Sentinel CAPITAL SOLUTIONS

The Commentary

Summer 2014

Double Issue & Strategy Guide

SUMMER 2014

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Preface

This double-edition expresses the likelihood of a stagnate economic condition for the foreseeable future. The Fed will see our lack of GDP growth as a threat to our huge debt load and is likely to debase our dollar. Under this environment, certain asset classes and equity sectors are very unlikely to produce acceptable returns, even for longer-term investors. Likewise, equities reflecting firms enjoying intrinsic-growth traits can be paired with certain inflationary-protected sectors to provide a "blended strategy" that is designed to preserve your purchasing power. Our entire issue is focused on detailed explanations regarding our present economic conditions, their headwinds and the theoretical "fixes" available. Since our discussion is critical to your future financial health, we ask you to stay with us as we outline where we are and where we believe we are going. We have also plotted a risk-averse voyage calculated to adeptly sail with the tailwinds at our back and avoid any squalls or rough seas. Please retain this edition for your future review. It's important to remember that all our explanations of economic factors are designed to set the stage for our investment strategies and advice. Once we set the economic stage, so to speak, we want to explain how to take advantage of the tailwinds as well as avoid the headwinds, squalls and rough seas. In both Part One and Part Two, we will cover the economic content which has formed the action plan outlined in the Strategy Guide that follows. Thank You!

PART ONE

> **"Recent readings of the CPI index have been on the high side, but the data that we're seeing is 'noisy.' Broadly speaking, inflation is evolving in line with the committee's expectations. And… we do not see a bubble in the equity market!"**
>
> **- Janet Yellen, Chair, Federal Reserve Board.**

Living Expense Item	Jan 2000	Mar 2014	% Increase
Barrel Of Oil	$24.11	$100	314.80%
Fuel Oil (Per Gallon)	$1.19	$4.07	242.00%
Gallon of Gas	$1.27	$3.51	176.40%
One Dozen Eggs	$0.97	$2.00	106.20%
Annual Healthcare Spending (Per Capita)	$4,550	$9,300	104.40%
Ground Beef (Per lb.)	$1.90	$3.73	96.30%
Movie Ticket	$5.25	$10.25	95.20%
Average Private College Tuition	$22,000	$37,000	68.20%
Electricity (Per Kwh)	$0.08	$0.13	59.50%
New Car	$20,300	$31,500	55.20%
Coffee (Per lb.)	$3.40	$5.20	52.90%
Natural Gas (Per Thermal)	$0.71	$1.08	51.40%
Avg. Home Price (Case Shiller)	$161,000	$242,000	50.30%
Postage Stamp	$0.33	$0.49	48.50%
Avg. Monthly Rent (Case Shiller)	$635	$890	40.20%
"Official" CPI	$168.80	$234.78	39.09%
PCE Deflator (Fed's Preferred Measure)	$81.78	$107.66	31.65%
Source: David Stockman			

"The expectation that …stronger payroll gains would spur consumers' income and spending has proved little more than a dream. In June, although 288,000 new jobs were created, 523,000 full-time jobs were eliminated, leaving full-time employment a stunning 3.4 million below its pre-crisis level!"

Stephanie Pomboy, CEO & Founder, Marco Mavens.

Our first quotation and the subsequent table are "paired" as a voiced assurance that inflation is not a problem, versus the factual evidence to the contrary. In my 21 years of writing this publication, this is the first time we have utilized a table as our 'quotation' focal point. This list of rather depressing examples demonstrates just how much purchasing power our Greenback has lost during the last 14 years. Yet, our new Fed-Chair's exact words (from her most recent press conference) blame inflation's 'high-side' on 'noisy-data' …whatever that is! If one looks at the FRB's favorite measurement of inflation, their PCE Deflator, you can see why it's their preferred gauge! It reduces inflation's true impact!

The Fed has two prime responsibilities. Their first duty was assigned in 1913, when they were created. Their obligation is to protect and defend the purchasing power of our Dollar. The second came from the "Full Employment Act of 1946". That charge was to "produce and maintain full-employment". So, let's see how well they've done during the past 14 years.

A look at their "official" record indicates only a 2.26% per-annum "loss". Not bad… not bad at all, if it were true. Our list has mostly necessities: the goods or services that most people require to live their daily lives and take care of their family. The data was collected by Reagan's Budget Director, David Stockman. All of it can be easily verified. The "tale of the tape" tells a completely different story. What have we got here? …some food, a car (or two), gasoline, healthcare, a home, electricity and heating oil to warm it along with a college education for each of the family's 2.8 kids. Now, what do the numbers show? Wow! On average, oil rose 22.5% per-annum and gasoline more than 12.5% a year! Per capita healthcare rose 7.5% per year, and, rent, about 3% a year. So, how well did income do? The average Joe's wages (or salary) hasn't kept up with this relentless rise in the cost of necessities. This is especially true since the 2008 financial crisis. Thus, the living standard for most Americans (and, certainly all of those in the bottom 40% of the income distribution) has fallen. And, since income taxes are not adjusted for inflation, Uncle Sam's share of your income has taken a bigger bite out of your paychecks.

Since the FRB's Congressional Charter, today's Greenback has lost just about 95% of its 1913 value. Since a 1913 Dollar has shrunk to about a nickel, it now costs about 20-times that amount in today's purchasing power. While the Fed points out that average wages have increased almost that amount, about 16 times their 1913 levels, no one can make an apples-to-apple comparison since the job market back then had very few skills that remain today. Also FICA, income taxes and sales taxes didn't exist in many instances back then. Here is where the difference really stands out: the top 15% of income producers (including bonuses and the value of stock incentives) account for almost 35% of the total figure. We are not taking sides about a "fairness issue" with regards to inequality income-levels; we are just stating the data. More importantly, today only about 146.5 million people are "officially employed" out of a total population of 320 million people. That's about 46%. Many of those without jobs, especially, the elderly, disabled and retired, live on fixed incomes. They are severely hampered by the constant rise in prices, especially in a zero-interest-rate investment environment. In the second segment of this issue, we demonstrate that the Fed's three QE exercises, which printed more than $3.5 Trillion, have induced a liquidity push inflation force! Previously, there was only cost-push or demand-pull inflation. Today there is a third source of rising prices! Is there a question that inflation is ongoing? …Is there a question as to who is to blame?

Yes, there are extenuating circumstances: at least seven wars, "9-11" with all its homeland security costs, OPEC's oil embargo, and Nixon's 1971 devaluation when he removed the gold backing from our Dollar. On the other hand, we have borrowed, and borrowed, and borrowed some more! We owe more than $17 Trillion, just about one year's total GDP for the US. So, what questions do these depressing facts and statistics "beg?" Here are a few:

- Will we ever pay all of our liabilities?
- If so, what value (read purchasing-power) will those Dollars retain?
- Is Congress or the White House doing anything about these discouraging statistics?
- Is the non-solution of "Kicking-the-Can down the road" our only response to these problems?

Those are the questions we ponder.

Investors should really be asking themselves, "What should I do to protect my nest-egg?" "How do I replace and maintain my lost "purchasing power?" Before we discuss these critical factors, our readers need to understand our newest assessment of the US economy! We believe it is actually "stuck in the "New Normal" for the foreseeable future. Thus, the US will not be able to grow itself out of its (sub-par) GDP funk. This creates two additional headwinds: not only will we be unable to chip away at our deficit and our large level of debt, but it is very likely we will also be adding to both for the foreseeable future.

So, now let's move on to our second quotation from one of our favorite economists, Stephanie Pomboy. Before Ms. Pomboy founded Marco Mavens, she spent many years at ISI Group. It is, without a doubt, the most revered and brilliant economic think tank in existence! ISI was founded by the economist, Ed Hyman, who has not only won Institutional Investor's (I.I.'s) prestigious "First Team" designation for an incredible 34 consecutive years, but was also elected to its Hall of Fame in 2011. The I.I. awards stem from annual surveys actually assembled from those who use their Wall Street research. Ms. Pomboy's work with ISI always focused on deep "drill-downs" of voluminous data-series. By examining the data that formed the larger database, she was able to deduce very detailed, minor but established trends that few others detected. By doing so, these sub-trends provided critical reasons and new directions that better explained why our economy was doing whatever it was doing. Her favorite targets are GDP, inflation and jobless numbers.

Pomboy has verified the trend of replacing full-time workers with several temporary ones as an established and increasing menace. Up to four part-timers are trading places with an employee who was a full-timer with benefits. Firms are hiring Tom, Dick and Harry to replace (and thus, rob) Peter in a successful effort to navigate around the mandates of the "Affordable Care Act." For whatever reasons, Pomboy has documented there are **3.4 million** fewer full-time workers than there were in 2007. Even the retirees were replaced with temps!

Her report goes on to say: those who fall within the lowest 40% income brackets are being forced to use their credit card for day to day necessities. Just last month, revolving credit leapt $19 Billion in additional borrowings. More than 65% of these charges were for gasoline and food. Over the past three months, these key necessities have had a sharp rise in price. People are using credit cards to give themselves more time to pay because they are short on cash! *One month… $19 Billion!* It's a clear sign of harder times.

So, what do the part-time replacements and the credit card surge in food and gas mean? First, let's look at the cause of this "squeeze-play." It's a nemesis that we've cited more than once in these pages. The rudimentary cause is tied to the lack of growth in wages and salaries to cover the rising costs of the necessities of life. Pomboy writes, "**For years** (our emphasis), income growth has been lacking and, inflation-adjusted, the average [post-crisis] worker has seen a paltry 1.9% gain on a year-over-year basis." For more than a year, we too have asserted the same stagnant cause of the "squeezed consumer." Our assessment is: it's all part and parcel of the "New Normal" the US is still in!

Many factors continue to suppress our GDP, despite the many who argue that we've escaped the repressive forces of too much debt and too little worldwide demand versus too much global capacity. And, there you have it, my dear readers. Those who argue otherwise must confront all the data that proves them wrong. That's why we went to the trouble of digging up the 14-year real inflation trends. Rising inflation is the last thing a weak economy needs, for it cuts real demand and allows the threat of deflation to spread. Remember, while Tom, Dick and Harry are working and off unemployment, they each are working at about 35%-40% of whatever Peter was making. These three are adding to the squeeze on a per-capita basis. Additionally, while Peter is on unemployment, his bi-weekly stipend doesn't allow him to make ends meet either. Thus, we have four who are unwillingly contributing to the "New Normal", and nobody is doing much about it, because no one can do much about it!! And, therein rests our no-solution plight!

Part One's Focus

Setting the Economic Stage

As we mentioned above, in the first installment of the Summer 2014 issue, we will be explaining the economic factors that have been taken into consideration while formulating specific advice for the management of your portfolio. This edition focuses on three ongoing problems facing our economy:

- Dealing with the New Normal,
- The Fed's Dollar Debasement Strategy, and
- The big risk: derivatives.

Our more recent editions have also focused on three points:

- We believe our economy was struggling with the "New Normal" and voiced doubts about its ability to reach 'escape velocity' as well as to achieve and maintain, a 'virtuous circle'. This latter term describes a rate of real-GDP growth that can maintain itself without additional fiscal or monetary stimulus. That rate of growth is necessary if we are to repay our debts in Dollars, whose

- ✦ Due to our sizable debt-load and our inability to obtain "pre-crisis" GDP-growth rates, the Fed has been forced into a Dollar-debasement strategy in an effort to inflate away our outstanding liabilities. This objective directly *opposes* their obligation to maintain a "Strong Dollar" policy.
- ✦ If this "Mexican-standoff" persists (rising debts with a sub-par GDP), we will someday face one of three outcomes: default, deflation, or devaluation. These are the only options the laws of economics provide! Our Policymakers will never choose either of the first two. That doesn't rule them out, however; instead their occurrence would be the result of an accident. Without a doubt, since the founding of Rome, the easiest and preferred option to escape the burdens of repaying debt is inflation! It cheapens the purchasing power of your Denarius (currency). Thus, the debtor retains more of his wealth. Move over Nero, it's the Fed's turn.

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 "New Normal" and the Fed.

So the Fed is willing to debase the Dollar and reduce the amount of wealth actually transferred to our lenders who hold Treasuries, even though their mandate states the opposite! That seems disingenuous, if not wrong. Lately, the Fed keeps shifting the timing of higher interest rates. Once it was this autumn, then early 2016, followed by mid-2015 and now, it's before the end of 2014. What gives? Are they looking at our GDP shortfall or the unemployment-rate and jobless claims numbers?

The Fed is confused and confusing, at the same time. That's due to the fact that they have been using the wrong economic model for years. Their model can't factor in intricate and complex interfaces that today's "New Normal" encompasses. That's why their forecasts have been so inaccurate. Almost every one of their predictions had our economy attaining our pre-crisis GDP pace within the next six months. This precluded the need to search for the proper monetary policy. Instead they could just sit back and wait for all the "cards to fall into place."

And, their Dollar debasement policy is a stealth-strategy! It's invisible. Don't expect Janet Yellen or any of her fellow governors to admit to an anti-dollar policy. Furthermore, unless our annual real-GDP can attain 3.25%+ we think it would be a big mistake to raise rates, regardless of the jobless rate. Their faulty model states: more jobs drives greater spending, and with it, a rising GDP. While that's logical and basic economics, it's tied to a "pre-crisis" model. It's not fitted for the structural (vs. cyclical) difficulties of the "New Normal."

Who wants a strong currency when everyone needs to boost their exports to help GDP growth?

Let's look at their Dollar policy. Is the Fed trying to boost our exports to improve our GDP? Is it the same strategy that Japan is using?

It's similar but not as blatant and forceful. As many have said, "There is no upside to those who have a strong currency!" In 22 months, Japan has purposely driven the Yen down from 78:$1 to 103:$1. Our Dollar buys 25 more Yen and that's a 32% hit to Japan. A Honda has become a lot cheaper in America, but the price is unchanged in Tokyo! Japan is trying to emerge from 25 years of deflationary woes. They want to drive exports and limit imports. A falling currency achieves that purpose, although at a heavy cost to those who hold assets denominated in Yen. Whether it will work long-term, is open to debate. It will be interesting to see what happens to Japan, the world's "inflate-and-resurrect" guinea pig. The history books are filled with nations who have failed at this ploy. After all, if the printing press was the key to never-ending GDP growth, then we wouldn't need taxes! Japan faces many unintended consequences, and we seriously doubt things will go the way they hope it will.

Shifting to the US, we compete with Germany in autos, Asia in electronics, Europe in airliners, and France plus New Zealand in wines. Currency values matter! Imagine this scenario: With the Euro at $1.36, the ECB buys $100 Billion of our 10-year Notes. Over the next 10-year period, the Fed devises a 20% debasement. The Note matures and we give the ECB $10 Billion back (after interest). By now, the Euro is at $1.632 … 20% higher (actually the Dollar is 20% lower by design). Yet, the Germans are not fooled! Without their consent, we've stripped-away 20% of their wealth in real terms.

Now, you can see: Money isn't about money; it's about Wealth! Wealth determines what one can buy! When one's debts are denominated in its currency, and these debts are held by foreign entities, it is always an advantage to devalue …at least initially! While the borrower retains more of its wealth, it invites reprisals and nasty paybacks. When all the dust settled after the 1930 "beggar thy neighbor" devaluations, everyone lost from the wealth perspective! Lots of job losses and failed firms.

So, the Fed's weak dollar policy is a good idea, considering our high levels of debt and low GDP-prospects. Right?

Given our huge debt-load and our inability to regain our pre-crisis GDP pace, the Fed probably feels like the Lone Ranger who has run out of bullets. "Lone" because Congress and White House are the "Do-Nothings". They are "Out of bullets" because after five years, our annual GDP seems like a constant re-run of the movie Groundhog Day; the economy isn't getting anywhere. All things being equal, a lower dollar retains wealth, increases our exports and reduces our imports, thus, helping GDP. However, all things are never equal when there is this much money …make that "wealth"… at stake!

Competitive devaluations and their retaliations.

I see what you mean. But, doesn't that eventually lead to competitive devaluations and price wars?

It can! Regardless of the economics, the most important factor to remember is: Competitive devaluations are always a political decision or one adopted as a retaliatory measure due to a trading partner's decision to "do it to you, first!" That's why they are termed competitive devaluations. While the early bird always obtains an advantage, scores of data indicate that, over time, no one comes out ahead, as the losers devalue by greater amounts to get even.

From purely the investors' perspective, there are two notable dynamics from an inflationary and devaluating-currency setting. The first dynamic encompasses the long-term effects from the inflating-nation's viewpoint. While foreign stocks and/or fixed income obligations always offer an alternative, they come with the risks and rewards of whatever currency in which they are denominated. And, no currency is completely free of inflation. Domestically, the businesses behind your stocks must consider almost 20 factors when dealing with their country debasement policies such as their pricing, input costs, inventories, productivity and outsourcing. The second dynamic is from the perspective of the foreign exchange (Forex) of one's trading partners. US investors and businesses must assess the probable loss of purchasing power relative to foreign goods and services as well as the hit they take to asset valuations denominated in other currencies. These determinations may result in sales, currency-hedging, and/or the purchase of real ("non-paper") assets such as gold, real estate, physical energy resources, etc. The first dynamic deals with its effects on commerce; the second impacts its effect on asset-valuations.

High levels of debt and lots of leverage = a deadly combo!!

Let's look at the big risks you indicated in this issue's focus. Is the Fed's constant "deflation" rhetoric a lot of hot air meaning nothing? After all, the Great Depression was 85 years ago. The Fed is fighting the last war. Surely today's FRB and the FOMC are misplacing their focus!

The Fed's concern is much less about deflation's proximity and much more about its potency. Deflation is like the Ebola virus. It's scarce and sparse, with a very rare chance of occurrence! But, it has very deadly effects that spread quickly. It's very tough to contain! One additional factor always makes it, not more likely, but more toxic! The higher the debt-level, and we're including all kinds of public and private debts, the greater the deflationary downside with more collateral damage!

The higher the nation's debt-to-GDP ratio and their entitlements' liability-levels, the greater are the risks of deflation. Today's global debt levels are many times those ever known! The Fed can't …and doesn't want to see this debt extinguished! Instead, they are trying to stimulate borrowing so that it generates spending! The Fed is very conscience of any deflationary threat! They are always on the lookout! Why? …Because they realize they are the only bastion able to fight deflation. And, many of today's Fed members lived through through the Lehman-AIG era. The banks that were "too-big-to-fail" are bigger still and the Dodd-Frank (Wall-Street-Reform) legislation has been so watered-down, it's not preventing any of the previous threats from being curtailed. That's why they are concerned! And, that's why we are concerned, too, but our big concern is the derivatives.

Our greatest concern: lots of money on the long shot bet that nothing really bad will go wrong!

What! Explain yourself! You're talking about derivatives, right?

Yes, derivatives. Our greatest concern is focused on the "Grizzly Bears" who have, over time, built up large positions that have huge payouts when something really bad happens to the economy or our financial structure that supports it. They are smart people in high places throughout the globe that can actually see the weak and the strong, the solid and the vulnerable. They talk to one another and some have placed big bets on situations that the takers think "can't happen!" Thus, they are willing to provide 15:1 and sometimes as much as 25:1 payoffs if the bears are correct. These are anti-systematic bets that something specific will go wrong.

And, there are plenty of takers on those wagers. Why? …because the Fed was able to rescue money market funds, GE, and all the investment bankers remaining after Bear Stearns and Lehman! Thus, almost all of Wall Street believes the Fed has got their back and will always have it. That is why today's stock market keeps going up in the face of so many who are calling for a correction or worse. The Fed is there; therefore, the system cannot fail! It just can't! So this crowd is ready, willing and able to take all bets that "nothing will ever go wrong", because the Fed can and will save it. It's hasn't dawned on them that the Fed may not be able to create all the multi-trillions of dollars needed to secure all the bleeding victims. And, what about those large foreign institutions who may be failing because of what happens here in the US? It's a global banking system.

We don't want to scare readers; we want to present a realistic scenario. An accident, by definition, is not foreseen in time to prevent it. It can't be seen ahead of time for the same reasons Lehman was opaque. Lehman was hiding their 40:1 borrowing leverage and lying about it on their financial statements. Sure, the offending entity will know it. But why would they disclose their weakness. They need more money to double-up and catch-up …as the saying goes! Thus, we believe that the trigger is likely to be as sudden as Lehman (which took six days to go from solvent and creditworthy to busted) and as unsuspected as Jon Corzine's MF Global overnight failure.

Few people discuss the $700 Trillion sized derivative market. This was the market that Alan Greenspan told Congress, "This market does not need to be regulated!" Thus today, it is neither illegal nor regulated. Dodd-Frank did take steps to try to ensure that margin levels were sufficient, and a clearing-house is there in case the margin call is not met. But any real crisis will overwhelm those clearing-houses. No private entity would ever put up enough (meaning unlimited) funds to underwrite any and all calamities. The clearing-houses are not players; they are there to support the system, until they can't, and then it's the Fed's problem. There is no upside whatsoever, to the Fed's willingness to publish concerns or the size of the derivative markets. None! They do not regulate these players; they are just the lender of last resort and the ones who have to bailout the system when it needs bailing!

But, look at the Fed's balance sheet. Can it create enough funds to still be the lender of last resort? Today, James Rickards, the economic expert, believes a serious "accident" would require about $6-$10 Trillion, if it was caught early enough! He questioned whether Congress would authorize that amount of money for a new TARP. Meanwhile, while all the Authorities are sitting in board rooms trying to decide what to do, and all the politicians are debating who to blame, the financial markets are not waiting for them to make their decisions. Lehman's impact was immediate! That week, GE (at the time an undeservedly AAA rated company) couldn't roll-over their 90-day commercial paper. It required the Fed's and Treasury help. That's how fast confidence can disappear. Would investors wait to see if the Fed could rescue everyone? Or would it be every man for himself?

Does being the cleanest shirt really help?

I understand you are not calling for this scenario now and while your concerns express a pretty harsh outcome, you, yourself, said, "The US is the cleanest shirt in the laundry." Wouldn't Europe or Japan be the first to have real problems? Wouldn't the US be likely to have a warning, and be the least affected? You could very well be correct, especially with Japan's experiment to escape the consequences of a debt-load that's 236% of their annual GDP. Europe and the ECB have a very under-capitalized banking system. More than €400 Billion is needed to meet international requirements. And, their regulatory system has not been consolidated into a single, uniform system. They are still debating who will pay for the "bad banks." Portugal's biggest bank just became insolvent. So, you make two good points. But, remember the cleanest shirt metaphor describes a relative comparison, and not a "clean enough" assurance of escaping harm concept!

For now, this is how we see it. The US is still the cleanest shirt in the developed economies' laundry, and will probably be so for the foreseeable future. But, if all these over-indebted nations continue to have a lousy GDP numbers and keep piling-up more debt, someday, we won't know when, a major creditor will either sell their holdings or just let them mature, pocketing the funds. His actions and concerns will affect the confidence of other investors who hold that nation's bonds. Across the board, the impacted bonds will see their yields rise sharply as others "get out while the getting's good." This initial flight is likely to favor the US, both our Dollar and our Treasury bonds! If the offending nation is one like Argentina or a small one like Cyprus, we would probably avoid contagion and the "domino effect." On the other hand, the weak will look to the strong for help! Remember, one-way or another, we are all in this together, and a sharp devaluation is the answer when the call for help goes unanswered. That would introduce the "beggar thy neighbor" menace.

But, there certainly is a "tipping point" where increasing levels of indebtedness is no longer tolerated. While our "cleanest shirt" buys time, lenders can see that Congress is unwilling to either cut spending or raise taxes (or a combination of both) and our constant "kick-the-can fix" is not a solution. Our role as the World's reserve currency carries responsibilities we are ignoring. Today, other blocs of nations are pursuing alternatives to the Greenback. But, what you say it's true …the weak sisters will probably be the first to go. But, that may be of little comfort if too many others are in line! By that time, mud is flying everywhere and all the shirts are getting dirty. By then, the difference in grime won't matter, if the laws of economics can't support the debt-loads of those whose creditworthiness is insufficient.

Why we are so concerned…

Today, all the developed-nations are using the same QE and zero-interest-rate policies. And they are all seeing similar results (or lack thereof). No one has achieved its pre-crisis GDP pace! The laws of supply and demand indicate that similar situations treated with identical remedies result in identical outcomes. This is our entire concern! None of us are succeeding and it's been more than five years of the "New Normal." Many experts agree that the Fed's efforts are not working. So, what are the solutions? And, who is actively pursuing remedies and trying to stop the bleeding? Not Congress and not the White House! Another year or two of no results will produce two things:

- ✦ the "Blame-Game" with each side at each-others' throats when we need them at the compromise table; and
- ✦ a bevy of potential solutions that are too costly, too uncertain as to their effectiveness and too unacceptable to one party or the other.

Meanwhile, our debts grow and our GDP growth falters! "Kick-the-Can" is a very expensive exercise as the costly future bills always demonstrate. Where's the leadership? Where is the concern to "fix" the problem before it's too big to fix? And, where will the money needed to do so come from? It would greatly ease our concerns if Congress and the White House were working on a realistic compromise. They're not, and they're unlikely to do so! They are just waiting for 2016! If the US continues to politically suffer more standoffs, we will be waiting until 2020!

But, for now… not forever… but now… we have concluded the US will be stuck in this "New Normal" for the foreseeable future. That's because our problems are structural, not cyclical. Nearly all economists agree that structural problems can't be cured by either fiscal or monetary remedies. Our solutions are not even on the drawing board.

Finally, investors… take note! We have one last point - the five-plus year bull-market that's almost tripled from the bottom, has done so with the "risk-on" and "the Fed's got our back" mentality as the bullish structure supporting its rise. If a large segment of these "players" come to the conclusions we've outlined, we may begin to see what the other side of the coin looks like. That's the "risk off" and "does anyone have our back?" investment scenario.

PART TWO

> **"The US economy contracted at almost a 3% annualized pace in Q-1. We have a big problem that the Fed can only hope to rectify by keeping interest rates low enough to induce households to pull forward more consumption and to entice firms to invest in projects with low expected returns. It is not exactly an ideal solution, but the alternative …a persistently depressed economy, is even worse"**
>
> **-Peter Berezin, Managing Editor, The Bank Credit Analyst**

These rather chilling words come from the 56 page report on our economic prospects. Having been a subscriber to this renowned and highly respected top-down research organization since 1967, it has almost always championed a glass half-full perspective - one that voiced hope that the Authorities would find a way to muddle through …once again! That had been their message! Not so, this time. They painstakingly point out that our 3% output gap cannot be bridged by the economy in which we are stuck.

While not labeling it specifically the "New Normal," they dismiss virtually all the sources of incremental demand[1]: the government is in an austerity mood, not a stimulative disposition, while consumers, whose wages and salaries haven't kept up with inflation, have almost finished rebuilding their savings and paying down their debt. CapEx[2] has really taken an unexpected hit, even though Corporate America has huge piles of cash. Surveys indicate these firms are willing to go crazy with M&A when the market's at all-time highs, but few, if any, are willing to expand their platforms. This is their formula: buy your competitor, relocate to Europe to lower your taxes, cut your payrolls, buy back your stock and raise your dividend! That's where their money is going to go! By the way, none of those activities adds a dime to our GDP - not one! Someday, the "New Normal" will have become the "same old abnormal"!

It seems all the developed economies, along with China, are slowing down or still stuck in the "New Normal" mode. European GDP has their one savior, Germany. As for Spain, Greece, and Portugal, unemployment is still near record highs. Italy continues to shut-down their uncompetitive industries and move them to Poland, Hungary and other Eastern European nations where cheaper labor and non-union work rules abide. By year-end, China may announce a 7%-7.5% gain in their 2014 GDP, but who will believe them. Data that can be confirmed indicates their imports are shrinking month-by-month and their credit woes are mounting. The direction of these indicators are just the opposite of what they would be, if their economy was increasing at anywhere near 7%. So, we can assume that corruption is still rampant, despite their headlines' claims of reformation. And, just look at their stock market! It peaked about five years ago and is in a solid bear market. Many have adopted the SSE Composite Index's 75% decline as their most reliable indicator of China's economic health, or lack thereof. Finally, these same observers perceive Japan's Yen-printing experiment as a rerun of the old movie that already played in most South American countries. It proves that one cannot inflate their way to prosperity.

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[1]Incremental demand, also sometimes called the marginal propensity to consume, the fraction of any additional income which is spent on additional consumption (or conversely, the fraction of any decrease in income which becomes a decrease in consumption)

[2]CapEx stands for Capital Expenditures. These are funds used by a company to improve existing or acquire new property or equipment. Examples range from purchasing land for a new factory to upgrading lighting for an existing parking lot.

While we know these facts and figures are depressing, one has to wonder what world Wall Street is living in! The DJIA was at 17,000 plus, and the S&P 500's onward march through 1900 is just amazing! In early March of 2009, it hit 667. It's almost tripled thanks to Uncle Ben's and Aunt Janet's printing presses. So where are we? While our economy is stuck in the sea called the "New Normal", not far away, the good ship, Wall Street is rocking and rolling in the Sea of Unlimited Liquidity. Instead of drowning, investors seem to be reveling in the endless flow of liquidity. Originally, Wall Street had to be rescued whenever strong storms caused heavy flooding. Nowadays, it's a welcomed sight. It seems it can boost stocks prices forever! Sadly, GDP isn't seeing the same benefits. Yes, a spurt here and a surge there, but no follow-through! It seems to be marooned on dry land, watching Wall Street from afar and longing to ride the same waves.

Part Two's Focus

Investing in an extended stock market when our problems are structural

The first half of our double issue dealt with the under-reported inflation. It pointed out that certain critical consumer goods or services are increasing in price at regular intervals and at above-average rates. It also focused on our huge debt load and our inability to generate enough GDP to grow ourselves out of that burden. This situation creates a dilemma for the Fed. Their "fix" is to over-inflate the Dollar and under-report the CPI's rise. Now, we'll examine our 3% "over-capacity" gap between current GDP-demand and our GDP's total capacity to produce, if the demand were there. We looked but found no "fixes" that were doable. We then turn our attention to investing in "the market that we have" in our strategy guide.

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 focus.

So let me see if I understand Part Two's theme and focus. The opening quotation, which always frames the theme, provides three messages. First there have been, and still are, significant shortfalls in our GDP growth rate. Second, this is a big problem, and we can only hope the Fed can work some magic to either have consumers spend more (beyond their current ability to do so) and/or have Corporate America go on a CapEx spending spree and fund new projects. Third, if this fails, we probably will face a stubbornly weak economy for some time to come. Have I stated them accurately?

Yes, you are correct. It's important to note that we are not the only nation under a restrictive GDP pace. This is a global problem, and the nations that are affected are those who are fully developed and have high debt-to-GDP ratios. We included Japan, the US, the EU, and the UK in our assessments. China is not one of these affected in this manner, but it too is slowing down, and their credit concerns are rising. For a number of reasons, the US is still the cleanest shirt in the laundry; it's just that all shirts have become dirtier. It may take quite a while before they can emerge white and starched.

Our many problems… cyclical or structural?

Earlier in this edition, you noted that you thought our problems are lingering for two reasons. First, they are structural in nature, not cyclical, and second, the Fed is unknowingly using a model that can't repair complex and operational difficulties, like the ones we have. What are your findings on this?

In recent months, our focus and research efforts have been almost entirely absorbed with investigative studies exploring the sources of our lethargic GDP and, more importantly, the future outlook for its growth rate. Our main emphasis was on the source of our "headwinds" or difficulties. No problem can be adequately solved without knowing its source! Was it structural or cyclical? Are our woes tied to deep-seated *structural* economic forces or are they *cyclical* and, by definition, temporary? We found that most of our difficulties and challenges are tied to structural "headwinds", as we like to call them.

Here are two notable examples of our findings. In the late 1940s, the top two GDP providers were manufacturing and farming. We'll review each.

During the past 40 years, the most costly and damaging loss the US has suffered was to our manufacturing and industrial base. These firms employed many workers who were well-paid and provided high ratios of "multiplier-effects." Many of their products were exported to other nations - another big plus! These factors drove our GDP considerably higher. Just after WWII, about 52% of our GDP was tied to our manufacturing and industrial commerce. Today, depending on how you quantify some trades, it's between 9%-13%. We lost these "rust-belt" companies for three key reasons. We will look at the steel market.

- *Aged infrastructure: The US had pre-WWII plants. Europe and Japan rebuilt their war-torn steel plants with new, highly productive facilities. In the 1950s, Korea did the same.*
- *Labor Costs: Our labor costs were, on average, about twice theirs, and that's not including the costs of our generous pensions or onerous work rules. Eventually, this disadvantage caught-up with us!*
- *Government Subsidies: Foreign-governments' subsidies helped our rivals capture our former "export markets" as well as expanded their reach.*

When you think about it, there wasn't anything our firms could have done to thwart the new plants, low labor-costs and high subsidies they confronted. Why? Because they were all structural advantages that we neither had nor could achieve! So US firms concentrated on resisting union demands, which generated strikes, and these work stoppages produced even greater market-share losses. Later, in the 60s and 70s, demand for steel was rising in Asia and South America. In the past 20 years, our environmental regulations, costly litigation and high corporate taxation kept the steelworkers jobs at small fractions of the 1950s. Today, our healthcare costs are extremely high relative to our foreign competitors, especially Asia. In early 2008, the average US manufacturing worker made 30 times what the average Chinese worker was paid. Today, productivity is so important, that low labor costs, like the one we just cited, will overwhelm whatever the finest US production line can turn out! While many think it was just the steel unions' fault, our job losses are almost never tied to just one factor! It's usually the shared result of a combination of causes.

Our second example involves the farming market. In 1948, it had, besides its huge domestic market, a big, broad and bountiful export trade! We used to feed the world with all our farm exports! Today, the world can feed itself. They did what made the most sense! They are farming their own lands with miracle pesticides and fertilizers. These beneficial inputs drive huge harvests relative to the 1940's per-acreage yields. Today, America's bountiful corn-crop feeds our ethanol refineries with steep subsides to the farmers. We can't think of a trade that has lost more of its relative (to the 40's) income than farming. Again, all the findings and factors involved are structural advantages that can't be undone!

These are the cold, hard facts about our jobs in the US. So you ask… where are the solutions? It's very easy to see where they are not! Neither the Fed with its monetary policies, nor Congress with its fiscal stimulus will solve our complex GDP problems. Here are some of our very important findings. Every country knows they must maintain full employment. Export markets are the key to "free new-money that's always coming in!" Find that market and hold on to it for dear life GDP growth! That's the free pass to a superior GDP pace! Just ask China.

From theory to the real world… BCA's five findings.

Enough theory, let's move on to the answers to your questions and findings. What's the problem and the potential "fixes?"

We want to take BCA's findings on a step-by-step basis! Otherwise, we fear a data-overload headache, in which too much information is confusing, not enlightening. Here are five critical, related and structural conditions or economic forces (like the ones in our two examples).

#1 The GDP Gap

First, as BCA's data verified, there is a permanent 3% structural-gap between the US's demand-based GDP potential (or maximum input) and our already-in-place GDP capacity (or our pre-crisis output.) Thus, we suffer from the labor-losses and overhead costs from this unused capacity. The big hit is permanent job-loss, as those jobs are no longer needed to keep it operating. Until our GDP can close this gap, this will be an ongoing burden. BCA classifies this gap as permanent, due to our nation's inability to generate sufficient demand through any and all fiscal or monetary stimulus, including government, consumer and corporate sources. Net exports are also considered in their calculations. One other key factor is inflation. It's important to keep in mind that GDP is measured on its real or inflation-adjusted basis. So it doesn't matter if we raise all prices 3% to increase our nominal demand; it would simply be reduced back to the uninflated figure.

#2 The Multiplier Effect

Second, in normal times, there are three sources of instant gratification whenever demand is lacking:

- ✦ Government deficit spending;
- ✦ Exports: foreign demand for our goods and services; and
- ✦ Domestic debt creation to fund consumer and corporate purchases.

All three have a "multiplier effect," as the same money is spent again and again by those who receive it. And, all three fountains provide new funds "out-of-thin air." That's always a big-plus …because we are not taking Peter's money, so that Paul can spend it. That's just a trade-off! No - newly-created funds enter the market with demand for goods and services! New homes, autos and factories have a tremendous impact: glass, cement, carpenters, realtors, steel, engines and paint. Demand for all these products can produce new jobs. So, what is the possibility of filling our 3% hole with any one of these "new-money" sources? Unfortunately, very little. Here's why…

BCA's conclusions are as follows. Both sides of the aisle are in an austerity mood - one wants to raise taxes and the other wants to cut spending. Neither one is a stimulus; both are opposite of what is needed. Just like the plot in the original movie, Fun with Dick and Jane, (the George Segal and Jane Fonda version), Dick & Jane end-up in debt… up to their ears! …the car breaks down, their savings are wiped out; Dick gets fired; no one will help. They quickly fall from the top 40% earners to the bottom 40% income bracket. The bottom 40% would love to borrow, but they don't qualify for a loan. There's no help for the 3% gap there! So, let's go to the top 40% of income providers. They are investing their excess income, not spending it. They don't need or want to borrow. So that leaves just the middle 20% percent to do all the heavy lifting. And they are working hard at it. As Pomboy pointed out earlier, they have already used their credit cards to purchase last week's food and gasoline. That's not a permanent "fix"; they are learning that living off of the credit card will soon push them down into the lower echelons.

Next we have Corporate America. The only thing firms want to spend money on are mergers and acquisitions along with stock buybacks. Yes, there is a little help there, as long as their takeover is not a foreign "inversion" where they escape paying corporate income taxes. As we noted earlier, the biggest and most unexpected loss of GDP came from a sharp decline in CapEx spending, the most important generator from businesses and commerce. Well let's consider our last hope, exports. What do we sell that the rest of the world wants: airliners, defense goods, natural gas, medicines, iPhones, hi-tech equipment, and Buicks. This has been helping, and maybe it will help some more. But many of our trading partners are hoping we will buy more of their exports and give them some positive "multiplier effect." Maybe we can narrow the gap down to 2¾% or 2½%, but it's going to take some time. Remember, to help, our exports have to be net of our imports. If we are buying lots of Beemers, champagne and Italian designer items, especially when we are in Milan or the Alps, then the Dollars are going right back into Euros. With our "cleanest-shirt" badge, most of our trading partners are in worse shape than we are. BCA thinks the bottom line is: exports will help …a little. It looks like almost all of the instant fixes are delayed or they've disappeared.

#3 Our Weak Labor Force

Third, BCA sees our labor market is slack, Properly measured, on an apples-to-apples basis, it is on par with the worst point of the 1990-91 recession. It is hampered by a surplus of unskilled labor that exceeds the sparse demand. Besides, these unfortunates barely subsist on whatever they're paid; it's close to the minimum wage. Their incremental impact on GDP growth is very small. As our earlier example demonstrated, the huge manufacturing job-loss has really hurt our GDP numbers. Some of it was taken by foreign competition (loss of market share), and some was voluntarily relocated to foreign shores to gain competitive advantages (the "if you can't beat them …join 'em" solution). Some, like steel companies, were strangled by the unions on one side and cheap imported steel on the other, resulting in bankruptcy and abandoned mills. This had a negative multiplier effect. How? It resulted in insolvent pension funds, the loss of high-paying jobs whose skills were no longer in demand, the resulting demise of the workers' families, the huge drain on government entitlements, as well as the lack of production and taxes. Very little could have been done to avoid this tragedy. But there is another side to America's "manufacturing job-loss" coin… it's the service jobs that have replaced steel's once mighty legions of employees. Look at all the growth in what is known today as the "knowledge-based" professions. While the manufacturing sectors drove huge positive-multiplier effect, today's "knowledge-based" professions drive little if any. Most of its residue is "hot air", and while we could have used a lot of it this past winter, most of these people were vacationing in Europe. It's evident that these well-paid specialists have little or no multiplier effect once their homes, cars and lifestyle are in place.

"…most of our problems are structural and don't have practical solutions."

#4 Our Broken Legislative System

Fourth, our legislative system has not only broken down, but there is little, if any, desire to fix it. Since neither side can secure an upper-hand (from a legislative perspective), both sides have decided to publicly express their political unwillingness to comprise. "It's the other party's fault and always will be!" Each side is waiting for the next election when they hope to gain all the votes needed to secure the ability to "impose their will" on the other guy. This has created an environment where all our problems have no solutions. Thus, the US is constantly kicking a very expensive can down the road at ever growing levels of painful and unaffordable costs. Not only is that not a solution, it actually adds to our difficulties.

#5 Our Trading Partners' Woes

Fifth, we've written frequently about the EU and the ECB, so we will just summarize our assessments. Europe's debt load, under-capitalized banks and noncompetitive labor union laws put them (and their banks) in worse shape than we are. If anything, they are looking to us (because of our dominance of the World Bank and the IMF) to help bail them out! Their GDP is only slightly positive, it's all tied to Germany's contribution, and it looks as if it may go back to negative numbers again. Most of our other trading partners are

A summary and conclusion.

I can easily see the difference between a cyclical and a structural problem. It's not just one is temporary and the other is not. The structural "headwind" is tied to a condition that actually inhibits the production or increases the costs of the goods or service produced. And, the monetary and fiscal stimuli are nothing more than government-directed injections of credit or spending to invigorate our economy. It's a shotgun approach. And the facts and figures indicate to me that we are stuck in a stagnant economy.

As we noted earlier, these conditions are almost entirely structural, and because of our inability to remedy the woes, they now represent "real and present dangers!" The reasons they still exist are: neither the Fed nor our ineffectual Policymakers (Congress and the White House) have the desire or the ability to craft and implement changes that would work! Nowadays politicians, and by association, politics, have become the servants of those who "buy" their elections. Today's campaigns are financed by the various "special interests." Those who are elected already know what their votes will be, regardless of our nation's best interests. If this were not true, both sides would have come together long ago and worked out viable solutions to our problems. To fix long-term and structural problems, there will be winners and losers. Usually the losers are with the status-quo folks who are told their union, work-rules, etc. are inhibiting profits, productivity etc. These parties care less about the nation's best interests, and will fight the changes. Some problems can't be fixed because the economics and the costs outstrip any benefits gained. That's why the steel-mills closed. It's a tough situation when economics favors the other nation's production facilities. After all, foreign lands can make as good or better a product much cheaper. Our overhead is the highest in the world of the developed nations. Just look at all the costs tied to our regulatory, legal, union, pension-benefits, and healthcare as well as the corporate-tax and other overhead-costs. Remember, eliminating those costs creates unemployment. There are no easy fixes. The savvy businesses moved overseas when they analyzed the problem. Theoretically, Boeing would be more profitable in Eastern Europe. Our point is very simple and emphatic: most of our problems are structural and don't have practical solutions.

STRATEGY GUIDE

Stocks or Bonds? Should I stay? …or, should I go?

After hearing your long-term economic concerns, I'm beginning to feel bonds are the safer investment. I know their yields are low, but don't stocks carry more risks?

Probably, but with a fixed interest rate at a level below inflation, you are fixed into a loss of purchasing power.. Much of the globe's very conservative excess savings are parked in bonds. If this money were spent instead, it would boost GDP. Instead, it sits in bonds. Let us explain why we do not favor traditional bonds for investors… not US Treasuries, Munis, Junk, Corporates or secured-mortgage paper. Nearly all yields are at record lows. And, when you take into consideration their credit risks, reaching for higher returns doesn't pay! They don't hedge inflation adequately, and we don't like the risk in debt itself, when the Fed has a "zero-interest-rate" policy in effect! Our concern is simple: there is way too much debt out there! And, while much of it may be repaid, we are more worried about your loss of purchasing power. Most bonds provide negative after-tax returns when adjusted for inflation. And, this is certain when it comes to cash and money-market funds.

"…with a fixed interest rate at a level below inflation, you are fixed into a loss of purchasing power"

Stocks: pros and cons; Bubble or no bubble?

I surmise your choice is equities. Let's look deeper into the stock market's bull-run. While our political and GDP outlook may be poor, at least we have a stock market that's been ignoring most of it. Now that I think about it... is that a good thing or a bad thing? I'd better be careful of what I wish for! Some say there is a bubble out there… what say you? Let's talks stocks.

It's always good to know where we are and how we got there. Since 2012, the S&P has risen 50%! About 60% of that rise was P/E[3] multiple expansion; the other 40% was earnings' growth. Consumer discretionary and telecoms were the only sectors that didn't expand their P/E's. Obviously, the Fed kept finding investors who would put their QE-funds to work. Has this created a bubble? Some say yes! Their opinion is based on money-driven valuations that are not tied to the fundamentals, i.e. higher levels of profit growth. They are comparing today's valuations and P/E's to those that existed before the '08 meltdown. We don't think that's a balanced or reasonable judgment given the Fed's massive increase in liquidity. Their newly created $3.5 Trillion shouldn't be ignored. The 'bubble-buffs' are looking at a market that used-to-be, not the present day version.

Janet Yellen recently denied there was a "bubble", as have all Fed governors. The Fed knows that if there was a "bubble," then their QE-antics created it. So, they would be the last ones who would want to see it pop. Instead, they hope it provides a "trickle-down wealth" effect. Most importantly, to many investors, bonds don't represent a rewarding or risk-averse investment. Its income is pitiful and negative after the effects of inflation and taxes. Besides, today's low interest-rates can only go up, putting a bond investor's principal at risk. Regardless of whether a bubble exists, this is the market we have. So, take it or leave it!

[3] P/E is short for the Price-Earnings ratio, a valuation ratio of a company's current share price compared to its per-share earnings. The P/E is sometimes referred to as the "multiple", because it shows how much investors are willing to pay per dollar of earnings. If a company were currently trading at a multiple (P/E) of 20, the interpretation is that an investor is willing to pay $20 for $1 of current earnings.

Stocks: Is a correction likely or not?

Do you think a correction is likely or already started?

We like to stay away from market calls. But, we don't mind relaying the opinions of those we respect who do so. We present two, and both are "contrary opinion" enthusiasts. Remember, today's market is a post-crisis one that is unique. So, the old rules may not always apply. Raymond James' noted equity strategist, Jeffrey Saut, is looking for a 10%-12% correction over the near-term. He was amazed to find that as the market dropped recently, his callers were 10:1 asking what to buy, not what to sell! He finds that unsettling and has increased his defensive measures. We have also, but for different reasons. And, while the large-caps catch most of the market's attention, the small caps have been under a "stealth" profit taking run.

John P. Hussman, founder of the Hussman Funds, has been managing financial assets since the 1970s. He publishes his insights frequently, and they are free to those who go on his website. We always find his work enlightening and his opinions stern and unaffected by the ups and downs of the markets. He recently noted his concerns that the internal technicals won't give much notice of a top or a pending "extended decline." He believes this market could (not will) fall sharply without much of a warning. He also believes that if it does so, the rallies will be few and far between. He cited two significant tops: 1972 and 2000. Both ushered in a nasty bear market. And, each occurred when all of Barron's experts, numbering about 12, were bullish in its most recent poll just before the top! Barron's just published its 2014 mid-year poll and all of their pundits were optimistic. Yup, it produced 100% bulls; there were no dissenters!

I understand you won't try to predict a correction, so let me get back to my earlier query. As I said, don't stocks carry more risks?

They do, but you have to weigh that against their rewarding potential. We believe the more intelligent investment choice is stocks. And, the proof is the 50% S&P gain in less than two years, regardless of the reasons. As we noted earlier, a large segment of the bulls have adopted the "risk-on" mentality and are counting on the Yellen "Put"[4] safety net. While this may be more hope than fundamentals, it's hard to deny either its logic or positive results. During the past five years, investors have realized and followed the Fed's lead to stabilize our financial market by virtually flooding it with unprecedented amounts of free money. This motivated those who became aware of its unannounced "monetary policy" and later became convinced that "the Fed has their back." This was more than enough justification to establish the "risk-on" trade. It became a moneymaker for two reasons:

- ✦ It had become the means by which the Fed had preferred to "fix" the huge lost "Wealth Effect." and
- ✦ Wall Street acts like a magnet! As it flourishes and increasingly prospers, it constantly draws more and more participants to the party. This is what has happened.

But, to be fair, we always like to present the other side of the coin. Since March 2009, there have been very few "risk off" market downtrends, and none lasted very long. That's because neither the printing press nor the "Fed's put" disappeared. So, the savvy investor saw any and all dips as a new opportunity. He borrowed, he bought, and he prospered. But five years later, we are faced with some real problems! First, to the Fed's surprise, the economy failed to produce a sustained recovery. Every GDP spurt is followed by offsetting sags. Stocks are priced at elevated valuations without the usual economic benefits to support today's prices. While some may visualize this environment as a "greater fool" atmosphere, we can understand why and how it came about. Yet, it does give us concerns. Our second headwind is the Fed's decision to try and normalize their monetary policy. Too many pundits are focused on why they are going to do so. It's the what that matters. So the punch bowl (low interest rates) may still be there, but the alcohol (quantitative easings) has been removed. The investment environment is slowly but surely changing.

So, what else does your "other side of the bullish coin" tell you? And, how are you adjusting your strategies to cope with these factors?

Here are the major factors that support a more skeptical or bearish viewpoint:

- ✦ The intelligent investor prefers stocks, but if he is objective, he also realizes there are some large, but so far still latent, risks out there. He's in the market because the "risk-on" trade is still working.
- ✦ Recently, some geo-political threats have emerged that have the potential to become significant! We believe the last few weeks can best be interpreted as the wise taking some money"off the table" to build a reserve for future buying. After all, there hasn't been a 12%-15% correction for some time. These

[4] U.S. Federal Reserve has, since Black Monday in 1987, actively sought to support the stock market against significant losses. This help has been known as the Fed's put, the Greenspan puts, the Bernanke puts, and now as the Yellen puts.

These periodic setbacks provide a supporting technical market structure to uptrends.

- ✦ If most GDPs are stuck in neutral, it will eventually inhibit and prevent ongoing earnings growth. While the 'higher-profit pundits' think otherwise, today's P/E's are too high for many disappointments.
- ✦ We are the cleanest shirt; we can't look for much, if any, help from our trading partners. Thus, our GDP estimates are too high, in our view.
- ✦ Almost every developed economy has a total debt-to-GDP level of more than 90% , which was set by Rogoff and Reinhart as the danger level. The US is at 110%. These ratios are growing every day, and most investors are ignoring their inhibiting influence.

Now, our strategies are also adjusted for the post-crisis environment. Remember, this post-crisis market is unchartered waters. No one really knows what an extended "risk-off" phase would do. But it would probably get ugly. Why? Interest rates are already as low as they can go; we have a "do nothing" Congress; GDP is, at best, uncertain; the Fed has already signaled the end of any further easing, and it's only a matter of time before rates rise. Finally, if the preceding events occur, both investor and consumer confidence would shrink.

All these factors have energized our risk-averse nature and we have crafted a "more defensive, use extra caution" strategy. Thus, we have executed a two-stage preparatory-tactics plan. The first step was to secure larger exposure to sectors known to be defensive, not only from a low-volatility standpoint, but also as an inflation-hedge. Hence, energy, consumer staples and healthcare hold a large portion of our portfolios. Blue Chips augment these holdings as consistent growers. Finally, we have a small handful of embryo healthcare firms whose prospects look excellent. Our second step was to increase our diversification, a well-known and widely practiced discipline, by increasing our holdings to as many as 25-30 issues. Finally, we think the energy holdings will perform double duty by acting as the traditional inflation hedge they have always played, but also, their proved reserves act as an "in the ground" asset similar to a gold or silver mine. Approximately 71% of our holdings qualify for the Russell 1000, a large cap index. Another 18% fall into the mid-cap arena, with the remaining 11% in the small-cap category.

"…these factors have energized our risk-averse nature and we have crafted a "more defensive, use extra

Stocks: Large cap or small?

I see you predominately favor the large caps over the mid- and small cap stocks? What are their characteristics?

Generally, the large caps are more solid and predictable. Small caps offer more upside and higher long-term growth rates, although at higher P/E ratios. We'll provide an assessment from a recent BCA report. The Russell 2000, a small cap index, is lower by about 5% for the year and sharply down from its outperformance top in March, when it was up 12% for the year and easily outpacing the Russell 1000 (large caps). Today, the large cap index is 6% higher in a complete turnabout. BCA points out a material difference in current P/E multiples, as the large-cap is a somewhat reasonable 18 times earnings, while their junior brethren sit at an exulted 30 P/E.

This multiple is somewhat deceiving for two reasons. First, a significant number of the holdings are fast-growing issues (15%-20%+) and thus, have elevated P/E's to match their high expectations. Other prized prospects have no profits at all (yet), and when their negative numbers are averaged in with the other holdings, it produces a distorted number. Separating out the outliers with no current profit provides a much more acceptable 24 P/E. Next, in a 5-year bull market the faster growth candidates are always going to carry higher valuations than the aging blue chips.

Nonetheless, it's a point well taken. According to BCA's regression models, they believe the smaller caps will underperform the large caps for two reasons:

- ✦ Growing geo-political risks always favor large Blue Chips over smaller and more volatile issues; and
- ✦ the full-time hiring intentions of smaller firms, as opposed to the temp-replacement policy in larger firms, is driving up labor costs. These expenditures will squeeze margins and impact profit growth expectations for these companies.

Year-end estimates have not been adjusted for these inflationary factors. Thus, BCA sees the large caps as the safer leadership with more than ample liquidity and big floats. As we indicated, the majority of our holdings qualify for the large cap index.

In a normal or pre-crisis investment environment, what are your overall long-term strategies for equities?

History demonstrates that long-term, double-digit growth stocks are the most rewarding, regardless of market and economic gyrations. Thus, we search through the sectors, such as medical, healthcare, hi-tech and energy, that have provided those gems. The most successful and rewarding companies demonstrate their internal (or organic) ability to consistently generate their incremental revenue and profit growth. This means they don't have to rely on the constant expansion in our GDP. Since we don't want to put all our stock in the same style basket, we add a sprinkling of value stocks with solid yields and other holdings that have unique long-term profiles. Some call these incubators or promising startups. We believe risk-averse money managers should utilize a multifaceted investment strategy that will help maintain purchasing power while protecting your capital at the same time.

Stocks: Foreign or domestic US holdings?

Do you still favor the US market with the S&P's 50% move? How about European or Asian issues?

"We believe risk-averse money managers should utilize a multifaceted investment strategy that will help maintain purchasing power while protecting your capital at the same time."

The US market has been the best place to stay invested. For example, only 12% of the global MSCI index's gain was attributed to profit growth; the other 88% was entirely P/E affected. The non-US corporate profit pace was tiny relative to ours. Besides, the sanctions are going to take a bite out of the EC firms. Most US bulls are once again forecasting double-digit earnings gains in the second half of the year. Corporate America is encouraging this bullish outlook with their huge buy-backs and M&A activity. Dividend boosts are almost universal in today's environment. Investor confidence levels are significantly higher than 12-18 months ago. Just after January's profit taking, money began to flow out of bond funds. Yields were rising then, and these funds came into the equity markets. This steady flow continues and stands as a reinforcing bullish prop to the growing equity chorus.

Strategy, sectors and reserves.

So, are you advocating more cash reserves in your defensive measures? Tell me your current strategy. Please, provide the major factors that will determine your changes in either sectors or strategy. And, that I think will wrap it up. Thank you.

We will answer your last question first. We believe three sobering factors stand out:

- an underperforming GDP;
- a "do nothing" Congress that will not solve or help ease our nation's problems; and
- a Fed that keeps interest rates at zero while constantly inflating to reduce our purchasing power.

Turning to our sector selection, we noted earlier: we are overweighting our holdings in Energy, HealthCare and Technology. Our next most favored sectors are Consumer Staples and Industrials. These are followed by Financials and Consumer Discretionary. We have no holdings in Telecom, Materials or Utilities. Most accounts have a 12% or higher buying reserve. Some want higher levels of cash for personal or gifting reasons.

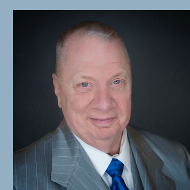
It is true that we have an expanding stock market without the supporting fundamentals of a growing economy and that this is likely to result in a tricky and volatile market. But those who flee merely to relieve themselves of what they perceive (however correctly) to be an unfavorable risk-reward relationship, may not be properly evaluating their steady and continuous loss of purchasing power. Anyone who is totally risk-averse, and we have met these souls, are really risk-evading to the point of totally avoiding all risks. They will never be willing to try and capture any rewards. High inflation can destroy their wealth, even though they retain every dollar they have. These investors are willing to crawl into hibernation to avoid what they will always see as a market that can fall at any moment. While this is true, the overall record favors intelligent management of risks because it exists not only in the financial markets but also throughout life itself. So, what is the best way to do this?

We believe the big risks are the top-down, macro-economic ones, for they wipeout wealth through the destruction of jobs, companies and the severe or ongoing decline in purchasing power. As we noted earlier, the 1913 Dollar is now worth five cents of

purchasing power. Explained another way, you need twenty dollars to buy what could have purchased for a buck back then. Worse still, the 1913 Dollar had gold backing; today, it's fiat money. To stay ahead of these trends, we strongly believe one must study economics, as well as the history of mankind's supervision of his fellow man (through government). While one can do almost nothing about the latter, we think we can, with the correct foresight, do a lot about the former. That way we will stay ahead of the crowd. We are pleased that our readers find value in what we say and do, and we make this Commentary available to any who request it.

Charles A Knott, Co-CIO
Author

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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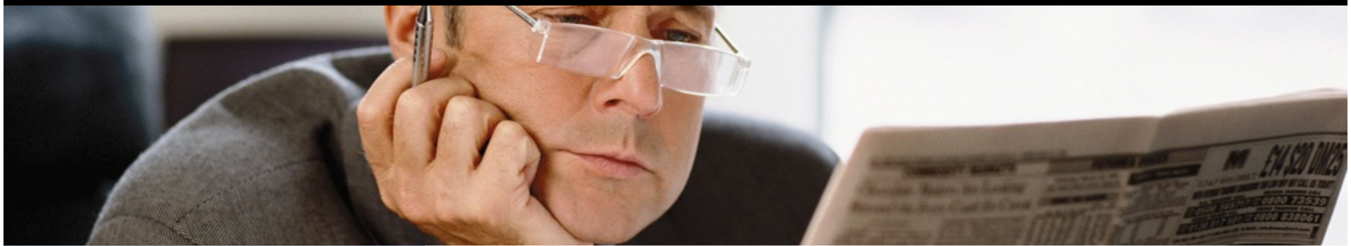

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Investor Newsletter

The Commentary

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

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