

“... the borrower is slave to the lender.” ~ *ancient proverb*

Global debt is out of control! Recent research indicates that debt has risen by a staggering \$57 trillion (33%) in just the last 7 years. If we limit our research to the IMF list of advanced economies, the increase in debt is even more troublesome. The most developed nations have seen their debt increase by 40% since 2008 going from 70% of GDP on average to more than 105%. If you consider government, corporate, and individual debt, the U.S. stands at 334% of GDP, Europe is at 460%, and Japan a staggering 655% debt to GDP.

Suffocating levels of debt is at the center of every macroeconomic challenge the world is facing. At its core, debt is simply consumption brought forward. If you are able to save

between 5% and 10% of your income, it would take a long time to save enough to pay for a house so debt allows you to own a house today and pay for it over time. The same is true whether it is a car you do not have enough money to pay for or a Hawaiian vacation you want to enjoy this year even though you don't have the necessary savings.

Economically, there is “good debt” and “bad debt.” Good debt leads to an increase in productivity that facilitates future growth and higher standards of living. Companies buying a piece of equipment or a student investing in an education (depending on the earning potential of their career) are examples of how debt can increase productivity. Bad debt is based on consumption that does not increase productivity or facilitate future growth. You may have great memories stored on your iPhone of that European vacation but the income you use to pay off your trip limits your future spending.

There is much debate about the impact that high debt levels have on economies. Common sense tells us that consumption brought forward will lead to slower future consumption and thus economic slowdown. The IMF forecasts only 1.6% annual growth for advanced economies over the next five years, the slowest in generations and debt seems to be an obvious cause of the slow growth. John Maynard Keynes, whose economic theory is practiced by nearly every developed economy, counseled governments to deficit spend (debt) during periods of recession or crisis to stimulate the economy.

The world has excelled at implementing Keynesian economics. Unfortunately, the same governments committed to deficit spending during recessions are ignoring Keynes admonition to pay down debt during periods of prosperity; reloading the tools necessary to fight the next crisis.

Binge spending by governments has left the world economy in shambles with policy makers simply navigating one crisis after another.

There are 3 serious consequences of high debt levels:

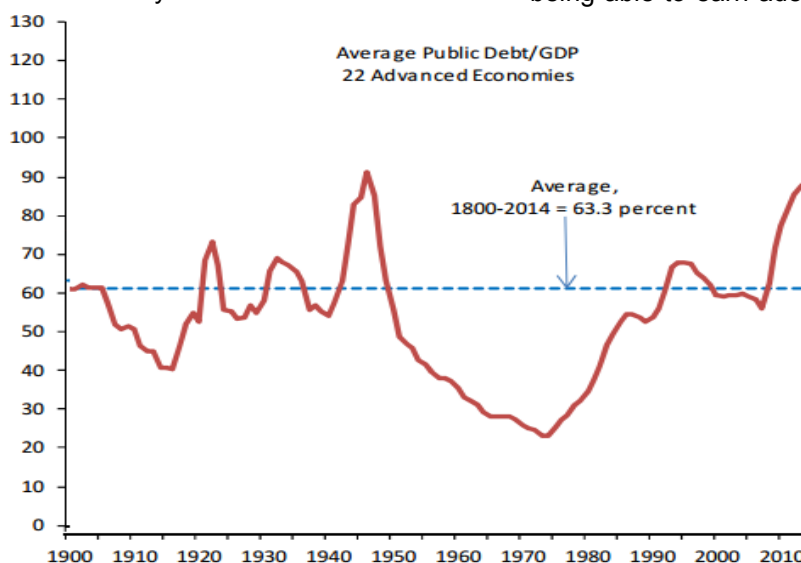
1. **Disinflation:** also known as deflation at the extreme. This is the result of a decrease in aggregate demand in an economy and caused by bringing consumption forward.
2. **Financial Repression:** central bankers are more concerned with their ability to repay debt than savers being able to earn adequate returns. Keeping interest rates at artificially suppressed lows essentially transfers wealth from retirees (fixed incomes) to risk takers (stock market investors).
3. **Ineffective Monetary Policy:** debt to GDP ratios have achieved levels that make the policies of the Fed and other central banks nearly useless; pushing on a string. The faster the Fed prints money the more the velocity of money falls making their attempts futile.

All hope is not lost, however. McKinsey Global Institute has done comprehensive

analysis on the impact of debt and performed case studies of countries who have recovered from extreme debt levels. They identified 32 examples over the last 100 years including 8 examples between 1990 and 2007 when extremely indebted countries reduced their debt to GDP ratio by 30% or more. Examples include:

- ▶ Belgium reduced their debt ratio by 51 percentage points from 1993 to 2007 falling from 139% to 81% of GDP.
- ▶ Canada was able to move from 101% to 67%, a drop of 34 percentage points, between 1996 and 2007.
- ▶ Sweden cut their debt ratio by 49 percentage points, from 70% GDP to 36% between the years 1996 and 2007.
- ▶ Even the U.S. succeeded in reducing debt to GDP by 19 percentage points, from 72% to 53%, from 1993 to 2001.

Herb Stein, who served as Chairman of the Council of Economic Advisors, coined what has become known as Stein's Law: If something cannot go on forever, it will stop. Centuries of experience has taught the world that debt has limits and when they are reached, the pain for those economies can become extreme. Let us hope that economic and political leaders emerge that have the conviction to implement necessary reform before it is too late.



The New Mediocre

The International Monetary Fund (IMF) convened in Washington D.C. this past month prior to, and in conjunction with, the G-20's spring meetings. Christine Lagarde, Managing Director of the IMF, furthered her coined phrase of describing the global economy as the "new mediocre." She continued by encouraging the financial community and central bankers to prevent the "new mediocre" from becoming the "new reality." Lagarde emphasized her view that global growth is moderate and uneven, and that boosting growth requires more effective demand-directed policies and structural reforms. She also pointed out that international cooperation is critical to global economic growth.

According to the IMF, global growth in 2014 was 3.4%, in line with the average for the past three decades. Lagarde pointed out that low oil prices have supported growth, but policymakers and central bankers worldwide must work together to facilitate smooth, sustainable growth. Driving home the point, she cited John F. Kennedy's quote "comfortable inaction is what must be avoided."

Global growth faces headwinds that must be acknowledged by portfolio managers, namely rising macroeconomic and financial risks. For growth to take hold, it likely requires structural reforms to replace accommodative monetary policy. There is significant risk of perpetuating the slow growth, elevated deflationary pressure, and high debt, high unemployment environment pervasive across developed economies, including the U.S. Furthermore, financial risks persist. Risk is being transferred from developed economies to emerging economies. Lagarde made the point that policymakers cannot take excessive risk in an attempt to spark economic demand during periods of stress given the potential that this can lead to vulnerabilities in market liquidity.

Lagarde pointed to research by the IMF that shows the benefits of structural reforms and sound monetary and fiscal policy. Examples from the IMF research include the benefit of infrastructure investment, namely. The research found that growth is largely a result of increases in productivity, labor force participation and trade. Reversing the decline in productivity is the product of lowering barriers to entry, according to the IMF. The IMF suggests dealing with inequality in the labor market as a solution to depressed labor force participation. Trade reform is necessary as it potentially furthers growth and inclusion of emerging countries in the global economy.

The case was made for developed and emerging economies to work together, leveraging each other's strengths. The IMF described itself as a partner to nations in providing financing, policy advice and analysis, and capacity building and technical assistance. Lagarde

concluded that "2015 presents a special moment: an opportunity to make a tangible difference in the lives of a large number of people in the world-especially the poorest people."

This is not the first time in economic history where nations have raced to devalue their currencies in order to strengthen their own economies. The IMF emphasized collaboration and cooperation given the extent to which the world functions in an interdependent capacity. Lagarde's comments seem altruistic, though, and contrary to the human tendency to care for one's own needs before caring for the "poorest's."

China to the rescue...doubtful?

China has played a key role in driving global economic growth over the last several years and concerns that its economy may be slowing continue to influence investor sentiment worldwide. In early April, China reported a 7.0% annualized growth rate for the first quarter, which marked a further slowdown in growth from the fourth quarter's 7.3% annual pace (China's National Bureau of Statistics). China has recently been experiencing its slowest economy in over 20 years and this is quite evident in the weak trends across the commodity complex.

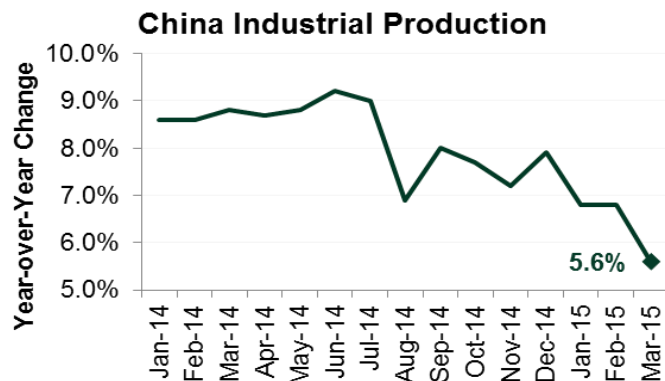


In late April, news that the People's Bank of China (PBOC) cut the reserve requirement ratio for banks, a form of stimulus, helped to propel stocks in Asia and the U.S. higher after a weak stretch related to earnings disappointments and mixed economic data. Weaker manufacturing data out of China, a few days later, caused added volatility for equity prices across the globe. It is clear to us that investors are paying close attention to China's growth prospects. As we've mentioned before, we believe China's growth in 2015 is very likely to come in lower than the PBOC's, China's central bank, 7.0% target. That is, if China is truly honest with its reporting. Given the 7.0% first quarter growth figure, we believe China has very little wiggle room if it is going to hit this target growth rate for 2015.

China's economy is struggling relative to recent history, but not relative to most other economies in the world. Many developed economies would love to have half the growth rate China has. Nevertheless, China is facing continued weakness across many sectors of their economy.

Growth in retail sales, fixed-asset investments and industrial production all remained in a downtrend at the end of March.

China's housing market remains weak as does its construction activity amid the strong headwinds abroad. Growth in industrial production continued to slow through March and it would appear that stagnant growth among



Source: China's National Bureau of Statistics

the economies of key trading partners like Europe and Japan continue to impact China's export growth, which surprisingly declined in March, according to China's General Administration of Customs. The U.S. economy may be stuttering as well, thus representing another potential headwind for China's largely export-dependent economy.

The slowing growth in China is prompting policymakers in that country to revert to old tricks in an attempt to stimulate its economy. Increased infrastructure spending, easier credit and lower borrowing costs are some of the methods they've implemented since the year began. Should China exceed 7.0% we may likely see a boost to investor sentiment. But it will probably be short-lived as we think any growth from stimulus will be fleeting and only serve to delay the real structural forms China needs in order to have a more balanced economy with potentially more sustainable, less export-dependent growth.

I'd Buy That

U.S. corporations are facing a serious problem; a problem they have to confront that will likely determine their long-term success. What is this menacing issue you ask? What do they do with their stockpiles of cash sitting on their balance sheets? Publicly traded U.S. companies have hoarded nearly \$2 trillion in cash and pressure is mounting for them to do something productive with these assets.

FactSet figures reveal that 362 of the 500 companies in the S&P 500 bought their own shares during the 4th quarter of 2014. The 500 largest market capitalization companies returned to shareholders more than \$900

billion in 2014, an increase of more than 15% from the prior year, and \$553 billion was in the form of share buybacks.

Not surprisingly, Apple, the largest market cap in the world, spent more than any other company to buy its own shares. Apple spent \$45 billion in 2013 alone on buybacks, more than three times what Exxon Mobil, the next largest spender, allocated for buying shares. On Monday, Apple announced during their earnings call they were increasing their capital return program from \$130 billion to \$200 billion with share repurchases increasing from \$90 billion to \$140 billion.

The question is do share repurchase commitments create value for shareholders? We believe the answer to that question is unequivocally yes. Reducing the number of shares outstanding essentially increases the amount of earnings per share for the remaining shareholders. This method of returning capital to shareholders is far more tax efficient than the alternative, paying dividends, and far less risky than spending excess cash on new acquisitions.

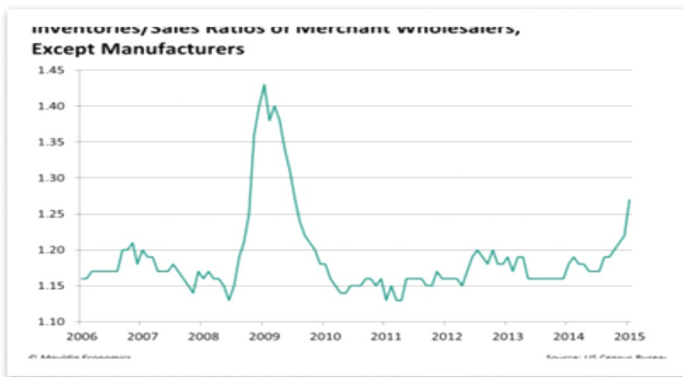


We are not suggesting dividends and acquisitions do not make sense. In fact, we favor companies with long track records of increasing their dividend payout, something Apple also announced this week. Dividends, however, are taxed at both the corporate level and at the shareholder level making them tax inefficient. Merger and acquisition activity is high but history suggests that in a majority of cases the company doing the acquiring spends too much on the target company and the benefits tend to be less accretive than management expected.

McKinsey analyzed share buybacks among S&P 500 companies and found it is an effective way of enhancing shareholder value. Goldman Sachs, who project more than \$60 billion will be spend on buybacks in 2015, is convinced companies with high capital return programs will outperform other companies. As the chart below shows, it is hard to argue with the results.

Macro View

The Fed on Wednesday cut their growth targets for the U.S. economy after the 1st print of Q1 GDP came in at a disappointing 0.2% according to the Bureau of Economic Analysis. Last month we began writing and speaking about our belief that the economy was headed towards a “profit recession” and the expectation that EPS (earnings per share) would be lower this year than last.



Consensus earnings estimates for 2015 on the S&P 500 stood at \$136 in October 2014. The consensus has fallen to \$119 and we expect further revisions lower. As the earnings season winds down in the next couple of weeks, earnings in the 1st quarter of 2015 appear to be on pace to come in 4.6% lower than Q4 and 2% below the dismal results of Q1 2014. We forecast profits to fall again in Q2, likely coming in around 2% lower than what was reported for Q1.

While there are several data points we track to make our forecasts, one of the most troubling for our macroeconomic outlook is inventory buildup. When inventory levels are rising it is typically a sign that end demand is weak. Companies will often keep existing orders in place but slow future orders. Inventory levels have climbed to the highest level since 2009 and suggest to us that the 2nd quarter is unlikely to experience a strong rebound in activity.

While this data is consistent with other data, such as Citi's Economic Surprise index, it remains a little bit puzzling why lower energy prices and solid consumer confidence numbers have not resulted in stronger consumer spending. The savings rate in the U.S. has risen this year by 50%, moving from 4% to 6%, time will

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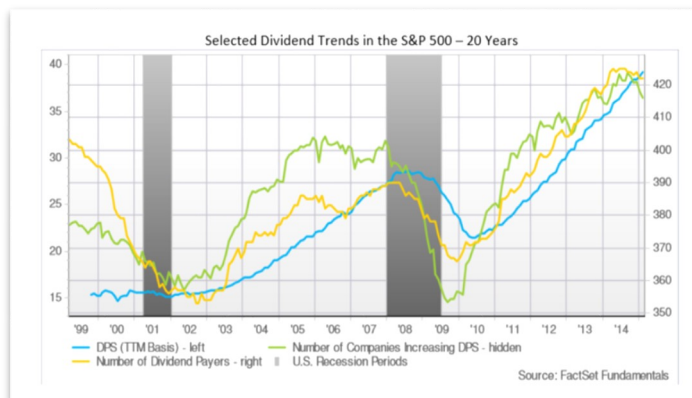
tell if consumers put frugality behind them anytime soon and begin to spend the savings at the pump.

Taking Stock

We've already touched on the overwhelming trend in share buybacks among corporations as they attempt to do something with the “glut” of cash in their coffers. A similar trend is occurring specific to dividends. Bloomberg demonstrates why dividends matter by stating that on a pretax basis, dividends have accounted for nearly half (46 percent) of total return for the S&P 500 index during the past 25 years. Companies in the S&P 500 paid \$375.9 Billion in dividends in aggregate during the trailing 12-month period ending in January 31, 2015 (Factset). The Fourth quarter of 2014 was the fourth consecutive quarter that the amount of dividends paid on a trailing 12-month basis reached a new record high.

The chart below shows the decline in dividend growth during the Great Recession. It also depicts in green the number of companies increasing dividends per share (DPS). The blue line is also very telling as it reveals the trailing 12-month (TTM) growth of DPS. DPS grew 11.9% to \$38.77, through January. Analysts estimate DPS growth will be 8.2% over the next 12 months.

On a sector breakdown, increases in dividends came predominantly from the Financial and Information



Technology sectors. Exxon Mobil and Apple paid the largest aggregate dividends on a trailing-12-month basis at \$11.6 billion and \$11.2 billion, respectively.

The dividend yield on a trailing-12-month basis was 1.9% at the end of Q4 2014. This is equal to the 10-year median for the S&P 500 (Factset).

In a low interest-rate environment, dividends are providing a possible cash flow solution. It requires careful analysis to determine whether the risks associated with equities are worth it relative to fixed income. In addition, there is the challenge of maintaining a higher yield in an equity portfolio than the 1.9% 10-year average available by holding the S&P 500 index. The trick is doing so without increasing the portfolio's risk.

Income Unconstrained

Volatility in the fixed income markets should get a short-term reprieve from the rather surprising (not to us) initial reading of 1st quarter GDP. Our macroeconomic models suggest a strong rebound in growth in the 2nd quarter is very unlikely so with the 10-year Treasury at 2.08% at the time of publishing this report we view long duration Treasuries as attractive.

Less attractive in the near term are emerging market bonds. This is for two reasons: first, massive levels of dollar denominated debt have been issued in the emerging market countries over the last 6 years and local currencies have fallen against the US dollar. This is making the debt burden much higher on these governments and companies and creating what is known as a dollar squeeze. We are also quite concerned about the political situation in two of the largest allocations in emerging markets; Russia and Venezuela. Both governments are highly dependent on oil revenues and instability internally is rising.

We have also been trimming our position in convertible bonds as we expect 2015 to experience an earnings recession. Convertible bonds have had a great run as the equity markets have stretched to new highs and profit taking through lower allocations simply makes sense.

We remain very bullish on muni bonds and recently increased our exposure to mortgage-backed bonds in a somewhat contrarian view. We think the slow growth economy gives the Fed more time and leeway before needing to tighten monetary policy and should result in the Fed extending their full reinvestment of mortgage-backed, paper likely keeping demand strong.

Getting Technical

There are signs of technical weakness for equities that could lead to much greater downside volatility for stocks. Near the end S&P 500 recently is currently just 2 points above its 50-day moving average and only 3% higher than its 200-day moving average. The only time in the last 3 years the market breached its 200-day moving average was October 10, 2014 and it only remained below for a period of 10 days.

While the economy slowed nearly to 0% growth in Q1, the Leading Economic Index (LEI) has remained surprisingly strong posting gains in all 3 months of the first quarter. The lagging index (LAG) showed the strongest gains being up a full 1% during January through March.

The Fed has been in an accommodative mode for so long (7 years) that many investors are unsure how the markets will respond when the Fed does start hiking rates. With earnings in decline, there is reason to be concerned the Fed could get ahead of the curve even though for years the concern has been that the Fed was slipping further and further behind the curve.

We like to follow the signals that emanate from the Dow Theory and believe a sell signal could result in May if weakness persists. The transportation index failed to surpass

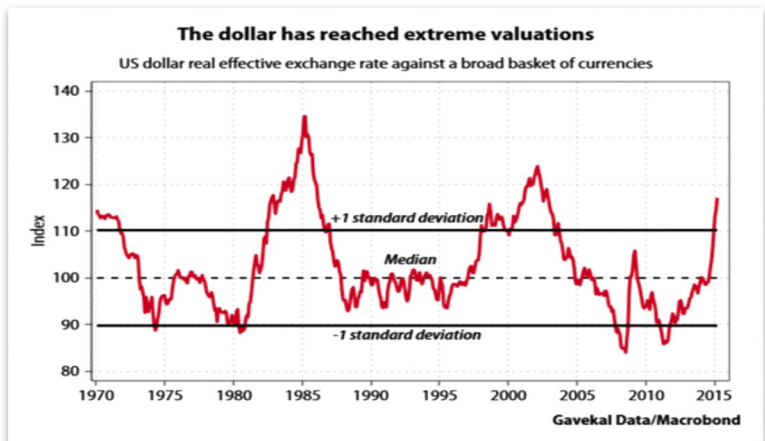
its December 29 high while the utility index is now 10% below its January 2015 high.

We believe volatility is almost certain to remain at elevated levels this year even though the VIX has only modestly risen off its lows. The number of trading days during Q1 where the Dow moved up or down by more than 1% equaled the total number of trading days this occurred during all of 2014. Keep your seatbelts buckled low and tight.

Currency and Commodities

This month, we wanted to take a moment to address a commodity that is removed from the usual suspects like oil, gold and wheat...water. The extent of the current drought in California hit us as we researched various data points and statistics around this vital resource. According to the U.S. Drought Monitor, over 44% of the state is in the most extreme measure of a drought, which is impacting over 37 million people, a staggering figure in our view.

The drought in California is a result of prolonged lack of rain combined with higher temperatures limiting the amount of snow in the mountains that often supplements a lack of rain and provides the state necessary water. The other two sources of water include manmade reservoirs and water pumped from underground aquifers. The political and environmental climate in California has put handcuffs on the water derived from reservoirs and aquifers. This makes any potential solution to the current drought very unique despite the Golden State's long



history of water shortages and finding a way to solve them. The drought's economic impact on the state and potential carryover into the price of other commodities may be the catalyst for state policymakers to seek out more capitalistic solutions surrounding their water challenges. It seems water in California is a rare commodity these days.

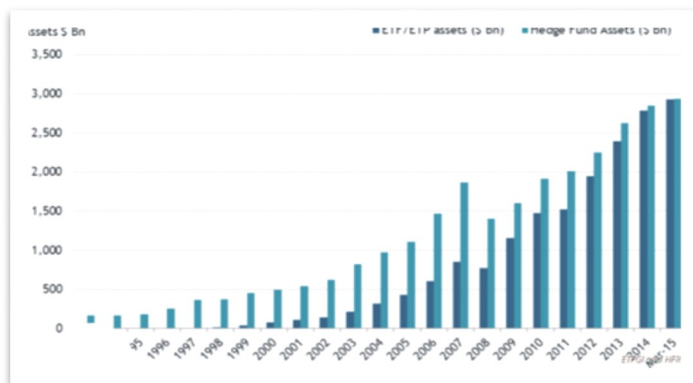
Turning to currencies, the dollar has come off recent highs, giving many analysts reason to take note. The Bulls are left reevaluating their stance on whether a slowdown in the U.S. extends beyond the first quarter. If it does, it could potentially delay the Fed's initial move towards rate normalization. The chart below demonstrates what has caught analysts' attention. The value of the dollar is above 1 standard deviation of its median value. This has only occurred two other times, since the 1970s. It is something we are closely watching.

Q : What's the big deal about ETFs?



Didn't you hear? ETF's are the new hedge funds for the investment community. Just 15 years ago ETF assets represented less than 10% of the assets in hedge funds and according to hedge fund tracker, HFR, ETF assets will surpass holdings in hedge funds.

I believe we are still in the early stages of the ETF revolution and we will see a great deal of innovation in this asset class. The ability of ETFs to combine the diversification offered by mutual funds with the liquidity and trading features of individual stocks, with low costs and transparency will make ETFs the preferred investment vehicle for most investors. When you add in tax efficiency



and ability to allocate to both passive index-based funds as well as actively managed strategies, it is not surprising ETFs are the fastest growing investment-product category.



Passive investing has garnered much attention since the turn of the century given its low costs and the difficulty active management has had in delivering value above its fees on average. You just have to look at fund flows and the phenomenal growth in ETFs over the past decade to see that advisors and investors alike have been frustrated with the relatively poor performance of actively-managed mutual funds. They have been abandoning them in large numbers. Some Morningstar data I recently reviewed indicated only 21% of actively-managed U.S. equity funds have outperformed their benchmarks over the last five-year period ending in March. Only 50% of these funds have outperformed over a ten-year period. So investors are justified in this exodus in my view.

Overall I think ETFs offer great flexibility for advisors to implement a low-cost tactical approach for their clients' portfolios and potentially add a great deal of value in the process. More and more advisors are presenting themselves as ETF strategists these days as a result. So, active management is not dead in my view. It's just moved into the hands of the advisor. Still, I firmly believe that active stock selection, if done with conviction and is driven by a highly disciplined rules-based process, can work. It

has to be truly active and the advisor must be willing to deviate from the targeted benchmark. Most actively-managed mutual funds fail to do this in my view, thus resulting in little value being delivered by them.

Q : How do you use "Alts"?



Alternative investments have a role in virtually every portfolio, even if you do not find yourself in that exclusive class of investors known as "accredited." An alternative investment can be defined as any type of investment that is not highly correlated to traditional stock or bond indices.

One of the greatest lessons from the great recession of 2008 involved how highly correlated different asset classes can become during times of crisis. While investors may have thought they had a well-diversified portfolio, what they experienced was quite different as nearly all risk asset classes posted significant losses. The goal of introducing alternatives into a portfolio is to have part of the portfolio as uncorrelated as possible to the rest of the portfolio.

We believe strongly in using alternatives for fixed income recognizing that rates have fallen over the last 30 years leading to impressive gains in bonds. When yields normalize bond prices will be under pressure and many fixed income investors will experience large losses. We utilize asset classes like tax liens that have the ability to provide a high level of current income that should not be negatively impacted by a rising rate environment.



Alternative investments have the potential to enhance a portfolio's overall risk and return profile over-and-above traditional investments like stocks and bonds. In general, we use them in an attempt to provide better diversification benefits and improved risk management. As I've mentioned before, I view alternatives to include hedge funds, commodities, private equity and real estate. These types of investments can be quite volatile and risky if viewed in isolation, but should they have low correlations to the other asset classes or investments within a portfolio, they can potentially reduce the overall risk of the portfolio. I personally like that aspect of alternative investments.

But there is a caveat. Hedge funds and private equity investments are notorious for their lack of transparency and data availability, making their analysis somewhat challenging in my view. However, if the firm offering the hedge fund or private equity fund provides monthly return data, and shows how it is calculated, particularly in terms of estimating the value of each holding in the fund, I would be more inclined to rely on that data than a less-transparent firm. The key in my view is in determining how transparent the firm is willing to be and favor those firms when choosing a particular alternative investment option.

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