

As the first quarter comes to a close, we see the foundation being laid for a significant economic divergence over the next two quarters. A divergence is simply the point where two things split off from each other and begin to move in distinct directions. Economically, we use this phrase to refer to conditions where the economy and stock market decouple and move in different directions.

Benjamin Graham famously stated, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." His quote, accurate in our view, supports the idea that short-term movements in stocks are based on supply and demand for stocks (voting yes when buying and voting no when selling) but that long-term market performance is based on the "weight" or quantity of corporate earnings. We, along with every other analyst and portfolio manager, spend considerable time forecasting earnings on individual companies, sectors, and indices in order to project where we expect the equity markets to trade.

The ability to accurately forecast profits, however, will not necessarily lead to success in investing as earnings are only part of the equation. The amount of value attributed to each dollar of earnings, referred to as the market multiple, is just as critical. During the bull market of the 1990's, approximately 67% of stock gains were the result of multiple expansion, not an increase in earnings. The effect of multiple expansion since October 2011 is even more pronounced with 75% of market gains resulting from higher multiples.

margins, sentiment, and interest rates. Multiples have also shown to be mean reverting over full market cycles. We identify two compelling reasons that may result in multiple contraction this year creating a divergence between economic growth and market gains. First, as the bar chart shows, the U.S. is the laggard in the Citi Economic Surprise Index that tracks countries' actual economic performances against forecasts. The U.S. data has mostly disappointed since the beginning of 2015, which tends to cause an

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erosion of confidence and enthusiasm among investors. Many of the misses can be attributed to strength in the U.S. dollar that should only be a transitory impact but the data has clearly not met expectations.

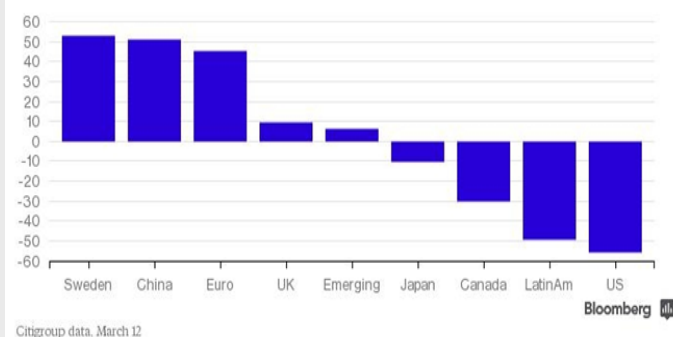
The second reason we anticipate seeing multiple compression is a global flight to safety as emerging markets will likely enter crisis mode when the Fed begins slowly raising rates. Even small rate hikes could have a disproportionate impact in emerging markets as it will drive the U.S. dollar higher and increase borrowing costs. There is a meaningful possibility that defaults could spike in the 2<sup>nd</sup> half of 2015 in the emerging markets, sparking some panic selling and reducing investor appetite for risk.

When the U.S. dollar rose strongly in the 1990's it caused a severe contraction in corporate profits. The combination of Paul Volker's rate hikes and Reaganomics (tax cuts and deregulation) resulted in a surge in the value of the dollar and a loss of competitiveness for U.S. export firms. We believe companies are better prepared this time but the impact will still be felt.

We are responding to the anticipated divergence by adjusting portfolios to more defensive sectors and companies with strong domestic revenues and earnings. As volatility increases, the importance of owning strong fundamental stocks grows as well. When the quality, not only quantity, of a company's earnings is high, they tend to correct less and rebound much more quickly.

## Most Disappointing in World

Citi's Economic Surprise Indexes show U.S. has most disappointment relative to forecasts



When multiples begin to compress, equity prices are very likely to fall even though economic growth may continue to be robust.

Stock market multiples historically expand or contract based on many factors including growth rates,

## “The Market’s Rigged”

Acclaimed author, Michael Lewis, is back in the news with the proclamation that “The market’s rigged.” Lewis reemerged in the media one year following his book “Flash Boys,” explaining things had not changed in the year since he penned the book. Lewis brought to the mainstream the debate over the impact high frequency trading (HFT), almost instantaneous computerized trading, has on markets and investors’ decision making. Lewis made the case and continues to postulate that the market is not fair for all participants. The implications, if this is an accurate assessment, potentially run deep and may impact all investors from Main Street to Wall Street.

Lewis, in support of the market unfairly favoring the HFT systems, said “[c]omplexity is the new opacity in the financial market. The way bad behavior gets disguised is it gets made very complicated. Complexity was at the root of the financial crisis.” Former SEC Director of Trading and Markets, John Ramsay is also speaking openly over concerns. “The current market ecosystem is not sustainable and significant changes are coming one way or another.”

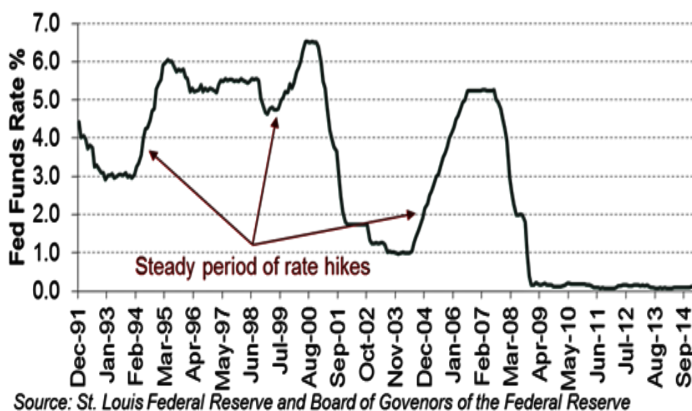
The HFT industry is not going to lay down, given the magnitude of activity and revenue generated from HFT. Trading and clearing company, ConvergEx, surveyed 3000 institutional investors. 57% of respondents did not think the market was fair for all participants, improved from 70% a year earlier. ConvergEx cites a growing confidence that the market can handle external shocks despite skepticism. The poll continued to state that 9% of respondents felt that HFT was “very harmful” and 20% stated that HFT was “helpful.” It may also be helpful that the percentage of shares traded through HFT is decreasing from 61% in 2009 to below 50% in 2014, according to thestreet.com.

Technology has made markets more liquid than ever, and current central bank policy have been helpful to market appreciation. For portfolio managers, the blessing can also be the curse, requiring mindful discipline. First, it becomes difficult to accurately price securities in the short term based on fundamental valuations of the securities. Prices may be artificially inflated based on HFT and central bank policy. Secondly, there is an assumption in portfolio theory that states that the capital market is perfectly competitive, and, therefore, it is not possible for anyone to manipulate the market. This may not be the case in evaluating portfolios and their holdings, specifically over the short term. Finally, the current, competitive environment requires a very high level of expertise in trade execution and in pursuing best execution. Poor execution can greatly erode returns for investors. The need for a research driven, disciplined, rules based process has never been more important in our view.

## To Hike or not to Hike... That is the Question

Here we are at what appears to be a key inflection point in U.S. Federal Reserve monetary policy. In March and right on cue, the Fed removed the word “patient” from its policy statement, suggesting an imminent move away from the unprecedented zero-interest-rate policy (ZIRP) that has existed for over 6 years. But while the removal of “patient” was widely expected and thought by many to mean a likely June rate hike, the Fed unexpectedly remained dovish in its overall tone, setting equity markets off to the races before some disappointing economic data and geopolitical worries dampened the bullish mood late in the month. Should the Fed begin normalizing monetary policy? And if so, what could it mean for equity markets and the U.S. economy?

The Fed continues to be a major driver of market sentiment and asset prices, and it has clearly signaled that the timing and pace of its policy normalization will depend on the status of the U.S. economy. In her press conference following the March 18<sup>th</sup> FOMC meeting, Fed Chairperson Janet Yellen said “...our policy needs to be data dependent and we need to respond to incoming data...” This suggests to us more uncertainty and the potential for greater volatility across asset classes as market participants attempt to guess the timing of the Fed’s initial rate hike and if it will follow the traditional steady pattern of recent history.



We continue to believe there is a great chance that the initial hike comes later than the June meeting, perhaps September or even December. If the initial hike does come in June, we believe the pace will not mirror the July 2004 to July 2006 string of hikes, or the ones from 1999 to 2000 and 1993 to 1995 (see chart). The U.S. economy remains fragile in our view. In addition, we think the Fed can afford to err on the side of caution given the absence of inflation and the deflationary pressures that continue to plague the global economy.

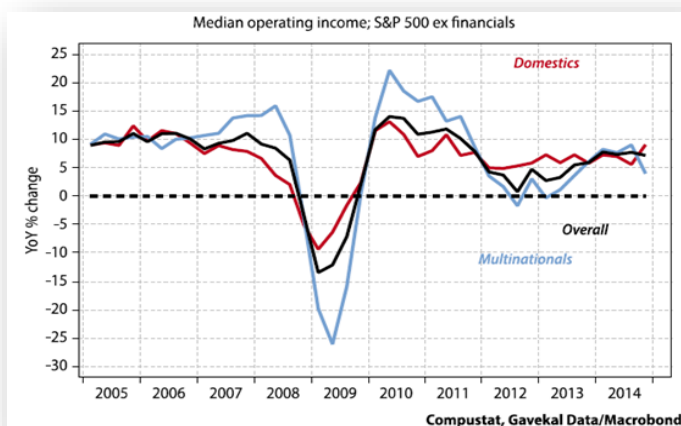
Sustainable economic growth and what represents neutral monetary policy are big unknowns in our view, particularly because of the unevenness of the current recovery, the fact that U.S. GDP growth has been well below the 4% historical average coming out of the 2009 recession and the relatively low inflation we have seen over the last decade or so. With the U.S. economy having possibly entered into a structurally slower average growth phase we believe this suggests the fed funds rate could top out at a much lower level than in the past. And, it could take quite some time before we see a fed funds rate above even 1%. In short, the Fed is likely to move very slowly, if at all, in lifting the federal funds rate.

The U.S. economy could likely withstand a 0.25-0.50% fed funds rate. For equity markets, the ZIRP has represented a tailwind. And with the tailwind lessening, we would expect more volatility in the months ahead and more of a stockpicker's market to materialize.

## Margin Squeeze

A confluence of events is resulting in one of the largest corporate earnings squeeze the market has experienced in several decades. Even though the Fed remains ultra-accommodative with rates at historic lows, growing headwinds are making it difficult for companies to maintain margins at record levels.

We are not currently forecasting a recession in the next two quarters but believe the market could experience a short-term profit recession. Operating earnings on the S&P 500 recently fell to stall speed level of



1.4% on a year-over-year basis. Revenue growth in the 4<sup>th</sup> quarter of 2014 was anemic on an aggregate basis, but the breakdown between domestic and multi-nationals was stark. Domestic revenue grew at an annualized +2.5% in the 4<sup>th</sup> quarter while

multinational firms saw a decrease of -4.3% in the same period (source: Bloomberg). When you consider companies with at least 30% of sales from overseas had +2.8% growth in the 3<sup>rd</sup> quarter, there was a sequential quarterly drop of -7.1% in revenues for multinationals (source: Bloomberg).

Even as the dollar gave back some gains against the euro and yen in March, the apparent slowdown in corporate activity remained intact. The real-time gauge of GDP from the Atlanta Fed fell to an abysmal 0.2% for the 1<sup>st</sup> quarter of 2015 as of March 30<sup>th</sup>, down from a forecasted 2.0% when March began.

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For multinational companies (over 30% of S&P 500 profits come from overseas operations), we are closely watching the movement of the U.S. dollar. Companies have but two choices in responding to the rising greenback (beyond what they have hedged in currency markets). First, they can protect margins and pass the impact of a stronger dollar along in their pricing. Unit-sale margins are protected in this strategy but the cost of their product overseas increases substantially and hurt competitiveness and future sales. The other option is to maintain pricing but that requires reducing margins by significant levels.

For domestic firms, we are tracking labor costs as that is where the bottom line is impacted the soonest. While the labor market is tight today after creating more than 200,000 new jobs in each of the last 12 months, there so far has been minimal increase in unit labor costs. Part of this can be explained by the low participation rate as workers not actively looking for a job today will start when they are confident good jobs are available.

The one bright spot from a valuation standpoint that shelters the impact of falling profits is corporate buybacks. As record levels of cash on balance sheets is used to buy company stock, the number of shares the earnings are divided by continues to shrink keeping earnings per share relatively stable.



## Macro View

The economy continues to show mixed signals with weaker data points building. It is well documented that the Fed is particularly focused on inflation, wage growth and employment. Soft economic results are clouding the Fed's decision making process as to when and at what pace to raise rates. Retail sales have fallen for three consecutive months. Industrial production only grew by 0.1% in February, following negative growth in December and January. Inflation has fallen for three months and has been below the Fed's 2.0% objective for 33 months (source: Federal Reserve Bank of St. Louis). Employment is one sign of strength. According to the Commerce Department, the unemployment rate dropped to 5.5% in February, the lowest in nearly seven years. The economy added 295,000 jobs in February and 3.3 million jobs in the 12 months through February. This is the greatest 12-month increase in the labor market since 2000. The market responded to the jobs numbers with a vote of confidence that the Fed would begin raising rates in June demonstrated by June fed-funds futures contracts pricing in a 70% probability of a move of 0.25% to 0.50%, up from 48% the day before the jobs report came out, according to 361 Capital.

The chart below, depicting economic surprise among US companies, was also very telling of the weakness in the economy. The U.S. Economic Surprise Index demonstrates whether economic data exceeded or fell below forecasts. The index is at its lowest level since

### Missing Expectations

The Bloomberg U.S. Economic Surprise Index is at its lowest point since 2009



2009. Citigroup tracks economic surprise indexes for nations across the globe. The U.S. is the most disappointing relative to consensus forecasts followed by Latin America and Canada, as of March 12 (source: Bloomberg). It should be noted that the index and the U.S.'s poor standing do not translate in to being the worst economy in the world. Rather, it can be

interpreted that the U.S. is repeatedly falling short of relatively high expectations. Analysts often use the index as a gauge for when an economy may be turning from strength to weakness or vice versa. We believe this is one more indication that the U.S. economic expansion and the bull market are "long in the tooth."

## Taking Stock

Entering 2015 we were not concerned about valuations as we expected earnings growth to be sufficient to not pressure multiples that were only slightly above



long-term averages. With the Atlanta Fed now forecasting 1Q15 GDP at 0.2%, we have no choice but to become concerned about forward equity valuations. It is not an issue of the market getting ahead of itself right now, but whether or not it will fail to deliver what investors are looking for to justify current valuations.

The Shiller P/E ratio which uses 10-year rolling periods to smooth the business cycle is currently trading at 34% above its long-term mean and at almost the exact level before the 2008 severe correction. Both the Shiller and traditional P/E measures are in the highest historical quintiles (20% most expensive) suggesting a steep correction in stock prices could come more rapidly than expected.

U.S. stocks have outperformed both their developed and emerging market counterparts each of the previous 4 years and most analysts went into 2015 believing history would repeat. After the first quarter, the Nikkei and Shanghai indices are up around 13% and the Eurozone is higher by 7.5%, leaving the flat U.S. markets behind.

We are likely to guide our earnings estimates lower after 1Q15 results are announced and it increasingly looks like it will require some good old-fashioned American ingenuity (i.e. financial engineering) to keep a bid in stocks the remainder of 2015.

## Income Unconstrained

### Losing Patience!

The fever pitch in which the market tracks every word spoken by the Fed has become absurd. In their latest policy statement, as expected, the Fed dropped the word “patient” when referring to when policy normalization would occur. Based on Chair Yellen’s previous guidance, this means the Fed “could” start raising rates two meetings from now (June) at the earliest.

The Committee did a good job of keeping the attention of fixed income traders focused on their commitment to be data-dependent. Since the unemployment rate continues to drop, the only criteria keeping the Fed from proceeding with rate hikes is their inflation expectations. They want to see expectations for 2% inflation and that simply is not happening after January CPI was -0.1% and February was essentially flat (source: St. Louis Fed).

We closely monitor the spread between the 10-year Treasury and the 2-year Treasury yields as it reveals whether the yield curve is steepening or flattening. Our expectation of long-term yields holding, or slightly declining, continues to be affirmed with current spreads. With some Eurozone yields falling below zero, U.S. Treasuries look like a bargain to us.

Based on the latest economic releases, we expect the Fed to raise rates in their September meeting and for the pace to remain even more measured than currently forecasted by the market.

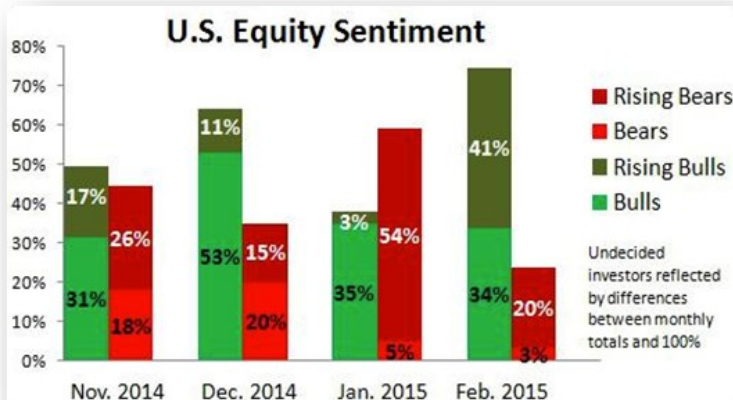


## Getting Technical

The markets are fighting to regain the lofty, historical highs even as the economic data has come in weak. Sentiment is extremely important to technical analysis even though it can be fickle and change direction rapidly. A bull market that is expensive and beaten all the odds to remain in place beyond 6 years, leaves us feeling somewhat vulnerable on all long positions. The outperformance in Asia and Europe, potentially giving investors an alternative to U.S. stocks, raises the fear level even more.

The latest Investor’s Intelligence survey showed the percentage of bearish advisors is at 14%, a level only achieved 3 times in the last 35 years. The chart from Seeking Alpha equally demonstrates the lack of fear or concern for a major correction in equities.

Another key technical indicator for us is margin debt that continues to be reduced from the highs set in 2014 when it peaked at nearly identical levels to the market tops in 2000



and 2007. If history is to repeat or rhyme, a greater than 20% correction could be imminent.

We have adjusted our equity models to hold slightly higher cash levels in order to minimize the impact of a sudden loss of confidence in the U.S. stock market.

## Currency and Commodities

Over the course of the year, discussion and analysis of the U.S. dollar versus other currencies and the collapse of oil have been in focus. This month, attention will be turned to base metals and what copper may or may not be telling investors about the global economy.

Copper has long been regarded for its ability as a leading economic indicator, rallying in advance of economic strength and declining ahead of economic contractions. This tenet has been challenged in the recent bull market. The price of copper has fallen by over 30% over the past three years while the U.S. economy has strengthened and market has dramatically appreciated (source: Bloomberg). The base metal showed potential weakness earlier in the year followed by a dramatic jump late in the month of March, oddly at a time defined by weakness in the global economy and a stagnant China.

Copper may be becoming more of a bellwether of China’s economy rather than the U.S. or the global economy. China, the number one purchaser of copper, consumes five times the quantity of copper than the second largest consumer, the U.S. According to the Shanghai Futures Exchange, deliverable stockpiles of copper are up 70% since December. Further, China’s share of world copper demand has more than doubled to 47% in December 2014 from 20% in 2003 (Source: Bloomberg).

Shifts in the U.S. economy also make a case for copper being a leading indicator of China’s economy more so than the U.S. or global condition. Former Fed Chairman, Alan Greenspan and Commerce Department data, pointed out that services account for 87% of U.S. economic output, compared with 72% in the early 1950s, shrinking manufacturing to less than 13% of economic output from 28%. It galvanizes the belief that the post Great Recession bull market and economic stability are largely attributed to accommodative Fed policy.

## Q : Can one really invest for the long-term like Warren Buffett?



Short answer, NO!

Warren Buffett is the greatest contemporary disciple of Benjamin Graham and has had a tremendous impact on stock market investors. He and his team's greatest contribution to investing, when the history books are written, will likely be their ability to determine the long-term intrinsic value of a company and then having the will to hold course and allow their research to be validated.

In practice, however, Mr. Buffett is able to bypass many of the laws set up to protect the investing public because of how he structured his firm. He carries many of the investments made in Berkshire Hathaway at a valuation other than current fair market value (even for stocks that trade publicly). He has accomplished this by buying special share classes that use common stock only as a proxy.

Berkshire was not required to write down many of the financial companies they owned during the Great Recession, a benefit that allowed him to shelter hundreds of millions in losses while waiting for his companies to recover.

We have a lot to learn from Mr. Buffett but are not afforded the ability to invest as he does.



I think a lot of investors like to think they already invest like Mr. Buffett, but the reality is that most fall short. One of the main principles Mr. Buffett follows is in fully understanding what he is investing in. I think this is a very good principle to follow regardless of the investment vehicle used. I think investors have a tendency to follow the "herd" and invest in the hottest fund or stock without really attempting to understand the investment strategy or what the company does. This is very dangerous in my view and can easily lead to buying high and selling low, something that can result in frustration and falling short of investment goals. I think fully understanding an investment before putting money at risk is something all investors can and should easily do.

I would also say that Mr. Buffett has a very long-term mindset, meaning he is looking at an investment that he would feel comfortable holding for at least five years and likely a lot longer. I think the attention span of the average investor – and I would lump some professional money managers and company CEOs into this group – is 3 months to a year. It's all about fund quartile performance or beating the "Street's" consensus estimates. This can lead to value destroying investing in my view. I like that Mr. Buffett considers the returns generated by the businesses he purchases and each company's unique value proposition or how wide the company's "moat" is. One other thing I've observed about Mr. Buffett is that he is a high-conviction investor. That is, he is quite comfortable in making a big bet. I am a big proponent of high-conviction investing, particularly if it follows a sound rules-based research driven process.

## Q : Are we on the brink of WWII?



A dangerous question to answer because it is easy to come across as reactionary and inflammatory on one hand and callous and uninformed on the other. While there is a lot of saber-rattling in the world right now, I do not believe we are near an outbreak of war pitting major nations or regions of the world against one another.

ISIS/ISIL/IS I believe has overplayed their hand leading to a coalition of nations united to stop their spread. It will always be true that the enemy of my enemy is my friend. Russia concerns me the most but it remains highly unlikely they would attempt aggression outside of their own geographic bordering countries and the West has shown little interest in drawing a line in the sand with either Ukraine or the Baltic nations.

A more interesting question, in my opinion, is what is causing the clear spike in global violence and conflict. I believe that economic policy, designed to try and stave off pain and displacement that results from too much debt and bad policy decisions, have actually compounded the plight of those being marginalized.

Too many global economic policies have targeted outcomes as their goal instead of pursuing greater levels of freedom and opportunity and allowing the free markets to pick winners and losers. The truth remains, if you remove the possibility of losing, by definition, you lose the possibility of winning.



This is certainly a legitimate question in my view given the continued turmoil in the Middle East and Russia's aggression in Ukraine. In fact, conditions in the Middle East have clearly deteriorated with Iranian-backed Shiite rebels in Yemen over throwing what used to be a U.S.-friendly government. Saudi Arabia, a largely Sunni population, has responded with an air campaign, taking the initiative and leading a coalition to quell the Yemen rebels. Then there is ISIS in Iraq, continued unrest in Libya and an ongoing civil war in Syria. Let's not forget the negotiations between the U.S. and Iran regarding Iran's nuclear program. There are a lot of things for investors to digest, many of which remain unpredictable.

The Middle East has always been a complicated region. This is not something new. But perhaps things are a little more concerning than normal. I recently read a Wall Street Journal article that put it rather eloquently by saying "[t]he Middle East has descended into a state of disarray unusual even for that troubled region..." Despite all of this, equity markets worldwide remain near multi-year or all-time highs and oil prices are still near recent lows. So, for now, the unrest has not spooked investors as financial markets do not appear to be discounting the potential for the regional conflict to escalate into something far more reaching, like another global war. I would not rule out the potential for a broader conflict at this point, but investors need to focus on things that are relatively predictable. And geopolitical events are quite difficult to forecast.

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