The Commentary

Annual Forecast and Outlook Edition 2014 - Part 1

PART 1 - OUTLOOK EDITION

P 1-2
INTRODUCTION
Defining Risk vs Volatility. Reiterating our methodology. It's your money...

P 2
THIS ISSUE'S FOCUS
Choosing the right money manager by choosing the right method. Review 2013.

P 2-5
Q & A
Philosophies, Strategies. and Disciplines - What works and why.

P 6
2013 REVIEW
How we fared.

"I continue to question whether to stay invested in this liquidity-driven bull market of risk assets or take profits and conserve my capital. I'm sure the monetary printing presses will not shut down any time soon and I'm well aware stock markets can overshoot and remain overvalued for a long time. And, while I don't want to 'Fight the Fed...' I worry that we seem to be on borrowed time with many serious and destabilizing complications. The EC's ailments are being utterly ignored. I'm afraid one may suddenly appear and precipitate a major economic crisis and selloff!"

-Mr. X, a long-time Bank Credit Analyst (BCA) client.

This quote is from BCA's 60 page annual review; we find their Q&A penetrating and risk-focused - absolutely superb! Your author has been a subscriber to the Bank Credit Analyst (now known as BCA) since 1967. Their revered, accurate and monetary driven publication has garnered so much respect, that according to a 1980s interview in Barron's, their greatest loss of clients was due to the subscriber's death.

Mr. X fulfills the same role as our questioner does in our monthly publication. He asks the type of questions that voice your concerns, and examines our analyses, conclusions, advice and strategies that emanate from our research efforts, as well as our time-tested disciplines. For those readers who may not be well-acquainted with Sentinel's investment processes, we are a top-down, macro-economic "shop" that focuses on the major factors that will determine the health, or lack thereof, of our GDP trends, employment, inflation, interest rates and corporate profits. We also evaluate this data for several other major nations. Our assessments lead to conclusions; these evolve into risks-reward evaluations with regards to probability of upside potential versus downside risks. We define risks as follows: the likelihood of a loss (expressed as a percentage) and the resulting percentage downside likely from that occurrence compared to the likelihood of gain (again, expressed as a percentage) and its resulting percentage upside reward.

Risk is not, and never will be, defined as volatility. Volatility is a minor and reoccurring variation within a stable and predictable trend. An example is the temperature changes that persist during certain seasons such as summer and winter. Those who were correctly warned of (and ignored) the risks from the 1929 stock market, did not experience "volatility" during the next 5-7 years. They suffered huge losses. They were finally made whole, (if their companies survived) in the early 1950s, if they lived that long and held on. If one never needs to worry about volatility, then if another volatile and extended decline in stock prices is somehow lurking in the future, those who follow their advisor's mantra, "Stay invested, it's only volatility!" (we believe) will regret that decision. Remember two

things: Hire a money manager, not a caretaker! If you will always have an ongoing exposure to the same asset classes, where is the management? More importantly: **It's your money and it will always be your money!** So, all the ultimate responsibility for its growth and preservation is *yours* and always will be!

Focus Part 1

Why we are different from the traditional providers and a discussion of the financial markets

In this installment, we discuss one of the most critical decisions that will affect your investment returns. It is the selection of an asset manager and the asset management style, process, or strategy used in managing your portfolio, and it will, in large part, determine the size of your future "nest egg.". Our examination details our risk-averse philosophy, strategies and disciplines alongside the one-size-fits-all methodology commonly employed by our competitors for the majority of their client base. There are great differences. Sentinel manages your money by anticipating large risks and dealing with their potential downside-forces before they are realized and reflected in the financial markets. Our competitors' process, however, is not designed to either anticipate large macro-economic risks or neutralize them before damage occurs. Will you select a risk-averse asset manager whose methodology will be greatly more protective than those most utilized investment processes in our industry?

After our annual reiteration of our philosophy, strategy and disciplines, this month's discussion will provide our summary of last year's economic performance. Since we have a lot to cover in this two-edition periodical, let's get right 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

The proper investment strategy.

So, we had a great 2013, and Sentinel heavily favored equities as the best asset class. Your selection of more specialized companies outperformed most of the big "blue chips" and provided steady investment performance. Your warning about rising interest rates was echoed two or three times before the Fed decided to taper. That was a value-adding but more importantly, also a timely call. Before we get into the details of your outlook, will you provide an outline of what your firm does and how they do it? I'm talking your basics: the investment philosophy, strategy and tactics.

Sure. Sentinel Capital Solutions is different than many investment advisors in three important ways:

First and foremost, we are a risk-averse money manager. Preservation of your capital is our most important mission. Second, in today's investment environment, many risks emerge from a macroeconomic and/or a geo-political cause. Since Sentinel spends more than 50% of its research efforts on the top-down big-picture elements, our focus is directly tied to where most of these problems are likely to develop. Recognizing them in advance is the key to avoiding their negative effects. In our efforts to neutralize (or in some instances, take advantage of) future macroeconomic risks, we devise specific strategies that are designed to add value to the portfolio. Some are defensive in nature (such as adding staples or health care holdings), while others are assertive (such as buying energy stocks when we expect inflation or rising oil prices).

Finally, our "style-box", as it is referred to in our industry, seeks out businesses that can consistently grow their earnings year after year, regardless of the economic headwinds that may be prevailing. These candidates usually have unique characteristics with patented products and technology as well as managerial advantages over their competition. Typically, these stocks usually provide strong dividend growth as

well as resistance to downward forces in difficult markets. In effect, they are well financed, the leaders and-or niche-players of their industries. Some see them as future "blue-chips" …depending on one's definition.

So, your investment philosophy seeks to protect your clients' capital, first and foremost. Then you look for the risks by staying focused on the large and economic generated headwinds. Lastly, you try to achieve better than average returns by selecting those unique performers that produce continual E.P.S. growth. How about the strategy and portfolio disciplines, sometimes referred to as tactics?

Let's start off with what not to do! It would be very difficult to formulate a "one-size-fits-all" stratagem since it would have to incorporate not only upside beta-oriented factors but also defensive, risk-averse features. Since these are on the opposite sides of the risk-reward relationship, one must either be willing and able to shift their focus when they believe it's appropriate and/or include parts of both strategies into their portfolio and then adjust their "sails" as the "winds change." The first approach is risky because it can produce poor results when one "zigs" when he should have "zagged" and vice-versa. Although it might produce the best of both possible worlds, it's an undisciplined and "hit or miss" tactic that's unreliable since it would have to be employed on a continuous basis. Thus, we have rejected that approach. On the other hand, a less volatile and considerably more conservative and disciplined strategy is to periodically take some "money off the table" whenever the stock market overshoots its value-parameters and to also buy the dips whenever below-average valuations occur. We like aspects of this philosophy but don't agree on pre-fixed levels of valuations (PE multiples, for instance). So we've adapted that tactic to devise a top-down-risk-from-macro-economic-factors "style."

We believe an investment strategy should not be a one-dimensional or "all-in" approach. Instead it should have both a risk-averse aspect as well as flexible beta facet. Most of our over-weightings are being applied to those sectors or industries that will be positively affected by:

- ✦ greater GDP growth,
- ✦ higher profits obtained from both pricing power and greater profit margin generation, and
- ✦ demonstrated managerial expertise.

Turning to our tactics, our risk-averse nature keeps us aware of valuations. This also comes in handy when today's "momentum-players" often propel prices to levels beyond reasonable valuations. We prefer to assess this risk-reward evaluation from a 24-36 month perspective, or based on their longer-term potential. When warranted, we will take some money 'off-the-table' whenever we believe it's prudent. We also look for those diamonds in the rough… those smaller and still being established opportunities that allow one to get in on the ground floor. Finally, we try to recognize our "mistakes" as early as we can. But then again, we want to give each prospect enough time to establish a "beachhead" (foundation). That way, they've had enough time to build a successful company. These are our strategies and portfolio disciplines.

How the other practioners do it.

Let's look at the investment process from the initial interview between the client and the money manager. What are the notable steps?

There are five points that most, if not all advisors try to establish. These are as follows:

Mr. Jones, I'm sure you want to be a long-term investor. And you will want to be fully diversified to protect yourself from the volatility (an incorrect substitution for the concept of risk) not only between asset classes (i.e. bonds, stocks and cash equivalents) but also globally. Next, according to your age and annual income, we have specific model portfolios (or if it's T-Rowe or Fidelity, etc., already established funds) that exactly fit the parameters that we speak of! Finally, every quarter we send you detailed portfolio-reports on all your accounts. At year-end, we write an annual review that charts your past year's progress as well as our outlook for the following year. Hence, you'll be able to monitor and understand exactly how we are fulfilling your (again) long-term investment goals. How does that sound?

Yikes! That sounds a lot like the first 30 to 45 minutes of an interview I had before I met you. It sounded so good… but, I couldn't help but notice that it avoided the "risk-threats" completely. Why do you think they do that? And, why does their pitch sound so inviting?

…because it's all about you and their assessment of your goals and how their process will fit your needs, perfectly! It's about you signing-up for an entire lifetime of their products. It's not about risk, or any missteps by the Fed, or a Euro credit crisis, or a collapse in Japan or dozens of other threats that can cause bear markets! Let's look at the record of risks that have occurred since 1997.

And in case you haven't noticed, in our recent history, we've faced:

✦ the "Asian Contagion,"
✦ the "Y-2K" Scare,
✦ the "Dot-Com Bubble,"
✦ "9-11,"
✦ the "Housing Bubble and Bust,"
✦ the Bear & Lehman Busts,
✦ the Fed's & Treasury's rescues of GM, Chrysler, AIG, Fannie and Freddie,
✦ and The Insolvencies of Wachovia, WaMu, Countrywide, and many other smaller lenders. Some that were too big to fail or merge got taxpayer handouts (through TARP) while others were merged into their not so voluntary brethren.

These are eight, yes eight, separate events that occurred within 12 years. Well-respected and highly visible professionals warned of these dangers! And, what about the two un-instigated "Flash Crashes" and the halt of Nasdaq trading? None of these un-prompted market events have ever been explained! And our top-regulator Alan Greenspan, who in the mid-'90's could plainly recognize "Irrational Exuberance" swore a few short-years later in Congressional testimony that there was neither a dot-com nor a housing-price bubble. Need we say more?

Our point is very simple: There are real and present dangers (risks) out there and any process that ignores them and advocates the 'long-term investor' defense …is doing their clientele a big disservice.

The one-size fits all approach.

Above you panned those "shops" that keep their clients in the major asset classes (cash equivalents, fixed income vehicles and equities) with little, if any, variation regardless of economic or financial market conditions. Don't most professionals endorse that practice?

They do. But it's very likely they've adopted that practice because any money-managers' system that is variable and requires changes has the risk of being wrong, in a business where you are being paid to be "right". The more prerequisites that can call for portfolio adjustments and the more variable the strategy in its attempt to achieve its investment goals, the more theoretical risks exist. **But**, and this is an important "but", these risks are necessary to those managers who are looking at their obligations to their clientele. The sought-after reward is the portfolios' enhanced-upside and/or less damaging-downside. So, depending on the existing process and disciplines, there's the win-win potential (client and firm) to lock in profits and avoid the bulk of damage in severe or ongoing bear markets. If their strategy and disciplines are effective, that will enhance profits to a far greater extent than any one-style-fits-all philosophy. Besides, by definition, any long-term "buy and hold" process cannot avoid the damage of bear markets!!

Unfortunately, there are enough theoretical reasons to argue to one's client-base that a one-stance-fits-all is justifiable

✦ less chance of change equals less chance of being wrong;
✦ less time, attention and research dollars spent on risk-assessments; and
✦ fewer and less complicated explanations in client presentations.

However, the buy-and-hold strategy tends to break down in the worst of times. But, that's exactly when you need a change… and, you need it ahead of time.

Since we are a "risk-averse shop", our use of our variable-modifications are designed to reduce risk and thus preserve capital regardless of the market's subsequent moves. Whether we are raising cash by taking profits and/or swapping an issue into a lower beta holding, both the portfolio's potential upside and its downside are reduced from our clients' pre-adjusted portfolios. Think about it! If the market rises, our measures will ensure smaller profits; and if the market falls, the losses are mitigated also. Remember, risk-reward measures never offer the choice of one without the other also being affected. They both live in the same relationship existence and each is governed by whatever change is made to enhance one of the two factors. Why … because there is no free lunch! You can't find a way to enhance reward without paying some costs or raising the risk level. The exact opposite is also true. To our way of thinking, risk-averse means we don't have to be sure that certain risks will be negatively influencing the equity market to employ it. The mere possibility motivates Sentinel to ponder if and what defensive tactics should be employed. To use a famous line from the 1970 movie, Love Story, "Love means never having to say you're sorry." Well, our intention is that *risk-averse* means that we won't have to say it either. In other words, we'd rather employ the defensive measures than to hope they won't be needed. We see a risk-averse methodology as a necessity!

Now that you have explained all that to me, I can see what you mean. But what about the client's nest egg? What will happen if there is another market-meltdown in say, 3, 5, or 8 years from now? …and the 58% S&P 500 loss in only 16 months, like we saw in '07–'09, isn't recovered in within the next 5 or so years? And, what if there is a risk that is so large, that the recovery of stock prices never approaches my original valuation? I'm not that young, you know!

Let me answer your questions with a question or two. Let's refer back to the original common interview example, and I'll play the role of the perspective client. Here's my reply to "How's that sound?"

Actually, it sounds to me that no one in your firm is giving any real consideration to the likelihood of an occurrence from the threats I read about. What if the massive bank reserves that the Fed oversees gets out of hand? How about a deflationary outcome from Japan's Yen-devaluation experiment? And, what's the solution to the EC's monetary union without a workable fiscal agreement? When will the more than 18 nations agree to a sensible plan?

We don't think any of those things will happen! But, if they do, the Authorities will be able to take care of everything.

I read where numerous experts disagree with you. These issues pose real risks. And, there are a lot more high-risk threats out there. How can you say that and ask me to agree to any buy and hold process …and any "long-term" investment plan is simply a buy and hold process. I might be nearly fully invested and vulnerable to any ongoing or serious bear market. For today's times and circumstances, it's about the worst process I've ever heard of!

I'm sure we would devise a strategy to deal with any one or all of those risks you cited.

A *strategy* has flexible options that adjust to the headwinds and tailwinds affecting the field of play. They are devised ***before*** the game begins! They are practiced weeks before the game is scheduled. My friend, you have a one-size-fits-all (styled) *process*! It is not an appropriate strategy to realize my risk-averse financial goals. Let me ask you, did you sell all or a very large portion of the hi-tech issues you held, before the top in early 2000? Or did the model tell you that your "diversification" should remain in place and your hi-tech darlings' growth rates would continue to compound at 20%-30% annually? How about the '08 financial sector meltdown? Did you exit most of those holdings before substantial valuation was loss? How well did buy-and-hold work for you then?

I wasn't here then. Besides all of '08 loss has been made up and everyone makes mistakes, now and then.

Yes, but the mistakes should not be built into the original design of the methodology! Some of the dot-com darlings went bust. And today's prices for Microsoft, Cisco, HP, Intel and many, many others never recovered to those firms' all-time highs. Let's reverse the roles a minute and pretend that you are a perspective new client. If you had a risk-averse philosophy and could have remembered the "gunslingers" from the late-'60s and early-'70s, you would have known how that movie ends… and the ending of LTV, Leasco Data, Quarterback & Gino's, Gulf & Western, Polaroid and the Manhattan Fund would have taught you to leave the theater as soon as possible, the endings were so devastating!

Here's a theoretical question for you... Let's say that there was another type of money manager, one whose primary investment philosophy is to research and avoid those big, macro-economic threats or huge over-valuations that were present between 1999 and 2008… Would you have wanted your asset manager to have materially reduced your risks by selling and reducing your exposure before things blew-up in 1999? How about selling in early 2008, after Bear Stearns failed? Would you have wanted them to sell and reduce your risk? And, remember you are answering from a perspective client's viewpoint!

Well, of course, but most advisors don't adopt that risk-averse philosophy.

Yes, I know that. I guess the real question is… when it's clearly in the client's best interest to lower risk parameters when danger is so obviously lurking… why wouldn't they?

Think about it, it's your nest egg and your responsibility.
Let's allow me and the readers to stop and review the point that we, Sentinel, believe you should be making your primary assessments as to how your asset managers should manage your money and what strategy (not process) should be utilized. What's next?

2013 Review

More than average headwinds, but we sailed through them successfully.

Let's look at how the major developed economies fared during 2013? Shall we?

That sounds good. The largest GDP producer, the US, managed to parallel 2012's 2%-2½% gain even though mandated fiscal measures such as tax hikes and cuts in spending emerged. Housing recovered nicely even though interest rates spiked in May and then held on to most of their rise, ending 2013 at their highs when the Fed surprised many with a year-end taper. It was Bernanke's Swan Song sung for Janet Yellen, the next Chair. Until very recently, Brent maintained a $110 floor with WTI holding a $100 base.* The primary support was the numerous nations with "political unrest." We cite Turkey, Iraq, Thailand, Syria and Libya. The EC (European Community) spent most of 2013 in a recession as nearly record unemployment and bank deleveraging hampered consumer demand as well as the flow of credit. China's hope for a 9%-9½% GDP gain soon melted to a 7%-7½% disappointment as exports fell and housing-prices spiked sparking inflated credit demand. This caused problems for the shadow-banking interests that feed that market. The Authorities intervened to provide several injections of liquidity and the needed credit relief. Nonetheless, their stock market fell along with investor and consumer confidence. The China Tiger beat around the bush for the remainder of the year. This summer, many EMs (Emerging Markets) fell into disrepair as bedlam ensued. Commodities prices fell as demand cratered. This combo caused flights of capital in Turkey, India, Brazil, Thailand and Singapore. This simultaneous cataclysm sent interest rates soaring and reinforced the weakness in currencies, commodities and equities. While matters have calmed down, capital remains securely parked in safe harbors in the US and Europe.

** Brent and Western Texas International (WTI) are two commonly referenced oil benchmarks.*

Now that we've covered the subject matter that the first installment traditionally addresses, let's move on to the second half of the annual issue. In Part 2, we will provide a discussion of the financial markets, with a specified focus on the stock market. I want to remind all readers that Sentinel does not forecast future market movements or changes in the prevailing trend. We instead focus on the macro-economic factors and the dominant risk-reward assessments and how these key influences will (or at least should) affect the market. While we may present stock market's outlooks of others, these are merely for discussion purposes.

The Commentary

Part 2

2014 Annual Forecast and Outlook Edition

"One of the biggest unknowns facing investors over the next five years is the behavior of key economic variables such as real economic growth, inflation and interest rates. There's been a four-fold increase in the Fed's balance sheet with a stealth increase (of $3.7 Trillion) in the supply of credit.

These are the "excess reserves" on deposit from US (Fed-member) banks and they can withdraw them anytime and use them as reserves against new loans. If so, today's 10% reserve rate would support $37 trillion of loans. If these new monies were expended into our $17 Trillion GDP-sized economy, inflation would quickly become our #1 problem.

Thus, the crucial question is: how will the Fed successfully unwind this huge juggernaut without serious or lasting damage? Last May, when Bernanke hinted at a tapering, the yield on the 10-year Treasury quickly rose about 1% ...in the face of a weak economy. At the time, pundits said the rise was due to a strengthening economy that would arrive soon, so the spike's good news. They all were wrong; GDP remained in its 2% rut. Someday the Fed will finish tapering and start reducing reserves! What then? We've become so used to our artificially-low rate environment! Remember, the 10-year sported a 5.29% yield in June '07 and a 1.39% in July '12!

When that reality hits, it's likely to pose problems."

-John Moffatt, founder and editor, Analytic Systems (ASC).

This "quote" is an edited multi-page reduction of several serious concerns voiced by another one of our favorite top-down researchers. ASC has been one of our must-reads since the mid-'90s. Moffatt's apprehensions are echoed by PIMCO's sleepless CIO (see Focus Part II). Rather than make ourselves the authors of our opening citations, we always prefer to find source material that supports the themes that we choose for our Commentaries.

PART II - OUTLOOK EDITION

P 7-8
INTRODUCTION
QE Concerns

P 8-9
THIS ISSUE'S FOCUS
2014 Forecast and Outlook

P 9-11
Q & A
Looking ahead - expectations and strategy

P 11-12
2014 OUTLOOK
Partly Cloudy with Occasional Turbulent Storms - caution advised.

P 13
THE FINANCIAL MARKETS
Quick overview

Mr. Moffatt's apprehensions run the same gamut of serious threats that we share! We call them, the "big-three" because they are the drivers of stock prices:

- ✦ economic (GDP) growth (it determines the ebb and flow of earnings),
- ✦ inflation and
- ✦ its attached-at-the-hip partner, interest-rate movements.

Lenders are always trying to protect their future purchasing power whenever they are purchasing bonds. However, John's current concerns surround the various risks and threats from the dangers that are tied to factors that the Authorities have created and we've never faced before. He sees, as we do also, the likelihood of bad and unknown outcomes from mistakes in their economic and interest-rate forecasts. Not only are they likely to zig when they should have zagged, but their proposed "remedy" is more likely to be a catalyst to a worsening scenario! It would be like the "hair off the dog that bit you", when one seeks a cure for a hangover. Then, there are the unintended consequences. As John points out, "It's $37 Trillion …and counting! We've never been here before!" We think our readers can understand our poker assessment of the situation: "We're 'All In' in a game we've never played before!" If something goes wrong, or even *appears* to be doing so, imagine the consternation that will follow when the audience thinks they smell smoke and head for the exits! And, it's not just stocks! Derivatives and futures are highly leveraged zero-sum game bets where big risks are portrayed by their computer-configured algorithms as "black swans" (or virtually impossible events). Thus, their "takers" assume it's perfectly okay to go "all-in" …virtually nothing can or will go wrong! Remember, in zero-sum games such as derivative trades, one side is always wrong!

But, don't get us wrong, we are not forecasting an outcome like this! Instead, it is our intention to point out *way* ahead of time, that

- ✦ huge amounts of capital are at stake, and
- ✦ we've never utilized QE's to create $3.7 Trillion …and,
- ✦ this can be quickly converted into as much as $37 Trillion

…so how would we know what the outcome will be? There are only two outcomes we must avoid: high or run-away inflation and any prolonged or deep-seated deflation. Unfortunately, these consequences come in many different forms and from many different sources. But, these are the risks we have to focus on and monitor closely …very closely!

Focus Part II

The 2014 Forecast and Outlook

While some of our readership has been with "us" for more than 20 years, we always like to review "the ground rules" and research processes that comprise our risk-averse investment methodology (covered in Part I). This way, everyone is acquainted (or refreshed) on how we add-value with our money management skills. Once that is achieved, we present our US economic forecast for the next 12-18 months. Today, we present this assessment in a compact, bottom-line format.

Ten years ago, things were much, much simpler. We could study the vital factors to determine which ones would be the drivers or determinants of the key economic trends (such as GDP, employment, and interest rates) as well as those that would materially influence investment decisions (such as earnings growth, inflation, valuations and again, interest rates). In past years, we've provided lots of supporting data as well as lengthy and reasoned arguments to support our predictions. The financial 2008-09 crisis brought on (thankfully) huge interruptive interferences and safety nets that still prevail today. These intrusions were a game-changer! No longer could we utilize the "natural ebb and flow of supply and demand forces" to determine our forecasts. Now, much of the financial arena is dominated by central-bank (The Fed's) policies. The Fed has assembled a $5 Trillion balance sheet from all their QE manipulations. As PIMCO's Bill Gross recently confessed in a Barron's interview,

> *It keeps me up at night, wondering how it will all play out when, someday, who knows when …that $5Trillion bet starts to unwind! Will we face large inflationary pressures? Some think it could be severe deflationary strains! Other say neither will occur… we'll escape unscathed! No one knows because no one* ***can*** *know! We've never been here before …so how can we adequately prepare for it?*

And, Bill's not the only insomniac; it's keeping some Fed governors wondering what to do! That's why the Fed has broken into dissonant factions. Untested market-changing practices and political insertions of mandates are affecting our banking system, especially those that dominate this "space." There also has to be benefits, hazards, and unintended consequences …but as Johnny Mathis sang, "Who knows where or when?"

Another fly in the ointment has been the constant political hassles. We still need the debt ceiling resolution as well as a full-year budget passed. These complications really make forecasting hazardous to one's (mental) health! We have a divided Congress with certain factions aligned to political agendas where any compromise is philosophically-opposed. This is true to "both sides of the aisle." We're hoping we will avoid the "Groundhog's-Day" (eternal) replay of the "kick-the-can-down-the-road" remedy, but that remains to be seen. The one that bothers the most is one that is not a "kick-the-can" candidate …it's ObamaCare. This law faces very big obstacles and uncertainties: the healthcare system for our citizens faces unknowable costs, funding, coverage and rules. No legislation could be crafted that would address all these key factors and satisfy every constituency: patient, payer, provider and political party! Huge buckets of money are tied to this monstrosity, as well as many peoples' well-being, not to mention future taxes and elections.

Ah, the good 'ole times… Back then, the US not only determined its own outcome, but pretty much also those of the other developed nations. Today's environment is certainly not without its risks …and, it's not just the domestic ones. Nowadays, it's a global economy! The international arena has one political difficulty after another. The EC (European Community) greatly impacts the rest of the world. Europe has yet to solve its banking, jobless and over-indebtedness problems. Many economists say a monetary union without a fiscal coalition can't survive. And Asia is a fierce competitor whose demand for commodities is unstoppable. "It's not your grandfather's economic-arena (Oldsmobile), anymore!" There are just way too many possibilities when you consider all the uncertainties. Thus, virtually all forecasts, regardless of how likely or data certified they appear to be, must, by definition, be influenced by the unpredictable hands of the Fed's and other intervening Authorities. Hence, well-reasoned, logical assessments don't count for much when the rules suddenly change without warning. However, we will still employ our "pro and con" debates, so that you will know both sides of the issues and where we stand. After all, our conclusions determine our risk-reward evaluations and these, in turn, form our strategies and stock selections. It's just that we *need* to reserve the right to revise our thinking and outlook whenever the rules change. There's one thing that won't change… **we are and will always be a risk-averse money manager.** Why? Because... "Opportunities come again and again. Your capital comes but once!"

With those backgrounds established, we'll provide our generalized risk-reward assessments for the US financial markets, with our primary focus on equities. As we've noted before, it's impossible to be focused on the economy alone if there are ongoing or severe difficulties with the financial markets… and vice-versa. Since we have a lot to cover in the second-half of our annual forecast edition, let's get right 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

The (US) domestic advantages.

What is your US forecast? Please focus on the beneficial effects on the predominance of your equity-holdings.

Sure. Before we provide those detailed forecasts, let's first look at the US's top-down advantages vis-à-vis our major competitors. Our markets are (and have been) enjoying four distinct benefits. These have cumulated into a strong and sustained glide-path that has produced the best returns relative to our rivals. These advantages are:

✦ the best GDP growth of any developed nation;
✦ stronger job-creation than any of our G-7 partners;
✦ the premier central bank that has kept our banks safer and better-capitalized than those of the EC, UK, and Japan. And,
✦ in many key sectors, Corporate America has the best products, technology and managements, bar none!

When you put that all that together, US markets have the best liquidity as well as the greatest transparency. Hence, they should be considered the safest place to invest your money! In addition, our corporations are the global leaders giving them the best upside potential and probably qualify as one of the better, if not the best, risk-to-reward relationships. Thus, we are in the catbird seat from the global investors' viewpoint and should attract foreign funds that will support a stronger US Dollar, higher PE ratios (valuations), and more-than-ample liquidity. This gives us our needed inflows of capital as well as greater advantages over our trading partners and their competing financial markets.

The US economic forecast and the investment outlook.

Got it. So, what is your economic forecast and investment outlook for the next 12-18 months? And, what are your major reasons to support your findings?

Since the end of the crisis in early 2009, we (the US and the developed economies) have faced a very slow and labored recovery. For the past four years (2010 through 2013), the IMF GDP forecasts have constantly been revised downward again and again, extending the upturn from a "full-recovery" to be obtained in 2011 to one that will be achieved in 2015. Today, the financial markets have settled in on the "Goldilocks" outlook: it's a "not too hot, not too cold, but just right" conditioned recovery. We have almost the "Perfect-Calm" (as opposed to 'storm') between much-better (than desired) GDP prospects (that would require a tighter Fed policy) and too weak environment that invites deflationary risks! Recent data indicates an improving job market that has prompted an initial "taper" move, months before earlier predictions. Housing has improved and whether it can continue to do so depends-on mortgage rates, buyer's ability to meet much stricter loan requirements and the pricing of new and existing homes. Inflation is tame. Last year's GDP will probably fall just under 2%, but investors will dismiss that figure as debt ceiling, sequestration and budget concerns all created a (hopefully) one-time impact on economic growth. Lastly, consumer spending, the driver of about 70% of our economy, has held up amazingly well when you consider the $4.00 gasoline and the poor gains for the average weekly wage, as well as the lack of hiring in full-time employment and the higher salaried professionals. Many of these positive factors came when they were unexpected. Our 2014 forecast projects a 2¾% to 3½% gain in GDP with a single figure of 3⅛%. However, this prediction is subject to the absence of an ECB or Euro crisis from the European Community (EC), as has been our policy for the last three years.

Turning to our investment outlook, we want to reiterate our assessment first aired in our October Commentary, which was composed in late September. In a strongly worded strategy, we advised to avoid any and all bonds and instead invest in equities for the foreseeable future. We stated that bonds would lose for two reasons: interest rates were likely to rise shortly and continue their upward yield trajectory for years to come. And that longer-term stocks were the only asset class that had significant and ongoing appreciation potential. Our November edition spent several pages detailing our reasoning and supporting risk-reward evaluations. In addition to suggesting to put more stocks in your Christmas stocking, we determined that equities were the best asset-class of the three to hold. The economic outlook is about as perfect as it could be, if one were to endorse a buy and hold stocks strategy.

**Previous editions are available upon request.*

The risks to our current "hold only equity" strategy.

I realize that you reserve the right to change your investment strategy, but what are the risks to your current investment blueprint?

As we see our risk-reward relationships, there are four main risks:

- ✦ an unexpected and severe shock to the US or a significant developed nation;
- ✦ a rapid increase in interest rates due to either a sharp rise in inflation or an acute credit squeeze due to a change in credit-worthiness assessments;
- ✦ unforeseen and grave deflationary pressures that affect the GDP and consumer demand in major nations; and
- ✦ a banking crisis that occurs "out-of-the-blue" that becomes uncontrollable or unrestrained.

As you can see each one of these events is tied to unexpected and unrestrained events that can have enormous impact. None are foreseeable or likely. We'll summarize our reply by saying that as long as there is no "crisis-created event," the economy should remain in its Goldilocks (all's well) scenario, and this should not inhibit or eliminate the ongoing bull market, with the exception of temporary or limited corrections to the downside to allow for normal profit-taking. The Fed has assured one and all that they intend to keep interest rates low into late 2014 or early 2015. They will also continue to conduct QE-3. These operations force liquidity into the economy and these funds either find their way into the securities markets (thus, boosting values) or into the consumers' pockets (thus, boosting spending). They act as a prop to valuations.

The bullish side of the current macro-viewpoint.

Now, what are the bullish factors that favor your current investment strategies?

In addition to the aforementioned, the bullish factors are improving GDP, growing job-creation, a strongly supportive Fed and the huge advantages Corporate America provides (products, technology, managements) combined with the best and most transparent and liquid financial markets.

✦ Then you can add the best and most respected currency in the world that should act as a magnet to draw in capital and lenders. The Yen has fallen about 30% during the past 16 months. The Euro is a fundamentally damaged currency without a fiscal union to support its debt instruments and is being propped up with ECB repos (repurchase-agreements). The UK is no longer in a recession, but their bailed-out banking system and poor trade balance doesn't attract any respect or resources. Our Greenbacks sport some of the best (lowest) inflation numbers on the planet, so it acts as a strong store of value. In addition, interest rates are rising on the longer maturities (5-years or more).

✦Next are the uptrends in all the major equity indices with some having established new all-time highs. In addition, momentum is positive, volatility is low and valuations are reasonable.

✦When compared to all the developed economies, we are the best looking horse in the glue-factory. Thus, we should continue to draw capital from Japan, Great Britain, and Europe!

✦Next on our list is the much stronger and sustained figures for Consumer Confidence. Again, we see multi-year highs and this category comprises more than 70% of our GDP.

✦Finally, you want to factor in the recent M&A activity, which is probably just gaining some momentum,. There are four solid reasons to expect more mergers and acquisitions. Since the top lines (revenues) are somewhat weak, and three years of "lean and mean" corporate supervision have wrung out almost anything that could boost Corporate America's profit margins, the only remaining avenue to better profitability is through the acquisition path to greater earnings growth. Consolidate and eliminate excess labor and merchandise while employing better production facilities is a never failing means to higher margins. And, have deals ever been cheaper to finance than with today's zero-interest rate funding available? Has regulatory acquiescence and acceptance even within identical industry and sector segments, ever been so un-resistant? We don't think so. Need we say more?

Nope, again I'm convinced! It seems that you've done your homework. All your fundamental and technical market data support the bullish side of the risk-reward relationship.

2014 OUTLOOK

PARTLY CLOUDY WITH OCCASIONAL TURBULENT STORMS - CAUTION ADVISED

If we can get through 2014 without a Congressional confrontation, a calm and 1½% positive GDP for the EC and no Mid-East political blow-ups or deflationary accidents in Japan, then we have high-hopes for the US stock market. As all our regular readers know, for 5-6 months, we've advised no investments in the fixed-income arena. Here are the details.

We believe that many of the '13 headwinds will be experiencing "self-exhaustion" or will have countervailing forces strong enough to neutralize their threats. Global GDP should approximate 2½%-3% as the US hopes to hit "escape velocity" and emerge in (or at least near to) the 3% neighborhood. Hopefully, our capital expenditures ("cap-ex") will pick-up and sustain itself to a double-digit percentage of GDP instead of the stuck-in-the-rut 6%-7% we've seen lately.

Another key factor, "wage-growth," has been totally absent in this recovery and is still jammed in neutral. This presents a dilemma for rising consumer spending. We think '14 will be the year it regains some footing. Since consumer-consumption is 70% of total GDP, this is the essential driver of economic growth and it would benefit from growing job-creation, a hike in the minimum wage and Corporate America's realization that to fill their needed higher-skillsets, they only have to raise the offers to find their vacancies met. We assume that there won't be further Congressional wrangling -- not because we have any crystal-ball guarantee -- but we can't have a cogent forecast in the midst of a hurricane.

Known headwinds are: rising interest-rates, un-expanding credit and loan growth as well as "reduced-tapering." This last issue amounts to less monetary ease; it does not spell a tighter Fed policy, just a less easy one!

On the fiscal side of the ledger, Congress should re-enact some expired tax breaks, fashion a budget deal where each side gets some of what they want. Finally, our nation is crying for meaningful infrastructure rebuilding as our roads, bridges and waterways are in dire need of repair and have been for quite a while. Congress should see this as the best job-creation device since gambling was established.

Our trade deficit should fall dramatically as (liquid and) natural gas replaces oil demanding uses. This greater independence of our energy needs should really help control our inflation also, since we are the largest global-user of hydro-carbons.

Thus, looking only at the domestic drivers, GDP growth has the real potential to hit break the 3% barrier for the first time since 2007. That forecast always includes the "no-foreseen crisis out of Europe and Japan" provisos.

Assuming that last hope is achieved, Europe should also hit a (much smaller) "escape-velocity" with Germany, firing on all rockets to pull all the southern peripheral nations along the way. We think a 1% to 1¼% real GDP would be a realistic goal. Their monetary union without a fiscal alliance is like a powerful engine but with no steering device to control the path to prosperity. Their banking woes include under-capitalized banks and the inability to, at least for now, impose uniform regulations across their borders. While their long-term repos delay the unenviable reforms necessary to cure an over-indebted southern tier, it's a kick-the-can tactic and not a solution. We could go on but then, we've focused on these problems as lingering and uncorrected risks for some time.

China's external demand will improve as both the UC and U.S. will experience higher GDP than they had in 2013. China's new policy reforms may act as fiscal drags, but if they are truly real reforms, that's good news. It's important to eliminate the numerous frauds that been uncovered there. China has a fairly large number of non-performing loans, however, the banks that aren't owned by the state are controlled by it, so one way or another these risks are not realistic threats. We expect a +5¾%-6¾% GDP gain for '14.

In summary, potential global-demand for goods and services is below potential capacity, thus some further deleveraging is likely. This should keep inflation below the central banks' targets. Theoretically, the U.S. faces three types of risks:

✦ high and rising inflation that carries the trailing interest-rates to levels that hurts demand and restricts economic growth;

✦ the opposite where an accident or Fed misstep incites a deflationary wave and everyone, the consumer, business and government hold-back to see what happens. This impairs hiring as well as a new round of layoffs and the Fed hasn't the room or the advanced notice to react quickly enough and stock prices get ahead of the actual events. While this is a scary scenario, it has the lowest likelihood. We'd guess between 8%-15%. Remember it's a theoretical risk. Thus, we've cited the too hot and too cold outcomes.

✦The last is a major and unforeseeable accident. These have low incidence of occurrence, but usually carry huge and immediate damage that roll onto one victim after another. Think Fannie, then Freddie, Lehman, AIG, etc.

So there you have it. Our job is to monitor all these possibilities and watch for danger. In almost all instances, we know what the best solutions are for inflation and deflation. The accidents depend on two factors, the damage and the timing and size of the response by the Authorities. Most of the "accidental-risks" are outside the US; they're in Japan and Europe as well as the hot-spots of political unrest.

The financial markets.

Let's move on to the financial markets. You were going to present a short, generalized investment outlook, with your focus on stocks.

Assuming the absence of a crisis environment, we foresee calm and less volatile stock market trend that remains in its present upward channel. It would be supported by higher GDP growth, reasonable-valuations and E.P.S. gains of 8% to 12%. In our opinion, stocks are still the preferred choice. Bonds offer only risks and cash offers no rewards whatsoever. Equities win, not only by default, but also by their attractiveness for the possibility of double-digit appreciation. M&A will also drive multiple-expansion. The sectors that we like include: energy, industrials, hi-tech, certain healthcare and a limited number of financials. The sectors we dislike are: telecom, utilities and most materials. We are neutral or market weighted on the two consumer categories: discretionary and staples.

With that, I think we'll call it an issue.

Charles A. Knott, Jr., Co-CIO
January 10, 2014

Copyright 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 (January 10th) 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.

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
Portfolio Manager

Chelsea Miller
COO

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

Jullie Caniford
Financial Advisor

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

Sentinel Capital Solutions
38 S Potomac Street
Suite 304
Hagerstown, MD 21740

p 301.665.9038
f 301.665.9039
www.sentinelcapitalsolutions.com

38 S Potomac Street
Suite 304
Hagerstown, MD 21740

p 301.665.9038
f 301.665.9039

www.sentinelcapitalsolutions.com

Investor Newsletter

The Commentary

This summer, the team at Sentinel was able to add a new team member, Charles A. Knott, Jr. 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 is sought and 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 304
Hagerstown, MD 21740