

A recent Reuters headline proclaimed: "U.S. Jobless Claims Lowest Since 2000."

The financial media tell us the new lows in unemployment finally mean the economy is healthy and prosperity lies ahead. We question, however, where the media are getting their data and is it reliable. The reliability and relevance of the data becomes even more important when you consider the world's largest central bank, the Federal Reserve, has stated their policies are "data dependent" on the same sources.

The Bureau of Labor Statistics (BLS) is the statistical gathering arm of the government responsible for all thing involving labor economics. This includes unemployment, average wages, hours worked, productivity, and price data like the consumer price index (CPI) and producer price index (PPI). Questioning the data from the BLS is not about transparency or a conspiracy theory. They are quite open about what information they gather and how they build their statistical models. We do question the relevance of the data and the accuracy of conclusions that can be reached from it.

The official unemployment rate in the U.S. is the U3, which is supposed to include everyone either with a job or actively looking for one. A broader measure of employment is the U6 index, which tracks people who are working part-time but need full-time work to make ends meet. The U6 also includes among the unemployed categories "short-term discouraged" and "marginally attached" workers. When including these other groups, you can see from the chart above that the unemployment rate rises from 5% to over 10%.

We believe the work of ShadowStats is probably the most accurate measure of the unemployed in the U.S. ShadowStats uses the exact same data the BLS uses but also includes "long-term discouraged" workers, taking into account the labor participation rate. The percentage of working age adults with a job is the lowest since the 1970's making the ShadowStats calculation nearly 25% of the U.S. workforce either unemployed or underemployed.

Some commentators have argued that the falling participation rate and large number of long-term

discouraged workers are symptoms of the aging baby boomer population. While it sounds nice in theory, that hypothesis does not align with reality. More than 9 million workers have been purged from the labor roles in what some have called a statistical cleansing. The breakdown of the ages of the 93 million Americans no longer considered part of the labor market are: 74% between the ages of 16-54; 26% age 55+. Further refuting the idea that retiring workers are the cause of

the low labor participation rate is the recent data showing the fastest growing age category getting a new job are workers 55 and older.

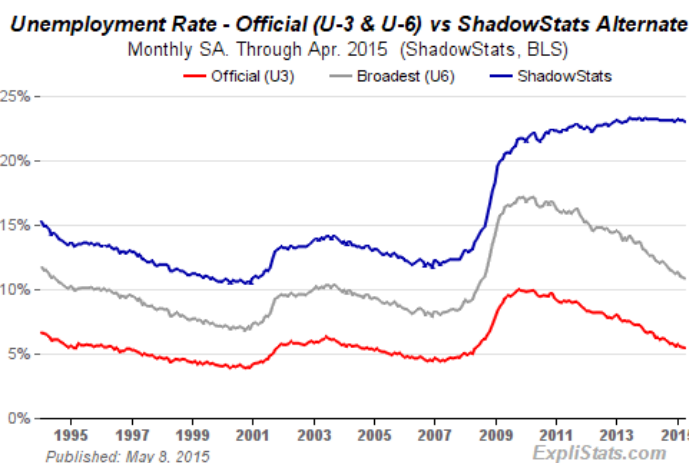
The number of part-time workers is reaching near epidemic proportions as well and creating a significantly skewed view of income. Today, 39% of workers make under \$20,000, 52% make less than \$30,000, and 72% earn less than \$50,000 per year. When

adjusting for inflation, wages have been declining for over 40 years according to calculations by *The Economist*. An economy that is only capable of creating part-time, low income service jobs with little or no benefits does not strike us as healthy.

This year is likely to become the first year in U.S. history where more businesses will close their doors than new businesses will start. The trade deficit for March soared to a 6-year high, \$9 billion above consensus, that will probably lead to a revised 1Q GDP reading of -0.8% as business fixed investment was also reduced amid contracting drilling activities.

There are many causes of the issues surrounding the weakness in the U.S. labor market and solutions are anything but obvious. Fed policies have been a hindrance as has government mandates like the ACA (the cost of providing required employer health insurance has skyrocketed). At a minimum, reality does not align with the rosy picture painted by the BLS showing unemployment back below mid-1990's levels.

Lenin stated, "A lie told often enough becomes truth." In the case of the U.S. labor market it is going to require more than repeating misleading statistics to bring healing to the economy.



A Recession...in Profits

A theme we have continued to revisit in 2015 is the idea that we are in the midst of a profit recession where earnings on the S&P 500 are likely to be lower this year than they were last year. Predominant among the causes of shrinking profits is the fact that margins are being squeezed as labor costs rise after years of dormancy. Consumer thriftiness is another reason profits are likely to disappoint and why most companies lowered forward guidance during their Q1 earnings reports.

Both employers and employees find themselves in unenviable positions. Spending is stagnant because wages are not rising. Even the savings generated from low energy prices is being used to boost savings and lower debt levels hindering top-line revenue growth in the corporate world. At the same time, as a result of sharply higher healthcare costs the, Employment Cost Index (ECI) is rising. According to Bank Credit Analyst figures, hourly earnings are up only 0.3% over the last 12 months but the ECI has risen 2.8%.

	Healthcare trend percentage	
	2015 (average)	2016 (projected)
Health maintenance organizations (HMO)	7.2	8.6
Point-of-service (POS)	7.7	8.8
Preferred provider organizations (PPO)	7.9	8.7
Consumer driver health plans	8.0	8.9
Indemnity plans	9.0	9.6
Prescription plans	10.2	10.1

Companies have lowered their labor cost as a percentage of sales to as low as is practically feasible. The result is very weak gains in consumer disposable income for more than a decade now, and that is currently impacting GDP growth. From the 4th quarter of 2014 to 1st quarter of 2015 real disposable income has risen at a paltry 1% annualized rate. The U.S. savings rate increased from 4.6% to 5.5% over the same period. This results in an increase in spending of only 0.1% annualized, clearly not sufficient for sustainable growth.

As companies are required to compete for consumers' wallets, deal with the headwind caused by the strong U.S. dollar, and pay double-digit costs for employee benefits, margins are under pressure. Equity market valuations are closely impacted by margins, especially in an economy with limited top-line (revenue) growth. Corporate America has been able to maintain record high profit margins that we believe will begin to revert to the mean over the next couple of years. If margins drop by more than a couple of percentage points, the markets could look extremely overvalued. Financial engineering has played a large part in keeping valuations in a "normal" range. Firms have used stock buybacks and

acquisitions to mask contracting growth in profits. Fewer shares outstanding mean EPS (earnings per share) can grow even when earnings are not. Most concerning for the U.S. economy is the continued downtrend in productivity. With productivity at decade low levels, companies prefer to invest in their own stock rather than invest in future growth. We view this as a result of the massive misallocation of resources as a consequence of the Fed's zero interest rate policy (ZIRP) since 2009. As the time approaches when the Fed begins to normalize policy we will be closely watching productivity growth for signs of health.

Looking through a Periscope

With the first quarter earnings season now largely over we have a fairly good recent example of how expectations can influence markets. The S&P 500 Index remains within a stone's throw of a new record, having hit a few new record highs during the month of May. Why is it, then, that earnings have actually declined when compared to the same quarter a year ago? In fact, quarterly earnings, an important scorecard for the health of Corporate America, posted their second consecutive year-over-year decline in the first quarter. And analysts are forecasting further year-over-year declines for the second quarter (see table), yet markets continued to rise. Why? The answer in our view to these questions is lowered, relatively tame expectations.

When we think about times when markets hit record high after record high, we usually see investor euphoria and overly optimistic expectations. We would argue that these traits are somewhat absent this time around. A healthy bull market is often described as "climbing a wall of worry." We would say this is what is playing out in today's markets. While none of this means we won't see overly enthusiastic expectations emerge or that the

	1Q14	1Q15	YoY % Chg	2Q14	2Q15E	YoY % Chg
S&P 500 Index	\$27.32	\$25.80	-5.56%	\$29.34	\$28.56	-2.66%
Consumer Discretionary	\$6.15	\$6.41	4.23%	\$6.95	\$7.30	5.04%
Consumer Staples	\$5.55	\$5.70	2.70%	\$6.32	\$6.15	-2.69%
Energy	\$11.70	-\$0.48	-104.10%	\$11.94	\$4.43	-62.90%
Financials	\$5.50	\$6.18	12.36%	\$5.84	\$5.58	-4.45%
Health Care	\$8.61	\$10.21	18.58%	\$9.54	\$11.57	21.28%
Industrials	\$5.86	\$6.13	4.61%	\$7.12	\$7.46	4.78%
Information Technology	\$8.23	\$9.17	11.42%	\$8.52	\$9.49	11.38%
Materials	\$4.43	\$3.09	-30.25%	\$4.49	\$4.69	4.45%
Telecommunication Services	\$2.82	\$2.90	2.84%	\$2.92	\$2.92	0.00%
Utilities	\$3.32	\$3.84	15.66%	\$2.64	\$2.82	6.82%

As of 5/21/2015. Source: Standard & Poor's

current expectations will not prove to be too optimistic, it does suggest to us that investors have been much more cautious and remained so as May came to a close. Upside earnings surprises, or companies that beat, consensus earnings expectations during the first quarter, were well above the 5-year average, according to FactSet. This is largely attributed to lowered expectations in our view.

In fact, FactSet recently pointed out that the aggregate downward earnings revision for the first quarter was the largest since 1Q09.

The drop in the price of oil and how that has impacted earnings within the Energy sector has largely been to blame for the lowered expectations and the year-over-year decline in earnings for the S&P 500 Index. If you exclude the 104% decline in the year-over-year earnings of energy stocks, earnings on the S&P 500 Index actually rose on a year-over-year basis in the first quarter. So, much of the weakness in earnings is tied to oil.

We would point out that the lowered estimates for earnings growth have carried over to subsequent quarters, possibly setting up the market for more upside surprises. But we remain cautious and expect the bumpy ride to continue going forward. Overall, we would say expectations remain fairly measured, somewhat offsetting our concern over elevated valuations and somewhat bullish sentiment. We think such an environment creates great opportunity for stock pickers.

Mission Accomplished

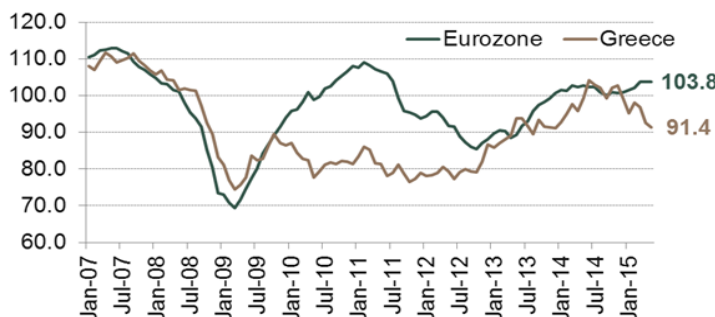
On May 1, 2003, President George W. Bush gave a speech announcing the end of the major combat operations in the Iraq War atop an aircraft carrier. As the photo depicts, a banner flew above President Bush proclaiming “Mission Accomplished.” The speech created strong criticism for a perceived victory celebration that may have been premature. In a similar light, many investors are proclaiming “Mission Accomplished” and victory among developed and emerging markets amid relatively solid market returns and economic stability.



As of May 26th, the developed markets index was up close to 10% for the year while the emerging markets index was up over 7% for the year. Developed and emerging markets are posting strong performance relative to the U.S. as the S&P 500 was up just over 2.5% for the same time period. Even more dramatic, Japanese and Chinese equities returned over 16% and 24% year to date, respectively.

Data released this past month by the European Commission showed that the eurozone grew by 0.4% in the first quarter of 2015. This represents the fastest quarterly growth rate in four years and marks the eighth consecutive quarter of expansion (Factset). Much of this growth is attributed to collapsing oil prices and European Central Bank quantitative easing. The economic sentiment indicator for the eurozone is currently at the highest level in nearly four years, depicted in the chart below. The green line represents the eurozone while the brown line represent economic sentiment for Greece.

Eurozone Economic Sentiment is Rising while Greece's Declines



As of May 2015. Source: European Commission

Greece continues to wade through muddy waters, demonstrated by 18 consecutive quarterly contractions in to 2014, followed by three quarters of expansion. Political instability fostered anxiety over the future of continued bailout and imminent need for Greece to meet existing debt obligations. The nation's economy has shrunk by 25% since 2007, with unemployment around 25% (Factset). The eurozone stands by, waiting to see if the Greek economy can put a stop to the downward spiral and make a serious attempt at repaying debts. China's year to date equity returns relative to the global equity returns give reason to peel back the layers and understand what is occurring behind the curtain. This is particularly interesting for an economy that has been slowing. China is demonstrating that it is committed to internationalizing the Chinese currency, the renminbi, making it available as a tradable and reserve currency. Asia and emerging markets are likely to benefit as China may push the renminbi into surrounding nations, particularly by financing infrastructure projects. The commitment to its currency can have a positive impact on both equity and fixed income returns for both China and economies closely tied to China.

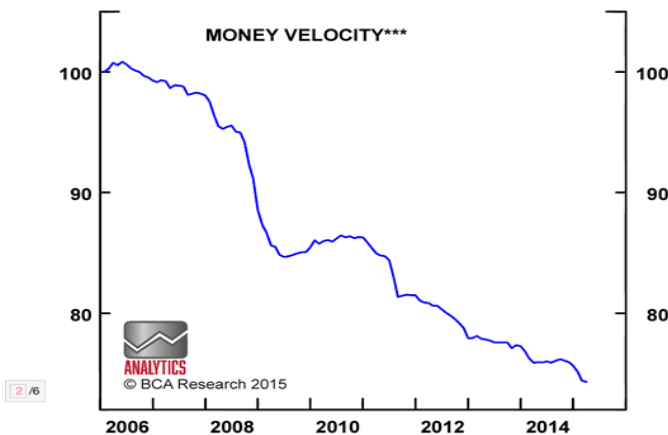
It is definitely premature to celebrate a “mission accomplished” but some regions outside the U.S. may very well be on a clear path to stronger economic growth.

Macro View

The macroeconomic picture has deteriorated in our view making the sharp rise in interest rates all the more confounding for us. Even though bond yields are likely to retreat from current levels, we remain at the tail end of a three-decade move lower in yields limiting future gains in bonds, especially once the Fed begins slowly hiking rates. Stocks look priced for perfection in our view and we are skeptical anything near that can be delivered by the broad economy.

We have often referenced the GDPNow reading from the Atlanta Fed that proved to be far more accurate forecasting the weakness in the first quarter than the blue chip economists. The adjustment in the revisions for exports should leave Q1 at around a -0.8% level. Current forecasts for Q2 are below 1% at this point making an early 2015 recession not out of the question.

There are many data points that suggest strong growth is not in the immediate future. The chart below shows how the velocity of money has continued to decline to post-2009 recession lows. We track the aggregate financing gap for the country and it recently increased to a level exceeding 1% of GDP. An indication of net negative free cash flow in the economy occurs when the gap has hit 1.5% of GDP.



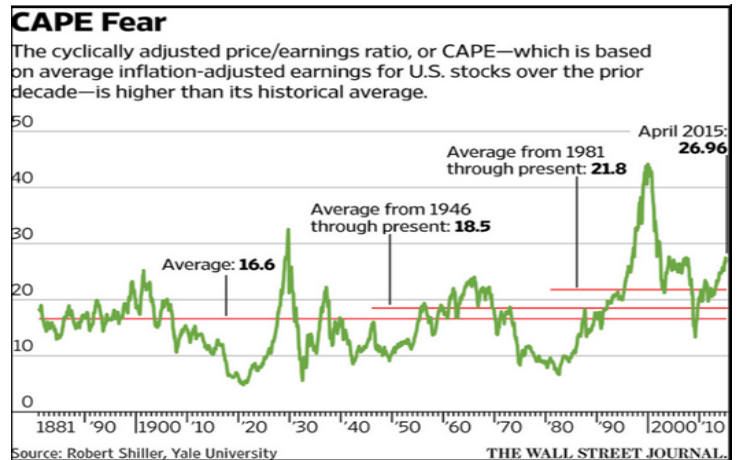
And when that has happened in the past, there has been a recession in every case but one. (Bloomberg) The inventory-to-sales ratio also looks weak suggesting sluggish growth at best for the near future.

With stretched valuations and non-inspiring growth anticipated, we remain very cautious about equity returns this summer.

Taking Stock

As equities continue to set all-time highs, investors are forced to ask if equity valuations are running rich and what will be the catalyst for correction. This past month, Janet Yellen weighed in saying stock prices are

“quite high.” The comments were reminiscent of Greenspan’s well known proclamation that “irrational exuberance has unduly escalated asset values.”



One of the most well-known methods for valuing stocks is the cyclically adjusted price/earnings ratio (CAPE), introduced by Nobel Prize winner and Yale economist, Robert Shiller. The ratio represents an attempt to smooth earnings and minimize the business cycle impact on valuations. So it looks at the smoothed earnings relative to prices over the previous decade, adjusted for inflation. The chart above shows that when the ratio is above average, future returns tend to be lower and when the ratio is below average, future returns tend to be higher.

Greenspan made the “irrational exuberance” comment on December 5th, 1996. That year the S&P 500 had gained 23%, including dividends. The year prior, the index was up around 38% (Factset). As Greenspan coined the phrase, the CAPE was just below 28. As Yellen expressed her opinion on stock prices, the CAPE was around 27. It is worth noting, though, that just because stocks are expensive, does not mean that they cannot become more expensive. At the height of the tech bubble, the CAPE was above 44 (Robert Shiller).

The CAPE and Yellen’s comments may be less telling of an impending pullback or double-digit correction as many sell in May and go away. It does give a clearer picture that investors should anticipate muted returns in U.S. equities over the next several years, though.

Mark Twain may be correct in stating that history doesn’t repeat itself but it does rhyme.

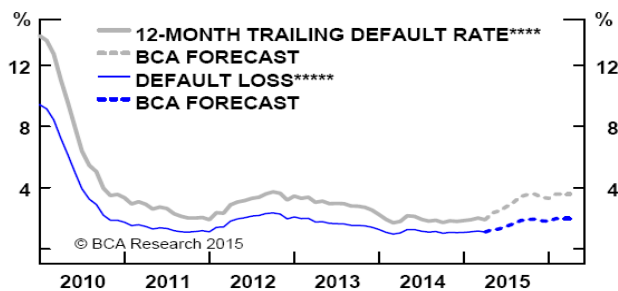
Income Unconstrained

There are many technical signs that the sell-off in bonds has come to an end and yields are unlikely to continue rising for the time being. The yield on the 10-year U.S. Treasury traded as high as 2.30% on an intra-day basis and became extremely attractive from a valuation standpoint so we significantly increased our allocation to long-term treasuries.

TIPS also continue to look attractive to us and provide a great hedge against inflation, especially if oil prices were to continue rising. There is still enough slack in the labor markets to keep a lid on rising wages, which we see as the most likely culprit to cause higher inflation in the future.

There has been little discussion about bond default rates over the last couple of years and we expect that to change as lower quality companies lose access to the debt markets. Not unexpectedly, there have already been several high yield defaults in the energy sector but other sectors are likely to come under pressure as well.

BCA analysts are forecasting a near doubling of the bond default rate over the next year from 2% to 4%. They also focus on loss rates, which is what ultimately matters when a bond defaults and why we continue to be quite bullish on municipal bonds. If a company issues bonds to buy drilling equipment for oil and gas exploration, the recovery rates in a default are quite low as equipment is often sold for pennies on the dollar. Municipal



defaults, by contrast, see recovery rates between 65% and 70% depending on the type of debt issued. This compares favorably to the mid-40% recovery rate we generally see with corporate defaults.

With little inflationary pressure and lackluster economic growth we expect the bond market to provide relatively strong and steady returns during the second half of the year.

Getting Technical

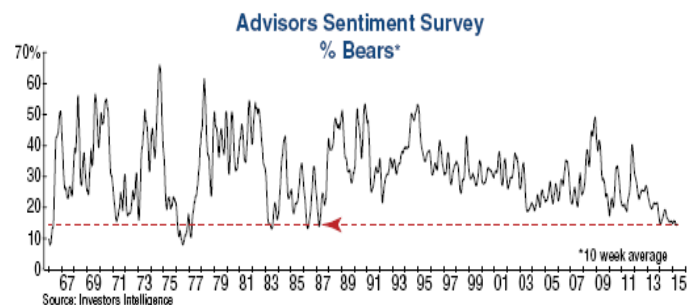
The technical picture became cloudy with a late May pullback but remains in bullish territory overall. The S&P 500 was right at its 50-day moving average in late May, but remained more than 3% above the more important, from a long-term trend standpoint, 200-day moving average.

Calling market tops has always been difficult, if not impossible, but there were always signs to pick up on in hindsight. As students of the markets, we constantly try to connect dots from macroeconomic and technical indicators that suggest greater levels of risk management might be necessary. Our experience tells us now may be one of those periods requiring heightened risk management to be deployed.

We have documented the economic slowdown and rising risk of two consecutive quarters of negative GDP growth. From a technical standpoint, we view the market's extreme bullishness to be troublesome. It is very common for extreme levels of bullishness, or bearishness, to suggest a market peak or bottom. As the chart to the right shows, there are only 5 occasions where the Investors Intelligence survey of advisors who are bearish

reached the low of 15%. Several of these instances were leading indicators of a steep correction in the markets.

Other indicators, like the Advance/Decline Line and moving averages, remain bullish for the most part. The length of this bull market has been impressive, approaching the 5th longest



expansion in the last 100 years, but bull markets do not die of old age. The challenge, in today's environment, is it is almost impossible to forecast how central bank policies will impact the eventual end of this bull market.

Becoming bearish too soon could be costly if the Fed/ECB/BOJ collaborate on new stimulus that again floods the markets with excess liquidity, helping to chase asset prices higher. If the Fed remains committed to policy normalization, it would be far easier to consider the risk/return relationship to be tilting negative for risk assets like stocks.

Currency and Commodities

A tremendous amount of attention remains on the price of oil and the impact it has on the broad economy. As portfolio managers, we place an emphasis on both managing risk and identifying opportunity given supply/demand forces and geopolitical implications. Oil prices have certainly rebounded, but risks persist, creating continued downward pressure on prices and the equity sector in our view.

Refiners and distributors have been the top performing groups while drillers, explorers and equipment service companies have notably lagged. Stocks of downstream refiners are recording new highs, as input costs have fallen. Midstream company performance has been flat. Upstream, namely drilling E&P, and equipment and services, are seeing their stocks face the greatest price depreciation. (Gavekal Research)

The divergence persists as private equity firms continue to support the sector's expansion and expectation that oil prices will continue their rebound back to the \$70-100/barrel range. Threatening this recovery is a sharp rise in interest rates, another precipitous drop in prices based on increased global production, and oil settling into a longer-term range below the desirable \$70-100/barrel range.

Supply and demand forces have evolved from a monopoly driven by OPEC to competitive pricing based on U.S. production through fracking. The U.S. has reduced production by 40,000 barrels per day (bpd) in 2014 and 100,000 bpd in 2016 while Saudi Arabia has increased output by 500,000 bpd in the past nine months (Gavekal Research). Risk and return will be determined by a keen understanding of who the winners and losers will be as oil prices respond to the new equilibrium between supply and demand that may be emerging.

Q : What the Frack?



Hydraulic fracking has certainly changed the face of energy production and is a large part of the reason for the greatly increased volatility in oil prices. The core difference is

how drilling companies plan to recoup the upfront investment they make to drill for oil.

Traditional oil wells only deplete between 2% and 5% of the reserves in the well per year. The owners plan for a 20+ year recoupment making short-term market gyrations less important. All that really matters with vertical wells is whether the current price is above the variable costs which is almost all of the time since variable costs are typically in the \$15-\$20 range.

Fracking wells are different. Production on these wells often reduce by 70% or more after the 1st year and can slow to a trickle after just 3 years of production. It is a very different business model where recouping the upfront costs depends heavily on current pricing and much less on variable costs.

I believe fracking is here for the long-term and will eventually be a difference maker in terms of U.S. energy independence, I just expect the road to be a bumpy one.



I recently finished a book called "The Quest," by Daniel Yergin. It's a rather lengthy read but I think it does a good job of reviewing the history of energy development and its recent

trends. One of the things I found to be quite interesting in the book was how many times "peak oil" has been forecasted. It seems to happen every 20 years or so.

The worry over tight oil supplies in the 1970s was followed by a period of abundance and the collapse of oil prices during the 1980s and into the 1990s. And the same could be said to have happened last decade. The one key piece that these prognosticators fail to consider is the advancement of technology. Hydraulic fracturing, or fracking, has played a huge role in unlocking "tight oil," or oil that is locked in different hard-to-access rock formations. And I believe we are still in the early stages of this revolution as most of the fracking is occurring in the U.S. It seems to me that we could be entering into another period of abundant energy resources, which may not bode well for the relative performance of energy stocks. I believe there will be a premium on good stock picking within that sector.

Q : Is the economy "deflating"?



Hmmm, do I take the bait? It would be a stretch to suggest that people associated with the New England Patriots are letting the air out of the economy!

In the case of the economy, unfortunately, letting the air out does not help anyone. Also, unlike the referees who could go into the locker room of the AFC Championship game and refill the game balls, the Fed (economic referees) may have a much harder time re-inflating the economy since their air pumps (cutting interest rates and QE) are proving to have little impact.

The health of the labor market is one of the best measures of economic health and there are not a lot of signs of strength right now. Most of the jobs being created are either part-time or are low paying service sector jobs. There is hope that affordable energy will result in a resurgence in manufacturing and higher quality jobs but in the mean time we might have to settle for a somewhat mushy economy.



It seems economists and market pundits are not the only ones discussing deflation these days. The NFL continued to make news on the topic with its own version of what is often referred to as a debilitating economic condition. Gaining a competitive edge these days in the NFL apparently is not limited to just training harder, having more talent or better coaching. Teams and/or players may be pursuing other unscrupulous avenues and Tom Brady may not be the only one trying to "rig" the game in his favor, not that he really needed to. But I digress.

It's easy for investors to feel that the stock market is rigged against them. Public relations firm Edelman puts out an annual report that summarizes their survey findings on the most trusted industries. In 2013 and 2014 the financial services industry was ranked at the bottom. Complex products, overall industry incentives, a Lack of transparency, a lack of perceived value and poor performance are largely to blame for the low image and distrust the general public has of our industry in my opinion.

I think this poses a big challenge for us as advisors, especially with the growth of robo-advisors and the ease at which investors can attempt to do this on their own given the vast amounts of information and available tools online. We frankly need to do a better job and that is why we focus on establishing trust and putting our clients' interests above our own.

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