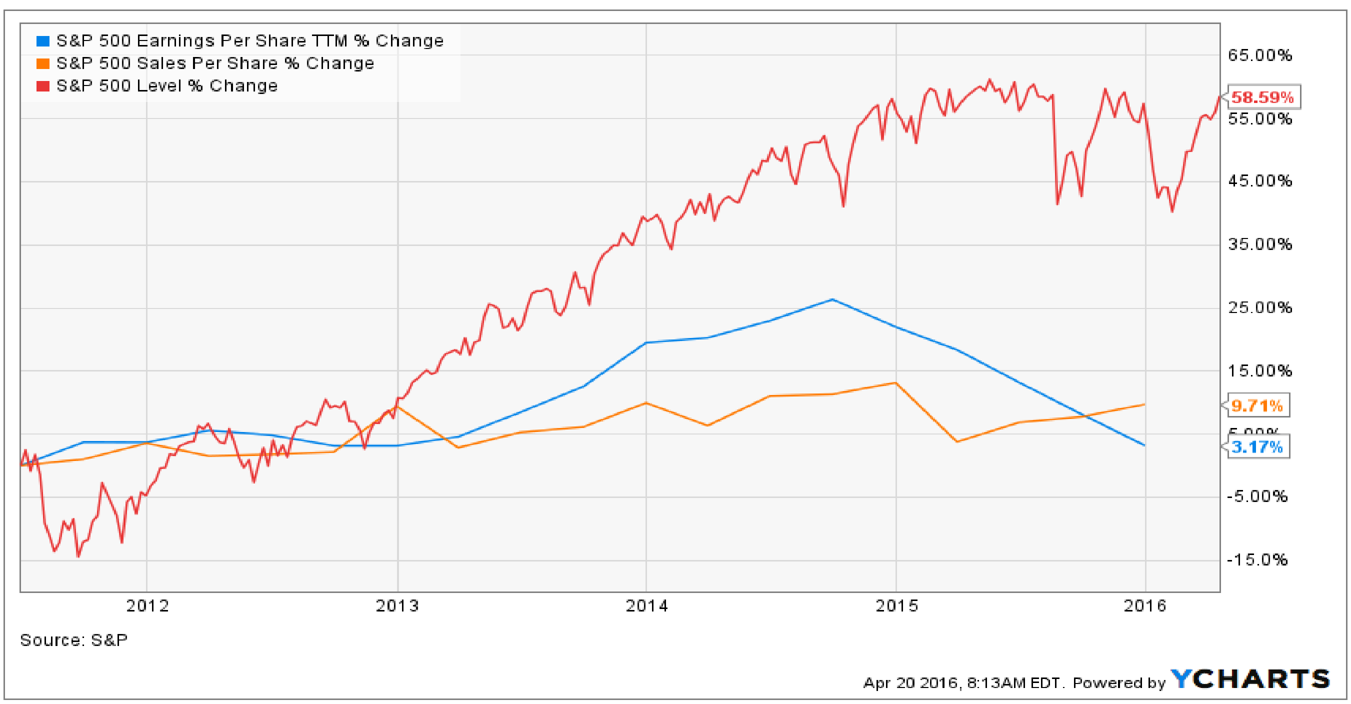
Small Cap (Russell 2000) -1.52%/-9.76% Emerging Mkts 5.71%/-12.03% High Yld Bonds 3.32%/-4.06%

US Aggregate Bond 3.03%/1.96% US Treasury 20+Yr 8.49%/2.46% DJ/UBS Commodity .42%/-19.56%

Despite an incredible rally in US and global stock markets in March we can observe tepid gains on the year and looking at the past 12 month returns can see that most areas are in a downtrend and those that are not, are barely positive. It is a classic characteristic of bear markets to have startling rallies while marking lower lows and lower highs along the way. The unfortunate lesson most investors are being taught is to disregard 10%+ market declines, because, as we see, it always comes back! That is, comes back almost all the way, prior to moving lower. This puts most retail investors in a complacent mindset, where they will only tend to their investments ***after*** a significant market decline. This is the behavior pattern of the majority of investors throughout history, and goes hand-in-glove with the problem of buying high and selling low.

The Mothers Milk of Stock Prices

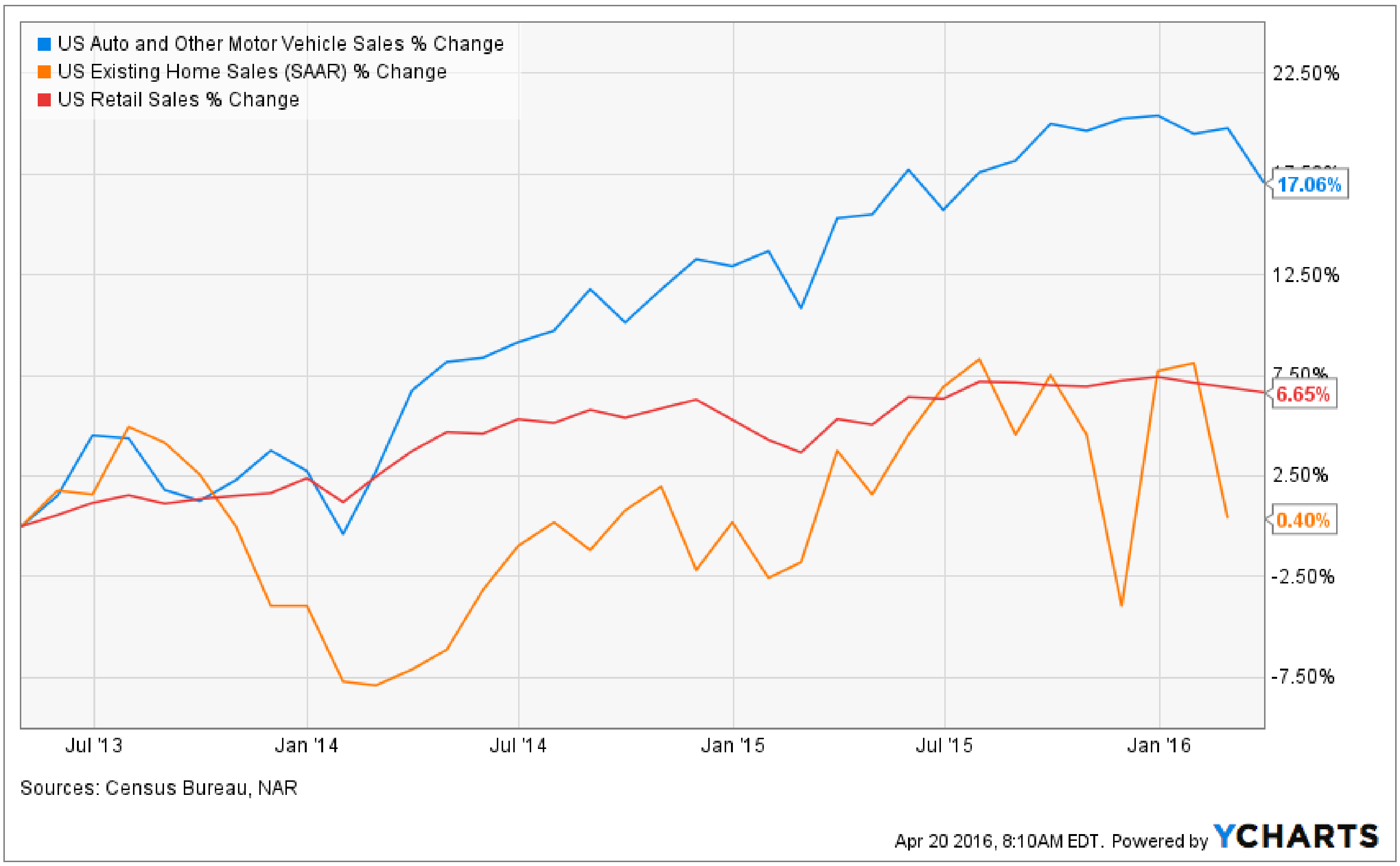
There is an old saying that earnings are the mother's milk of stock prices. Prices grow when earnings increase. Due to the constant and continued intervention (despite a 7 year economic expansion) by global central banks, earnings as a foundational input into stock valuations has given way to the central bank 'put'. It is widely perceived (which is the most important part) that central banks will not allow equity prices to go down. Those who believe in the omnipotence of central banks need only look to 2007 and 2008, when the Fed cut rates multiple times while the stock market lost 54% of its value.



GAAP earnings on the S&P500 are negative for the entire preceding 12 month period ending March 31, 2016. Full year 2015 GAAP earnings are at the same level as they were in 2012. Today the market is some 40% higher in price than in 2012, with the same level of earnings. Investors are always hopeful, but how long will the hope last, while waiting for earnings to catch up to stock prices?

Reasons for Continued Bull Market: Housing, Auto and Retail Sales are Strong

Market cheerleaders claim the economy and by extension, the stock market is healthy because home, automobile and retail sales continue to improve. One could claim they are improving by comparing a few years back to recent numbers, but the year over year figures tell a different tale. The chart below clearly shows home sales declining over the past year, retail sales flat, and automobile sales rolling over from 2015 levels.



The 'low gas prices will spur spending' theme never materialized. Now consumers are accustomed to low gas prices. Not only did low prices not spur the economy, higher prices going forward will be a drag on spending and growth. Auto sales are in decline. Used car prices are in decline. As I have indicated in previous posts, a significant portion of the growth in car sales is directly related to a lowering of lending standards. Subprime, deep-subprime, used car loans stretching for 7 years, and the highest average payments for new cars are all unsustainable factors. This will likely lead to a slowdown for auto manufacturers.

A factor these three areas have in common is that they each rely on new credit. Incomes for most Americans has remained flat or declined over the past 15 years. In order to increase their standard of living they need to consume using new debt. Autos require new debt and housing most definitely requires credit. Low rates facilitate this. However, at the end of the day, the ability to service the debt is the critical factor. No matter how low rates might be, if the debt cannot be serviced, the loans will fail. Personal incomes and wages are the critical factor, and must increase, in order for people to consume more using credit.

What To Do

Going forward, the difficult question is *when* will stock markets come back down to reality. That is, come back down to reasonable valuations based on earnings and prospects for earnings growth. Stocks will decline at some point, and unfortunately they often overshoot their mark—both on the way up (over optimistic), and their way down (too pessimistic about the future). There are several ways one can continue to earn returns if stocks do not perform. One way is simply to avoid the stock market. There are seven asset classes (stocks, bonds, cash, real estate, precious metals, oil, commodities). Some move together, some move independently and some move in opposite directions.

Hedging one's portfolio with negatively correlated assets (assets that move in opposite directions) or investing in assets that move independently of the stock market are ways to get of out the way of a declining stock market. Unfortunately, few investors or even brokers are willing or even able to do anything except buy more stocks. That is why it is so important to be able to see investment areas outside of stocks and not to rely solely on the stock market for returns.

There are many paths to positive returns. Some invest in real estate and rent it out; others buy bonds and hold to maturity. Most people in the US buy stocks and hope for higher prices. Everyone does the same thing. But no one talks about avoiding declines or investing in other areas besides equities. The classic 60/40 portfolio has only a dash of gold or real estate***. A truly aware investor will understand that in some asset class, at any given time is the potential for 20% price gains; and in another 20% price declines.*** And the goal is to be open minded enough to take advantage of both scenarios, enabling one to have positive returns no matter what the stock market does.

The time to employ an Investment Advisor who can do more than buy and hold is now.

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