

"If it keeps on rainin', levee's goin' to break"
-Led Zeppelin

While I doubt that Chairwoman Yellen, or any members of the Federal Open Market Committee, sit around listening to Led Zeppelin, the lyrics from their 1971 album Led Zeppelin IV might prove to be prescient. The Fed has rained liquidity into the markets and succeeded once again at driving risk assets higher. In their latest, post-Brexit, efforts they have driven the stock market back to new highs allowing the Bull market that many counted as dead, to live. Viva El Toro!

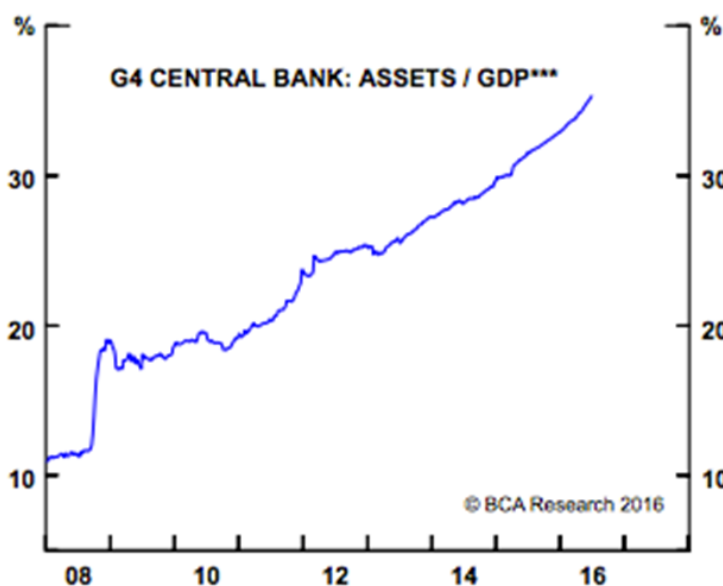
The latest global stock market advance can easily be attributed to the global liquidity party after the Brexit vote. The chart of the G4 Central Banks assets to GDP ratio shows levels have climbed to new highs and now stands at 35%. The percentage of central banks assets to total GDP has risen more than 300% compared to 2008 levels.

As Led Zeppelin sang nearly a half century ago, too much of a good thing can eventually lead to disastrous results. The economic underpinnings typically present when stock markets are achieving all-time highs are conspicuously absent. Earnings for the 2nd quarter are going to come in roughly 4% lower than the one year ago period. This will mark the 5th consecutive quarter that earnings have declined. The expectation (desperate hope) for an earnings rebound in the second half of 2016 is also being put on hold. As late as April 1st analysts expected nearly 3.5% earnings growth for the 3rd quarter but according to the latest FactSet data this has been revised all the way down to a forecast of (.1%). That would mark a 6th straight quarter of negative earnings growth.

The combination of negative earnings growth and new market highs would typically signify valuations being stretched to galaxial limits. However, thanks to stock market cheerleaders and talking heads that probably do not understand the difference between "operating

earnings" and "GAAP earnings" companies continue report earnings more aggressively to mask their true condition. The delta between operating earnings and GAAP earnings will likely achieve new highs in the current quarter.

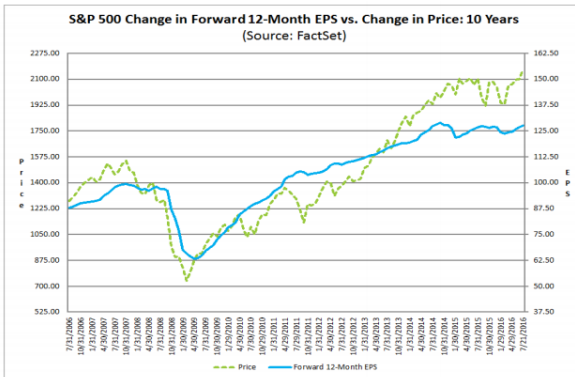
Even if companies reported earnings using historical standards, we are not sure the bull market would cease. Bull markets typically end when investors perceive the risk of stocks being too high and rotate out of equities to more risk-attractive assets like bonds. With global bond yields at levels that many thought impossible just a couple of years ago there really is no place outside of stocks for investors to turn. A large part of the stock market's advance can be attributed to the view that bonds represent a greater threat to loss of wealth than stocks do.



Consider that at the start of 2015 there were less than \$100 billion of government bonds worldwide with negative yields. Barely 18 months later, there is now over \$8 trillion in negatively yielding government bonds; an increase of 8,000%. Give investors the option of paying a government to hold their money or invest in stocks and it becomes obvious why money is flowing into overvalued equities. Short duration investment grade corporate debt generally pays less than forecasted inflation and high yield spreads have contracted to levels that do not compensate for the risk of default. Stocks may be overvalued but less so than bonds in today's environment.

Can the bull market continue through the end of 2016? We are looking at three important metrics that probably need to be in place for that to happen. First, a shift in leadership from defensive stocks to cyclical stocks that suggest investors have confidence that economic growth is accelerating. Second, indications that contraction in Europe has bottomed and a global recession is no longer a risk. Third, we believe a bear capitulation could result in cash sitting on the sidelines driving stocks higher.

Guiding to Nowhere

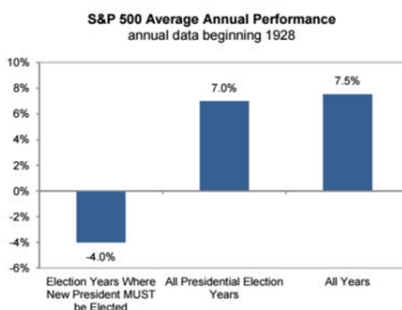


Negative forward guidance continues to be largely ignored by investors as companies report their 2nd quarter results. This quarter will represent the 5th consecutive quarter where year-over-year earnings have declined, the longest such stretch since the five consecutive quarter decline from 3Q 2008 to 3Q 2009. The quarter will also see year-over-year declines in revenues for the 6th consecutive quarter as companies continue to try to squeeze higher earnings out of lower sales. Of the companies providing forward guidance, 74% guided future earnings lower with just 26% forecasting higher than mean estimates. With the S&P 500 at all-time highs, the gap between stock prices (green) and EPS (blue) is as exaggerated as it has been in many years.

- Apple represents the largest drag on earnings growth in the technology sector estimated to report earnings that are 24% lower than 2Q 2015 earnings.
- The earnings surprise index rose during the quarter to +6.7%, well above the 5-year average of 4.2% for the index. This was achieved largely as a result of previously lowered mean estimates.
- 68% of companies already reporting have beaten the mean estimate for earnings while just 57% reported higher sales than forecasts.

The Presidential Cycle

S&P 500 Average Performance & Presidential Election Years



Source: BMO Investment Strategy Group, Bloomberg.

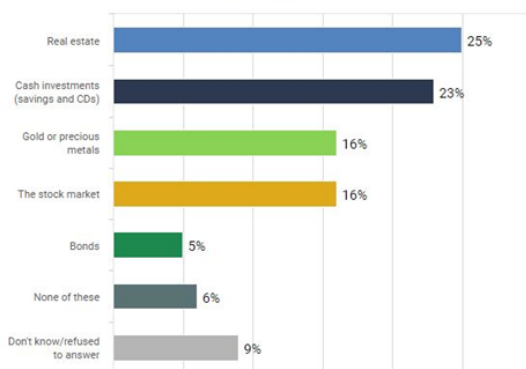
There is a significant quantity of data regarding market returns during the presidential election year. Generally, the U.S. stock market delivers positive, mid - single digit gains during the election year. The chart below shows average annual performance of the S&P during election years. On average, over the past 60 years, the S&P has gained around 7%. It is notable that, on average, the market finished down 4% when a new president was required to be elected as the existing president reached the two term limit. Election years can deliver can be surprisingly volatile, as demonstrated by the current year. 1988, 1996, 2004, and 2012 all experienced one or more 7% corrections, but each year ended with a gain between 9-21% (Investech Research).

- In 13 of the past 22 election years, the S&P has had a yearly high in the 4th quarter. In 3 of the past 22 election years, the S&P experienced its low.
- In over 80% of election years, the majority of gains came about in the second half of the year.
- 7 of the past 9 election years have finished the year with positive returns.
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Smoke Signals

With abysmal yields from the bond market and a growing distrust in equities among investors, real estate has become the most favored asset class, based on recent Gallup polling data. The results say much about the future return potential across various asset classes. What the trend reflects is that perhaps the trillions of dollars sitting in cash today isn't going into equities any time soon, particularly as a large percentage of the population is aging and has little desire for equity volatility, and can find no attractive yield in the bond market. This trend might simply be a return to the norm after the catastrophic losses in real estate during the housing crisis, but the underlying data suggests that real estate is favored by those 65 and older, which is becoming a larger part of the population.

Which would be the best way to invest money you wouldn't need for more than 10 years?

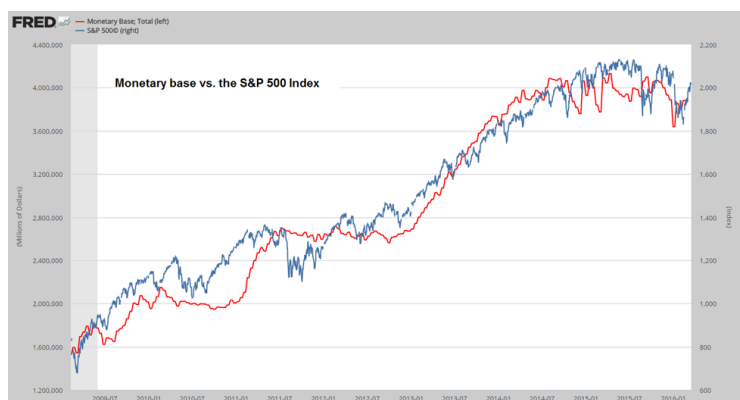


Source: Bankrate Financial Security Index survey, July 19, 2016.

- In a separate survey by Bankrate.com, 25% of investors with disposable cash would investment in real estate over the next 10 years versus 16% who would favor equities (see chart).
- According to the survey much of the appeal of real estate is that it is a tangible investment, unlike equities. Furthermore, the income from real estate is much more favorable than what can be obtained in the bond market. REITs, for example, yield north of 4%, while bonds are mired around 2%.

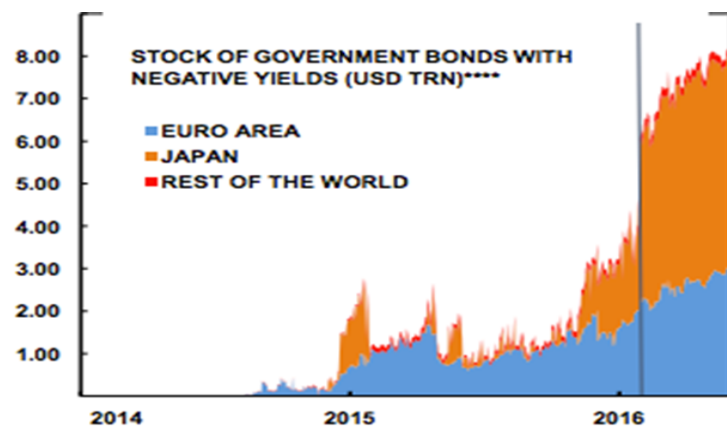
Macro View – The Punch Bowl Remains

There are divergent opinions among managers for the U.S. economy's current standing and direction. On One side is a case supporting a bull market that has legs to climb further. The other side maintains that the rubber band has been stretched to capacity. We believe that the market high is being achieved strictly on liquidity, masking poor fundamentals. Below is a chart from the St. Louis Federal Reserve showing the monetary base (red) versus the S&P 500 (blue). The chart shows the monetary base falling towards the end of 2015 followed by the single worst 6 week start to any year in Wall Street history. The monetary based quickly ticked back up and equities followed. Anticipation of the FOMC meeting at the end of July exposed little to no expectation for an interest rate hike. As equity markets charge higher, the raging bull is likely to tire.



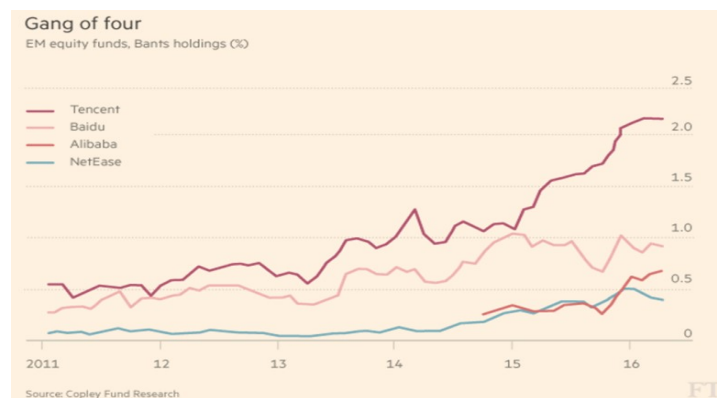
Fixed Income – Is there a Floor?

There was a time, recently, when the idea of negative yields, even on government-issued bonds, would sound absurd. The absurd has become the reality (resisting urge to make political comment) with more than \$8 trillion in negative yielding bonds issued and a promise from Japan this week to move yields to even lower levels. Negative interest rates are nothing more than an attempt to stimulate an economy by robbing Peter to pay Paul. Governments are stealing from savers (often retirees living on a fixed income) and from pension plans/insurance companies in their attempts to increase economic activity. If quantitative easing or negative yields showed any signs of working, you could make the case that it is for the best interests of society. Given that there is virtually no evidence that these policies have increased economic activity, it borders on foolishness.



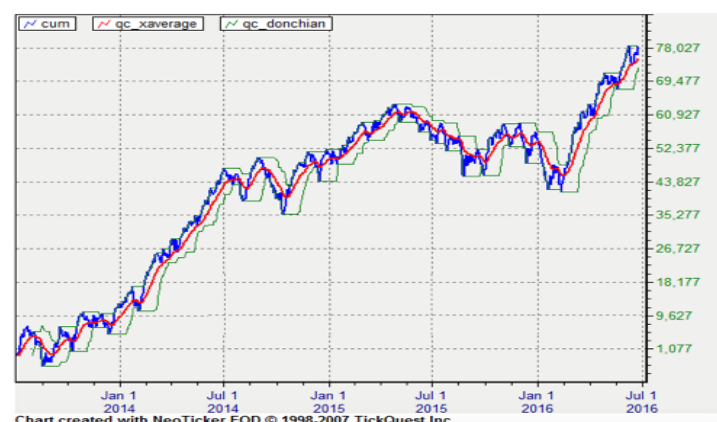
Taking Stock – The Chinese FANG Stocks

It is well documented the impact the FANG stocks had for U.S. markets in 2015. China is not slow to take ownership for a knockoff. So, the Chinese market has also become driven by just a few names, labeled as the BANT stocks. They include, Baidu, Alibaba, NetEase, and Tencent Holdings. All four firms are technology companies that benefit greatly from the exponential demand of the Chinese consumer. President Xi Jinping is quoted in Bloomberg as demanding a "China dominated by high value tech companies." Chinese internet companies make up 83% of emerging market equity funds internet holdings (Financial Times). Since 2013, emerging market equity funds have quadrupled exposure to these four firms (Copley Fund Research). 79% of emerging market funds hold at least one of the BANTs (Copley Fund Research). The chart below shows meaningful appreciation since 2011 from Tencent.



Technical – Thrusting Higher

The trading volume on the NYSE during the summer is often very light leading to larger than normal moves in the stock market, up or down. Technical analysts understand that a market move of greater than 1% in a day is typically only meaningful if it occurs when volume is significant. Volume thrusts occur when up volume exceeds down volume by a margin of 5:1 or greater, and vice-versa. When multiple volume thrusts occur in a short period of time it is an indication of a change in sentiment. The post-Brexit rebound that took the markets to new highs experienced back-to-back positive volume thrusts above 8:1 suggesting strong bullish sentiment. More importantly, this bullish technical indicator is being confirmed by the Advance-Dcline Line moving to a new high (chart). The technical picture suggest the market achieving a new high is not a fluke.



Reaching for Yield Intelligently

Clint Pekrul, CFA

Peak Capital recently launched the Dynamic Risk Hedged – Balanced Income Index in conjunction with S&P Dow Jones Indices. The index represents an investment in non-traditional fixed income assets, such as U.S. and international dividend paying equities, REITs and high yield bonds. These exposures are non-traditional in the sense that they are not represented in the Barclay's Aggregate Index, which is considered the industry standard for measuring the performance of traditional, core fixed income portfolios.

Historically, the index exposures provide yields above what is generally obtainable from the core exposures of the Barclay's Aggregate Index. However, there is generally additional risk associated with this increase in yield. For example, dividend paying stocks can be as volatile as the overall equity markets (i.e. they can exhibit a beta to the equity market close to 1). When credit conditions deteriorate, the principal value of high yield bonds can decline considerably. Likewise, the value of REITs can be highly influenced by the health of the housing market (remember 2008?).

For example, if credit conditions are favorable, the risk of investing in high yield bonds might be relatively low compared to REITs, dividend paying stocks and Treasuries. As a result the risk contribution of high yield to the total portfolio might be below its desired target. Our methodology would add (marginally) to high yield and reduce an offsetting exposure(s) until the portfolio is aligned to the risk budget. This allows us to step out of the way when the uncertainty of returns (i.e. volatility) is too high. In other words, the added income we desire might not be worth the potential loss of principal at a certain point in time. As markets normalize we can then step back into the asset class.

When we reduce a position, we add to another asset that might have lower relative volatility, or to an asset that exhibits low correlation. This dynamic helps ensure diversification. However, when correlations rise across all assets, we can use short positions to help ensure a minimum degree of diversification. Lastly, if overall volatility exceeds certain levels, we can use cash to limit portfolio risk.

Exhibit 1: Historical Asset Allocation for the Dynamic Risk Hedged – Balanced Income Index

Asset Class	Risk Budget	Dollar Weights			
		6/31/02 – Credit Downgrades	6/31/04 – Interest Rate Hike	12/31/08 – Credit Crisis	7/31/13 – Taper Tantrum
US Dividend	23.75%	19.36%	15.78%	9.15%	17.61%
INTL Dividend	23.75%	22.81%	11.96%	9.82%	14.02%
US REITs	23.75%	18.77%	7.48%	5.31%	10.41%
High Yield Bond	23.75%	9.70%	60.53%	36.74%	46.49%
Treasuries	5.00%	29.37%	5.73%	38.98%	6.91%
Hedges					
Short Equity	---	0.00%	0.96%	0.00%	4.56%
Cash	---	0.00%	0.00%	0.00%	0.00%

The question from a portfolio construction standpoint is how do you allocate capital across these higher-yielding asset classes without risking a considerable blow to your principal? The answer, in our view, is to allocate capital based on a risk budget, rather than simply relying on a static dollar allocation. The Dynamic Risk Hedged – Balanced Income Index provides a framework for allocating capital based on the value-at-risk for each asset class, and adjusts the dollar weights accordingly over time.

Our methodology is to allocate an equal amount of risk to 1) U.S. dividend stocks, 2) international dividend stocks, 3) REITs and 4) high yield bonds. In total, roughly 95% of total portfolio risk comes from the volatility of these four asset classes combined. We allocate the remaining 5% of total portfolio risk to longer-term Treasuries. Collectively, these allocations represent our acceptable risk exposures to each asset class. Over time, as market dynamics change, the risk that each asset class contributes to the total portfolio will rise above or fall below the desired risk budget. Our methodology is to systematically rebalance the capital exposures so that the risk each asset contributes to the total portfolio remains consistent.

In the exhibit above, we illustrate the dynamic weighting across the underlying assets. We are strategic in terms of the risk we take, and then simply rebalance capital as market conditions change. For example, 2002 was a volatile year for high yield bonds. As the volatility in high yield surged, its risk contribution to the portfolio exceeded the risk budget and the position was reduced down to 9.7%. But amid the 2004 interest rate hike, high yield bonds held the highest position due to lower duration risk. The same scenario applied to Treasuries with a meaningful reduction amid the taper tantrum of 2013, when duration took a hit. But amid the 2008 credit crisis, Treasuries held the highest weight in the portfolio as the safe haven asset.

In summary, it's possible to intelligently reach for yield with non-traditional fixed income asset classes through a framework of risk budgeting. The mistake many investors make in trying to increase yield is to make a set allocation to a potentially risky asset with no framework for scaling the exposure based on prevailing market conditions. While the added yield might seem attractive today, the potential loss of principal amid heightened volatility tomorrow might be very unattractive. With a risk budgeting framework, it's possible to step into and away from asset classes and better balance current yield with the potential for principal loss.

Q: Do Geopolitics matter anymore?



That is a really interesting question given all that has recently happened around the world. Certainly the recent Brexit vote was the most significant geopolitical event to take place in more than a decade. The "Remain" crowd made the argument that the U.K. leaving the EU would be disastrous for not only England but the global economy. The surprise result took the Dow down some 870 points in 2 days but in only a few weeks the markets not only made up the losses but managed to push to new highs; something it had failed to do since May 2015.

My view is that geopolitics do not matter until they do. While that may sound contradictory, what I mean by the statement is that until a geopolitical event impacts the economy enough to cause a recession (or conversely, to exit an ongoing recession) the impact is relatively muted in terms of influencing the markets.

Sovereign debt defaults, yawn. Russia invades Ukraine, yawn. China devalues the Renminbi, yawn. Unrest in the Middle East, yawn. You get the point. Any of these significant geopolitical events over the last couple of years were thought to have the power to derail the markets but they have not.

In hindsight, many analysts and commentators during the next global recession will point to a geopolitical event and suggest that was the cause of the market meltdown and broken clocks are accurate twice every day.



This is an interesting question because every time there seems to be a geopolitical event the market more-or-less has been shrugging it off. Brexit is a good example of a recent major event that seemed to pass as a blurb on the screen because the market shot right back up and extended into new highs. Even more recently were the events in Turkey with the attempted government overthrow. The market didn't seem to notice all that much. This is not to say, by any means, that the market will not respond to a sizeable event. At times it feels like some major event is brewing under the surface that might roil global markets at any time. But it just seems that the problems with the Eurozone in particular have become somewhat of an old story for investors.

Perhaps part of the issue is that the impact some of these events should have on fundamental valuations and asset prices is so manipulated by central bank policy, investors tend shrug it off to some degree. Just ask any global macro manager who tries to allocate capital based on relative valuations across global markets. It has not been an easy environment for several years now because of how central bank intervention has manipulated asset prices.

Q: Where does this bull market rank in history?



The first words that come to mind are "unloved" and "distrusted". Many portfolio managers, myself included, thought we would see 20% correction in stocks before equities exceeded the highs established in May 2015. We were wrong.

The current bull market started an amazing 2,337 days ago at the end of the Great Recession. On May 4th, the current Bull surpassed what had been the 3rd longest bull market in history at 2,248 days. To achieve the next milestone would require the market to advance another 9 months to May 1, 2017, surpassing the bull market of 1949-1956. I will go on the record stating there is zero probability the current Bull exceeds the longest ever bull market which started in 1987 and ended in 2000, an astounding 4,494 days.

It is not surprising this has been one of the least participated in bull markets in history despite its length. The economic recovery coming out of the Great Recession has been the poorest on record with many gauges still well below pre-recession levels. Standards of living tend to move higher during bull markets and lower during bear markets. It is amazing that stocks have moved higher for over 7 years without increasing a majority of people's living standards.

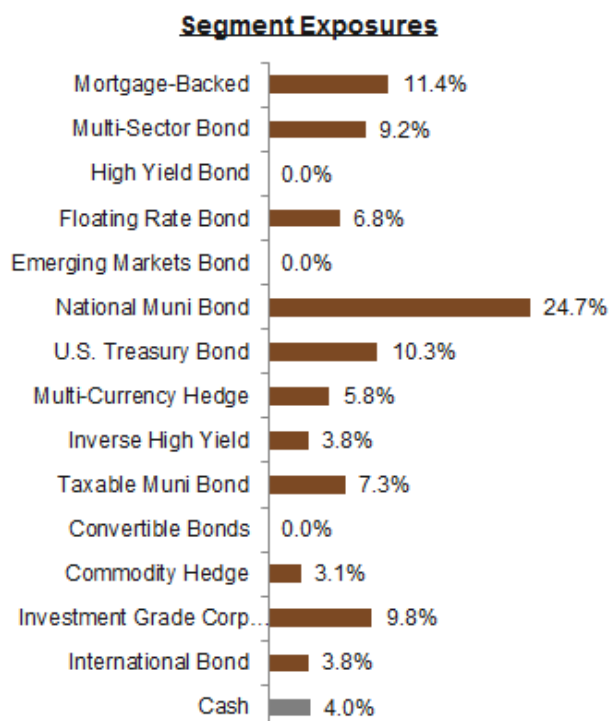
We are in a new era of Central Bank policy experimentation. Equity investors owe a massive hat tip to Central Banks even while acknowledging the eventual limits their policies can deliver.



Assuming you are talking about equities, I would think towards the top, both in terms of total returns and longevity. But it's a bull market into uncharted territory without question. What began in March 2009 hasn't really stopped, even though we've hit a few bumps along the way. Our economic picture today is certainly better than at the depths of the 2008-2009 recession and overall, companies are in better shape. But you can't help but wonder what the end game is. Does the Fed get it wrong on interest rates and raise too quickly?

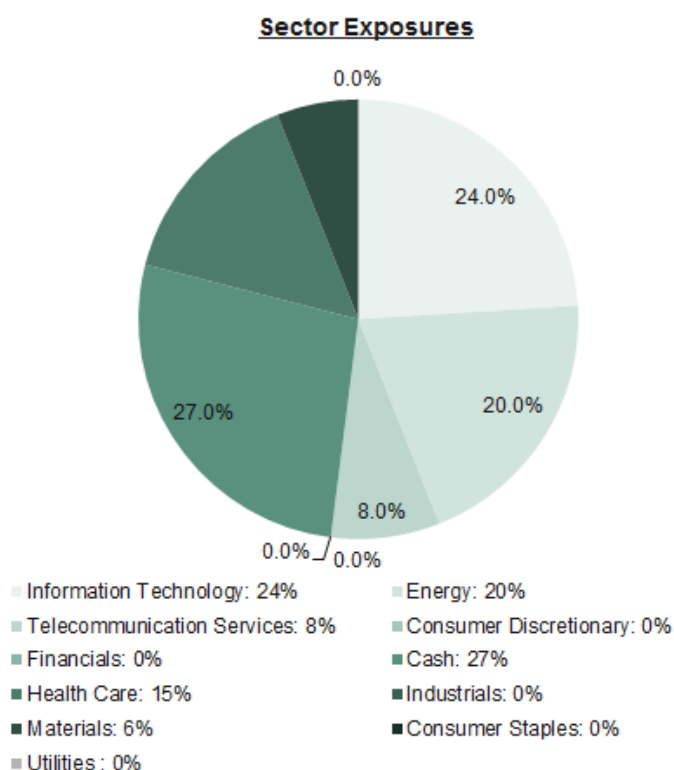
What I find interesting about this market run is that, unlike at the peak of other bull markets, there's not much to rotate into. In the classic sense, equities get overvalued from a fundamental standpoint and investors gravitate to bonds. But bonds are reaching the zero bound (and in some cases have gone negative), so there's little to no yield. When we talk about asset valuations, it's important to consider valuations relative to something else. Right now, with interest rates so low, many assets seem overvalued based on traditional metrics. So investors might not be so quick to sell equities at what might seem like high valuations (based on price-to-earnings, price-to-book, etc.) simply because bonds offer so little in terms of yield.

Fixed Income



- A global 'risk-off' trade occurred in the fixed income market with a flight to safety following Brexit. Yields ticked up slightly in July.
- In July, the Fed met and left the discount rate unchanged. Based on comments at the meeting, there may be a likelihood in September that rates may rise.
- The 2/10 spread on U.S. Treasuries is alarmingly low and could be signaling a pending recession which would benefit fixed income with long durations and high credit quality.
- The allocation to Treasuries and Inflation-Protected securities will rise as a result of the uncertainty created by Britain voting to leave the EU.

Equity



- The market's reaction to the Brexit vote was immediate and severe and negatively impacted virtually every equity market and sector.
- Following Brexit, the market reversed quickly and is posting new highs.
- Posture in the equity portfolio remains defensive with the belief that equity highs are being driven by Fed accommodative policy.

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