The Commentary

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Editor's Note:

In our past editions, we always tried to adhere to a monthly calendar schedule. But sometimes, certain critical or unexpected events cause us to delay the release of our publication. Why? Because the nature of the incidents preempts what we have already written, making it stale or unimportant in the light of the new reality. Moreover, it's likely to shift our focal points, assessments, conclusions and strategies. Thus, since this publication is devoted to providing value-adding investment insights and current risk-assessments, we believe we must delay its release until we have accomplished our stated goals. The accelerating pace of unexpected news affecting GDP, oil prices, as well as sovereign debt and bond prices has had a sudden and profound impact on financial markets. Thus, we believe the better option is to write two editions as one. This allows us to provide both the pertinent info that was unaffected by the news, as well as our new assessments including our "take" on the markets' reactions to those incidents. Hence, the entire issue is divided into two parts: one covers subject matter that is still pertinent and the other focuses on the new data or the markets' reactions thereto. Now, back to our originally scheduled program.

PART ONE

This month, our "opening quotation" is encapsulated in a cartoon that appeared decades ago when it was far more humorous. Back then it was pretty far from the truth. Nowadays, the situation depicted above seems to almost perfectly fit our times.

Part One's Focus

Investing in an environment that doesn't seem "real" to us

A month ago, the daily trading environment displayed the contradiction that "good" news is good news and "bad" news is better still. As we noted in earlier editions, any promise that proclaims a stronger recovery, regardless of how frail or unlikely the assurance or assertion might be, is celebrated with higher stock prices. And, any "bad news" is also greeted with still-higher equity markets. The latter coincides with the belief that the Fed will not only delay any interest-rate hikes but also initiate the Greenspan, no the Bernanke …no, now it's become …the Yellen "Put." This notion incorporates an unfailing 'faith' that the Fed would 'come to the rescue' of any serious downtrend before a bear market could begin to get legs. So, heads …investors win; and tails …they can't lose.

Today's 'can't lose' mindset.

This mindset reminds us of past eras. We think back to the "dot-com era" and the "no housing bubble" periods! And, those of you with long memories will recall the late-60s when Gerry Tsai, founder of the infamous Manhattan Fund, was an idol. His mutual fund was the hottest performing vehicle around! Mr. Tsai literally invented, (not discovered, but invented) the momentum stocks: Xerox, Fairchild Camera, Leasco, and Jimmy Ling's LTV were just some of the stocks that would go up forever. This time, it's a similar feeling, but

not exactly! When Tesla, Facebook, Chipotle and Netflix become fast-moving paper (read: momentum stocks), instead of a specific sector or genre spiking, the entire market rises with them! Why? Because the buying power of the banks' prop-desks, the might of the Goldman-like Investment Bankers, the many hedge funds and the hi-frequency traders …they all "go-to-work." They do so, by concentrating on the futures markets where ownership only requires a 3% to 5% outlay. These "cartels" have more than enough resources to start a good-sized rally. We call them "cartels" because that's exactly what they are… associations of like-minded players all of whom seek the same goals. As the S&P futures rise, the arbitrageurs do the rest. They short the "futures" and buy the "cash" …thereby locking-in the difference as profit. That "paired" trade pushes the physical (as opposed to the derivative) market up and the lemmings follow the "pied-piper's" lead. As more and more join this winning strategy, its success ratio attracts growing numbers of participants, all seeking a similar return from the identical tactics. The initial buyers have the highest returns, as they are the earliest ones in the fray. They usually concentrate on whatever is the "specialty of that day." Usually, it's a big-cap momentum stock or two. The TV media and programed computers pick up the scent, and the chase is on! Some have come to believe that the whole stock market is "safe!" Why? Because this rising trend attracts new buyers: the so-called "trend-followers." Short sell-offs occur now and then, but they are followed by acceleration to new highs. It seems as if the market can't go down …or if it does …it won't stay down!

It's an old and bizarre movie.

There is so much that is so bizarre about today's markets… it's surreal! And, while today's "New Normal" economic environment is the primary determinant for the bond market, its effects are completely absent of any presence in the equity markets. It's a strange and inexplicable situation. Haven't we all seen this movie before? …1985-87 "Greenmail era"? …the dot-com era? …the "it's not a "housing bubble" Greenspan quote? …and the ridiculous, "Bear-Lehman denials of any problems" assertions?

When greed is alive and well, it causes an affliction known as "short memory." This causes obvious risks to disappear! Just look at all the geo-political and warring factions that are fighting one another, a number of which are taking place in our "Get-nothing-done" Congress. How about lower unemployment data that reflects fewer workers participating in the labor-force? Big take-overs to escape taxation? The investment, political and economic environment resembles a crazed episode from the "Twilight Zone." Bizarre patterns and ignored warnings of declining GDP present greater risks, not better returns. Today's "cautiously-bullish" "talking heads" provide no more usefulness than a recorded message that's played over and over again.

We believe the best way we can add value is to devote the first part to a question and answer segment that reflects the risks we saw before the sell-off occurred. They were the 'real and present dangers' that have been ignored by the market's nonchalant and continuous "risk-on" status …regardless of their number or their precarious nature. We think our Q&A can be a "slap in the face" that will bring some realistic and levelheaded-rationale reasoning to the "risk-on" crowd.

We return to the layout that our long-time readers have endorsed… the question-answer format. With this, we find it useful to "play the devil's advocate," asking "tough" and critical questions of ourselves! It also lends itself to quick shifts in subject matter and reviews of past editions.

Q&A

It's today's stock-market participants who create its environment.

Let's start off with your slant on the market environment that existed as the S&P 500 was topping during the dot-com era of the late 90's. You said it was similar to the S&P's recent "breakout" of the 2000 resistance. How would you characterize this move as it took place about a month ago?

As we see it, both eras had similar attributes: First, for the most part, neither market was "discounting the future" accurately. Second, valuations were stretched: in the tech-darlings back then, and in the whole market now. But both eras were a very crucial departure from the

1970s, '80s and early '90s. Before the dot-com bubble formed, stocks in general at least attempted to discount the future.[1] This was a practice that evolved from Peter Lynch, a brilliant money manager whose fame and fortune rose above all others, even Warren Buffett. He was a fundamental analyst who "kicked-the-tires" of every company he owned. He established himself as the ultimate stock picker by creating an all-encompassing methodology and perfecting it. While his art may not be extinct, it's at least an endangered species. Those who try to imitate his practice may be sorely disappointed by their results nowadays. Markets no longer adequately discount their future prospects. Instead, they react to today's news. Third, certain "momentum" stocks have obtained (from a valuation perspective) nosebleed heights. Everyone's trying to get rich on the same issues. Usually that spells trouble, but not if there are more and more "latecomers-to-the-party" that keep arriving in larger and larger numbers. Their "new money" keeps the "good times" rolling along.

Fourth, as noted earlier, today's markets are completely dominated by "players" who actively trade daily. These "forces" dominate today's exchanges with the sole purpose of eking out small but consistent returns where most positions are "flattened" (read: closed-out) before the trading-day ends. If they can average 1% or perhaps an occasional 2% daily, their boss and their bonus are both in fine shape. As we once noted, both Merrill and Goldman have reported (through the SEC) years where the number of "losing-returns" days totaled less than 4%. So, hypothetically, if they had an entire year (252 trading days) in which 96% of the time they earn assumed per-day returns of only ½% , they'd make 121%. Their "take" is phenomenal. With the exception of a bear market, we can't see any reason why this practice would end. Much like a school of piranha that smells blood in the water, this unified effort attracts larger and more aggressive brutes; the high frequency trading practice is likely to get bigger, attracting more players and increasing the risk.

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It's a terrific beach party!

I think you've hit one nail right on the head! The past two to four years have been a rewarding and correction free environment!

Yes, it has! You are right! It's so unrealistic, but oh so rewarding, all at the same time. Its success continues to attract investors in ever growing numbers. Yes, a number of prudent and risk-averse investors have warned of a market level that's not being supported by GDP and top-line growth. But most participants have been lulled to the party by the constant uptrend and the ever-growing crowd. And why would you want to avoid such a lavish and enjoyable beach party? Here's the investment scene: always a sunny day at the beach, with plenty of great food and free-flowing drinks; the music's great and the company happy due to its ongoing enrichment. The highpoint is the 24-hour life-guard! The sign on her chair reads: "You can yell for Yellen, for I've got your back!" Why would you be standing outside looking in?

Bubbles, recessions, and big debt-loads.

You've explained the confusion as well as the various "systems" in place, nowadays. While the investment scene is far different from its environment that existed 20 or more years ago, don't you need a catalyst to end the festivities and send everyone to a safer harbor? Don't you think an environment this rewarding requires some risks to be actually realized before the party-goers will come to their senses? And, if you are questioning the market's stability, is it a bubble? There are more than a few who have said so, and some for quite some time.

If it is a bubble, it's not like any we've seen in the past! It's very hard to say, one way or another, with any certainty, if there's a bubble. After all, it was purposely created by the huge liquidity the Fed's 3-QEs supplied. If over-valuations encompass the total-remaining issues that make-up the S&P index, how can it be a bubble? It's not affecting one industry sector or even a broad genre. It's everywhere! And, you're right about a catalyst! Something pretty big and (more importantly) lasting, serious and far-reaching would have to occur to have a significant effect on this Fed-sponsored party. That implies any "pop" will be due to two possible factors: 1] the sudden and inopportune withdrawal of that excess liquidity, and/or 2] a financial or economic crisis that

[1] Discounting the future refers to the tendency for a companies outlook, either good or bad, to be factored into the price of its stock.

occurs from an unforeseen accident.

This somewhat rules out a recession as the catalyst, since recessions are not an "out-of-the-blue" occurrence. By definition, they are gradual and difficult to perceive, at first. However, the huge balloon could develop a leak and slowly deflate. If that happened, a recession would be the likely cause. The good news is: if you are on a constant recession-watch, you will probably spot it coming before others do. The bad news is: in today's political environment and highly indebted setting, it will be difficult to find the remedy to arrest and reverse the downturn. Hence, we strongly believe that any "popping of the market's balloon" will be an accident or an unforeseeable event. Even today's growing hostilities and political unrest don't have any lasting effect on the stock market. One thing is for sure, the costs and size of these conflicts are growing daily. Hence, the number and diversity of today's risks are becoming more prevalent every day. Remember, some risks have always been there; they've just been mostly ignored.

The Fed to the rescue??

Regardless of what risk triggers a critical and lasting difficulty, wouldn't our monetary and fiscal policymakers come to the rescue? Couldn't they get us back on track? In other words, can't we rely on them to right the ship, calm the waters, and reset our voyage at safe "GDP pace?

That's the key question! And, we are going to spend some time and ink on it.

Perhaps they won't! Things are a lot different now than they were in 2008-09. Our answer is a very "iffy" maybe! Why, you ask? Interest rates are already at their lowest point. Every developed nation except Japan is in an austerity mode. Thus, our current fiscal policy is very restrictive, and unlikely to change, until the 2016 elections are over. The US faces a hopelessly divided Congress. Any stimulative programs would be impossible to pass with the upcoming election a couple of months away. Finally, the "too big to fail" financial giants are much larger than their 2008 size. Today, we face much greater financial leverage, and thus much higher levels of risk. Finally, the bull market has created more massive and wider-reaching levels of wealth.

But, to answer your question, we need to focus on the combination of three factors! And all three must be present for a crisis to be relieved and the financial markets to be calmed.

1. Confidence in our financial markets and institutions

   If this confidence is missing, the other two factors don't matter much! Why? Because financial markets will be abandoned. Few will want to wait around to see if the Policymakers will succeed or fail. We think it will be every investor for himself. Margin calls will echo throughout Wall Street. Remember, every liability is someone else's asset.

2. A quick solution

   If a crisis arises, the Fed and the White House would need to resolve the calamity within the very limited time available. This is no small task. Consider what they would need to accomplish.

   First, they would have to estimate the total size of the damage, including all the "collateral damage" likely and possible. Second, they have to figure how to contain all the current damage from contaminating any other global assets. Third, they have to calm the public, even if they are lying and concealing known, but yet-to-be-discovered, losses. Fourth, they must determine when and how they will contain the damage within the timeframe available. Fifth, if possible, they must construct an additional safety-net amount for good measure. Sixth, they must figure out where all this fresh funding is coming from and whether they have the authority, in hand, to implement it now. Does anything have to go through Congress? Can they get instant passage?

3. Faith in the authorities and their plan

   Finally, the markets must believe the plan of action proposed by the Authorities is workable and give them enough time to prevent a selling wave that initiates so many margin calls that investors decide to walk away from it all.

Derivatives: the lottery ticket for bears!

Wow! Am I hopeful there are never any difficulties? I guess you are correct. I saw the movie, "Too Big to Fail," and Bernanke went through meeting after meeting trying to understand what needed to be done. And when some banks refused to pitch-in to help by either taking some "walking-wounded" brethren or making a bailout "contribution", he had the director of the FDIC beside him who explained that it may withdraw its insurance for all their depositors, if they didn't follow the Fed's suggestions. Are there any other critical elements to this "risk-off" scenario, if an accident develops?

Readers should completely understand that we were describing an accident or risk that is unforeseeable due to its lack of transparency. As we noted earlier, that would rule out a

recession. However, in a deep or ongoing recession, it would not preclude an unanticipated and sizable mishap (like Lehman's) where the transparency is lacking or the collateral is suspect. Citibank recently lost $400 million on a phony loan to an oil funding finance company with fraudulent collateralized papers on what were real assets. To answer your question, we are extremely concerned about the unregulated derivative securities out there. For those who seek more details, we've covered this area extensively in our last two editions, but we'll summarize those risks here.

Derivatives are side-bets between two opposing entities wagering on the result of real economic or financial outcomes. While the issue may relate to the possibility of a default involving $1 billion of Brazilian bonds maturing a year from now, there could be 100 bets on this result, and thus its ultimate fate will produce an impact that's 100 times greater than the original outcome. The bets are stipulated in a security agreement, and neither side has to own the bonds, for it is the outcome they are gambling on. This practice almost always involves banks or Wall Street investment houses. While adherents point out it's a hedging operation, critics argue it is gambling and should be prevented because neither side owns the object "being hedged." Opponents also maintain that Wall Street and the big banks are not using their money. They are using depositors' money, and in 2008, they needed taxpayers' money to survive.

Two examples.

Example 1

Investor A believes gold will go to $1,300 an oz., while Investor B thinks it will not reach that level by January 2015. A buys the Jan $1,300 future (representing 100 ounces), and B sells it to him at an agreed to price. If A is right, then B owes him 100 oz. of gold; if B is right, he keeps A's money. B did not have to own gold to make the bet. A did not have to have $130,000 to pay for the gold he would receive. These two facts are important to understand: neither side has to have anything close to its payoff or the value of the bet. The latter is known as the *notional value*.

Example 2

Now, the bet is on a packet of 10,000 sub-prime mortgages that each one will not suffer a default. If so, the loss of interest and principle on each one will result in an impairment of the bond and that annual loss times each-year remaining is paid to the winner. Because of the multi-year outcomes on each of the mortgages, annual payoffs and additional (pre-agreed-to) up-front payments are due to B, or else the bet is over. Hence, B demands not only an amount for the bet, but also an annual fee to compensate for his risks. The math is much more complicated, but if this were 2007, A would collect a huge return, approximating about 50-60 times his original bet.

John Paulson did just that with the billions his hedge fund had. By March of 2009, those mortgages had lost (on average) 40% of the original value. Paulson reportedly only put up 1%-2% of their value. He only needed three things to accomplish these "lottery-ticket" winnings:

- ✦ the intelligence to understand that these AAA-rated mortgages would default, big time;
- ✦ someone willing to take his bet (AIG), and
- ✦ the money to place the bet.

While you will argue that B (AIG) needed the money to cover the bet, you would be wrong. AIG made these bets to all comers, and all day-long. Why? Because it relied on the AAA rating that S&P assigned to those NINJNA (no income, no job, no assets) homeowners. Their back up was that home prices always go up. Actually, their real back up became the US Treasury when the Fed decided their counter-party, Goldman Sachs (who had to pay Paulson), might fail unless they were paid 100% on the dollar for AIG's losing bet. Another factor was the "would-be" failure of a huge insurance firm that didn't perform on its contract. It would set a precedent! There were thousands of side-bets on these type of mortgages.

Derivatives are dangerous to our nation's health.

So, what are the dangers?

There are plenty of them, and if something really goes wrong in our financial arena, there are hundreds, if not thousands, of bets that are big lottery tickets, just waiting for something really negative to happen. And there are many takers, because they believe 1] It won't happen… again; 2] The Fed's got their back; and 3] It's "free money," they won't lose this time. Estimates put the size of the notional (or theoretical) value of all these bets at $1.5 Quadrillion (that's a one with 15 zeros behind it)! Again, this represents the current underlying total value of each bet.

About 80% of these bets are in the unregulated market where the trust of each party to uphold his side of the bet is all that stands between payment and default. The big banks and the major Investment firms are playing with money that isn't theirs. Recently, JP Morgan lost over $6 billion on just one bet. It was a "whale" of a bet. Warren Buffett said of derivatives that in his view they are "financial weapons of mass destruction" and that he sees them as "time bombs, both for the parties that deal in them and the economic system." Our greatest concern is their negative impact, if a really big or unlikely negative event surprises us. More than a few smart people have already placed bets that probably carry 40:1, 50:1 and even 75:1 payoffs. They want to be the next Paulson! Such bets include a US default on its Treasuries and the collapse of the Euro.

I view derivatives as time bombs, both for the parties that deal in them and the economic system.

-Warren Buffet , Berkshire Hathaway Annual Report 2002

How did this happen?

Yikes! You are not kidding, are you? Whose smart idea was it to let our banks and investment firms do such a dangerous and unregulated thing with our money? I know that the banks' money is our money, and I suspect that Goldman's bets aren't their money!

You are right on both of points; it's not their money. Goldman is borrowing that money from the banks. In succession, the blame starts with the bankers' lobbyists, who in 1998 were paid by the banks to repeal the 1930s Glass-Steagall Act. Congress thought they would benefit from larger contributions for their next elections if they helped these poor fellows get a little richer off of our money. The former Chairman of Citigroup, Robert Rubin, who was then our Treasury Secretary, asked Bill Clinton to sign it into law. In the end, all politicians benefit whenever someone else's money helps others. Although more than 1-out-of-100 Congressmen did not understand these unregulated derivatives, the bets began to grow like mushrooms.

By 2004, Congress became worried! What had they done? They needed to cover their @*>! They called for some expert to give testimony! He would calm the rough waters! The guru appeared, and without any qualifications, he said, "These financial instruments do not need to be regulated! The free-market will be able to supervise and police their activities." Oh, yes! His name? …Alan Greenspan. All was well! Congress had transferred their risk. Alan had their back.

In the 2008 crisis, Ben Bernanke, who had inherited that job, remarked, "Sometimes you just can't put the Genie back into the bottle." Just to make sure that we include all the co-conspirators, after the Dodd-Frank bill was passed by Congress and signed (2010) as a reform to the derivative-ills that made the Great Recession so costly, numerous attempts have been introduced to repeal the "Volcker-Rule", as well as most of the other regulatory parts of the legislation. The date for enactment has been changed more than five times. And the part about having a back-up clearing house for the registration of all new derivatives… well, no one is interested in that safeguard. It would cost way too much money to insure the taxpayers never have their funds used again to bail out those who bet when they couldn't cover their wager. The bankers and brokers want things to remain just like they are.

What has this country come to? Are those regulators and legislators mad? How can they subject our financial system to that type of risk?

Hey, you are expecting too much. I told you less than 1 out-of 100 understand these things; 99 out-of 100 understand the lobbyists. I think we will give you a short rest and let you cool-off. I have a feeling the next segment isn't going to help you with the new risks we are facing.

PART TWO

"To think that two and two are four
And neither five nor three
The heart of man has long been sore
And long 'tis like to be."

-A.E. Housman, 1859-1936, Last Poems, XXXV.

"The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought!"

- Rudiger Dornbusch, 1942-2002, Economist, developed The Overshooting Model.

We have selected two rather diverse and disparate quotations to create two themes that we shall bring together by joining the first's simple but ironclad logic with one that makes little logical or analytical sense but is nevertheless as true in practice as the first one. Older readers, who may have been "forced" to withstand poetry classes, are likely to have encountered this admired and skilled bard from England. Considered one of the most learned men of his day, Housman's A Shropshire Lad with its 63 poems, became his most famous work and one with whom scholar and common-man alike could identify. While the King's English seems a bit alien to us, the poem's message is that, as with so many other things in life, regardless of how often or how much mankind would like the facts to conclude otherwise, two plus two equals four. Today, we know this as: "It is… what it is!"

Our second passage was delivered on the PBS show, Frontline. When we examine the German-born but American-bred economist's thoughts, it is clear what he said is true, but not why it is so! That is in marked contrast to the first quote we pose. Yet, when one considers all the various twists and turns that life hands us, as opposed to those we voluntarily choose, we find we must deal with incongruent situations more often than we realize. That is the point of this month's dual themes. While much of our world and environment seem, at least on the surface, to be logically tied down to simple and unquestioned outcomes, in fact many of them don't meet or comply with our timing, hopes and final expectations. But, as they say… "C'est la vie."

Part Two's Focus

Dealing with risks, uncertainty and an overvalued stock market

Our challenge is to reconcile the "headwinds" that we observe on the horizon with today's financial markets and screen the risk-reward relationships under the microscope of a risk-averse philosophy. Thus, the facts or the "It is, what it is" factor must be reconciled with the "crisis timeframe" that Dr. Dornbusch evokes. We believe four principles will be combined to provide a value-adding strategy. They are flexibility, diversification, realistic valuations and appealing earnings prospects. Since our assessment of an over-valued market is essential to our defensive posture, it has the primary focus. With this introduction, let's continue with the Q&A format from the first part of the Fall edition.

Let's explore the defensive measures before and after the selloff. Explain them just as if you were providing a memo to your clientele.

Risks-on - Risks-off.

We believe the recent selloff is the product from years of the "risk-on" investing environment that abruptly became the "risk-off" trade… and, for good reason. Risks that have been "out there for years" are now being recognized. Investors need to know that the 50% increase in the S&P 500 index within the last two years, though originally an upward correction from previous undervaluation, has put the recent high (just above 2000) at rather lofty levels from a valuation perspective. We provide three elements to justify our assessment:

- ✦A declining rate of GDP growth in our global trading partners, although less so here in the US;
- ✦Elevated P/E multiples relative to the current number and nature of risks prevailing; and
- ✦The lack of monetary and fiscal stimulus available, if an economic downturn was to occur.

Thus, it's our opinion that any material negative and/or lasting forces, be they economic or financial market related, **may** produce a more than 'a minor correction' and **could** develop into an ongoing downtrend. However, we are not forecasting such an occurrence. Instead, we are stating the risky nature of today's equity markets. As we noted earlier, we believe that the "risk-on" milieu that has provided years of rising stock prices has created complacency amongst investors. Experience demonstrates that larger "slides" occur when they are least expected.

…the "risk-on" milieu that has provided years of rising stock prices has created complacency amongst investors.

Risk-averse & our advantages.

The last few weeks proved that the previous ambiance has been suddenly and rudely interrupted by an unremitting wave of selling. A "reflex" rally has provided "a bounce." So, what's happening? Why? What does all this mean? …and what, if anything, should investors do about it? We want to explore these key questions with our readers. But, before we do, let's review our investment philosophy and its risk-averse origin. Why? Because this is the "glass" that we see everything through. As you know, our founding philosophy is a very risk-averse one. This means our primary objective is the preservation of capital. Once that protection is in place, then we work to enhance it. Our process is different than most "shops" in our business, which tend to focus solely on a company's outlook, sector-selections, or growth versus value research. It's important for you to understand what we do and why we do it.

Our two advantages.

We believe our methodology provides two advantages that few other money managers possess. Our focus starts with the belief that most large and ongoing risks are tied to big macro-economic or financial-market risks. We are constantly (re-)searching for those threats. We make these studies the core and critical factor in our investment inputs. This gives us two big advantages over the bulk of the other "shops."

- ✦ We utilize macro-economics and a top-down assessment of critical factors to determine the allocation of our portfolio in to equity and defensive (or non-correlative) parts. In truth, all earnings, dividends and P/E multiples must be determined within the economic forces as well as the financial-market's dynamics that will shape the future.

- ✦ We want to get in front of (and stay ahead) of the crowd. So we are primarily focused on the longer-term (6-12 months) outlook. Our assessments of these factors (and their dynamics) are the most critical considerations in determining our strategies and portfolio adjustments.

While we have two advantages, we completely share in the one disadvantage that everyone in our business has: no one knows what the longer-term consequences are for all the debt the world has created and/or the ultimate aftermath of the quantitative easings. As the globe's Reserve Currency, the US and its Dollar's fortune or fate will impact and determine much of the developed world's GDP and prosperity. Our current debt-load is large and growing every day and we have guaranteed, by legislation, sizable retirement and medical liabilities but haven't provided the funding sources to pay for them. We do not hear much about this particular risk in today's news or analyst reports. As they say, it doesn't matter… until it does!

The "buy & hold" strategy.

Wall Street's rejoinder to a top-down risk assessment philosophy is something along the lines of, "While there may be problems, even considerable ones, invest for the long-term, for it is always bright and rewarding." This view removes the need to even consider any substantive risks under two assumptions - there are no material risks out there, and even if there are, the Fed and the policymakers will remedy them before any "real" damage occurs. Notice, however, the remedy-providers are the same regulators whose primary purpose is to prevent these "accidents" in the first place. Why does it make sense to assume all will always be fine? If they could truly control outcomes, why did the '08 crisis even occur? Returning to our first query: What's happening? We think that is best explained by first telling you where we are.

Where are we? What's happening?

So, where are we? One should always keep in mind two separate but somewhat interdependent entities: the economy and the stock market. For several years, the stock market has been in the "risk-on" mode, as the Fed decided to push the "wealth-enhancement" button. QE-1, 2 and 3 produced an outpouring of new 'liquidity.' These funds were augmented by its pledge to keep interest rates at its "zero floor" rate, as well as enforce the (now) Yellen Put, if an accident were to occur. Let's see what their one-two punch accomplished. By September, the S&P 500 index surpassed 2000, a level 3-times it's March '09 low, twice its 2010 low, and 50% higher than its 2012 level. While we will grant that some of this is a comeback from previous undervaluation, our GDP has been stuck in the same "New Normal" (sub-par) rate of growth that we had when we exited the recession in 2010. We understand why the market is where it is. (See our cartoon.) It just doesn't belong at that level if our economic growth can't return to a consistent and sustained 3.5 percent or greater. Hence the most recent data out of China and the EC all point to a much slower economic growth with greater credit-worthiness-risks. Also negatively affecting the "risks-on" investors are the 20+ percent decline in oil prices and the rising US Dollar, as money flows here whenever risks heighten in the rest of the globe.

So, what does all this mean?

These four factors, and a few more, have changed the full-scale "risk-on" mentality to one that is adjusting to the two new threats as well as some older ones that have reemerged. We are more than a little concerned about these risks for four reasons, though only one was necessary. First, a European political dispute related to budget-deficits, QE, as well as restructuring their banking and labor laws; Second, our stock market's elevated-level and its "risk-on" status provide an above-average "correction" threat; all it needs is a catalyst or two; Third, potential catalysts-concerns include: recessionary-GDP tendencies in major developed nations, deflationary developments due to an oil-glut and China's credit and or GDP headwinds; and fourth, a rising US Dollar with declining Treasury yields.

What are we doing about it?

Here were the "tactics" of the "risk-on" strategy we were utilizing up until recently. We pursued these diverse strategies to provide a defensive yet value-adding portfolio:

- ✦ consumer staples with reasonable P/Es and above-average dividends;
- ✦ defensive holdings to provide yields and stability to our portfolios;
- ✦ financials such as business development companies with relatively high yields;
- ✦ technology stocks - near double-digit growers;
- ✦ energy and industrial holdings providing sizable dividends and potential for capital appreciation;
- ✦ healthcare firms with strong R&D characteristics as well as long-lived patent-protection; and
- ✦ consumer discretionary niche specialized-retailers.

That was then - this is now!

John Maynard Keynes said, "When the facts change, I change my mind! …what would you do, sir?" We've provided enough concerns for the "headwinds" we see coming closer and closer to realization. Here are today's strategies and what their implementation is designed to accomplish. We will continue to utilize the techniques outlined above. The first three each have defensive features while the remaining four have positive and assertive qualities. We will also continue to use asset allocation based on our assessment of the risks and related macro-economic "headwinds" and our confidence indicators to determine entire exposure to the "market". To these we introduce five additional tactics:

- ✦. increased defensive holdings;
- ✦ removal of all energy and industrials;
- ✦ Real Estate Investment Trusts (REITs); and

- ✦ ETFs that mimic longer-maturing US Treasury Bonds. While their yield is positive, the primary reason behind their addition is their ability to appreciate rapidly in a crisis or recessionary environment. This is both an offensive and a defensive security.
- ✦ Lastly, we added gold related holdings. While "gold" (like other precious metals) is often seen as an unpredictable and 'why bother' holding, history demonstrates that it can and often does appreciate at a 1.5 inverse ratio to a declining S&P index. In other words, if the market declines 10%, gold may (not will, but may) increase as much as 15%. This would provide a 27.7% difference. We have initially set a 10% maximum allocation for this strategy.

Wrapping up our tactical discussion

Think about this: if we had told you in 2010 that our economy was not going to reach "escape velocity" as of 2014, Russia would be threatening the Ukraine, oil would drop 20 percent in two and a half months, there would be wars in the Middle East, Europe would not have solved its banking under-capitalization, its budget deficits or its unemployment in the PIIGS countries, and the US would have a deadlocked, do-nothing Congress… and then we asked you, "Where will the S&P 500 index be?", we doubt you would say, or even believe, that it had doubled.

Here is where we are at this point and time:

✦the majority of economists agree that our debt-load is unsupportable, in the long-run: the optimists believe we will adjust it in time to avert a crisis; the realists see either the political impossibility of that outcome, and/or the lack of time to do so.

✦Today's stock market lives for one day only, and doesn't worry about tomorrow's potential problems until then. It's a day-trading festival.

✦Thus, the long-term investor must fend for himself. But, one thing is for sure: a "buy-and-hold" strategy will be extremely dangerous to your wealth if practiced on faith alone.

✦ Data shows that very many conservative and older investors sold their entire portfolio near the '08-'09 bottom and either failed to reinvest in equities or bought back-in well after the rally was established.

Given the bevy of risks facing us, we very well may be at a tipping point, where an overvalued market faces a correction. Emotions are reactive, and pre-positioned creeds are not money management tools! In addition, we see the "buy and hold" 'state' as more of a "buy and hope" prayer. So ask yourself… do I want to have my money managed in a risk-averse manner or just sitting there? Have we made our point? Any questions?

Excess reserves and our big debt-load.

Earlier, you mentioned our heavy debt-load and the effects of all the Fed's QEs have placed the same disadvantage on all money managers. Let's explore those two factors a little further.

As a result of all the Fed's easings, the reserves of their member banks exceed $4 trillion as shown on the Fed's balance sheet. This created 'mountain' of dollars has not produced higher inflation because it hasn't been spent on goods and services. However, it could be, if those banks used it for generating loans to their customers. It's estimated that the equivalent of another $6 trillion in other currencies was created elsewhere around our globe. This inflationary threat is muted because the world suffers from excess supply of money and not enough demand. Thus, until the world's GDP improves, this is just a surplus of funds, some of which finds its way into the security markets. The purchase and sale of stocks and bonds do not affect one's GDP.

It's estimated that between $175 and $200 trillion of US debt exists! This includes all public and private liabilities. On top of this, there are more than $100 trillion of (corporate, federal, state and local government) liabilities facing our future. We speak of retirement, health, defense, bureaucracy obligations etc. These salaries and promised benefits aren't much different than debt-related liabilities. How will all these unfunded obligations be dealt with? That's the big question.

The Republicans want to eliminate many of these costs and lower taxes. On the surface, this "solution" appeals to many who believe that "matters have gotten out of hand." However, one needs to understand the economic impact of the lost jobs, eliminated safety nets and promised, but unpaid, retirement and healthcare benefits on our GDP. In some cases, these are contractual commitments. When these payments aren't made to those who rely on them, not only are the goods and services of these designates lost, but also those who would have benefitted from their purchases. This "multiplier effect" is important in reinforcing our GDP growth. Since, these dependents spend virtually all of the funds they receive, the "multiplier effect" has its maximum impact. Their support-infrastructures, homes for the aged, food and healthcare, as well as the jobs of those who care for them, are all parts of our economy that require funding to

exist. We're concerned about the negative impact of austerity. Europe's "austerity experiment" has proven to be a failure from its economic stabilization objective, as many economists stated it would be. We have made our economic point; this is infrastructures, homes for the aged, food and healthcare, as well as the jobs of those who care for them, are all parts of our economy that require funding to exist. We're concerned about the negative impact of austerity. Europe's "austerity experiment" has proven to be a failure from its economic stabilization objective, as many economists stated it would be. We have made our economic point; this is not a political statement. Let's look at the other side of the coin. Democrats, for political reasons, are gathering votes of the growing numbers of what has been termed "inequality of wealth" participants. As their totals increase, so will their voting-power at the polls. They, as well as those affected by their loss of funding (relatives, children, charities), will also join the revolt against austerity. It will become a battle of the haves and have-nots.

Let's look at the US corporate tax structure. Our nation has the highest corporate tax-rate of any major nation. Yes, through many years of "litigated loopholes" some firms pay less than their "fair share." Recently, many large companies have sought to be acquired through "inversions" and replace their US tax base with ones that have much lower tax rates. Part of this effort is to raise earnings in a stalled economy where the top-line growth is lacking. But another part is their inability to compete effectively with their foreign competition. After all, taxes are a cost of doing business. Leave it to the lawyers to find a way around the "inversion" litigation. This issue was addressed on a Bloomberg TV interview, and a very learned and forthright expert said,

> "It's unlikely Congress will address this matter adequately for two reasons: first, that body hasn't the power to resolve the non-competitiveness dynamic of this predicament; and second, the tax-rate can't be reduced enough to solve the foreign-competitor's advantages. So, unfortunately, and over time, most of our manufacturing facilities will be closed and moved overseas, or just permanently closed! This will result in the loss of highly skilled US jobs and greater pressures on our nation's revenues. We will suffer the same fate that Europe and Great Britain experienced when the US became the number one economic power after WWI and WWII."

He is correct. That's how economics works. We have the highest SG&A-overhead of any nation.[2] We are the most productive nation, but only when the costs of labor and government-waste are excluded. The transformation to overseas started in the late '70s when steel and mining firms couldn't compete. We have already become a services-driven nation. When one includes all healthcare and government employees, approximately 82percent of our GDP is derived from services, not goods. Manufacturing represents about 9percent. The process is almost complete. We, by necessity, will be importing our goods and few, if any nations, export their services. The new exception to this rule is the natural gas industry, as a result of fracking technology. Our exports are soaring to overseas markets. It's become a breath of fresh air… if we can get away with that pun.

Here's where this economic quagmire creates high risks - the US is using new debt as a substitute for its lost GDP, and tax revenues to pay for "post-9-11" infrastructures: the huge and ongoing costs of Homeland Security, wars, and NSA spying activities. The Republican and Democratic administrations have decided, they cannot do without them, and they cannot raise taxes to pay for them. Thus, they will borrow the funds until the day when they can no longer do so. They have no solution, other than to hope that when the 'game is up', another administration is in power." Unless someone out there can awake the electorate, we will probably persist in using debt to fill the shortfall in tax revenues. Our deficit is tied to our "New Normal" economic conditions. The US wants to "have its cake and eat it too." If Congress, by some magic, were willing to completely revise our system, it would have to rescind all the "special interests" perks. Unfortunately, Congress has put its reelections and influence ahead of what they have sworn to uphold! While you may think we have made a political speech, instead we are entirely focused on the economic damage we face down the road. As a smart economist once said, "If something cannot go on forever, it will stop." [3]

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[2] SG&A stands for the Income Statement item "Selling, General and Administrative Expenses"

[3] This is known as "Stein's Law" as stated by Herbert Stein, the Chairman of the Council of Economic Advisors under the Nixon Administration.

Europe, China and oil prices.

Let's finish with a quick summary of Europe, China's slowdown and the big drop in oil prices.

Every issue has featured Europe as our most critical concern for two reasons: Its importance to our global economy and the seriousness and complexity of their many problems. That assessment remains true today. Europe is slowly losing its GDP momentum. Germany is the only truly strong nation in the EU, confidence. France is resisting austerity and restructuring and its recent weakness is leaning towards the threat of a recession; it just reported its sixth straight month of lower business mandates, and as many economists point out, the "austerity-solution" is not a remedy. The EU's fiscal union is a mess. That's why Draghi keeps saying, "Whatever it takes." He has yet to find the correct 'whatever'!

This morning, the ECB's "stress tests" were released. Bad bank loans were $1.1 trillion (in US dollar equivalent). The failures were 25 out of 130 banks. The test did not test for deflation, because Europe will not (ever?) suffer from deflation. Banks need to raise $37 billion to adequately capitalize the weak banks. There was no mention of how many banks just squeaked by with a passing grade.

Some experts put China's current GDP in the four to five percent area. China's official numbers can't be verified or trusted. One thing is certain: it's having a sharp reversal in its trade surplus and very difficult repercussions to its secondary credit obligations. Their home prices have been falling for more than six months.

As far as our stock market goes, the apparent price war over a barrel of oil is of importance. The Mid-East nations of OPEC have vowed to maintain their daily output. They want to retain their market share; it's being threatened by all the newly discovered resources from the natural gas industry due to fracking. Excessive supplies are going global to find a home as storage facilities are filled to the brim. Some estimates put the daily over-production at more than 200,000 barrels a day. If this continues, it's projected that it will drive oil to $65-$75. However, this will make most of the newer players in the fracking industry unprofitable. But it will also materially impact Russia, Iran and ISISs ability to generate profits, which may be their true goal.

This is a very large concern for three reasons:

1. Oil firms comprise a large part of the S&P 500 with big labor forces of highly paid people, huge infrastructures and very profitable enterprises. Thus, chopping off $30-$40 from WTI's pre-discounted levy of $105 comes right off of their bottom line.[4] All costs will remain the same, and only the revenues suffer. Hence, it will dramatically hurt profits.
2. Who knows how long this price-war will last? It appears most investors see it as a temporary condition and have utilized the stocks' decline as a buying opportunity. We don't agree with that tactic.
3. We are taking the futures market as our barometer. This market was caught net long and needs to liquidate these speculative positions; otherwise they will be taking on a lot of unwanted deliveries from the shorts. By this we mean they cannot sell to another new long, as that just shifts the parties involved, not the market itself. Instead, they must sell to one who will cover their short and reduce the outstanding "open-interests." However, the shorts have the longs just where they want them: hurtin' and unable to accept delivery!

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[4]West Texas Intermediate is a grade of crude oil used as a benchmark in oil pricing. It is often referred to as Texas light sweet.

Commodity traders have only two rules: always follow the trend, and never help out those who are in trouble. So, many producers have few, if any reason to cover their shorts. In fact, they may be increasing their positions as the daily margin calls increase in size. We believe the oil fundamentals are too unpredictable.

We're finished. I can't remember a double edition that covered more extensive or complex subject matter than this one. It practically "wore me out" …I hope it didn't do the same to our readership, for there is a lot of meat in here about the risks and threats our economy and financial system faces. There is also not much in the way of safety nets to help us out.

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THE COMMENTARY

This publication is written by Charles A. Knott, Jr. with the support of the Sentinel staff. Mr. Knott has been writing his monthly investor updates for more than two decades and strives to provide readers with unbiased and utilitarian research and advice.

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Investor Newsletter

The Commentary

Over a 35 year span, Charles Knott has developed and improved on a unique, macro-economic based investment process that utilizes risk-reward relationships to determine its investment strategy. He recognized as an expert on the economy, investments and other financial matters. Mr. Knott has been writing his monthly investor updates for more than two decades and strives to provide readers with unbiased and utilitarian research and advice.

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