The Commentary

November 2014

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P 1 - 2
INTRODUCTION
Three points

P 2
FOCUS
Risk Rewards from the investors' standpoint

P 2 - 9
Q&A
Our great concerns and the changes to our portfolio

"Are we facing the 2004 or the 2007 economic and stock market scenario? Do we have several more years of good times ahead or should we be battening-down the hatches? Today's markets seem much more like the latter than the former!"

Anatole Kaletsky, Co-founder, GaveKal Research.

"Most contend the sharp drop in oil prices translates into a tax cut for consumers. Yet the facts indicate an initial 0.25% boost to GDP from the consumers' additional spending but a loss of 0.5% from the reduction of output from the energy sector ...and that's a continuing annual loss, as long as oil prices remain depressed!"

Randall W. Forsyth, Barron's November 17, 2014.

"Today, one could argue that the pessimists weren't pessimistic enough. They couldn't have imagined how self-absorption and full-blown narcissism would become so inseparable from mainstream culture. ...we are becoming a society that wants it now ...regardless of the consequences."

Paul Roberts, The Impulse Society: America in the Age of Instant Gratification

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Our three opening quotations examine two of the critical questions investors should be considering today. What does the sharp and sudden drop in oil (and most commodity-prices) mean from an investor's standpoint? And, where are we from a risk perspective both to the economic outlook as well as the financial stability of the various global markets? Finally, we top it off with the type of longer-term risks that we risk-averse investment advisors worry about constantly …because their hazards are structural in nature and injurious in effect to the investment returns over an extended time-period. Thus, from the risk of loss of capital perspective, we are upfront about our bias! We tell one and all that,

we come to the table with our "risk-averse" DNA clearly implanted into our essence. And, we don't make apologies for this trait. We are extremely concerned due to the inability of Congressional and Administrative parties to provide for a reasonably healthy and rewarding investment environment. As time goes by, the gridlock gets worse and worse as the costs to the taxpayers grow, and the parties move further and further apart.

November's Focus

Becoming more worried and defensive as global issues evolve

This month we want to pinpoint the critical factors that we believe are important and, in some instances, essential to investors' input and consideration. We also continue to look at the difficulty of obtaining "escape velocity" as well as achieving a "virtuous circle" of GDP growth where in its strength produces ongoing demand, jobs, earnings, tax revenue, prosperity and sound economic growth that funds bond interest payments as well as stock dividend enhancement. Thus, our nation's standard of living constantly improves along with our budget deficit as it emerges as a surplus and reduces our debt load… sort of a "Wizard of Oz" ending. Or at least that's how more than a few pundits express it.

Because the last two double issues devoted most of our "print" to the various looming and serious economic and financial market issues that we believe are not being adequately addressed, we will skip over most of the analysis that lead up to our conclusions and concerns, and instead focus on the risk-rewards relationships from an investor's standpoint. So, let's get to it.

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 concerns.

What are your greatest concerns?

In their descending order of concern, our major apprehensions include:

- the Euro-Zone's inability to escape a serious recession;
- Japan's (ongoing) extremely dangerous Yen devaluation;
- Russia's willingness to overtake the entire Ukraine (and NATO's refusal to militarily fulfill its treaty obligations); our already stated "New Normal" GDP concerns;
- Congress' inability to do three essential duties to "right our wayward ship:"

1. to cut unnecessary spending and truly balance the budget before the Fed is forced to "print our way" out of the mess they have allowed to occur;
2. to stop their constant willingness to put their special-interests contributors' agenda ahead of our nation's best interests; and
3. to rid themselves of "budget-reforms" that never occur. By this we are referring to their useless bills that always put the "cures" to our spendthrift-ways 10-15 years into the future with little or no pain in the near and medium-term. When the time for pain is about to arrive, Congress agrees to a new bill that's like "Déjà vu" all over again! It re-relegates the austerity measures "back to the future!"

[1] Escape velocity refers to the need for an economy to grow at a sufficiently fast rate to escape a recession and return to a normal long run rate of economic growth. Virtuous circle describes a rate of real-GDP growth that can maintain itself without additional fiscal or monetary stimulus.

We want to spend a more detailed analysis on these political and philosophical-based issues, even though we've spent time on this issue in our past editions.

One of our greatest concerns… our inability to be fiscally responsible!
So, why are you so worried about what Congress and the policymakers do?

The above quote from the best-selling The Impulse Society says it all. Paul Roberts shows how the US has become a nation in pursuit of short-term fixes and self-gratification. Thirty years ago, "special interests" were seen as a sign of selfish exploits and counter to the best interests of our people. But today, our political and business leaders choose short-term fixes in lieu of (long-term) value-adding and sustainable social programs that will provide for our citizens' and investors' well-being. Here are a couple of examples.

The US is not producing enough highly-educated professionals to meet today's precise-skill sets required for our hi-tech competitive world. Hence, to fill all the high paying vacancies, we are forced to hire foreigners. And, many of them came here to be educated! The college entrants from our high-schools are being constantly "edged-out" by those who have much better math scores. Exxon has run ads indicating that the US ranks 26th in the world in that category, just behind Hungary. It's evidence of inadequate preparation from our educational system, yet ours carries the highest price-tag.

Here's another wasteful opportunity missed: we live in a nation where: promises made and never properly funded become promises broken; where today's public education system does not provide their "graduates" the skill sets for today's more demanding jobs that require higher learning. We rightly fear that the US will have to spend huge amounts of welfare dollars to pay for the failure of an education-system that we provided but knew, ahead of time, was not properly preparing our children to become responsible citizens. Instead of adding to our nation's GDP we will be either paying for their welfare or their incarceration. As many "inequality-of-wealth" books have revealed, the number of those who exist at or below the poverty level is growing daily, and there are almost no public programs that are providing a solution to these problems. Thus, we will be forced to pay for programs that "treat" but not "cure" the self-generated obstacles of an inadequate education and preparation for life. Philadelphia has been closing schools and using money that could have been spent to keep them open, for a new prison construction program. In many instances, the prisons under construction are being built in the same neighborhood where the schools are. The young kids tend to see them as their future homes. A large majority will not be able to adequately support themselves and their families. This is not a local problem; to differing degrees, it is an urban city problem that no one, in authority, cares to address adequately. But, it's going to cost a lot of money regardless of what the future policymakers decide. It reminds us of the 1970's Fram oil filter ad, "You can pay me now, or you can pay me later!"

Lots of future money down the drain… money that will be collected in taxes for education and later, prisons …or when the taxpayers have had enough …the Fed will have to print the money out of thin air. And, we all can see how useful and beneficial that practice has become. A world of low interest rates where income seekers are forced to either have inadequate funds to reasonably exist and/or must take risks that elder-seniors should not incur just because "too big to fail" and "too connected to jail" entities got taxpayers' bailouts. They also got a free "stay out of jail" card as part of their bonus plan. Yes, the long-term consequences are already in place as the "lather, rinse, and repeat" 'miseducation program' goes on and on. We'd like to see a stop to the unproductive and wasteful spending. That way the US can craft a plan to repay all the debt we've created over the past 20 years.

Finally, while no one knows (for sure) what, when or how bad (or good) the repercussions from all the Fed's QE's will be, if there are any major dislocations, it's hard to imagine any quick, safe or effective remedy that will magically hold together the hugely leveraged financial structure our banks enjoy without putting all the burden, again, back on the taxpayers. The 2008-09 mountains of bailout funds were created out of thin air. We want to make an important point that will eventually impact all long-term investors: stop wasting our tax dollars and start spending them on long-term beneficial projects that will produce better GDP growth with higher standards of living, a healthier environment and an end to deficit-spending so we stop mortgaging our children's future.

The Euro-Zone (E-Z).

Good luck! Shifting to your concerns, it seems to me that your first three concerns: a European recession, Japan's fate, and Putin's goal are less important than our Congressional and GDP factors. Why aren't our internal problems first and foremost?

Because of timing… we've selected the "mines" that admittedly are smaller than the ones you just cited, but they are much closer to our ship than those domestic ones that are further out to sea. Europe is the first minefield because it's the most likely candidate to develop a serious problem before any other …with the possible exception of Japan. (Japan is a wild card!) Any critical difficulty in Europe will be very hard to address. As we have noted often, the EU (European Union) is only a monetary union… not a fiscal union. And the EU's charter requires all members to pass any new rules, regulations or fiscal measures (read proposed solutions) before it can become law. Most observers believe that is virtually impossible. Another obstacle is the EU's key Policymakers; most of them were appointed, not elected, and the Germans have a very large proportion of the positions of authority. Hence, the electorates of the nations to be governed have no representation through the voting process. This means the offending nation will be given a decree that will be dictated to them. That won't work when structural obstacles are being addressed …such as uncompetitive labor laws and work rules, as well as protective tariffs and differing tax regulations.

Those issues must win the acceptance of those who are receiving the painful and costly changes. Italy, France and Spain are unlikely to embrace new work-rules and more competitive labor-laws. At the very least, this will call for lengthy and feisty negotiations with the unions before they can be implemented. Otherwise strikes and work-stoppages will occur. The big unions only answer to their membership, not the politicians. They will try to protect their jobs and wages. These tough issues have yet to be tackled and for good reasons! There are "special interests" that will lose their benefits and they will react. Think back to the riots in the streets of Athens when the IMF and the ECB were demanding austerity measures that would impact 70% of the Greeks. Greece faced default and had to accept the fate that the IMF's loans were conditioned on. France and Italy don't confront a default of their debt. This week, France was demanding that its austerity requirements be lifted, and they are going to exceed the maximum budget deficit allowed. They told the EU… "Take that stipulation… and shove it …"s'il vous plait".

You've made your point. It will be very difficult to make the laws for the needed solutions. Let's move on to the threats and risks you foresee.

Basically, there are two.

First, we see the likelihood of a Euro-Zone recession. Italy has just reentered its Triple-Dip recession in the last seven years. Europe recorded a barely positive +0.2% GDP for Q-3, after its Q-2 figure had been revised down. Deflation keeps creeping in on the EZ. Germany is being severely hurt by the sanctions since Russia is its third largest trading partner. Most of its trade is in essential commodities. However, not all trade between the two nations has stopped. Gas, that's needed to warm German homes and run their factories was an exception. The political leaders now see what many told them would happen: "Their sanctions would cut-off the E-Z's nose to spite its face!" But the West decided that sanctions would be their response.

But you ask, isn't Russia suffering also? Maybe, but it doesn't matter much. Why? …because the entire purpose was to make Putin stop his aggressive behavior. In our opinion, Putin doesn't care about anything other than the entire Ukraine… not sanctions, not the Russian economy or its people or its Ruble! He won't stop until he gets what he wants. So the West's sanctions are "helping" Germany's slide into an accelerating-slowdown; it just reported its second month of declining factory orders. Thus, Q-4's GDP is almost certain to be a negative number and Germany is the largest contributor to the E-Z's GDP. What can they do? Pride prevents a "let's back-down" response and more of the same becomes an even greater punishment for the E-Z. Finally, Japan's currency war, the Emerging Markets' sluggish economies and China's recent admission of stagnant growth is also hurting the EZ.

Our second risk is the resulting "bad loan" losses of the under-capitalized E-Z banks when the recession exposes them. Can their respective governments afford to take these hits? Or will "Super Mario" and the European Central Bank be asked to make this one of his "whatever it takes" miracles? It seems Mario may be running out of… whatever's!

Japan.

What about Japan and its constant printing of more and more Yen? I understand that South Korea's Hyundai, Samsung and others are screaming over their inability to match prices with Toyota, Honda and the Sony's of Japan. As you noted, when a nation devalues their currency in a meaningful way, and 44% is a huge amount, they export deflation to their trading competitors in spades! What's going on and what is anyone doing about it?

Almost nothing is being done about it, because other than complain or devalue your own currency, there is little one could do. Two wrongs don't make a right, and Japan has been locked into a "wipe-on… wipe-off" deflationary limbo since 1992. Its fundamentals are absolutely horrible. Their sovereign debt amounts to almost 250% of their GDP. Japan has the oldest demographics of any major nation. Their interest rates are the lowest of any major nation. The Q-3 GDP result was a negative 1.6% when expectations called for a 2.2% gain. This followed a horrible Q-2 report of -7.3%. We have reviewed some of Japan's dreary history in previous Commentaries. What their Prime Minister faces is this: the economy will not be able to revive any GDP growth rate that can support its debt load. Its population is too old, they save too much, and they cannot compete with either China or Korea for an export market. They have a nuclear utility system that's severely impaired and no natural resources to utilize or export. Thus, they will someday, probably pretty soon, face default and/or the inability to rollover their maturing debts. Japan has one of two choices:

devalue the Yen and print enough money to make the cost of repaying their debt essentially worthless; or

default on their bonds.

Since 95% of all Japan's debt is owned by the Japanese or their interest, such as the GPIF, their retirement system (think our Social Security), defaulting on their retirees is not a choice. Neither is paying their maturing bonds with scads of worthless Yen. So here is their plan. The BOJ (their Fed) has begun buying more than twice as many newly issued JGB's (Japanese Government Bonds) and their central bank will be left holding the bag many years from now. The $1.4 trillion (Dollar equivalent) GPIF (the Government Pension Investment Fund) once held almost 85% of their assets in JGBs. By decree, they have already reduced that number to 60% and must now lower it to 35%. Essentially, someone other than Japan's citizens and corporations will end up taking the hit. The central bank doesn't really buy things; instead they fund liquidity just as our Fed doesn't buy things, only securities… so the lack of purchasing power is of little concern. Japan is moving its wealth, or what's left of it, into Japanese equities or real estate. Many are also finding European and American stocks and bonds are the better choices, by far! That's just one reason why our Dollar has soared! We've become the globe's safe haven. That's the good news. The bad news is that much of the world realizes it needs a safe haven!

What are the eventual repercussions to this Japanese madness? I understand it's a forced madness! But, it's madness, nonetheless!

Last week, J.P. Morgan sponsored a conference call to assess Japan's fate. Their chief strategist, Jesper Koll, conducted the presentation. He offered the following opinions:

- "My November 2015 estimate of the Dollar-Yen exchange-rate is 145 Yen to the dollar. Today, it is 118. The chance of a 10% appreciation of the Yen is nil… the chance of a 20% decline is greater than 50%."
- Prime Minister Shinzo Abe's call for an election is a move to consolidate his party's power. His radical demands were causing political infighting. Thus, he needed to restore enough control to ensure his continuing "printing-press" strategy.
- Japan will try to boost "real wages" to the bulk of their workforce. This will require Japan's corporations' cooperation! Japan is very short of qualified young workers. When tough times hit in 1989, families decided to have far-fewer children. Hence, today's demographics indicate a loss of one million new entrants into the workforce during each of the next 5-7 years. Yet, there will be a constant number of retirees. Boosting wages for the remaining workers doesn't make up for the lack of recruits. So why pay them more? These companies rely heavily on exports to produce adequate profits. It's their life-blood! In a world of very competitive prices, boosting your largest operating cost, wages, is not good strategy. But, from the nation's economic difficulties, it is a needed thing! Why?
- For the last 15 years or so, Japan has been unable to counteract their economy's ongoing deflationary pressures. Their stock market has remained 60% below its 1989 peak. Real estate had fallen 40% or more. And, the cost of external goods, such as oil and metals had soared (in Yen terms) due to worldwide inflation. Japan needs to escape these forces to restore their economy to one that can, someday, be self-sufficient. Unfortunately, we don't see that happening. Twenty-five years of stagnation must end.
- Finally, the shutdown of their utility network and its nuclear power structure (following their accident), has been a costly, disruptive and devastating incident.
- Here is Abe's "solution." Japan must print their way out of its no-win predicament. Abe has convinced the electorate that this is their "last hope." He needs them to validate his 'strategy' at the polls.

What do you think will happen?

Before we provide our future economic outlook for this beleaguered nation, we'd like to summarize our bottom line. As we see it: since 1989, Japan's deflation from one sizable, lengthy recession after another has left it further and further "behind the eight ball." It has floated massive quantities of bonds in an effort to stimulate their economy out of this depression-like state, and cushion their people's need for survival under the rest of the globe's growing cost of living. Meanwhile, South Korea and China have been "eating their lunch and expensive sushi." Japan's competitive edge has been lost forever. Even they know it! Their monetary stimulus has failed leaving them with a huge debt load that their economic system cannot "grow out of" and thus this ongoing burden has become unsupportable in real terms of its costs and its pain. Today, Japanese interests hold 96% of its debt. As we noted, these holdings are being sold and replaced with equities and other assets that will command something of value (read purchasing power) underlying its ownership. After a huge "sales tax" increase, Japan faced another deflationary episode as Korea and China continued to take its market share. Japan's entire economy depends on EXPORTS! Today, Japan has little in the way of natural resources, widespread land masses or agricultural goods. The next recession means fewer profits, more layoffs, greater budget deficits and more pain. What should they do now to prevent this from happening? What can they do? Their debt load is everyone else's assets! Forget debt default: it hits Japan's people. Whoever holds those bonds will not be repaid with Yen having real purchasing power. When you think about it, there is no painless solution… so they are trying the "beggar my neighbor" 1930's policies as a last resort. No one knows how it will turn out, but few …very few if any, think it will turn out well. Here are our conclusions.

First and foremost: this is a very critical "experiment." While no one has any certainty as to its eventual outcome, logic, past experiences and the relationship of economic principles all lead to the same conclusion: one cannot obtain anything of value from his efforts to destroy value. In theory, there appears to be four possible outcomes:

- a devaluation of the Yuan or other Asian currencies;
- a rocketing US Dollar as a global flight to safety occurs;
- Japan's demise from a monetary-policy mistake that produces either hyper-inflation (think 1920's Germany) or default (think Argentina); or
- war or hostilities.

The first option is a retaliatory strike against the offender. The second option is the natural reaction to the Asian nations' efforts to regain parity. The third option is a "printer gone wild" mistake that sets off a contagion. The last is very unlikely in today's environment. If Japan continues its strategy, the most likely eventual-outcome is an Asian currency-war. The competing governments will cry, "Enough is enough!"

Let's move on to something positive that we can discuss rationally …gasoline prices.

Oil and gasoline prices: good news or bad?...or both!

I read that OPEC lowered its worldwide-demand (2015) estimate by 1 million barrels a day. Perhaps, that forecast was a scare tactic. Today, I saw regular at $2.87 a gallon. I didn't know whether I should have filled my tank, or waited a few minutes for the station across the street to lower its price to $2.86 a gallon. This is terrific for me and the economy. Don't you think so?

Seen from just your and the US consumers' perspective, you are correct. However, as we indicated in our opening quote … with economics, there is no free lunch. Your advantage comes at your counter-party's disadvantage. Oil speculators, who are "long-oil" in the futures markets, are very unhappy. They're suffering along with the members of OPEC, Russia and nations that border the North Sea. And there are a large amount of jobs, revenues, profits and stock valuations that depend on the viability of future energy prices. After all, the US firms control about 60% of the globe's "finding and servicing" operations for energy producers. Thus, a huge amount of US cap-ex budgets are tied to the alliance of the E&P operators and the entire infrastructure that they support. Let's look at the other side of the coin.

Essentially, all economic relationships have a reciprocal association. Think about it …six months ago, Brent traded at $117¼ a barrel but hit a low today of $71.12. That's almost a 40% drop. Those (unhedged) producers are receiving about $46 less for their oil. And, WTI traded at $105 only to fall to $67.75 or a $37.25 decline …and a 35.5% hit per barrel. Your 75¢ (per gal.) saving comes at the cost of some oil producers who are highly-

[2] Brent Crude is a major trading classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide. Brent Crude is extracted from the North Sea.

leveraged and saddled with high finding costs. Some have had to (temporarily) shut-down parts of their production and lay-off staff. Those workers are highly-skilled but are joining their brothers on the unemployment line. Others are operating at a loss but who knows how long that can continue? And, your wondrous gas-pump savings that you are so pleased with, is negatively affecting your retirement portfolio. Here are some frightening figures. Exxon produces 2.3 million barrels (of mostly Brent) oil a day. Their $46-a-barrel hit puts their revenue shortfall at $106 million per-day and $38.62 billion a year. Other than lower royalties (due to the price decline), all other costs remain the same. All of Exxon's lost-revenue hits the bottom-line profit figure. The same effect is true for the producers. And, those savings cannot recover as long as prices remain depressed. So, be careful what you wish for!

The 10-year price war ended in the late '90s with prices falling from $34.69 a barrel (in October 1990) to just under $10. A price war can be vicious! If every firm decides the "other guy" is going to "give-in" before I do… everyone will over-produce, and where will all the unneeded crude go? When you understand that the oil market's pricing-system is tied to the quote of the last few million-of-barrels sold, everyone suffers. So, constant excessive-supplies mean the likelihood of continuous price erosion. And a few more realities are noteworthy. Will the Exxon's of the world continue looking for new discoveries? And, what about their deep-water commitments? Will they explore their Artic Circle find with its extremely high drilling costs in sub-zero temperatures? Investors care more about the quote for their oil stocks than the gas price at the pump. There is little doubt that cap-ex for energy related firms will decline. That's a lot of dough that won't be spent, as all energy firms will adopt an austerity policy. And those confident energy producers who financed their firms with junk-bonds have already seen their bond value decline as yields have increased by more than 1% over the past two months. Remember, there is always another side of every economic coin.

Wow! I never realized how big an impact oil prices could have! I assume that you are now underweight or absent the energy stocks you liked in the spring of this year ...am I correct?

You are. While many energy pundits see the recent decline as buying opportunities… the last two years of stock market environment have 'conditioned' investors to that mindset! They buy the dips. Those new oil-stock investors may discover that there are "strangers in a strange land" and may have unknowingly ventured into a "value-trap." No one knows how long prices will stay down or exactly how big the hit to earnings will be. And all of a sudden, one of the largest risks to the economy is tied to one of the largest and most important sectors in our economy. These firms with their highly-paid workers face a lot of uncertainty. In fact, there is nothing but uncertainty! We believe the Saudi's recent cut in oil prices, along with OPEC's decision to maintain their members' quotas and market shares is the first round fired in the new price war. The "open-interests" figures indicate a large number of oil-deficient speculators were caught with too many "longs" and are still in that position. Meanwhile the oil producers trade is short, and they remain in that position. Thus, the future-players are feeling the pain as the margin-calls increase both in numbers and dollars. It appears November 29th's 6% drop was an air-pocket that "spelled" margin-liquidation. The price drop was fast and furious. The last thing they want is a seller who delivers oil to them …for at that moment, the longs must pay for their entire contractual (dollar) amount.

2004 or 2007… which is it?

So, let's finish this month's critique by examining the second quotation in your opening trio. I assume your always-cautious and risk-averse nature is leaning in the 2007 camp. By that, I assume you think we are closer to a material and lasting correction than one that is likely to be years from now. The 2004-scenario supposes a few more years of up-trending markets. So, what is your assessment?

First, there are very few pundits employed by money managers that trumpet the bearish side of the stock market, on a consistent basis. It is very difficult to "sell" a buy and hold strategy if your firm is calling for a decline in the market. On the other hand, those strategists who regularly make bullish calls are "preaching to the choir." They imply that investors who remain invested will have better performance than any other strategy one can devise. However, the "buy and hold" forever approach implies three unlikely conditions:

- ✦ You never need a large portion of the invested funds.
- ✦ You have the wherewithal to make additions to have a portfolio that can maintain your standard of living.
- ✦ Upon retirement, your portfolio outlives you.

History proves there are times (1929, 2000, and 2008) when defensive measures clearly saved capital versus the static, fully invested arrangement.

Sentinel believes a risk-averse philosophy is more protective of one's capital and the best manner to access risks lies in a top-down, macro-economic assessment of future risk-reward assessments. Hence, not only do we avoid predicting stock market gyrations, but we try to sidestep anything that involves or would be influenced by the unknown future. On the other hand, we are very comfortable with economic analysis and their eventual outcomes through risk-reward evaluations. In lieu of market predictions, our research efforts include evaluations of the risk-rewards relationships based on a top-down, macro-view.

Quick overview

Run us through a quick overview of your major forecasts/ positions

Detailed information about these items have been covered in previous Commentaries, so very briefly:

None of the major economic powers will be able to generate or sustain their pre-recessionary rates of GDP growth.

We continue to expect a 4%-5% GDP pace in China short of their 7.5% target. Last week, when China surprised the world with a material cut in their interest-rates, it was a tacit admission that economic growth not only is slowing, but it is doing so at an accelerating rate.

Europe is likely to succumb to a recession and they will have a difficult time escaping from it.

The Fed's QE stimulus has not met their GDP recovery pace to its pre-2008 3.5 %-plus tempo. And, while our unemployment numbers are much improved, they have done so due to 'technical' factors: a lower participation rate and the large number of part-time (as opposed to full-time) jobs. The key 'average work-week income' statistic has remained stuck in neutral. During the past three years or so, the average 'Joe' is not able to maintain his standard of living. While part of the reason is he's under-employed, most of it is tied his inability to obtain raises that exceed the real CPI.

We're stuck in the 'New Normal' along with its deflationary-pressures risks, but the US is the best looking horse in the glue factory.

The stock market vs. the fundamentals.

But, how do forecasts of the economy mesh with a stock market that has recently hit new all-time highs? Most investors are more than satisfied …so why does it matter why it is… where it is? And, so what if the economy isn't back to its "Old Normal?" … the bottom line is we are better off!

Before we comment on that important question, we want to frame our answer. Always remember we are not assessing the market. We are assessing the big top-down risks versus the probable rewards. The WSJ and other financial publications have been listing the increasing risks: geo-political, economic and financial markets. Stocks (the S&P) have been ignoring the threatening headwinds that are gathering. The plunge in oil prices has been disregarded by investors! And few can deny that global threats have been increasing both in numbers and severity. Today, we live in a global economic environment as well as a financial market setting. We believe the market is ignoring reality, similar to its 1999 spurt.

Few deny the two factors we just stated: (1) a higher stock market in spite of (2) the mounting risks parameters. It seems to us that the advance is totally disregarding the fundamentals! And global bond-yields are declining. That's a sure sign that economic weakness is more likely than strength. With this dichotomy between the bond market's downbeat forecast and the stock market's upscale action, we are receiving mixed messages. Assuming the bond market is realistically priced and the stock market is feasting on the huge liquidity the major central banks have created during the past five years, we will take the more prudent and risk-averse measures.

Fixed income is traditionally considered the less risky asset class. and stocks are usually more likely to decline than bonds. By further diversifying into non-traditional assets, we are becoming more defensive,lowering our risks, and improving our capital preservation measures. And, that's what we want to focus on.

The defensive tactics we have employed.

OK, I get it. What defensive measures have you employed?

As noted earlier, we've exited the energy sector. We've increased our fixed-income/floating rate fund and cash reserves. Utilities are higher weighted versus the S&P. Income flow is much higher than the S&P 500 index's yield. Staples and healthcare are about a market weighting. Technology and precious metals are over-weightings. Consumer discretionary and our very selective financials (BDCs) are underweights.

Charles A Knott, Co-CIO
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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

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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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