

On May 3, 2003 then President George W. Bush stood on the aircraft carrier the USS Abraham Lincoln in a flight suit and proclaimed victory in the war in Iraq and an end to major combat operations in the Middle East. A banner hung behind the President that became a flashpoint for future criticism of both the President and the efforts in Iraq since most U.S. casualties occurred after that fateful day. The message of the banner was simply "Mission Accomplished."

Based on the latest data, we are wondering if the Federal Reserve might trot out Chairwoman Yellen to provide testimony before Congress declaring completion of the Fed's end to major combat operations in monetary policy? If so, our advice to the Fed would be to leave the much-maligned banner in storage.

Why might Yellen be considering a Mission Accomplished speech? The Fed operates with a dual-mandate: maintain stable prices (inflation) and full employment (jobs). While it may appear easy to identify success, it is far more complicated given the numerous ways both inflation and jobs can be calculated.

Starting with inflation, the Fed must decide which gauge of inflation they pay attention to. While rent has been increasing at an annual pace of 3.7% and spending on medical care rising 3.3%, the prices for apparel are actually lower today than they were 15 years ago. Our preferred gauge is either the Sticky CPI published by the Atlanta Fed or the Median CPI used by the Cleveland Fed. We know that the Fed closely watches Core PCE (personal consumption expenditures) that is currently generating the lowest projected inflation rate.

The Fed has a stated target of 2% inflation and we believe the most accurate gauges of inflation are already approaching 2.5%, the highest level since 2009. This poses a significant risk to the equity and fixed income markets because if the Fed gets behind the curve in hiking interest rates to combat inflation they will be forced to move more quickly than the market expects and likely causes a severe correction and potential recession.

The latest employment readings also appear to suggest the Fed is succeeding in their pursuit of full employment. The latest unemployment reading (new report to be

released on Friday) shows just 4.9% of the "counted population" as unemployed. There is much debate about who should be counted as unemployed and the labor participation rate remains at multi-decade lows. However, there is anecdotal evidence that suggests the labor market is in fact very healthy.

The Fed uses 5% as the NAIUR (non-accelerating inflation rate of unemployment) benchmark for full employment.

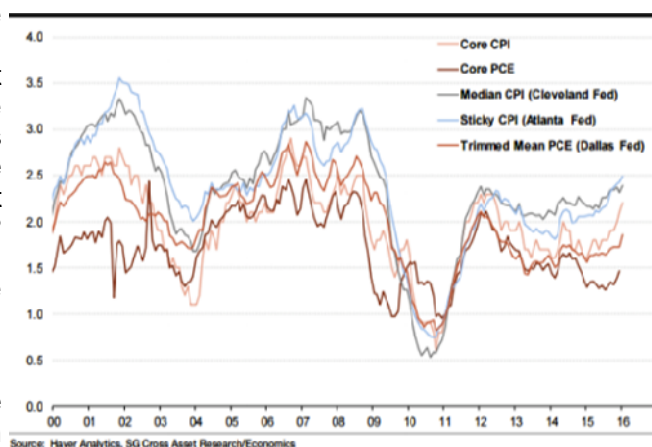
One of the best indicators of the health of the labor market is wage inflation and the "quits" rate. Wages have been steadily rising the last six months and the quits rate is currently at the 2008 peak levels. Common sense suggests that people do not quit their current job unless they either already have another job or are very confident in their ability to secure employment.

Voting members of the Federal Open Markets Committee (FOMC) have recently been making speeches indicating that the market may be underestimating

pressure on the Fed to increase interest rates. John Williams of the San Francisco Fed recently stated in a speech that any measure of the output gap suggests an immediate increase in rates is necessary. Similarly, Fed Vice-Chair Stanley Fischer told a group of economists "the first stirrings of an increase in the inflation rate is present."

The market is currently pricing in few, if any, rate hikes from the Fed in 2016. History has shown that if the Fed increases rates at a pace faster than what the market anticipates it is very unsettling for investors. Current data suggests the Fed's hand may be forced sooner than expected. Yellen has maintained a very dovish stance on rates and points to weak retail sales and contraction in manufacturing as reasons to leave rates alone. A mutiny at the Fed where a majority decide rates must move higher could lead to a difficult investment landscape later in 2016.

The dovish response by Yellen is certainly supportive for equity prices in the short-term and align with other short-term buy signals we have identified. The most consistent message from the Yellen-led Fed is that they will be data-dependent. The economy seems to be balanced like a teeter-totter right now with an equal chance of an acceleration in growth leading to higher inflation and more rapid tightening and slipping into a deflationary recession. Portfolios need to be prepared to adjust for either scenario.



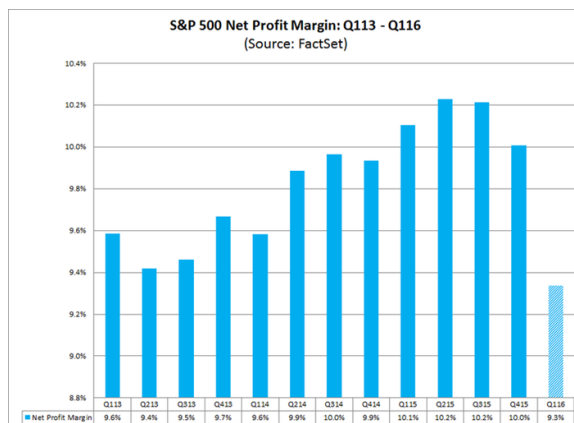
A Buy on Volatility?

MSI Bearish Signal	VIX 30	S&P 500 Two Months Post
9/26/2014	10/15/2014	7.2%
7/2/2015	8/24/2014 - 9/1/2015	8.9%
12/17/2015	1/15/2016 - 1/20/2015	10.2%
12/17/2015	2/11/2016	?

Volatility, like most stock market indicators, has a very strong tendency towards reversion to the mean. Two of the gauges we closely track relate directly to the VIX (volatility index). Cross Point Capital produces a market sentiment indicator (MSI) that is either bearish, neutral, or bullish based on their multi-factor approach. Over the past 2 years, there were four occasions when the VIX hit 30 during a bearish signal. The market bounced significantly higher in the prior 3 occurrences. Our own PCM internal research shows a very strong correlation when the VIX falls by 10% or more with positive moves in equities. The VIX has fallen 25% from the Feb 1st level and 50% from the Feb 12th high. Both indicators suggest stocks will move higher in the short-term.

- Stocks historically have outperformed when the VIX is falling and underperformed when the VIX rises. This indicator is currently bullish for stocks.
- When the VIX hits a reading of 30, the corresponding 2-month returns are typically very strong. The last time the VIX hit 30 was February 11, 2016.
- The average monthly return when the VIX falls by 30% or more is 6.19% compared to the average monthly loss when the VIX rises 30% of -4.47%.

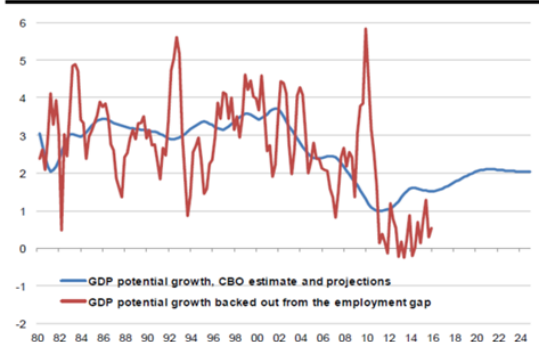
Cliff Diving Profit Margins



The estimated net profit margin for the S&P 500 is 9.3%, showing a meaningful drop. There are a myriad of factors driving the reduction in net profit margins, given that half of the 10 sectors are projected to have lower profit margins. After the Energy sector, the other four sectors projected to report net profit margins below the three-year averages for Q1 2016 are the Industrials, Information Technology, Consumer Staples and Consumer Discretionary sectors. There is a silver lining, though. Eight of the 10 sectors are projected to see higher average net profit margins over the next three quarters relative to Q1, led by the Energy, Industrials, and Information Technology sectors (Factset).

- Five of the 10 sectors are projected to see lower net profit margins in Q1 2016 relative to the three-year average for each sector, led by the Energy sector (0.1% vs. 6.5%) (Factset).
- Excluding the Energy sector, the estimated net profit margin for the S&P 500 would be 10.0% (Factset).
- If 9.3% is the actual net profit margin for the quarter, it will mark the lowest net profit margin for the S&P 500 for a quarter since Q4 2012 (8.9%) (Factset).

Pushing on a String



Source: Haver Analytics, SG Cross Asset Research/Economics

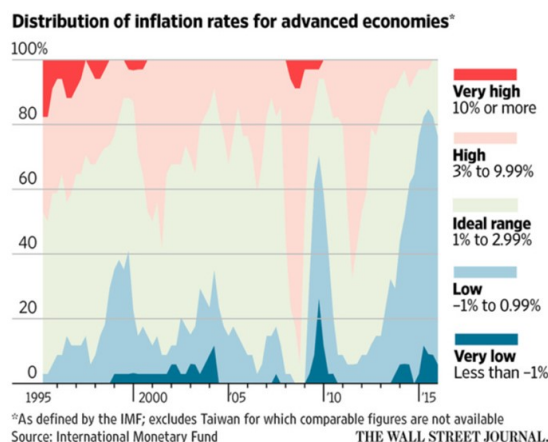
The Efficacy of Central Bank Policy

With U.S. GDP creeping along at a sluggish pace and global economic growth showing little signs of life, many look back over the years since the crisis of 2008 and wonder if central bank policy has been all that effective. While the unprecedented actions at the height of the crisis may have avoided catastrophe, the long-term effects of monetary policy are uncertain. The U.S. seems to be the only bright spot in an otherwise no-growth global economy. What the central bankers have not been able to accomplish seems to be an increase in overall aggregate demand.

- Lower GDP growth (as predicted by the CBO) has many market participants questioning the efficacy of central bank policy.
- Their attempt to stimulate via accommodative monetary policy has led to large balance sheets at the biggest banks. In other words, the banks have not made loans that were intended to spur growth in the economy through business development and capital projects.
- The question is what is going to spur aggregate demand, because it seems that monetary policy has not achieved this goal.

Macro View– Inflation Watch

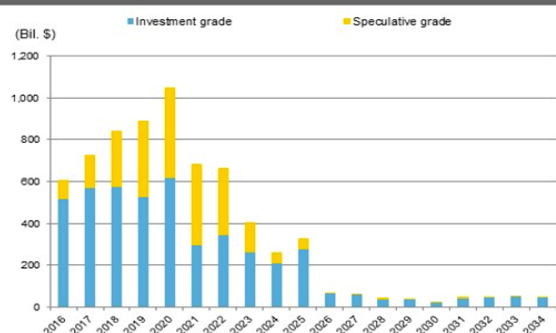
Central banks around the world are pursuing an inflation rate of 2%, not too high and not too low. European Central Bank President, Mario Draghi, initiated further stimulus after the Eurozone inflation fell below zero in February. The U.S., on the other hand, see inflation ticking up closer to the 2% target set by the Federal Reserve. The chart below gives a clear depiction of inflation rates among advanced economies. Heading into 2015, there was a dramatic ramp up among countries with inflation between .99% and -1%, making up over 80% of countries evaluated. The implications are significant. Central banks cannot cut nominal interest rates much below zero as investors will simply choose not to deposit funds at rates falling below zero, especially if the banking system is viewed as unstable.



Fixed Income– Maturity Concerns

While few strive for immaturity, the issue of maturity in the bond market is very likely to concern if not outright panic. The chart shows the projected level of bond maturities over the next 20 years broken down into investment grade (blue) and high yield (yellow). Of particular concern is high yield (junk bonds) that jump from \$70B in 2016 maturities to over \$400B by the year 2020. Given the current state of the high yield market and the number of issues in the energy sector, future default rates could be directly tied to the price of oil. Using forecasted inflation to project future interest rates also suggests that rates will be higher when many of these bonds will be attempting to refinance and could lead to a sharp drop in corporate profits.

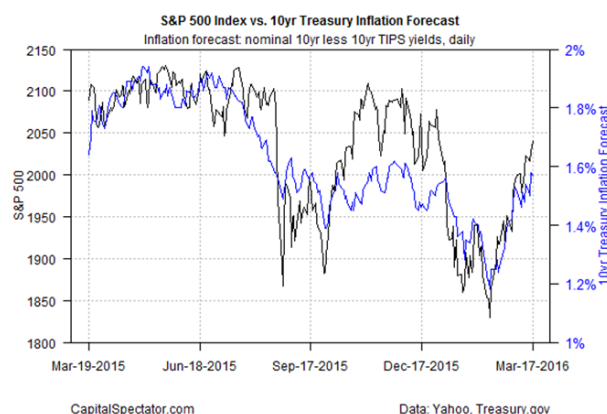
Rated Debt Maturing By Year (Investment- And Speculative-Grade)



Note: Data as of Dec. 31, 2015. Includes bonds, loans, and revolving credit facilities. Foreign currencies are converted to U.S. dollars at the exchange rate on the close of business on Dec. 31, 2015. Source: Standard & Poor's Global Fixed Income Research.

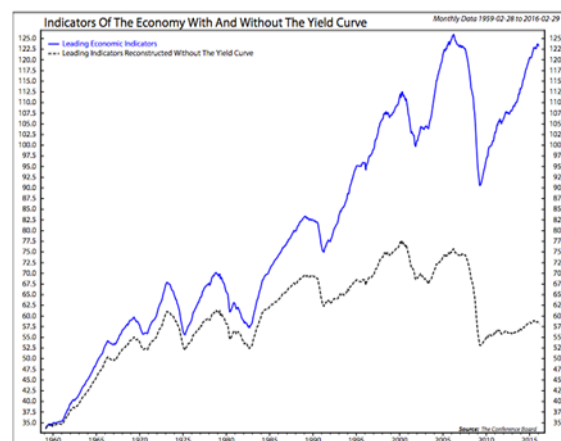
Taking Stock– Equities and Inflation

Stocks climbed over the course of February and March, working their way out of the hole created in January. Equities certainly may be responding to the Fed's desire to keep rates lower for a longer period of time. The relationship between stock prices and inflation is something we track closely, especially given that inflation is an important barometer for Yellen. The Treasury market's 10 year inflation estimate is at a three month high with the implied forecast given 5 year maturities is also at the highest level in close to a year (Treasury.gov). The chart below shows the 10 year forecast against the S&P 500, demonstrating higher correlations coming out of the beginning of the year. This correlation may come unglued as higher inflation will inspire the Fed to raise rates.



Technical– (Mis)Leading Economic Indicators

One of the most followed technical indicators on Wall Street is the LEI (leading economic indicators). This is a composite of several data points that include manufacturers' orders, the M2 money supply, weekly jobless claims, new building permits, and interest rate spreads (between the 10-years Treasury and Fed Funds). Many point to the chart of LEI to suggest that recession is nowhere on the horizon because the current reading is back near 2007 highs. It is possible, however, the chart is misleading because of the sole impact of the interest rate spread. If that one factor were removed, the LEI would be languishing near 1985 levels with little rebound since 2009. The Fed's mastery of interest rate manipulation is solely responsible for the recovery in the LEI's and is reason for caution in our view.



Risk Weighting Approach to Asset Allocation

Clint Pekrul, CFA

Over the past few months, we've highlighted how advisors and portfolio managers can allocate their portfolios based on risk rather than dollars. The rationale, in our view, is fairly straightforward.

We want to understand how each position in the portfolio contributes to the overall risk of the portfolio. In other words, what impact does an incremental change in one holding have on the entire portfolio?

If we construct portfolios with this frame of reference, we've answered an important question. What is the risk that a single holding might derail, or "blow up", my entire allocation, and as a consequence, my client's investment objective?

We can measure risk exposure directly. While there is some mathematical engineering involved, the risk to any single holding is merely a function of two things: 1) the volatility of that holding, and 2) the correlation of that holding's returns to the other holdings in the portfolio. By observing these two metrics, we can calculate how total portfolio risk is decomposed across the underlying constituents. Furthermore, we can create a buy and sell discipline based off of the exposures. This process is often called risk budgeting.

For example, suppose a portfolio manager likes stock A and stock B. Generally, the way a portfolio is constructed is to place 50% of *capital* to each stock. This seems like a balanced portfolio with an equal dollar allocation to each holding.

But what if stock A is three times more volatile than stock B? If we weight by dollars, then we've essentially taken a much larger investment in stock A.

Why? The simple reason is that any change in the price of stock A will impact the total portfolio by a much larger amount than a change in stock B. Obviously, this will be a good thing if stock A rises. But, as we know, stock returns are uncertain. If stock A falls, then the portfolio will suffer a larger loss.

	Dollar Weight	Risk Weight
Stock A	50%	75%
Stock B	50%	25%

At a casual glance, it might seem that we have made an equal bet in each stock by allocating capital evenly to each holding. But in reality, the portfolio essentially has three times the exposure to stock A.

We ask a simple question. Why not weight stock A and stock B by their volatilities? In the long-run we like both securities, but in the short-run, returns are uncertain.

If stock A is three times more volatile than stock B, then a risk weighted portfolio will allocate 25% to stock A and 75% to stock B. Now we have sized the positions such that a change in price for either stock will impact the total portfolio by roughly the same amount.

If we extend this example to a 10 stock portfolio (all of which we like in the long run), then we have to account for the correlations across all the holdings. After all, total portfolio volatility is determined by three factors: 1) the weight to each holding, 2) the volatility of each holding and 3) the correlations across all the holdings.

We can determine how much *risk* we want to allocate to each holdings, and through an optimization process, back into a set of optimal dollar weights. As volatilities and correlations change, we alter the capital exposure to the portfolio constituents in order to keep the portfolio in line.

In a sense, we are strategic in terms of our risk budget, and are simply reallocating the capital structure of the portfolio as volatilities and correlations evolve over time.

We feel that in the long-run, a risk weighting mythology can help avoid the risk that any single position derails the entire portfolio. This structure can be applied to individual equities or across a multi-asset class portfolio.

Q: Should the Fed be focused on overseas markets for policy decisions?



While I agree that the Federal Reserve cannot operate in a vacuum with respect to monetary policy, it appears to me that they are too focused on overseas markets based on Chairwoman Yellen's recent speeches. All of the available data in September 2015 pointed to a growing economy with inflation ticking higher. More importantly, the market was clearly expecting a rate hike and had priced in such a move meaning there would be no negative reaction to the first rate hike in nearly a decade. When Yellen left rates unchanged and cited uncertainty in China as the primary reason to not act, it left many of us scratching our heads.

If interest rates were already at "normal" levels it would have been easy to make the argument that there was no urgency for a rate hike. My concern is that there is almost always a reason somewhere in the world to argue for not raising rates. Rate hikes could hurt emerging market economies or cause the U.S. dollar to rise against the Euro, Yen or Brazilian Real. If these are reasons to not implement necessary monetary policy decisions then we are seceding sovereignty over policy decisions to factors out of our control and will ultimately lead to far greater uncertainty for the markets.



To an extent, I believe so. After all, the U.S. economy does not exist in a vacuum. What we do here impacts the relationships we have with our trading partners. U.S. monetary policy, or the pricing of dollars, impacts every facet of the economy. If our currency is valued much higher than the currencies of other markets, then we could face meaningful trade imbalances. So Janet Yellen and the Fed have to be cognizant of what their actions will do in the context of the global economy.

That said, I don't think we should necessarily follow the actions of other central banks. For example, the ECB is buying corporate debt directly in an attempt to spur growth. And other central banks have gone to negative interest rates. Fortunately, the U.S. economy is not in such dire straits that the Fed has had to resort to these kinds of measures. But if we hit a recession, the Fed shouldn't necessarily follow the actions that other central bankers are taking now.

Q: Have we seen a bottom in commodity prices?



I believe it is very likely we have experienced a bottom in most commodity prices although I do not expect to see a V-shaped recovery among the broadly followed commodities. The prices for industrial metals tend to be very economically sensitive. Copper, for example, is referred to as the commodity with a PhD in economics because of the strong correlation between copper prices and global GDP growth. The weakness across the European economies will limit the level of growth for emerging markets but the worst should be behind us.

Precious metals, gold in particular, is more sensitive to changes in inflation expectations and the direction of the greenback. Gold has moved considerably higher as inflation has picked up and concern over deflation in the U.S. has abated. Gold could rise quickly if the market perceives the Fed is getting behind the curve in addressing rising prices. Oil is very sensitive to supply and demand changes as there is limited ability to store the product. I think the cycle low in oil was achieved in early February and expect crude to trade in a range between \$30 and \$50 this year.

This outlook would be altered if the U.S. economy joined greater Europe by slipping into a recession. Demand for oil would likely drop leading to excess supply and weaker prices. Industrial commodities (steel, coal, copper, etc.) would also fall on weak demand while gold may hold its value in a flight to safety market reaction.

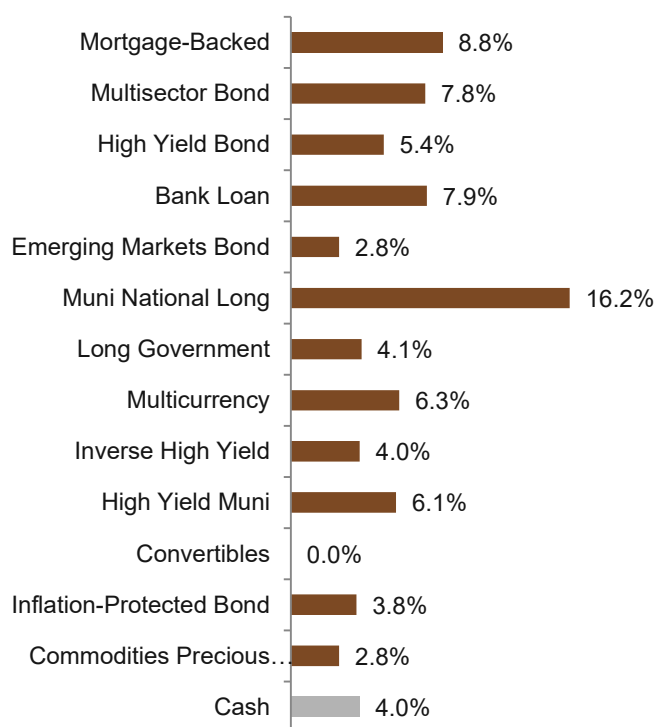


This is a tough one. Oil seems to have hit a resistance level, as have the prices of other commodities. I think ultimately commodity prices are a reflection of aggregate supply and demand, and right now, global aggregate demand is fairly weak. But, we have seen a modest uptick in inflation in the U.S., so perhaps that is a prelude to an overall move to the upside. Another thing to consider is that since the crisis of 2008, efficiencies in the economy have improved (i.e. we get more out of less). This ultimately places some downward pressure on commodities.

If we do see a rebound, then I think emerging markets should do well. These markets have been depressed for some time, but investors could quickly change their outlook and allocate capital back to these markets.

Fixed Income

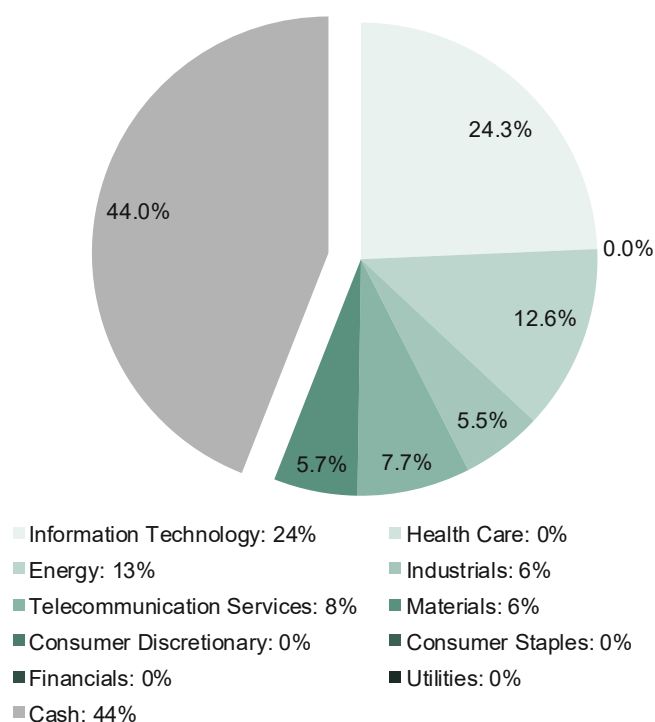
Segment Exposures



- Expectations for Fed rate hikes has been cut in half in the last month based on the "Dot Chart" provided by the Fed.
- We believe outperformance in the first half of 2016 will come from holding high credit quality and long durations.
- Taxable and Tax-Free municipal bonds continue to demonstrate the best risk/reward ratio in the fixed income universe.
- The U.S. dollar has been weak in early 2016 but we anticipate this is a transitory move and the dollar will end the year higher against most currencies.

Equity

Sector Exposures



- Earnings on the S&P 500 were revised lower by -8.5% during the first 2 months of 2016, the highest downward revision since 2009.
- Yellen's latest speech suggest an extremely dovish Fed which is viewed as supportive for stock prices.
- The energy sector is showing signs of having put in a bottom but higher earnings in the sector will probably not materialize until 2017.
- Market leadership is very uncertain at this time with last year's leaders being laggards this year making the cash hedge appropriate.

As of 02/29/2016

PCM

PEAK CAPITAL MANAGEMENT

**15455 Gleneagle Dr., Suite 100
Colorado Springs, CO 80921**

Phone: 719.203.6926

Fax: 719.465.1386

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

The information contained in this report represents the opinions of Peak Capital Management, LLC, as of the report date and does not constitute investment advice or an offer to provide investment management services. Before purchasing any investment, a prospective investor should consult with its own investment, accounting, legal and tax advisers to evaluate independently the risks, consequences and suitability of any investment.

Past performance is not indicative of future results, loss of principal is possible.
Please consider charges, risks, expenses and investment objectives carefully before investing.

The data and information presented and used in generating this report are believed to be reliable.
Peak Capital Management, LLC. does not warrant or guarantee the accuracy or completeness of such data.

Peak Capital Management, LLC is a Registered Investment Adviser. Advisory services are only offered to clients or prospective clients where our firm and its representatives are properly licensed or exempt from licensure. No advice may be rendered by Peak Capital Management, LLC unless a client service agreement is in place. Nothing herein should be construed as a solicitation to purchase or sell securities or an attempt to render personalized investment advice.