

Slaughtered Giants

PCM Report March 2016

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We titled the January 2016 issue of the PCM Report, "Time to Buckle Up" as we forecasted the markets were likely to experience an elevated level of risk and volatility early this year. We could not have predicted that January 2016 would turn out to be the worst start of a year for the stock market in its entire history. There is little indication that things are close to improving for investors who are relying on the equity markets for their returns.

We also detailed that market leadership in 2015 was provided by what are now referred to as FANG stocks. Just four companies, Facebook, Amazon, Netflix, Alphabet (formerly and Google) were responsible for last year's stock prices from showing significant declines. fliers Netflix and Amazon appear to be leading the broad market into a bear market as both have fallen approximately 18% since the start of

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2016. Alphabet, along with market giant Apple, are down around 8% in the first two months of the year leaving only Facebook, the relative outperformer with a slight gain year-to-date.

The destruction of investor wealth has been swift and global. The London FTSE, German DAX, and Tokyo Nikkei are all experiencing bear markets down over 20% from recent highs. They are joined by the small cap Russell 2000 that is down 25% and the Dow Jones Transportation Index that has fallen nearly as much. The S&P 500 and Dow Jones Industrials have only fallen 8% for the year but appear to be following the other indices lower.

The current lack of leadership in the stock market can be seen in many ways. Market breadth has continued to deteriorate to the point where 60% of the S&P 500 stocks are down over 20% from their highs and nearly 40% of the index is down over 30%. As we have pointed out before, the market very much resembles late 1999 when the average stock was faring poorly but the market cap weighted indices masked the underlying weakness of the markets.

The stock market is often referred to as the most effective leading economic indicator as the market intuitively anticipates where the economy is headed. Corroborating the likelihood of economic weakness or recession is the bond market. The 10-year U.S. Treasury began 2016 as a yield of 2.26% and has fallen to 1.76%. The Fed, which began their path to interest rate normalization in December

2015 with a quarter-point rate hike, may be forced to consider cutting rates again and creating more stimulus for a weakening economy.

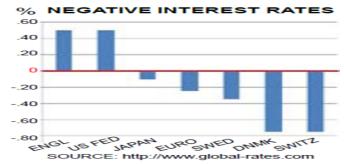
The most concerning data point was January's reading of the Service PMI (Purchasing Managers Index). The weakness in manufacturing has been well documented but it is widely known that consumer spending represents almost 70% of GDP and the service sector is the best

gauge of the health of consumers. The latest Service PMI showed a decline below the key level of 50 for the first time since October 2013 when the government shut down over the debt ceiling.

Central banks around the world are showing that 0% does not need to be floor for official policy rates. The Bank of Japan this month joined a number of other central banks by lowering rates into

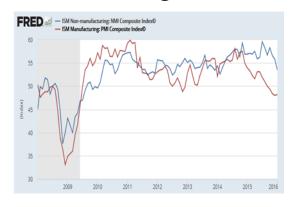
negative territory in an attempt to boost their struggling economy. Japan joins the European Central Bank, Sweden, Denmark, and Switzerland as major central banks with official policy rates below 0% with only the Federal Reserve and Bank of England with rates above 0%.

Credit spreads are widening in a sign that bond traders believe economic weakness is going to expand. Other indicators we track, like the Baltic Dry Index that indicates global shipping activity, has fallen 75% in just six months and sits at an all-time low.



An economic recession and prolonged bear market in stocks is now our most-likely scenario. Equity markets experienced a nice bounce in the last half of February that we believe hindsight will suggest was a better selling point than entry point. Portfolios should hedge market risk especially as indices approach key support levels that often lead to large scale selling.

Notable Divergence

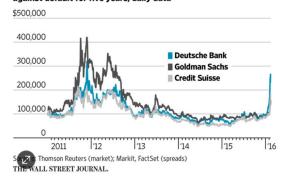


As mentioned in the Introduction, the divergence between the manufacturing sectors and service sectors of the economy may be disappearing. ISM Manufacturing has been in contraction several months while Non-manufacturing has remained in expansion territory. Consecutive sharp declines in the economy's service sector suggest weakness is no longer contained to manufacturing, inventory buildup, and export activity. The latest data suggests that domestic demand is declining even with the sharply lower prices for energy and gasoline. The New Orders component of the Non-manufacturing report was the weakest in nearly six years.

- If Non-manufacturing activity falls below 50 into contraction levels a recession in the U.S. would be all but certain to occur.
- The ISM surveys continue to show strength in the labor market and remain the lone hope for the economy to avoid a recession in 2016.
- Consumer Confidence and Consumer Sentiment have not confirmed a slowdown in the service sector and remain above their long-term averages.

Credit Default Swaps

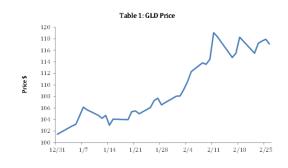
The annual cost of insuring \$10 million of debt against default for five years, daily data



Credit default swaps (CDS) became a • household term as investors recognized their contribution to the 2008 credit crisis. CDS demonstrate insurance on credit that ranges from mortgages to corporate paper. Watchful eyes have turned their attention back towards this canary in • the coal mine in both the US and Europe. The chart below shows the spike in CDS in 2016 for Deutsche Bank, Goldman Sachs, and Credit Suisse. The spike furthered concern over a global slowdown in growth combined with fear over low and negative interest rates. The downward pressure on rates creates significant headwinds on banks resulting in the spike in CDS.

- The cost of insuring against a default on \$10mm worth of Goldman Sachs debt for five years rose \$20,000 to \$159,000 a year during the month of February (Markit).
- The cost of insuring against a default on \$10mm worth of Deutsche Bank debt for five years rost \$36,000 to \$268,000 a year, the highest level since November 2011 (Markit).
- At the end of June, the global CDS market was \$14.6 trillion compared to \$57.9 trillion in 2007 (Bank for International Settlements).

Does Gold Shine Again?



Gold prices, as measured by the SPDR GOLD Trust, have risen by roughly 15% since the beginning of the year (Table 1). Gold, longtime a hedge against inflation, is rising, despite benign CPI readings

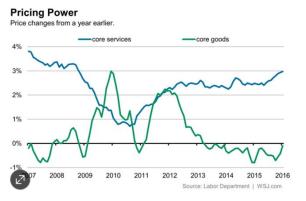
The prospect of negative interest rates on a global scale makes gold shine, as the value of fiat currencies becomes more uncertain. With low to negative rates, the effective future cost of holding gold, which has no yield, is not that high.

- Gold remains well off its 2011 highs, but has come back in favor over the past months
- Gold is one of the few commodities to shine against the backdrop of the lower prices across energy and most basic materials
- Recent fund flows into gold have seen a strong surge, with hedge fund managers taking bullish bets on U.S. COMEX futures
- Holdings in precious metals ETFs have risen to their highest levels in roughly 17 months.

Macro View- Inflation Mixed Signals

Inflation is showing both signs of life and death. Core, excluding energy and food, rose .3% for the month and up 2.2% for the year. The chart below shows core services in blue rising precipitously since 2011. Core goods, in green, has had a steady drop since 2012, struggling to break 0% since 2013.

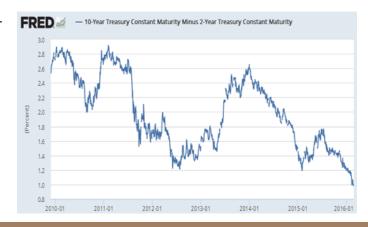
The dollar has had a meaningful impact, challenging inflation among core goods, while dollar deprecation has less of an impact on core services. This also creates greater and greater headwinds for US companies that produce goods that are sensitive to dollar strength. To add insult to injury, if core services continues to increase, the Fed is more likely to raise rates in to 2016. This will cascade into further dollar appreciation and spells even more trouble for US companies producing goods.



Fixed Income- All About Spreads

An easy way to gauge the health of a fixed income market is to calculate the spreads on various offerings. When the difference in yields between "risk-free" Treasury's and corporate bonds is narrowing, it is a sign of health and low default risk. When spreads are expanding, it suggests fear is rising and bond holders demand higher returns.

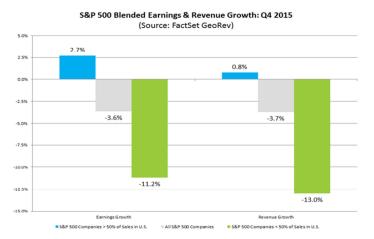
We are closely watching two fixed income spreads. The Merrill Lynch High Yield Energy spread has risen to unprecedented levels. The spread is normally between 2.5% and 5% but rose to 15% above Treasury's in late 2008 during the financial crisis. This currently trades above 17% and suggests a default rate of more than 30%. The spread between the 2-year and 10-year Treasury bonds is also worth noting. It has slipped below 1% for the first time since the economic recovery began and is a sign that expansion could soon be over.



Taking Stock- Multinational Blues

There is significant concern over the perception that US multinational companies will struggle significantly as the dollar continues to march higher. Q4 sales and revenue results are beginning to show that perception is reality.

The Factset chart below S&P 500 earnings for Q4 2015 declined 3.6%. For companies that generate more than 50% of sales inside the US, there was growth of 2.7%. For companies that generate less than 50% of sales inside the US, the blended earnings declined 11.2%. Sales showed similar results. Broad index sales were down 3.7%, companies with more than 50% of sales inside the use had sales growth of .8%, and for companies with less than 50% of sales inside the US, blended sales were down 13%.



Technical– **Scary Patterns**

John Hussman of Hussman Funds released research in February sending shivers down the spine of unhedged investors. He produced a chart of a pattern occurring for only the third time in history. The first was in 1929, the second was in 1987, with today being the third. When you consider the magnitude of market crashes that occurred in 1929 and 1987 it is worth taking note.

The specific pattern he refers to as "five days of Armageddon" involves a market retreat of 14% that occurs over a 10-12 week period followed by a recovery of around half the losses. If the market turns back lower after the rebound and breaks through support he suggest a steep drop in equity prices will occur. The key target Hussman is watching is 1812 on the S&P 500, a level we are comfortably above right now but would cause concern if the market retreats to that level in the near future.



An Introduction to Risk Budgeting

Clint Pekrul, CFA

Given recent market volatility, risk management has come more into the spotlight. As practitioners, advisors and portfolio managers should have a firm grasp of the risks they are taking on behalf of their clients.

We believe that asset managers should have a robust and comprehensive system for handling risk. One approach that we embrace is risk budgeting. This framework evaluates how much each asset contributes to the risk of the overall portfolio.

Changes in the risk contributions dictate how the portfolio is rebalanced over time. Intuitively, this process "sizes" the bets in the portfolio so that we avoid unintended risk concentrations that could potentially derail our portfolio. We can't manage returns directly, but we can manage how uncertainty is spread across the portfolio.

The inputs into the risk budgeting process are asset prices. We first calculate daily returns across all the portfolio holdings. Next, we determine the volatility of each holding based on historical performance. Lastly, we calculate the correlation of returns across all portfolio constituents.

Taken together, volatility and correlation gives us covariance, which is a metric that captures not only the variability of each asset's returns, but also how these returns are related.

Using covariance, we can break down portfolio risk by individual holdings. In addition, as portfolio managers, we can target a specific risk contribution for each holding.

Risk budgeting then becomes as optimization process. We can set a desired risk contribution for each holding in the portfolio, and then determine the proper dollar allocations that provide the desired risk exposures.

Using this framework, we know at any point in time how risk is concentrated in our portfolio. Are we over- or under-weight *from a risk standpoint* in a particular holding? If so, we have a framework for rebalancing the portfolio.

Risk Budgeting Example

Define the Investment Universe Based on Investment Objective and Time Horizon



Determine a Desired Risk Budget (i.e. How Much Risk is Dedicated to Each Holding)



Optimize Using Volatility and Correlations to Determine the Proper Dollar Mix

Risk budgeting can help manage uncertainty. However, it does not guarantee diversification. If all the holdings in the portfolio exhibit similar volatilities and correlations are high, then the portfolio as a whole is at increased risk.

As a complement to risk budgeting, portfolio managers can incorporate additional measures to help manage uncertainty. For example, when correlations rise above expected levels, a robust allocation trading system can ensure diversification by including an uncorrelated source of risk, such as a short position to equities or Treasuries.

Furthermore, a trading system should monitor the overall risk of the portfolio and impose a volatility constraint, or cap, if market conditions become highly uncertain (e.g. 2008). Under these scenarios, cash can be a desirable portfolio component.

In summary, we propose a portfolio construction framework that allocates capital based on risk exposures, rather than the standard "60/40" dollar-weighted mentality.

It takes only one constituent to derail a portfolio. We recommend using a framework that sizes the bets we make, so that any single holding doesn't overwhelm the portfolio.

Q: Do you expect the election season to impact the markets?



At this point, no, I do not anticipate the markets responding strongly to whatever this election season brings. Had the Sanders' campaign been able to continue their momentum beyond

his New Hampshire victory I might answer the question differently. Bernie Sanders' vision for America and the American economy is very much outside of mainstream thought and if it appeared as though he could be the Democratic nominee with the potential to take up residence in the White House I believe the markets would become unnerved. That seems like more than a long shot today and likely to almost removed as a possibility after Super Tuesday.

Of the remaining viable candidates, Clinton on the Democrat side and Trump, Cruz and Rubio among Republicans, I do not anticipate the market responding positively or negatively to the eventual winner. Donald Trump is clearly much more of a wildcard than the other candidates but would be viewed predominately as pro-business and markets.

Republicans are often viewed as the pro-business and pro-Wall Street party but that does not line up with the actual market results during Republican and Democrat administrations. While Hillary Clinton has vocally attacked Wall Street in her campaign, many will point to how well the stock market did during the prior Clinton administration. Having the White House and Congress controlled by opposing parties may not lead to a lot being accomplished but seems to be what much of the country is most comfortable with.



At this point, I think the markets have discounted the potential impact of a Trump or Clinton presidency. The one wildcard from a few months ago was the possibility of a Bernie Sanders run.

Given his anti-Wall Street stance and attack on banks, and his affiliation with socialism in general, a Sanders run would have been disruptive.

But Trump is no stranger to Wall Street, coming from New York with a long history of doing real estate deals. He's business friendly so I don't think a Trump nomination would be disruptive to markets.

Hillary has a long political history. As we've seen revealed this political season (speeches to Goldman Sachs), she is no stranger to Wall Street.

So, overall, I don't think either Trump or Clinton will impact the markets to a great extent. What's much more pertinent, I believe, is Janet Yellen and the Fed, and their monetary policy over the next year.

${f Q}$: Why is everyone so focused on China?



China has been the dominant economic growth engine of the world coming out of the Great Recession of 2008/2009 and has contributed about 34% of the gross economic

growth around the world. When you combine China and the U.S., these countries contribute more than 60% of global economic growth. It used to be said that if the U.S. economy sneezed, the world caught a cold. China now needs to be included in that and they have been reaching for a box of tissues.

A hard landing in China resulting in outright recession from 7% annual growth would have a tremendous impact on the global economy, especially among emerging markets of which China makes up more than 50% of GDP. China's population is sufficient to maintain very healthy economic growth from domestic demand but Chinese economic leaders have been slow to develop domestic demand choosing to remain focused on exports. In many ways China was almost solely responsible for the commodity bubble that developed and eventually burst.

The global economy is being forced to come to grips with the fact that China can no longer be the sole growth engine at a time when few large economies are seeing growth accelerate.



China is the second largest economy in the world, next to the U.S., and they are America's largest trading partner. But, there's only so much the developed market economies can do to drive global growth

over the next decade.

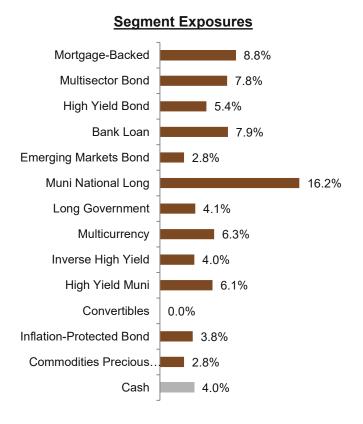
The evolution of China's emerging market economy will drive global demand for goods and services. As they move from a rural, agrarian economy to a consumption-based economy, their aggregate demand will drive prices higher.

Currently, we're not seeing that. Weak demand from China is reflected in lower commodity prices. There are also currency effects at play.

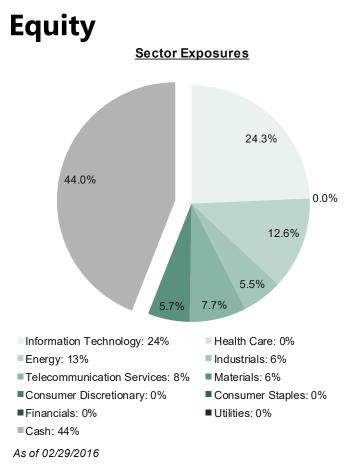
China's government continues to report weaker than expected economic data, with seven straight months of contraction in activity from their largest factories. Their central bank has taken further steps at quantitative easing, but some analyst say it may be too little and too late to ward off recession.

Bottom line is investors should care about China because any material developments there will likely have an impact on U.S. equities markets to some degree, either good or bad.

Fixed Income



- Municipal bonds continue to comprise the largest allocation in the portfolio with a recent tilt towards increasing the credit quality of muni's.
- Our theme of high credit quality and longer than benchmark duration has benefitted from the drop in yields since the beginning of 2016.
- We maintain a small "net short" position with corporate high yield bonds.
- We believe there is very little risk of a rapid increase in yields or further Fed action until the macro economy shows signs of stabilizing.



- We have maintained a significant cash hedge (44%) in response to growing equity volatility both domestically and internationally.
- Earnings estimates, according to FactSet, continue to fall at a more rapid pace than multiples suggesting valuations are still too high.
- Financials, banks and insurance companies in particular, should provide market leadership but not until the Fed is able to consistently raise rates.
- Elevated risk of recession should keep investors focused on capital preservation more than capital growth.



Fundame,

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

Phone: 719.203.6926

Fax: 719.465.1386

Technic Email: info@pcmstrategies.com

Website: www.pcmstrategies.com

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