

Roundtable Special Edition

This month, Peak Capital offers a unique perspective by providing answers to some pressing questions based on the conversations we have with the readers of the PCM Report.

We are fortunate to be joined by a luminary in the financial industry, Adam Schenck of Milliman in addition to PCM's Chief Investment Officer and Head of Research. All three will weigh in on where the markets and economy are headed including growth, inflation, and mid-term elections. Highlighted are some great calls from this year and a sense of where they are positioning for the future.

Roundtable Contributor Biographies**Brian Lockhart, CFP**

PMC Founder &
Chief Investment Officer



Brian Lockhart is the founder and Chief Investment Officer of Peak Capital Management, LLC (PCM). With over 20 years of portfolio management experience, he has led the company through exceptional growth since its inception.

Brian directs the company's tactical allocation of PCM's unique investment models including their Income Opportunity strategy, a model that dynamically navigates the fixed income market. He has been crafting ETF strategies for nearly a decade, making PCM an early adopter of ETFs. He also serves as the managing editor of the firm's PCM Report, a monthly publication that provides research and commentary for the investment advisory community.

Brian is routinely quoted in major financial media outlets including Barrons, Forbes, Bloomberg Businessweek, Fortune, Investment News, and ETF.com and is frequently requested to communicate on a national level on topics ranging from portfolio and risk management to opportunistic fixed income solutions.

Brian is a graduate of California Polytechnic State University in California where he received his Bachelor of Science degree in Business

Clint Pekrul, CFA

Head of Research

Administration with a concentration in Financial Management.

Mr. Clint Pekrul, CFA, serves as a consultant to Peak Capital in the capacity as Head of Research at Peak Capital. Clint is responsible for portfolio management and design. Mr. Pekrul is currently employed by Curian Capital a Registered Investment Advisor, where he has managed portfolios for 13 years. Prior to joining Curian, Mr. Pekrul worked at Merrill Lynch Private Client for 3 years. Mr. Pekrul holds a BA in Business Administration from the University of Oklahoma, and is a Chartered Financial Analyst.

Adam Schenck, CFA, FRM

Milliman Principal, Lead Portfolio Manager

Q: How do you see Global GDP shaping up for 2016 and where do you anticipate strength and weakness?



I can start by saying worse than what I would have projected just one month ago. I think Fed Governor Richard Fisher's recent statement is true referring to all major Central Banks. *"The Federal Reserve is a giant weapon that has no ammunition."*

The Grand Experiment being implemented by the Fed, European Central Bank, and the Bank of Japan with Quantitative Easing clearly delivers less economic growth than the central bankers had counted on.

The risk of global recession has risen significantly since the beginning of 2016 and that weighs on my forecast for global GDP. The slowdown being experienced in the U.S., Europe and Asia will give central banks confidence to keep pulling the stimulus trigger even if they are only firing blanks.

I expect somewhere around 2.6% global GDP this year as there are still pockets of strength in the global economy. I anticipate that India will take over as the new global growth engine and will likely stay at the top of the fastest growing major economies for the next decade. I think Mexico could also surprise in terms of growth also I worry about the peso.

As far as weakness is concerned, I am below current consensus for both Japan and Germany primarily because these two economies have the most exposure to the emerging market economies that are in the worst shape.



The global view is fragmented. I would expect the U.S. to continue to grow but at a rather lackluster pace. China could finally bottom, which would be a benefit to those countries selling to China and include many commodity producers. This bottoming could be a multi-year event, but would eventually curb the recent free-fall in commodity prices.

From a macro standpoint, I expect more sluggish growth from the U.S., and better prospects here relative to the global economy. Consumers should benefit from lower gas prices heading into the year. We've also seen solid gains in the job market and rising home prices in general, which should help consumer confidence.

In Europe, quantitative easing continues with the ECB cutting rates further and expanding its bond purchases. This could ultimately prove to be stimulative this year. With QE and a weaker euro currency, I would expect GDP in the euro zone to grind ahead, but at a slower pace than in the U.S.

China was fairly active with stimulus last year. The consensus is that their economic growth will continue to slow over the next year, but again, if they can hit a bottom or sorts, this should reverberate across the broader economy and help other emerging market economies in particular.

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Q: Narrowing the scope, what do you expect from the U.S. economy this year?



Slower growth with pockets of opportunities. Continued uncertainty with the Fed along with progression along the market cycle may create dispersion within U.S. equities. Cyclical sectors tend to have stronger performance in the later stages of economic recovery as well as in rising rate environments. A stronger dollar has helped push down food and energy prices which may entice consumers to increase spending which would benefit discretionary areas of the market. From an investment standpoint we think investors will begin shifting towards firms focused on creating long-term value as opposed to short term objectives like stock buybacks.



Job gains have been a driving factor for economic growth in the U.S. over the past several years. I would expect more job market improvements in 2016, but the pace of job gains will likely slow as we move through the natural progression of the economic cycle. October and November of last year delivered some solid payroll numbers, and job opening have increased almost exponentially since the bottom of the credit crisis. However, many

of these jobs were added in the energy sector, which was doing quite well when oil was trading at \$100 per barrel. With energy prices cut by more than 70%, the energy sector will continue reducing its workforce as operations are trimmed back. Overall, the pace of job openings might slow from the robust pace of recent years.

On the wage front, the percentage change in hourly year-over-year earnings finally broke above 2%. This is due to the overall tighter labor market conditions. As a result, employees now have more pricing power. While higher wages means a greater cost for employers, I expect that consumers overall will be in a better position. And with consumption representing 70% of U.S. GDP, a stronger job market and increasing wages will drive the economy forward in 2016.

Are there any specific risks to your outlook?

Obviously, low energy prices are a challenge for the energy sector, and as I mentioned before, layoffs in this sector could be a potential headwind for the labor market. But for the broader economy, lower oil costs should be a boost to the bottom line, as consumers can spend their disposable income in other places rather than at the pump.

Rising home prices have increased the wealth effect for homeowners, who were hit hard in the crisis. Much of this is due to the affordability of credit, as mortgage rates are still low by historical standards. But, with the Fed on a path of increasing interest rates, this affordability could certainly be adversely impacted.

Adding a few basis points to the cost of a mortgage could

translate into hundreds of extra dollars on a monthly payment. Potential new homeowners could find themselves priced out of a home loan, which will ultimately impact housing prices. However, higher wages and a robust labor market could absorb much of any shock.



I frankly cannot remember when the last time I saw so much disparity among growth forecasts as what we have in the U.S. right now. The Fed has flooded the financial system with so much excess liquidity over the last 6 years making it very difficult to forecast the impact of even marginal tightening.

Research firms we place a high degree of confidence in, Gavekal and Ned Davis Research, both have recession indicators that suggest a recession will occur in 2016. I would not bet against them!

Manufacturing and Industrial production are already in a recession (consecutive quarters with negative growth), the real issue is whether or not the service sector is dragged down as well. To answer that question you have to determine whether or not consumers will start spending some of the savings at the gas pump or if aggregate savings will continue to climb as it did last year going from 4.75% to 5.50%?

I think we could see negative growth Q4 of 2015 and Q1 and Q2 in 2016 before growth resumes in the 2nd half of 2016. If that takes place, I would peg GDP to be a positive 1.2% after a relatively mild economic contraction.

Are there any specific risks to your outlook?

I see an upside risk if consumer spending dramatically increases during the first half of the year. Given the weakness in consumer confidence, this seems like a

long shot to me. It is very possible the expected consumer spending boom from sub-\$30/barrel oil proves to be as elusive in 2016 as it was in 2015.

The crisis in the energy sector is very different than the crisis in housing in 2008. Nearly 70% of Americans were homeowners in 2008 meaning the collapse in housing impacted almost everyone, particularly if you had a significant mortgage. The vast majority of Americans are "short" oil, meaning they benefit from lower oil prices.

The negative surprise would be the Fed stubbornly sticking to their plan to hike rates twice in the first 2 quarters and the rally that ensues in the U.S. dollar takes manufacturing even lower and spreads to the service sector. I don't expect this to occur as true conviction at the Fed is as unlikely as Tom Brady playing quarterback for the Denver Broncos next year (sorry, I could not resist).



Q: Volatility in the stock market is at historically high levels to begin the year, where do stocks go from here?



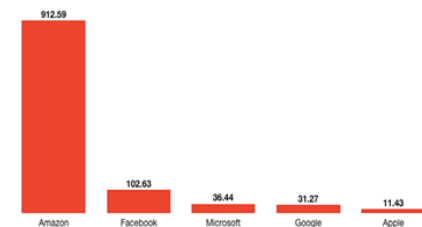
Stocks are headed lower, at least for the first half of 2016. The unassailable Art Cashin recently referenced a statistic that cannot help but get your attention. The stock market has experienced a

10% or greater correction twice in a 6-month period on only 3 occasions in the last 100 years before this year. Those other periods? 1929, 2000, and 2008.

Research from the aforementioned Ned Davis Research shows that 50% of stocks today are already experiencing a bear market, off 20% from their previous highs. This market is very reminiscent of 2000 when a handful of mega cap technology stocks masked the deterioration taking place with most stocks. As the chart below shows, the surge in Amazon, Facebook, and Google (now Alphabet) have taken these companies to unsustainable levels and when profit taking starts in these names look out below.

Price to Earnings Ratio

Trailing 12 months



Source: Thomson Reuters

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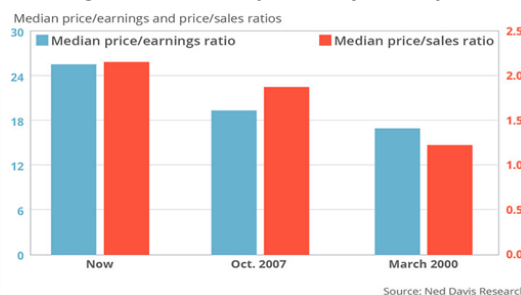
I think companies with very strong balance sheets (low debt levels) who can continue to grow free cash flow will best survive the bear market that is just beginning to take hold of the market.

Opinions on valuations really vary among analysts, are stocks fairly valued or overvalued today?

At this point I think you have to be a sell-side analyst to suggest stocks are not overvalued. Market multiples are highly correlated to expectations for future results making it impossible to think multiples could expand from current levels. FactSet data suggest EPS (earnings per share) could fall between 5% and 6% based on current estimates. Maintaining a

P/E ratio above long-term trends in a slowing, and possibly contracting, economy is hard to imagine.

While I tend to be in the camp that believes statistics can be manipulated to tell any story you want to tell, there are data points I believe are often missed by the investing public (and talking heads in the financial media). Overlooked data points today include the median price/earnings and price/sales ratios on the S&P 500. If you can remain bullish in this market knowing that the median valuation on stocks are higher today than in 2000 and 2007 you might have lost your objectivity.



Source: Ned Davis Research



The often sighted VIX index, which measures the expected volatility of U.S. equities over the next 30 days, historically trades around 15. This year it has traded as high as 40, which is essentially a reflection of greater uncertainty about the global economy. And to be sure, economies are more linked today than they have ever been.

Over the long term equity prices reflect underlying fundamentals, and given where interest rates are today and their expected path higher, I would still favor equities over bonds. But that's not to say we are going to get double digit, or even high single digit returns from stocks. Look at 1994 and 2004 as examples. Not spectacular years for either stocks or bonds as the Fed began raising interest rates. But, with my view that the economy will continue to grow through 2016, I believe there is more

upside potential with equities than with fixed income.

From a portfolio standpoint, a tilt to lower volatility or more defensive stocks might be in order, because I think higher volatility will persist. Conversely, momentum or higher beta names could underperform this year.

Opinions on valuations really vary among analysts. Are stocks fairly valued or overvalued today?

Valuations have risen over the past couple of years. We've gone from a PE on the S&P 500 of roughly 13 back in 2011 to roughly 18 today. Much of this rise in the PE ratio has been a meaningful drop in earnings from the energy sector. Plus, the run up in the FANG stocks (Facebook, Amazon, NetFlix and Google), which are mega cap companies, have pushed the PE ratio higher as well.

Overall, a PE of 18 might seem a bit rich for long term sustainability. However, this opens the door for alpha possibilities by positioning portfolios across different factors, which might materially diverge much like they did in 2000-2002.



Volatility tends to be mean reverting, and only in extreme down markets does it stay at elevated levels for extended periods of time. Barring an extreme market sell-off, heightened levels of volatility in the market have typically coincided with opportunities to re-enter the stock market.

Q : Looking at fixed income, the market expects two rates hikes in 2016 while Fed policymakers are signaling four hikes. Who will be right?



This is a softball question if there ever was one. The Federal Reserve, the group responsible for setting interest rate policy, has a worse track record for forecasting the future path of interest rates than Terry Bradshaw has of picking NFL games. Remember, Terry Bradshaw stated he had a 4.0 cumulative GPA during his 4 years at Louisiana Tech, meaning a 1.0 GPA for 4 consecutive years.

The market is going to be right on this one and I am not even convinced the Fed will hike rates twice this year based on the latest data that shows first time unemployment claims rising above expectations.

In last month's PCM Report, I suggested the 30-year U.S. Treasury bond could be the surprise winner in 2016 and nothing has changed my opinion. First, a strong U.S. dollar and plunging commodity prices are doing the Fed's heavy lifting for them in terms of moderating economic growth and containing inflation.

The spread between Baa bonds and U.S. Treasuries are expanding which suggests we are rapidly moving towards a risk-off environment and slowing economy. I believe now is the time to shift fixed income portfolios to exceptionally strong credit quality and take on duration risk for those willing to speculate in the bond market. When you compare the 10-year U.S. Treasury bond to Germany, Japan, or the U.K. it is clear we could fall another 50 basis points to 1.50% or lower.

Q: *Is there one particular risk for investors you think most analysts are over looking?*



Q: *Looking at opportunities in the market, any investment picks or asset classes you are particularly bullish on?*



Not surprisingly, the opportunities I see are predominately large cap domestic companies. I expect stock picking to re-emerge in 2015 with broader indices volatile and upside limited. A common theme is also identifying companies poised to benefit from higher levels of discretionary income.

1. Harley Davidson (HOG) - The company has excellent management that transformed it into one of the most efficient manufacturers in the U.S. They have been consistently growing their market share in the U.S. and overseas through the introduction of the The Street models with low entry points. Motorcycle aficionados have endorsed the Live Wire project, an electric bike set to be released in 2017. HOG is trading at 16.8x 2014 earnings with 17% EPS growth, selling for 14 times this year's earnings. Lastly, how many companies can boast customers so loyal as to tattoo their brand on their biceps?
2. Apple (AAPL) - Could be the company that benefits the most from low energy prices. Consumers' savings at the pump over a few months can pay for a new smartphone or wearable. AAPL is the strongest brand in the world with tremendous upside potential domestically and abroad. I love AAPL's valuations, trading at a 20% discount to the S&P 500's PE ratio with over 25% EPS growth in our forecasts (5% EPS growth on S&P 500). AAPL is a bargain at 14x 2015 earnings.
3. Southwest Energy (SWN) - Given the weakness in energy, this may surprise some. This is a natural gas play with an enterprise value more

than double the current stock price and one of the most attractive debt-to-EBITDA ratios in the industry. With 6 new liquid natural gas (LNG) plants approved for construction, demand for natural gas should increase as the U.S. increases exports to Europe to help them reduce dependence on Russian gas. SWN trades at 10x our 2015 estimate making their valuation compelling.



I think U.S. equities remain relatively attractive to me amid better prospects for the U.S. economy relative to Europe and Japan. Earnings growth could slow and valuations on U.S. stocks are already above long-term averages, so I think investors will have to be selective in playing the next leg of the bull market. Technology sticks out to me as an attractive area as productivity growth has been stagnant, not to mention the benefit of low gas prices likely accruing to consumer electronic companies. I would expect capital spending in technology to improve as companies seek to make their employees more productive.

I like long-term U.S. Treasuries and investment-grade corporate debt as well. I've already mentioned global yields are at historically low levels and that the U.S. remains one of the more attractive areas for yield seekers. I think this will help put downward pressure on long-term U.S. Treasury yields. I'm not that bullish on high yield debt amid its high exposure to energy prices. I think the rally in the U.S. dollar has more to run. Europe is likely to remain mired in economic stagnation, as is Japan. This does not mean stocks in those regions will perform poorly. Valuations in Europe and emerging markets are more reasonable when compared to U.S. stocks, but there is the strengthening dollar to contend with. If you are interested in those areas, I would suggest hedging

some of the currency exposure. I see stock picking to be at a premium in what will continue to be an uneven world. Unlike 2014, stock pickers as a whole could finally see better relative performance this year.

Conclusion:



I want to sincerely thank Adam Schenk, lead portfolio manager for Milliman Financial Risk Management, for participating in this round table discussion. His responses were both insightful and well articulated.

The list of concerns that can keep portfolio managers up at night is quite long today. At the top of the list might be the overwhelming consensus for what is "supposed" to occur. I get very nervous when the entire investment community appears to be on the same side of the trade. Regardless of how likely that outcome is, rarely is every-one right.

Where consensus is almost certain to be right is that volatility will be higher in 2015 than in 2014. Volatility spiked in the first month of 2015 causing some to wonder if the TOGIT market remains (the only game in town). January finished down 3.1% giving hope to bears according to the so-called January effect. Their memories, however, must be as short as a QB's after an interception as January 2014 saw a 3% decline and still finished the year with double-digit gains.

Stay tuned

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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

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