PCM
PEAK CAPITAL MANAGEMENT

Soft Patch or Contraction?

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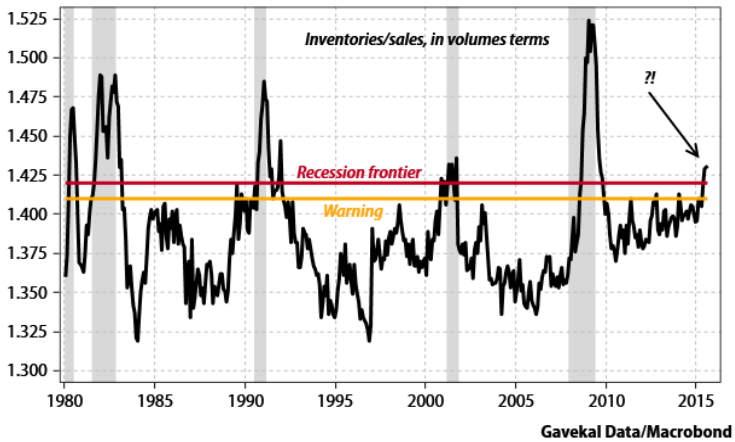
Dismal earnings, weaker than expected job creation, rising inventories, and weak consumer spending, not exactly a recipe for economic growth. For several months the macro economic data in the U.S. has been trending lower as the stock market has rebounded off the 3rd quarter lows. The most important question investors can be asking right now is whether the weak economic data is a sign of an impending recession or if we are simply experiencing a soft patch?

Beginning with earnings, the year over year comparisons are continuing to worsen. The latest data from Thompson Reuters suggests Q3 earnings will come in 3.9% lower than the same period last year. Earlier this year, contracting earnings could be blamed on the collapse of energy prices as that sector's earnings fell by over 80%. Recently, however, we have seen large misses from stalwarts like Walmart, 3M, and Caterpillar who simultaneously announced 10,000 in new layoffs in response to global economic weakness. Large numbers of companies are also guiding lower to the point where the forward P/E ratio could fall below the trailing earnings P/E; screaming overvaluation for stocks.



While labor reports like unemployment claims and job creation has traditionally been seen as a lagging economic indicator, the trend in the reports is helpful as a leading or coincident indicator. The September payroll report came in much weaker than expected and the Bureau of Labor Statistics (BLS) also revised lower July and August numbers. The more reliable 3-month average has fallen to 167,000 new jobs from 231,000 average the three prior months and 260,000 average during the first quarter of 2015. Economist David Rosenberg recently pointed out that the latest jobs report was worse than the headline as the average work week also dropped, equating to nearly 350,000 lost jobs. Announced layoffs in the 3rd quarter were the worst since Q3 of 2009 with September layoffs 93% above the same period last year.

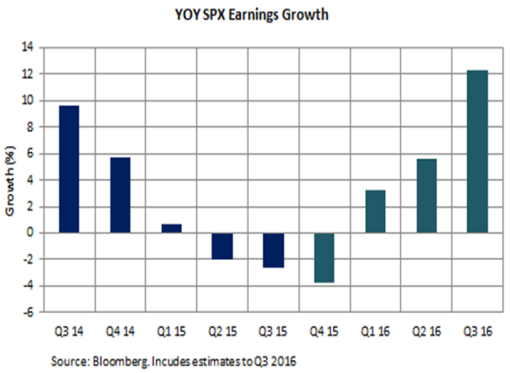
The struggle with retail sales was seen in the surprising miss by Walmart accompanied by dramatically lower forward guidance. The king of retail reported lower than expected earnings on weak sales and higher costs and told analysts they expect earnings to fall between 6% and 12% over the next 4 quarters. September retail sales came in at a seasonally adjusted +.01% but nearly every sector was lower. Without strong gains of 1.8% in car sales, retail sales would have been -.03%.

The most worrisome sign that we are not simply in a soft patch is seen in the inventory figures. GDP calculations for final sales are greatly impacted by changes in inventory. When inventories rise faster than sales, it is an ominous sign for future growth. As the chart attests, the wholesale inventory to sales ratio has been climbing and reached the level of 1.3 traditionally seen with recessions. The GDPNow figure published by the Federal Reserve Bank of Atlanta seems to validate a sharp decline in economic activity hovering right around 1% growth at the end of October, much lower than consensus estimates. Unless the upward trend in inventories reverses, we would expect a recession to be declared within the next six months.

Recessions are the greatest threat to investor portfolios. As John Mauldin frequently reiterates, the average drop from peak to trough in the stock market during a recession is over 40%. From a technical perspective, the current rally resembles a rally off recent lows with a likelihood of the next leg down in stock prices to follow. Our view continues to be that the current rally is simply giving equity investors an opportunity to sell into strength rather than the beginning of an extended move higher in stock prices.

The manipulation of short-term interest rates by the Federal Reserve and other central banks have made traditional indicators like an inverted yield curve useless. Bond traders seem convinced that the economy is weakening by virtue of yields on long duration bonds like the 10-year U.S. Treasury falling to near 2.0% in October. It is still possible that the current weakness proves to be a soft patch, similar to what happened in the first quarter, but with risk of rapid and steep losses elevated we prefer the view from the sidelines and are increasing the level of cash in portfolios.

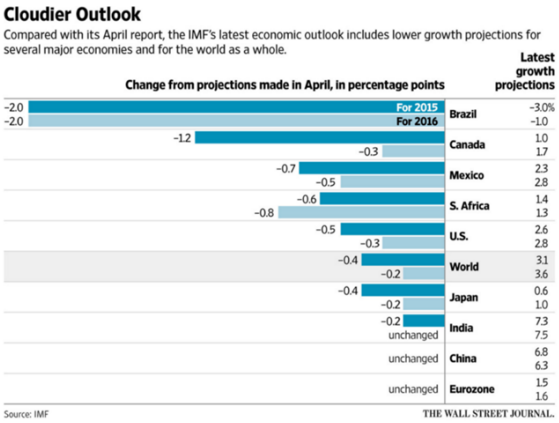
Earnings Update



As of late October, strong quarterly results from the technology sector have helped improve overall expectations for Q3 earnings. However, recent declines in commodity prices have weighed heavily on both the energy and material sectors. On a blended basis (actual reported versus forecast) S&P 500 earnings are expected to have declined roughly -2.8% in the quarter, versus a -4.2% decline forecast at the beginning of the month, according to Thompson Reuters. The estimated decline for the month of October, being the first month of the 4th quarter was also telling as it was lower than the 1-year average, but higher than the 5-year and 10-year averages. (Factset).

- Many analysts expect earnings growth to resume in the first quarter of 2016.
- Most companies are likely to focus on the impact that slower global growth, lower energy prices and a strengthening dollar will have on their reported results over the near term.
- Earnings estimates for the month of October continue to send mixed signals of a slowing economy headed towards recession versus an economy that has the legs to overcome recessionary headwinds.

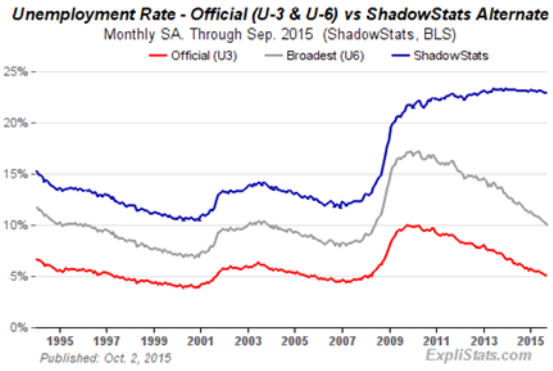
IMF Meeting and Global Slowdown



The International Monetary Fund (IMF) announced in October that the global economy faced the slowest growth since the 2008 economic collapse, pointing toward s possible global recession. The IMF lowered its projection of global growth for this year from 3.3% to 3.1% (Wall Street Journal). Modest growth in the U.S. and a paltry recovery from the Eurozone are not offsetting emerging markets or China, leading the IMF to the conclusion of a global economic slump. Head of the IMF, Christine Lagarde, is asking central banks to take action, namely asking the Federal Reserve to hold off until next year in raising rates.

- The global slowdown can be linked to falling commodity prices and deceleration in China's economy. The Institute of International Finance estimated that investors have pulled $1 trillion out of emerging markets this year.
- IMF growth projections for emerging markets today, 4%, are half of their growth projections 5 years ago (Wall Street Journal).
- The IMF stated there is a 50% chance that the global economy slows below 3% in 2015.

Get A Job

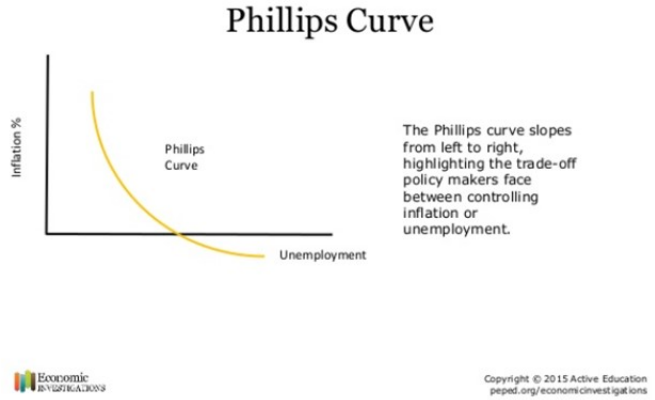


The disappointing jobs report for September was referenced in the Introduction along with economist David Rosenberg's analysis of net jobs lost due to a shorter work week. John Williams of ShadowStats also provides great insight into employment. The BLS produces 2 unemployment rates, the U-3 and U-6. The U-6 is higher because it includes a category called "discouraged workers" or those who have not actively looked for a job in the last 4 weeks and are counted as unemployed for up to 12 months. The ShadowStats number includes long-term discouraged workers as long as they are still of working age. The blue line clearly indicates that the fall in unemployment has more been a case of workers leaving the workforce than healthy job growth.

- The steep drop in the unemployment rate starting in 2010 is the result of lower workforce participation rates and not new job growth.
- When unemployment includes "long-term discouraged" workers, the rate remains today at 23% and is the most compelling reason why salaries or average income figures are not trending higher at a more rapid rate.
- Gallup also maintains a monthly underemployment rate similar to the U-6 based on their nationwide surveys. Gallup figures suggest a U-6 rate of 14.1%, much higher than the BLS figure of 9.6%.

Macro View– Phillips Curve Crystal Ball

The Fed continues to turn their attention towards raising rates and maintaining close watch on inflation. It was noted that in a 2007 speech, Yellen cited the Phillips curve as "a core component of every realistic macroeconomic model." The curve, depicted graphically, demonstrates the potential relationship between unemployment and inflation. Yellen and other colleagues at the Fed are making the case that the current Phillips curve shows that if rates are not raised in the near future, excessive inflation may likely follow. Nonetheless, Fed governor's Brainard and Tarullo argue against a rate hike. Mr. Tarullo is quoted as saying that it was "probably not wise not to be counting so much on past correlations, things like the Phillips curve, which haven't been working effectively for 10 years now." (New York Times).



Taking Stock– Buybacks and Dividends

As earnings season is under way, great scrutiny has been made of the impact share buy backs and dividends have on the company's valuation and further the S&P 500 valuation. The concern among analysts is that the overwhelming trend for companies to buy back shares and increase dividends has overstated earnings and further understated price/earnings multiples. It is critical to note that, upon careful examination of the S&P 500 methodology, the index adjusts for the impact of share buy backs.

Share buy backs and dividends certainly do impact individual equities in inflating earnings and underestimating the P/E, though. The chart below of the PowerShares Dividend Achievers ETF demonstrates that companies with that have increased their dividend over time have begun to lag the market despite the impact the dividends may have on earnings.

Fixed Income– Nothing but an IOU

We have been bullish on municipal bonds for the last couple of years on the basis of much higher yields on muni's for comparable credit quality with Treasuries and corporate bonds. While we continue to see compelling valuations, we are also increasingly concerned that some bonds in this sector are poised for ratings cuts.

Unfunded pension liabilities will likely lead to the next bond crisis with many plans having less than 50% of assets required to meet future promises. There are 25 states whose pension plans have less than 70% of required funding. When states have to decide whether to fund pensions or bond payments, you do not want to be a bondholder. The next bear market in equities will likely be the trigger for widespread downgrades.

Technical– No Longer Helping?

One of the drivers of stock prices the last several years has been companies buying back their stock. When firms buy their own stock, they not only increase the demand for their stock but also reduce the total number of shares traded making their Earnings Per Share (EPS) calculation more attractive. Many companies are reporting lower gross earnings than they did two years ago but are able to report higher EPS as a result of buybacks.

The correction in equities that began in August has caused a troubling indicator to surface. Companies with high levels of buybacks have typically outperformed the broad market but in both 2000 and in 2007 that trend reversed. That same warning has surfaced right now as seen in the chart of PowerShares Buyback Achievers recent lagging the S&P 500. This is just one of many indicators we are watching that indicate the need to be defensive in this market.

A Quantative Approach to Investing

Clint Pekrul, CFA

Quant Models and ETFs

At PCM we believe that asset allocation must be fluid and responsive to changing trends and systemic risks. Amid finite time horizons and heightened systemic risks, risk management needs to be comprehensive by considering various measures of uncertainty, including fat-tails, which pose a real threat and require a keen focus on downside protection and capital preservation.

Sustainable risk-adjusted outperformance, regardless of market cycles, is achievable through high-conviction, systematic rules-based investing with a focus on exploitable market patterns and a strong sell discipline. As such we believe that a robust quantitative trading system can provide framework for providing attractive long-term risk-adjusted returns.

What is Quant?

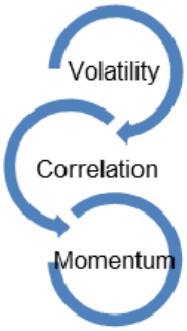
Quant is short for quantitative, which is a framework for allocating capital based on some clearly defined set of rules, or algorithms, that are generally formulaic. With a quantitative system, the user determines a set of buy and sell rules that are intended to be objective and unemotional. Most quant systems rely on mathematical formulas to determine a set of optimal portfolio weights. The portfolios are reviewed periodically for rebalancing to ensure that the asset allocation is aligned with the optimal allocation. Quantitative systems are common with hedge funds and investment programs that don't follow traditional buy-and-hold policies.

How Does Quant Work?

The spectrum of quantitative platforms is quite varied and can range from relatively simple single-factor models to complex global macro strategies. Perhaps one of the most common applications of quant models is based on momentum, such as simple moving averages. For example, a comparison of short-term to long-term moving averages could trigger buy and sell signals based on relative strength and weakness. Trend following strategies are an example of momentum-based quantitative systems.

Portfolio Construction

- **Volatility and Momentum Factors**
- **P/L measurement to mitigate downside risk**



More recently, in the post 2008 crisis era, many quantitative programs focus on volatility. These models are structured such that the risks of the underlying components contribute some percentage to the overall portfolio risk.

The investment rationale is to avoid large, often unintended, risk concentrations in the portfolio. Practitioners will often spread risk evenly across the underlying portfolio constituents (i.e. risk parity) or target a specific level of portfolio volatility (i.e. target risk).

Regardless of the factors used (e.g. momentum or volatility, or both) quant systems are intended to be dynamic in that they absorb new information (i.e. prices) to make investment decisions. The capital allocation decision is a function of the algorithm. This feature can be quite useful given the fluid nature of the capital markets and their hidden systemic risks.

The Role of ETFs

With the advent of ETFs and their proliferation over the past decade, investors can now trade broad segments of the capital markets (i.e. betas) with minimal friction and reasonable transaction costs. In addition many ETFs have deep liquidity and long price histories. ETFs can be efficiently traded which makes them ideal for use in quantitative systems.

For example, a quantitative model can now move efficiently between single sectors, broad asset classes and cash with reasonable transaction costs and fees. The ETF structure allows a quant manager to be nimble if needed.

The Potential for Quant Strategies

In the post 2008 environment, investors are looking increasingly beyond traditional asset allocation policies to manage their portfolios. It is little wonder the magnitude of rules-based products that have come to market (e.g. smart beta, risk-weighting, relative strength, etc.). At the end of the day, a quantitative model is only as good as the assumptions used in its design. Successful quant strategies will have been thoroughly tested (e.g. stochastic analysis and back testing) with clearly stated rules and objectives.

With a properly designed quantitative system, investors can potentially add value over time in terms of risk-adjusted returns, and avoid unexpected outcomes.

Q: Is the Fed stealing from retirees?

While there is no risk of Fed Chair Janet Yellen or her cohorts on the Federal Open Market Committee (FOMC) going to jail, I absolutely believe the Fed has been stealing from not only retirees but savers in general. The Fed's ZIRP (zero interest rate policy) made sense in 2008 at the onset of the Great Recession. Banks faced illiquidity as the global economy teetered on the brink of collapse. The Fed's actions, followed later by other major central banks, helped bring necessary stabilization.

We are now more than 6 years removed from the risks of financial collapse and the need for ZIRP has long passed. Decades from now in retrospect, I believe we will look at the last 6 years as one of the greatest transfers of wealth in history. Earnings on trillions of dollars for years has evaporated and benefitted a segment of the population more prone to risk taking.

The most basic measurement of effectiveness of any central bank policymaking is whether or not the policies Implemented raised the standard of living for the masses. In some countries this would be measured by per capital income while in other economies it might make sense to measure job growth to identify opportunity and higher standards of living. It is virtually impossible to analyze the Fed's policies over the last 6 years and come to the conclusion that the average person's standard of living has increased and for this reason they have failed.

I think this a question of how zero interest rates are hurting savers. I think one of the adverse effects of this zero interest rate policy is that it pushes some clients into asset classes that they normally would not consider, particularly high yield credit, longer duration Treasuries and dividend paying equities, just to generate sufficient income. These clients might not understand the principal side of the equation. That is to say, what happens when rates rise, or we have a credit event? These clients will have fluctuations in their principal balances they might not have experienced before.

So I guess in a way, the Fed has stolen a sense of security that used to come with bank deposits, FDIC insured investments, etc., that would generate sufficient income and preserve capital.

Q: Does social responsible investing work?

First, I would say doing anything in a socially responsible manner makes sense. Whether countries, companies, or people, we value and appreciate those who look beyond their own immediate interest and act in a way that benefits society as a whole. To this end, indices have been created that attempt to identify and track companies with positive environmental, social or governance impact.

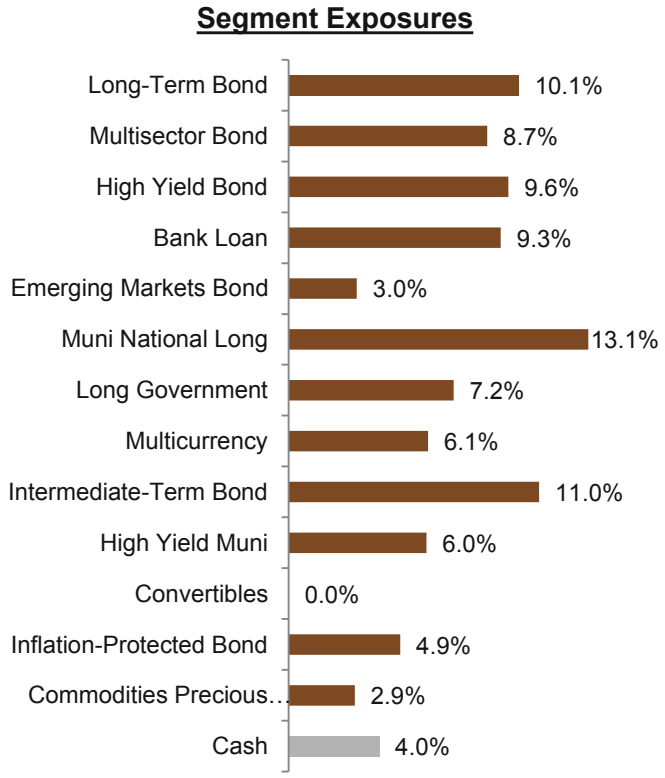
The challenge is that it is very difficult to determine how a positive impact should be defined. The vast array of environmental, political, spiritual, and economic beliefs mean what is environmentally responsible to one group may not be to another. Put another way, you are unlikely to find agreement on the definition of environmentally responsible between Green Peace and lobbyists for oil drilling companies.

From an investment standpoint, socially responsible investing (SRI) has traditionally underperformed the broad benchmarks for stocks. Over the last 5 years, for example, the iShares SRI index has delivered about 20% lower returns than the S&P 500. Investing in socially responsible companies might make investors feel good but it is unlikely to be a strategy that keeps pace with the stock market in general.

I think it depends on a few factors. First, do the screens that are used effectively filter out those companies that the end investor wants to avoid? There have been cases where pooled investments, such as mutual funds, have taken positions in companies that the end client might not have bought on their own. Before adopting an SRI strategy, check the investment's historical holdings and decide if it satisfies your criteria. If not, you might want to consider building your own portfolio.

Second, investors must be mindful of the impact that social exclusions can have on a portfolio. If you exclude too many companies, sectors, etc., you could end up with a highly risk-concentrated equity portfolio that's inconsistent with your risk tolerance. Also be mindful of SRI on the fixed income side. If you won't buy the equity of a certain company, are you comfortable owning that company's bonds? As far as I know, there aren't many SRI options in the credit markets.

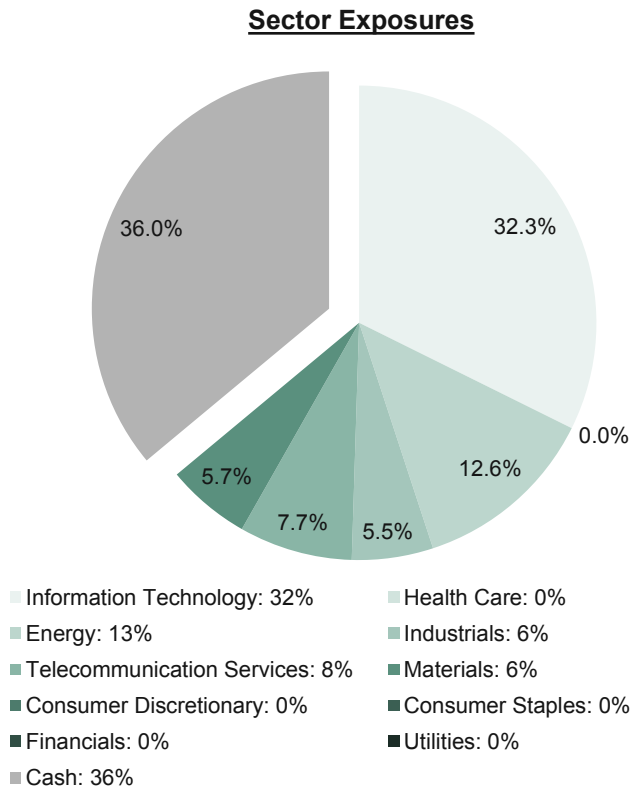
Fixed Income



As of 09/30/2015

- Portfolio continues to evolve towards higher credit quality and a barbell approach overweighting short and long duration and underweighting intermediate holdings.
- Spreads in the muni sector continue to provide more of a hedge against future rate hikes making them attractive.
- Latest economic data suggests the Fed is unlikely to raise rates before 2016.
- Moving towards currency neutral as a result of delayed Fed interest rate action.

Equity



As of 09/30/2015

- Cash has risen to 36% in anticipation of higher volatility from earnings season and expectation of weak forward guidance for many companies.
- The Information Technology sector has lagged the broad market and is currently compelling on a price to earnings basis.
- Financials are likely to be added to the portfolio in the near term and should benefit when the Fed begins to normalize interest rates.
- Overall risk in equities remains high warranting the cash hedge as we expect selling pressure to return prior to year end.

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