The Commentary

May 2014

MAY 2014

P 1
INTRODUCTION
Cost versus Value

P 1 - 2
MAY'S FOCUS
Making some defensive and conservative adjustments to your portfolios

P 2 - 7
Q&A
Fed Policies and the G-4

"Price is what you pay! Value is what you get!
- Warren Buffett, the Oracle of Omaha.

"Investment success is not a function of what you buy; it's determined by what you pay!"
- Howard Marks, partner Oaktree Capital.

"Most bull markets end with the emergence of speculative excesses. Some end with bubbles, and this one could be ending with both!"
- Douglas Kass, President, Seabreeze Partners.

As the first of our three opening quotations indicate, we have focused our sights on value received for payment provided! The next quote takes a "value" investor's assessment of the amount paid to be the core of a fruitful investment. Finally, Doug Kass, a successful "value-investor," provides his concerns and cautionary words about today's valuations in our equity markets. His recent interview goes on to highlight how far the stock market has increased during the past five years. He has three apprehensions:

- Corporate America's lack of top-line or revenue growth;
- the Fed's huge increase in liquidity from their three QEs (quantitative easings);
- and the ongoing rise in PEs (or price-earnings multiples) in a sub-par GDP environment.

While we don't want to debate the "bubble" controversy, we do share some of his uneasiness.

May's Focus

Making some defensive and conservative adjustments to our portfolios

This month we want to alert our readers that our top-down, macro-economic research has produced evidence of a growing number of distant "headwinds", some of which, we have been monitoring on our radar screens for quite a while. And although no single squall is enough to cause us to taper our sails, taken together they present a sufficient body of concerns. In today's world of "financial-contagion", a complication in one market can quickly impact others either through its transmitted impact or just through investors' fear of such an occurrence. If this ensues, it's possible for a growing "Northeaster" to form and perhaps disrupt even the largest and most buoyant aircraft carrier. Thus, as risk-averse sailors, we have decided to adjust our sails before any serious or ongoing squalls hit us.

We are fond of saying, "We haven't changed our destination; instead, we've tapered our sails and speed!" By employing a more protective and conservative strategy, we are adding extra layers of reinforced-measures that act as preemptive defenses to reduce portfolio volatility. We are also increasing our dividend yields and annual incomes.

This strategy is designed to lessen or mitigate the diverse headwinds we will cover in our Q & A presentation. While most of the threats fall within the scope of fundamental or economic-oriented risks, we also want to consider any technical signals emanating from the financial markets. These include valuations, sector selections, Treasury yields, chart patterns, as well as changes in the market's leaders and laggards. For example, the market's leadership has recently shifted from the high-momentum, high-P/E darlings to the low-P/E value issues that provide more generous dividend yields. This move indicates investors want to own more defensive and "value-oriented" holdings.

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

Our Greatest Concern

What is your greatest concern?

We want our readers to pay special attention to the systemic risks that we have featured as regular subject matter in our publication. The current economic and financial environments have settled into a "New Normal" while the Authorities are still employing the remedies that worked in the "Old Normal!" It's like trying to fit a round peg into a square hole. Today's woes reflect much more vexing and persistent storms, which are likely to continue producing rough waters. Until the Authorities understand that they must fashion a new antidote to deal with our afflictions, these risks will probably exist in one form or another. For example, most of the EU and ECB problems are systemic impediments as opposed to cyclical hurdles or temporary snags. Systemic problems call for reforming their structures, not shifts in fiscal stimulus or monetary policies!

Our "fundamental concerns"

Let's begin your assessment of the headwinds with the fundamental issues.

"Fundamental concerns" involve the world's top-down, macro-economic trends. All commerce determines a nation's GDP. An expanding GDP raises a country's output and its prosperity as long as inflation is reasonable relative to its level of GDP growth. The opposite is true when GDP declines. We will stick with these "basics" and will not explain the workings of central banks, government, etc. We want to focus on a nation's ability to grow their GDP and wealth. Here's our outline.

Four territories determine 65% of the world's GDP:

- the EC (including the UK),
- the US,
- China and
- Japan.

Thus, as this G-4 Consortium goes… so goes the global economy. To a certain degree, we are all in this together. China needs the US to buy its goods, and the US needs China to buy our planes and fund our trade and budget deficits. That's because they have a huge trade surplus from all the goods they sell, for the most part, to the developed economies. We're competitors in a few exports, and they buy medical devices and hi-tech equipment from us, but we are interdependent in most respects. While a material and lasting slowdown has a negative impact on the nations involved, it's detrimental for many others, too. This "Global Connection" functions in this manner throughout the world.

Today, the G-4's developed economies are stuck in a "New Normal" and this is evolving into two critical conclusions. First, the "traditional" stimulus and low interest-rate policies of the central banks are not doing enough to get the GDP growth rates back to their usual pre-recession pace. It's been almost six years since the Lehman collapse.

Second, there's a growing faction of eminent economists who believe there are unknown but potentially severe costs, along with some unintended consequences, due to the central banks' many QEs! While the economy's slow-pace is undesirable, at least it's palatable. The "severe cost" fears vary from runaway inflation to widespread deflation. Both of those environments are totally unacceptable, and each one is probably uncontrollable.

Our latest GDP report showed a tiny +0.1% gain (vs. the +1.3% consensus). The culprit was a 6.1% decline in Cap-Ex spending. It's a very serious condition when Corporate America, with its huge cash hoard, is unwilling to invest in their future growth. Having in place the latest manufacturing infrastructure leads to the best profit margins and competitive advantages! So, why are firms reluctant to upgrade? Surveys clearly indicate it's a hostile and uncertain business environment! The tiny +0.1% gain is proof-positive of Corporate America's self-fulfilling prophecy. Their cutbacks have certified their own outlook!

Isn't this the responsibility of the Fed? Are they at fault?

…only to a minor degree. While the Fed's forecasts have been reliably-wrong as to their theory that the US will reach "escape velocity" when GDP can sustain itself at 3½% or more, many say their view purposely incorporates very optimistic targets to encourage greater confidence and spending. Yet, the Fed is not at fault; they've done all they can to create more economic growth. As Keynes demonstrated, when monetary policies can't work, fiscal stimulus is the only remedy remaining. But today, this therapy is hampered by three factors:

- ✦ a split Congress where neither side will seek compromise;
- ✦ a budget deficit that hasn't "the room" for a massive stimulus-program; and,
- ✦ a lame-duck President who is unwilling to sign any legislation that doesn't fit with his viewpoint. His vetoes cannot be over-ridden by Congress.

Let's look at our GDP concerns.

Here are the major issues that we believe have impaired our GDP progress. Our annual deficits, while much smaller than the bailout years of 2008-09, are nevertheless constantly adding to our overall debt-load. Thus, the Fed has opted to try to force a reduction of this growing debt-burden through the age-old tactic of inflation. With three QE's, the falling Dollar allows the US to repay its creditors with Greenbacks that have lost some of their purchasing power! Furthermore, the Fed hopes to boost spending and capital investment, and therefore economic growth, by making it almost free to borrow money. Since we have the strongest economy (within the G-4), hopefully, our current creditors are still likely to "rollover" their maturing notes into the new issues replacing them. Lately, that's not the case. Last year, the Fed was forced to buy 70% of the Treasury's newly issued (but unsold) bonds. Not only are fewer and fewer foreign creditors willing to "re-up", but China has actually sold-off large chunks of their holdings. They preferred to put those funds into Euros, gold and Swiss

<u>Does the US's "stuck-in-neutral" status, our outstanding debt-load and a weak Dollar matter now?</u>

Are these concerns current headwinds or are they out on the horizon, so to speak?

For several reasons, there is no easy or certain answer to that question. We will frame a response, but no one can fix a timeframe.

As long as the faith in our Dollar as the world's Reserve Currency is sustained, and the creditor-confidence in our Treasury Notes remains strong, these headwinds will <u>always</u> be in the future. But, there's no doubt: we must maintain that faith in *both* factors. They are joined-at-the-hip. The loss of trust in either one will also collapse the reliance in the other.

The Dollar's status stands as the first and foremost issue. It must be credible in two manners: its ability to hold its purchasing power and its status to remain the World's reserve currency. This latter condition implies the commitment by the Federal Reserve to maintain the first prerequisite! The Fed must not print excessive amounts of Greenbacks; but no one knows how many they would have to print, before that confidence is lost. Once lost, the slide would gather momentum before the Authorities could step in and try to regain the trust that was once there.

The second "vote of confidence" is tied to our ability to repay our Treasury debt, upon maturity, with funds that have held and will *continue* to hold their purchasing power. This assurance and conviction can be lost in two manners - the failure of the Dollar to maintain its role as the World's Reserve currency (as we outlined above), or if our creditors perceive, correctly or not, that our debt load has become so lofty that we are likely to default. By default, we do NOT mean we would fail to provide payment. After all, we can always print the money! What we mean is that our creditors wouldn't want the newly-printed Greenbacks, due to their fear of its loss of purchasing power. China has already decided they have too many of our IOUs!

Faith is a fragile article! But it's a vital and necessary component of all large financial transactions. When it is lost, the unfaithful quietly begin to sell … to exit the party, so to speak. But, once the number of bonds being sold overwhelms demand and yields begin to soar, the secret is out, and it's every man for himself. About 10 years ago, that happened to Argentina's US-dollar-denominated bonds and default was certain within a week. Greece's Euro bonds are another example. When the selling snowballs into a flight of capital, the party is over. We do not see this happening, but the US does not have a credible deficit reduction plan. And, our debt-load is still rising! Just because it's climbing at a less rapid pace, doesn't mean we've solved the problem. We've only bought more time. This concludes our US analyses.

China, Japan, and the other concerns.

What are the specifics on the overseas' headwinds you have analyzed?

We'll start with our main tempest: **China**. It produces the world's second largest GDP. It is experiencing rapid deterioration on three fronts: GDP, currency and credit. China's economic slowdown is becoming more apparent and more protracted. The past few months have produced data points that have consistently missed, and even lowered, consensus estimates. Falling GDP obviously causes dislocations with their importing trading-partners. We expect further declines. Next, in order to boost its sales, China has manipulated its currency to gain more exports. The Yuan has declined to its 2009 level. By devaluing their Yuan, they effectively "export deflation" to their competing nations. Finally, its credit woes have become more extensive. China has seen their first defaults of publically issued corporate debts. At least two SME's (small & medium enterprises) have defaulted. Credit defaults signal two unfavorable conditions: excessive financial leverage and/or a poor economic environment. The good news is we do NOT expect any debt-defaults by any SOE (State-owned enterprise), since this would signal much greater distress than anyone believes is likely.

Japan has the fourth largest GDP. Simply said, Japan's economy, debt load and declining currency are a mess. It's been a mess since 1989, and Japan has been in a deflationary environment for almost the entire quarter-century. Every remedy they have tried has failed. About 16 months ago, Japan began an experiment with massive printing of the Yen. It's lost 30% of its value. Her trading partners don't want a currency that's lost that much value; her competitors don't want to contend with a nation whose export prices have fallen 30%. Initially, the Nikkei appreciated about 40%; but it's backtracked each of the past three months. Their bonds (called JGBs: Japanese Government Bonds) have only declined a little. That's because a whopping 91% are held inside Japan. Those investors are experiencing negative-returns (after-inflation) of almost 2% annually. Their government's debt-load is equal to more than 240% of their GDP. (Our ratio is around 100%.) They recently raised their sales tax by 3%. It's believed they have never rid themselves of the "zombie corporations" who provide lifetime-employment with generous retirement benefits. These firms are supported by (whom else?) "zombie banks." It's no secret: political corruption still exists. Throw in the Tsunami-nuclear plant debacle, the lack of natural resources, and the high price of land, and one has to ask? - "Where's the hope?"

While most economists think their fate is sealed, we think the key question is: "Will Japan's demise really bring about a global currency or debt-crisis?" We will only make that assessment when its eventual failure becomes more imminent.

One final point... China's and Japan's problems are causing her Asian trading partners to experience higher interest rates, more volatile currency fluctuations and flights-of-capital. This was, and still is, to be expected.

The EC: We have constantly written about the European Community's problems. So we will just summarize them here. In a nutshell, the EC has put the monetary-union 'cart' before the (required) fiscal-union 'horse!' The PIIGS as they've become known, (Portugal, Italy, Greece and Spain) – we've removed Ireland; it's much improved - still have four big, systemic and costly problems:

- ✦ an overburdening debt-load;
- ✦ many DOA and severely ailing banks;
- ✦ union shops whose rules, wages and benefits make it impossible for their country to compete in the real world;

✦ and finally, unemployment that approaches 25% in some countries. This joblessness is the effect of the other three causes.

To solve these structural problems, you need the politicians from more than 20 countries to agree on one solution that will be implemented throughout all the nations. These entities have many different cultures, laws, electorates and tax systems. It's little wonder the powers-that-be have opted for the familiar "kick the can" non-solution. And, the banking reforms/measures, originally planned for 2014, have been "kicked-down-the-road" until 2016, when, it's rumored, they will engage a much larger shoe to give the politicians more than a two-year reprieve.

To really see what is happening in the EC and the ECB, one needs to separate mighty-Germany's data from the woefully-sick sister nations. Deflation is threatening more than a few of them, and Mario Draghi, head of the ECB, is considering the same miracle-cure the Fed has found so effective… Quantitative Easing! Instead of using Germany's funds to recapitalize the Italian, Spanish and Portuguese banks, they opted to try to grow their way out of their struggling economies. In the last year, the Euro has increased 10% against the Dollar. Why? Because the US Federal Reserve is orchestrating a higher-inflation and lower-dollar policy. Its "stated purpose" is to boost inflation up to a 2-2½% level. According to the Cleveland Fed, our latest year-over-year number shows a 2.1% rise in their CPI index. We continue to see a weaker Dollar. Meanwhile the EU's money supply continues to decline as their annual CPI has gained only ½%. Fewer Euros combined with little or no inflation is always a formula for a stronger currency. Yet, their strong Euro will keep taking a bite out of their GDP as exports decline.

While all of these G-3 headwinds are offshore from the US-of-A, readers must remember, we are trading in a world arena where the difficulties of one large nation can produce headwinds that are contagious and evolve into the woes of many!

Summing up the fundamentals and looking at the technicals.

Let me sum up the "fundamentals", and then I'll let you outline the technical market signals. Japan will probably default on their debt or let their creditors (their own people) experience runaway inflation. China's problems are worsening as their economy continues to slow. As their credit woes rise, they will push the Yuan lower to offset those pressures. The EC is hoping for a miracle GDP solution for the PIGS while it tries to deal with very low inflation, an over-valued Euro and an under-capitalized banking system. The key is to secure and employ an EC-wide fiscal union. But that goal faces many nearly-impossible hurdles. The US is the best performing of the G-4! While almost every one of its problems has a long-term nature, its political gridlock doesn't allow for any ready-to-apply cures. You emphasized huge uncertainties and questions due to the Fed's QEs. Have they created a bubble? Can they produce "escape velocity" that's sustainable? Will the US experience either a deflationary or inflationary mishap? Where's the Cap-Ex spending?

Let's examine the concerns you alluded to earlier about the various stock-market "factors" that form and fashion the prices and trends of the equity market.

Not the equity market… today's equity markets! This is not the stock market we'd like to be investing in. We could deal with the one from the "Old Normal" much more easily. However, this is the only one we have to work with.

We'll start with the positives! While the bullish side of the coin has seven supporting factors, these "props" have been around for many years and are "old hat", thus, they're "fully-discounted" in today's prices. We could argue that they are so ingrained that they may have created a bubble. They are:

✦near-zero interest rates;

✦a Fed with extremely easy monetary policies (not the same as the interest rate issue);

✦reasonable P/E-multiples;

✦a long-term uptrend with no overhead resistance;

✦the huge "sideline" reserves flowing from money-market and funds into stocks; a

✦a Corporate America whose profit-margins, balance-sheets, E.P.S. and cash-flows are setting all-time records; and

✦a superior-economic position with regards to Japan, China and the EC. This pulls funds to our shores and feeds two more perks: a stronger Dollar and stock market.

Now, here's the flip side of the coin. Here are our cautious (not negative) evaluations. First of all, we will claim the valuable "Contrary Opinion" prize. Since so many of the bulls' "props" are well-known, longstanding and "old hat," we will believe that are already "fully discounted." Next, valuations are too high! Last year, the S&P gained about 31% while the Earnings Per Share that

supported that rally produced profits that only increased 6% (from only a 4% gain in revenues). So the P/E-multiple valuations increased by 25%. How can a 4% revenue gain and a 6% E.P.S. gain support a 25% bump in P/E-multiples? It wasn't "discounting" 2014's or 2015's results. Momentum markets only react to the present, not the distant future.

Here are the technical market signals that support our more cautious and protective strategies. In the last month, the percentage of S&P 500 stocks that are still above their 50-day moving averages has fallen to 53% from 73%. That's such a low number that it indicates a pause. Whether it is one that refreshes is yet to be determined. The two strongest sectors in the last month have been energy, followed by utilities. Both sectors employ the defensive, low-P/E and high yielding stocks. The other side of the same coin is that high-P/E momentum plays have ceased to be today's leaders. Despite lower levels of joblessness and more increases in earnings estimates, the stock market can't hold on to gains on days when the surprises are bullish. In fact, the momentum players are beginning to sell into the rallies as their preferred near-term tactics. Five months ago, the 10-year's yield was 3%-plus; today, it's 2.58%... almost a 50 basis-point decline. Yet, the Fed is tapering!! What does this move indicate? It was nothing more certain than that the economy was slowing, as our +0.1% GDP report verified. We see this as a solid indicator, not an outlier! Finally, the volume has definitely shifted from the high-P/E to the defensive sectors thereby confirm the price direction shift as a validated change in trend.

Whether you are a bull or a bear, most pundits agree on three factors:

we are in a momentum-driven and liquidity-funded stock market due to the Fed's monetary policies;

this is not an "Old Normal" stock market; many don't agree on what to call it, but they all admit that it's one they've never seen before; and

if you had told a large group of "market experts" to look at all the key data of the past five years (revenue, earnings and dividends), and then ask them to estimate where stock prices would be, you would not get any answers that fit today's levels. So maybe these levels aren't realistic.

To summarize our assessment, we have seven major points on more cautious side of the ledger, which give a risk-averse investor reasons to play the defense.:

✦contrary opinion;

✦not only are the two best-performing sectors defensive, but the previous leaders have fallen to the middle of the pack;

✦only slightly more than half of all S&P issues are above their 50-day moving average;

✦last-year's 25% jump in valuations

✦the confirming volume numbers;

✦a lower-yielding 10-year; and

✦the absence of an "Old Normal" market

Our new strategy for a more cautious and defensive portfolio.

That's a pretty convincing assessment for me. So, please provide me the details of your defensive investment strategy.

We believe the best strategy is one that emphasizes five risk-averse as well as reward-enhancing themes that provide a portfolio for all seasons, so to speak. Here are our guidelines:

✦low P/E stocks that pay 3% (or more) annual dividends and increased their payouts on a yearly basis;

✦solid growth stocks with high-single or low-double digit compounded E.P.S. gains;

✦appealing special-situations that take advantage of strong top-line growth, such as monopolistic characteristics with rising profit-margins;

✦a sprinkling of promising long-term developmental hi-tech or healthcare firms whose technology shows leading-edge characteristics; and

✦inflation protected sectors, that are tied to traditional inflation hedges or have solid patent protection that permits pricing power.

The last theme is very important: if the Fed turns to printing money to avoid either deflationary pressures or large credit default risks; these are the issues that should have the strongest relative performance. In our energy selections, we have chosen firms with substantial reserves of natural resources. We have over-weighted this theme since they have three of our five characteristics. We are underweighted or are completely avoiding utility, telecom, banks and most big-ticket consumer discretionary stocks. Expect more volatile markets that are driven by the daily news. Our goal is to preserve your wealth, as well as its purchasing power.

These adjustments should produce the following portfolio characteristics: predictable earnings flow and dividend increases with defensive properties due to their non-cyclical nature and low-P/E valuations. These fortified holding are complemented by an array of solid growth stocks whose long-term records

are enhanced by their pricing-power, returns on equity and growing-market leadership. Finally, we seek a few leading-edge technology candidates for the longer-term. That's it!

Charles A Knott, Co-CIO
Author
May 5, 2014

© 2014 by Sentinel Capital Solutions. The information contained herein is intended for the use of our addressees. Although we believe the information and data in this report were obtained from sources considered reliable and accurate, we cannot guarantee their correctness or completeness. This *Commentary* is prepared and periodically published by Sentinel Capital Solutions. Our opinions are subject to change without notice. Neither this Commentary, nor any opinions expressed herein, should be construed as an offer to sell or a solicitation of an offer to acquire any securities or other investments mentioned herein. The cited date (May 5th) represents that last time any data was available and utilized in the preparation of this edition. The "S&P 500" is a trademark of the Standard & Poor Corporation; the "DOW" is a trademark of the Dow Jones Co.

Sentinel Capital Solutions, Inc. is an independently-owned Registered Investment Advisor. Securities offered through Capital Investment Group, Inc. Member FINRA & SIPC. 17 Glenwood Ave, Raleigh, NC 27603. (919) 831-2370.

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.

SENTINEL STAFF

Cort Meinelschmidt
CEO, Co-CIO

Chelsea Miller
COO

Charles A. Knott, Jr.
Co-CIO, Portfolio Manager
Author *The Commentary*

Jullie Caniford
Financial Advisor

Linsay Sharma
Office Administrator

To subscribe or to unsubscribe, contact 301.665.9038 or info@sentinelcapitalsolutions.com

Sentinel Capital Solutions
38 S Potomac Street
Suite 203
Hagerstown, MD 21740

38 S Potomac Street
Suite 203
Hagerstown, MD 21740

p 301.665.9038
f 301.665.9039

www.sentinelcapitalsolutions.com

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.

Sentinel would like to invite you to receive this monthly publication, dubbed "The Commentary" which brings investors information on our investment philosophy, processes, and current view of investment-related events. If you would like to receive "The Commentary", please opt-in by sending your email address to info@sentinelcapitalsolutions.com. If you would prefer to receive via mail, please notify via the address or phone number to the left. Back issues available upon request.

Sentinel Capital Solutions, Inc.
38 S Potomac Street
Suite 203
Hagerstown, MD 21740