

E Pluribus Unum. Out of many, One. We recognize this phrase chosen by Charles Thompson in 1776 to be the motto of the United States as submitted by the Benjamin Franklin-led committee designing the Great Seal. That seal is emblazoned on our currency giving the motto an enduring meaning in our society. Just as 13 colonies or independent states came together for the common good of all, it appears that Central Banks from across the world have decided to act in unison, hoping an economic benefit for all is the result.

To suggest we are skeptical of the absolute, even blind, trust placed in the Fed would be an understatement. More than seven years removed from the Great Recession, interest rates remain at near-zero and Fed governors are publicly discussing the concept of “perma-zero.” Two days ago the bull market in equities became the 2nd longest bull market in U.S. history with only the tech bubble of the 1990’s lasting longer. We have gone the average length of the entire business cycle without the Fed acting to move interest rates off of what were described at the time as, **“temporary, emergency measures.”** The Central Banks of the largest economies of the world have participated, some even choosing to maintain negative rates all the way to 10 years out on the yield curve.

Greenspan, Bernanke, and now Yellen have made valiant efforts to build confidence in the economy but what are we to put our confidence in? An economy that appears to meet the Fed’s mandates of full employment and low (stable) inflation but cannot grow out of its own shadow. With earnings on the S&P 500 slated to decline by -16% in 2016, the Fed and other Central Banks appear to have reached a stage of impotence.

Fed policies have failed to produce:

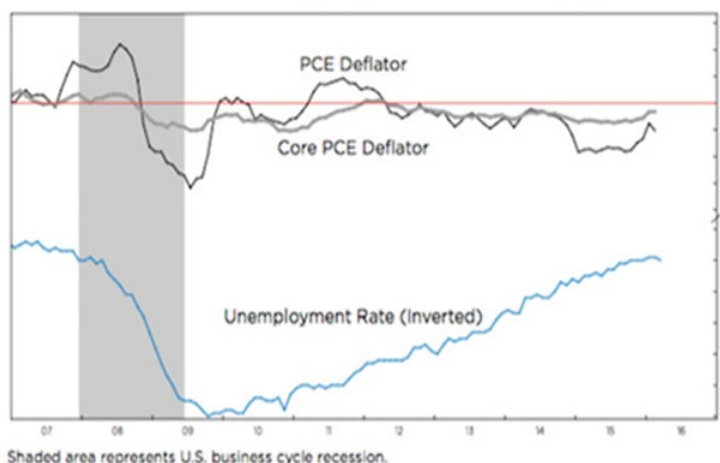
1. Broad labor market expansion (low unemployment attributed to low participation rates).
2. Higher wages for employees (real wages are 1.2% lower than January 2009).
3. More robust GDP growth (15 of the last 29 quarters have seen less than 2% growth).
4. Higher productivity (worst decline in productivity since 1993).

It is not that the Fed and other Central Bank policies have not had an impact. The Fed has created:

1. Asset inflation (i.e. bubbles).
2. Financial leverage (businesses borrowed \$800B last year mostly to pay dividends and buy stock).
3. Rising home prices (fueled by historically low mortgage rates).

The Fed’s unwillingness to normalize rates given 5% unemployment and 2% inflation make it obvious they operate with a 3rd, more controversial mandate: stock prices. Greenspan had the Plunge Protection Team (Executive Order signed by Reagan in 1988 called Working Group on Financial Markets), there was the Bernanke Put, a backstop against a crash in equities, and now the Yellen Call, designed to encourage global risk taking in stocks.

With the exception of creating asset bubbles, the inefficacy of the policies enacted by the Fed, Bank of Japan, and European Central Bank can lead to only one conclusion: **Central Bank Impotence.** What Central Banks need in



order to get economic growth back on track is a “large red pill” (small blue pills are already used). This pill would counteract the effects of global deflationary pressure in “mature” economies. The large red pill would be guaranteed to increase monetary velocity (blood flow) to economies lacking vitality.

This pill would of course come with the proper warning that in the event of a rise in inflation for longer than two quarters they

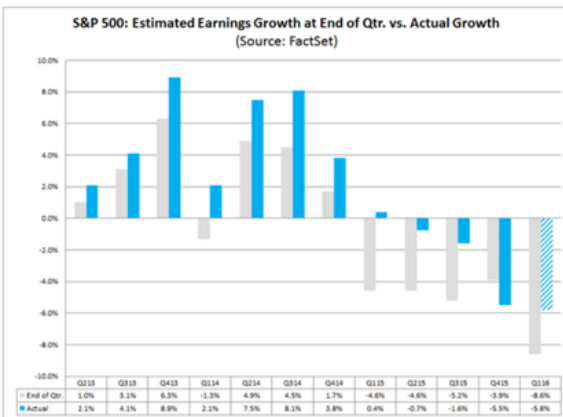
should seek immediate professional help. If only such a pill existed. Language from Yellen speeches suggest she believes the Fed has access to such an economic-miracle producing drug but history suggests otherwise.

Central Bankers are too often driven by academic analysis leading to flawed assumptions on how the economy is going to react to policy initiatives. The Bank of Japan clearly wanted to weaken the Yen by moving to negative interest rates and yet the Yen has rallied around 8% instead.

The idea of “perma-zero” rates, negative interest rates, and encouraging debt creation that can never be repaid can only result in a complete loss of credibility at some point in the future. Fed policies may appear to work on the surface but the day the Emperor is recognized as being without clothes economic Armageddon could ensue.

I believe the Fed is in the process of falling victim to one of the classic blunders. The most famous of which is “never get involved in a land war in Asia,” but only slightly less well-known is this: “Never risk all your credibility on failed policies!” Credibility is difficult to garner and near impossible to recover.

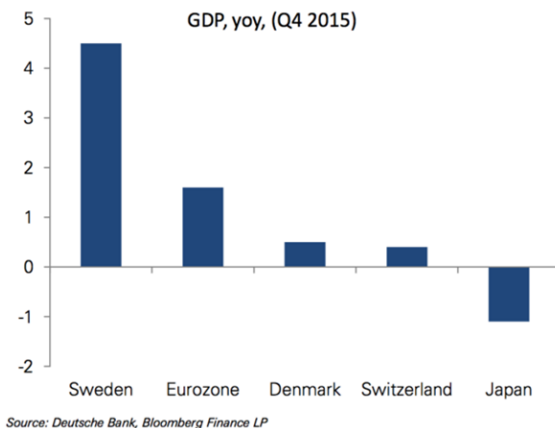
Earnings: Beating (lowered) Expectations



According to FactSet data, over the last 4 years 67% of companies have reported actual earnings that were higher than the consensus estimated EPS. On average, reported earnings beat the estimate by 4%. The S&P 500 companies are in the midst of 4 consecutive quarters of lower overall EPS and the negative growth appears to be accelerating. It becomes obvious that the way for two-thirds of companies to report better than expected EPS is to continually lower expectations. Make the hurdle low enough and even the weakest of companies can suddenly appear strong. Q4 of 2015 was the lowest EPS since Q1 of 2010 and those numbers benefitted from those non-recurring (one-time) charges that tend to inflate actual results.

- Q1 bottom up estimates fell from \$29.13 to \$26.32 since Jan 1st, the largest drop since the 1st quarter of 2009 (-26.9%).
- It has been 82 months since the last recession which historically occur on average every 67 months suggesting negative EPS could remain (NBER).
- A string of 8 consecutive quarters of negative EPS growth occurred during the last recession in 2008/2009.

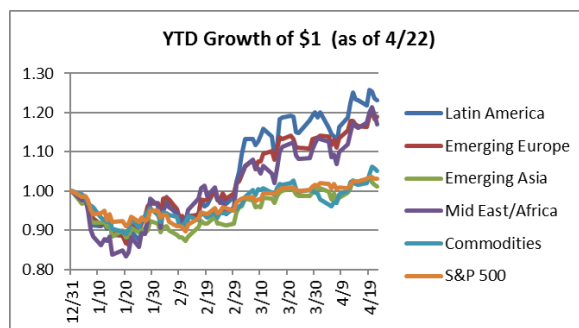
The Good, The Bad, The Ugly



A number of countries have spiraled into a negative interest rate policy (NIRP) where depositors are actually charged to hold their assets at the bank rather than being paid interest by the bank. This has been effective for some nations while tumultuous for others. The chart from Deutsche Bank below demonstrates an NIRP policy among Sweden, the Eurozone, Denmark, Switzerland, and Japan. NIRP has served Sweden well with year after year GDP growth over 4%. Japan, on the other hand, has experienced negative GDP growth in conjunction with their attempt at stimulus through NIRP. It appears that the ECB is running out of silver bullets, with or without NIRP, leaving GDP growth below 2%.

- The objective of NIRP by central banks is to seek to expand lending and spending by setting short-term rates at a negative level.
- The Bank for International Settlements warned in a March 2016 report of "great uncertainty" if rates stay negative for a prolonged period (Bloomberg).
- If banks make more customers pay to hold their money, cash may go under the mattress instead, leaving lenders without a critical source of funding.

Remember Emerging Markets?

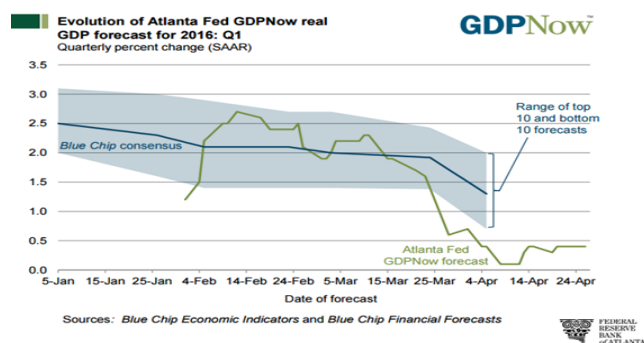


Since the credit crisis of 2008, domestic equity markets have dominated the headlines by delivering very attractive risk-adjusted returns. On a relative basis, the U.S. economy has held up better than developed and emerging market economies, and as a consequence the performance of U.S. equity markets have delivered better overall returns. However, year-to-date, the best equity returns have come from emerging markets. This is largely due to the fact that commodity prices have seemed to have found a bottom support level after extended declines. Given that emerging economies are rich in natural resources, there's generally a high correlation between the returns of emerging market equities and commodity prices across agriculture, energy and basic material sectors.

- Many emerging market economies are higher by double digits year-to-date, and have outpaced their domestic counterparts such as the S&P 500 by a fairly wide margin.
- In addition, commodity prices have risen for the year which has provided support for emerging market equity returns. Among the leaders are Latin America, emerging Europe, and the Middle East and Africa.
- If commodity prices continue to rally, and currency headwinds remain at bay, expect continued strong returns from these natural resource rich markets for U.S. based investors.

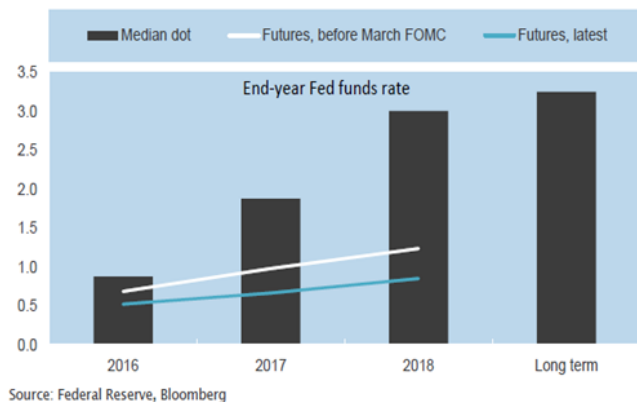
Macro View– GDP-Revising Down

Heading into April, GDP estimates were revised lower, provided by the Atlanta Fed GDP Now. This revision preceded a speech by Janet Yellen where she communicated that the likelihood of consistent rate hikes over the course of 2016 was diminishing, leaving the next rate hike possibly until 2017. This was a stark contrast from the plan laid out in 2015 to progressively raise rates. Yellen made it clear that the U.S. economy remains on stable ground but faced with headwinds by the global economy, headwinds that may be insurmountable. The chart below shows in the gold line the dramatic drop in GDPNow forecast from the middle of March in to the beginning of April, just before Yellen's speech (Atlanta Federal Reserve). Real time forecasting of the GDP has not recovered



Fixed Income–The Great Disconnect

The amount of edge-of-your-seat focus on the Federal Reserve's every action is disquieting to say the least. The Fed (created in 1913 by the Federal Reserve Act) was intended to be an independent committee that determined monetary policy for the U.S. While the Fed has fought to maintain its "independence" from Congress and the White House, it clearly remains uber-dependent on market sentiment. The futures market is pricing in only 1 rate hike in 2016 and just 1 in 2017 while the Fed is still suggesting there will be 7 rate hikes over the next 2 years. We expect Fed Funds to be far closer to 1% at the end of 2018 as indicated by the futures market. This slower pace of rate hikes should investors in long duration investment-grade bonds to outperform. The latest survey of Blue Chip economists suggests there is a 42% chance the Fed raises rates at its June meeting, we believe the odds are much lower. The weak Q1 GDP report is likely to keep long-term rates from rising and result in a yield curve that remains flat for an extended period of time.



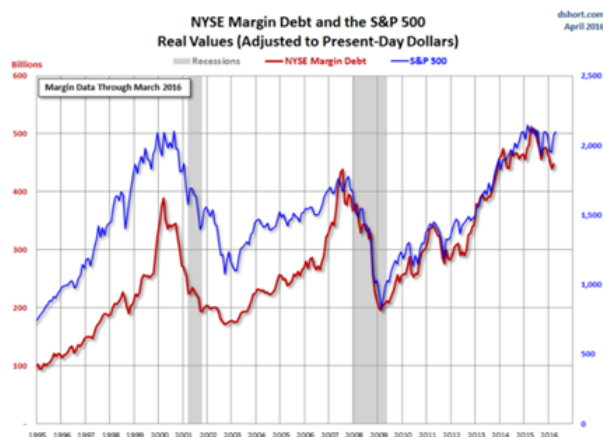
Taking Stock–“Fundamental (Mis)Valuations”

The chart below of the S&P 500 demonstrates a return to the 1 year high. There has been a meaningful shift in the fundamental valuations since a year ago, though. Yet, the equity markets charge higher, testing new highs. There is little debate that the Fed's dovish policy continues to propel the U.S. market. The price to earnings ratio as of the end of April was 17.71. The P/E ratio stood at 23.62 for the fourth quarter, 2015 (Y Charts). There has been a 10% advance in stock prices at the same time that projections for annual earnings growth on the S&P 500 Index over the next several quarters have been lowered by as much as -5%. Adding insult to injury, projections for 2016 Q2 have now turned marginally negative. This has been revised down from low single digit projections.



Technical–Technically Speaking

There is a saying in Colorado, "If you don't like the weather, wait 15 minutes because it is sure to change." That adage has equally applied to the technical picture of the broad stock market indices since the beginning of the year. Deciding whether the market's climate is "partly cloudy" or "partly sunny" is the difference between adding equity exposure or reducing it. Technical analysts are searching for clues whether we are in a bear market or a correction in the aging bull market after the markets recovered losses in a V-shaped recovery off the February lows. We remain concerned that storm clouds are not far off the horizon and risks are elevated. The Advance/Decline line is flashing green as it recently broke out to new highs. The Leading Economic Indicators (LEI) are flashing yellow having declined each month since last November. Margin debt is flashing red as 6 of the last 8 market peaks coincided with a peak in margin debt which occurred in April 2015.

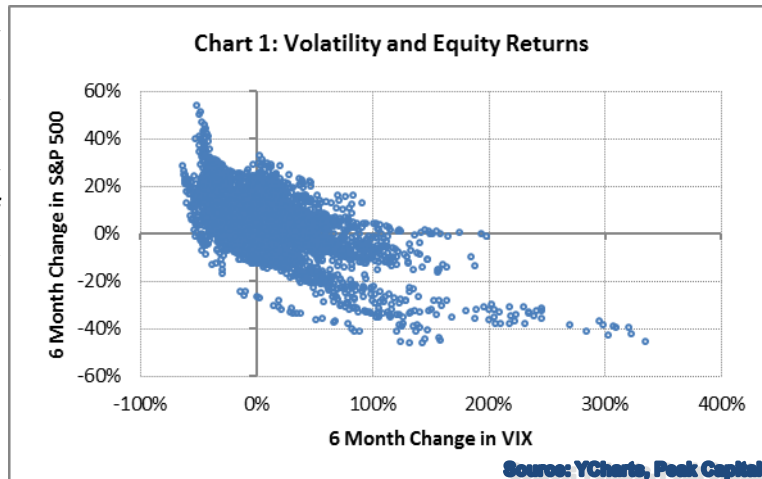


Volatility and Returns

Clint Pekrul, CFA

This month we're illustrating the relationship between volatility and returns. While most investors are aware that in general, as volatility rises, returns tend to suffer, and vice versa. We evaluated the actual data between the S&P 500 Index (equities) and the VIX Index (the expected 30-day volatility of the S&P 500 Index) and quantified the relationship between the two measures.

Chart 1 illustrates how the VIX and S&P returns tend to be negatively correlated (not surprisingly). The blue plots show the six-month rate of change in the VIX Index (bottom axis) and the corresponding six-month rate of change in the S&P 500 Index (vertical axis). The data set goes back to 1996.



At first glance, it's fairly obvious that changes in the VIX and the S&P 500 tend to move in opposite directions. In other words, as the VIX rises, or moves to the right, the S&P falls, or moves down the vertical axis. This suggests that poor equity returns tend to be associated with rising volatility, and vice versa. From a regression standpoint, the beta of six month changes in VIX to six month changes in the S&P 500 over the entire data set (1996 to present) is roughly -0.18.

When looking at how the data is distributed in the chart, it's clear that the further we move to the left on the bottom axis (i.e. the VIX is falling) the corresponding S&P Index returns tends to accelerate upwards. Intuitively, this makes sense. As volatility begins to fall after a spike in risk, the S&P 500 Index tends to move higher (think 2009 after the credit crisis and 2003 after the dot.com bubble). Conversely, as we move to the right on the bottom axis (i.e. the VIX is rising) the corresponding S&P 500 Index tends to accelerate downwards. Again, this makes sense intuitively. As uncertainty rises, investors tend to shun equities, which in turn places downward pressure on the S&P 500 Index (think 2002 heading into the dot.com decline and 2008 heading into the credit crisis).

What is interesting about the relationship between changes in the VIX and the S&P 500 Index is that it's not necessarily a negative one-for-one relationship (i.e. the relationship is not linear), but a convex one. In other words, what is most important to investors is not necessarily the absolute level of VIX but how quickly the VIX is accelerating upwards or downwards.

When looking at the data, if the six-month change in the VIX is greater than 100%, the average corresponding six-month change in the S&P 500 Index is roughly -21%. Furthermore, if the six-month change in the VIX is greater than 200%, the average six-month change in the S&P 500 Index drops to -36% (i.e. equity losses accelerate as the

VIX moves higher). On the flip side, if the six-month change in the VIX is less than -25%, the average corresponding change in the S&P 500 Index is roughly 14%. Furthermore, if the six-month change in the VIX is less than -50%, the average corresponding change in the S&P 500 Index is roughly 19% (i.e. equity gains accelerate as the VIX moves lower).

Portfolio Applications

The example above is fairly simple but it drives home an important point: as practitioners, we can use volatility to make investment decisions. This holds true not just for the S&P 500 Index, but for other asset classes as well, such as commodities and high yield bonds. As we've seen, when volatility rises (e.g. the VIX moves higher), equity returns tend to fall, and vice versa. At Peak Capital, we use a risk budgeting methodology that seeks to control how much risk, or uncertainty, each portfolio constituent contributes to the risk of the total portfolio. When we see volatility accelerate, we can step aside and allocate capital elsewhere. Likewise, if we observe volatility reverting to more normal levels, we can redeploy capital to capture upside return.

Q: Do 2/20 Hedge Funds Add Value?



Some investors have gone even further with this question wondering if hedging strategies add value even if they were free. What is certain is that any high net worth investor who has paid a 2% management fee and 20% of profits in a hedge fund has probably been disappointed.

The term Hedge Fund is generic with strategies like market neutral, long/short equity, risk arbitrage, and global macro included in the category. Data from research firm HFRI shows the average hedge fund lost money in each of the last 2 years. The loss of -3.6% in 2015 was poor given the S&P advanced 1.4% but 2014 was possibly the worst ever when funds on average lost -.58% compared to the S&P advancing +13.7%.

One of the primary reasons hedge fund assets are diminishing is increasingly the strategies previously only available as a hedge fund is available to all investors. Why pay 2/20 (or 1.5/15) when you can access the same level of sophistication and hedging (risk management) through an ETF strategist that might charge less than .50%? Hedge funds attracted large investors and institutions because of their ability to limit systemic market risk which is being done at a high level by many non-hedge fund managers today. Technology has become a great equalizer in investment management and that trend is likely to only become more dominant.



This is certainly a question on the minds of many investors. If you look at some of the recent returns from the Hedge Fund Research Institute, the performance as of late for many hedge funds have been less than stellar. If you look at their total hedge fund composite index over the past five years, it's up roughly 1.7%, and their multi-strategy composite index is just up 2.7% for the same period.

I think in general, investors expect more from hedge fund strategies, particularly if they are going to pay 2% annual fees and 20% of profits. One reason I think hedge fund returns have come under such pressure is that there are more players in this space than a decade ago. It's simple arbitrage. There are only so many trades that these hedge fund managers can implement.

So, the more players there are the more quickly these trading opportunities disappear. So only a few of the top managers can execute effectively and the rest fall by the wayside. As a result, picking the best managers becomes a real challenge, because what worked in the past might not work in the future.

Another factor is the fact that on a macro scale, events are driven not as much by fundamentals today as they are driven by central banks and monetary policy. This can make global macro strategies difficult to implement.

Q: Are Emerging Markets a Buy?



That answer will say as much about an investors risk tolerance as it will the underlying fundamentals of emerging markets today. Through the end of April, emerging markets have gained 7.3% versus a paltry gain of 1.5% on the S&P 500. However, over the last 12 months, emerging markets returned -20% versus 0% with large cap U.S. stocks. Even worse, emerging markets returned -28% over the last five years combined while the S&P 500 advanced +55%.

There is a strong case that the headwinds for emerging markets; a strong U.S. dollar, weak commodity prices, and weak global demand for goods are diminishing or turning positive. However, it is impossible to ignore the tremendous impact that China has on emerging markets as it represents one-fourth of the index. I remain highly skeptical that China has done anything meaningful to address structural economic problems including over capacity and non-performing loan balances. Until China restores some level of economic confidence, emerging markets will remain volatile at best.

My long-term outlook for emerging markets is extremely positive given that most of the world's growth will occur there. India, in particular, should shine economically for the next decade or more as markets are opened up and foreign investment restrictions are lifted. At the other extreme, Europe accounts for 7% of the world's population, 25% of global GDP, and over 50% of total welfare spending. That is a no-growth policy for much of the developed world.



As we mentioned earlier in the report, emerging markets have rallied substantially this year as commodities have found some bottom line support. In addition, the currency headwinds from the past year or so have not been such a drag on returns year-to-date for domestic investors.

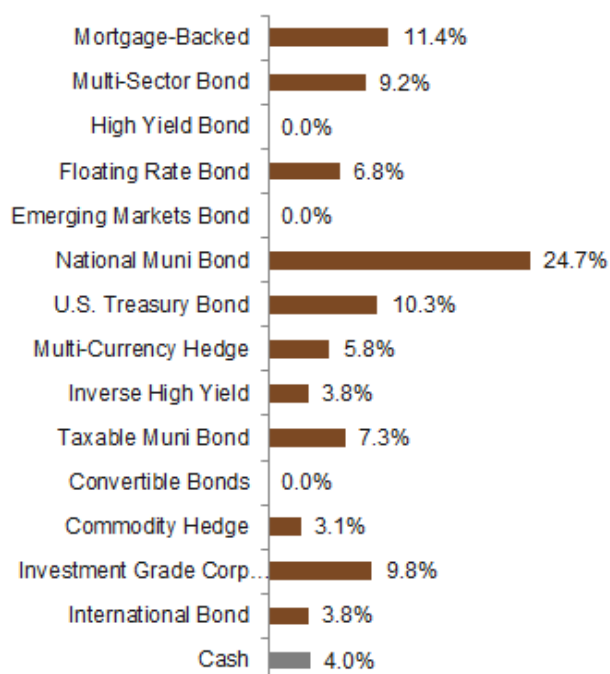
From a pure valuation standpoint, the price-to-earnings on emerging markets as an asset class is roughly 12.7x, compared to the same measure on the S&P 500 of roughly 19.4x, and 15.6x for developed markets. So on a fundamental basis, emerging markets seem cheap when compared to underlying earnings. In addition, the dividend yields on emerging markets tend to be somewhat higher than in the U.S. From a volatility standpoint, the spread between emerging market and U.S. equity risk is fairly tight, relative to historical standards.

However, one thing we have learned since the crisis of 2008 is that markets might not be driven by fundamentals as much as central bank policy, particularly in the near term. Any change in currency valuations will likely overwhelm any underlying fundamental value. In the longer-term, what is really going to drive emerging market returns is aggregate global demand for natural resources, and we are not quite seeing that yet.

The recent rally might just be a dead cat bounce after a prolonged slide in emerging market shares. From a portfolio standpoint, it might be prudent to incorporate some emerging market equities. But be mindful of the risk and be prepared to scale back the exposure.

Fixed Income

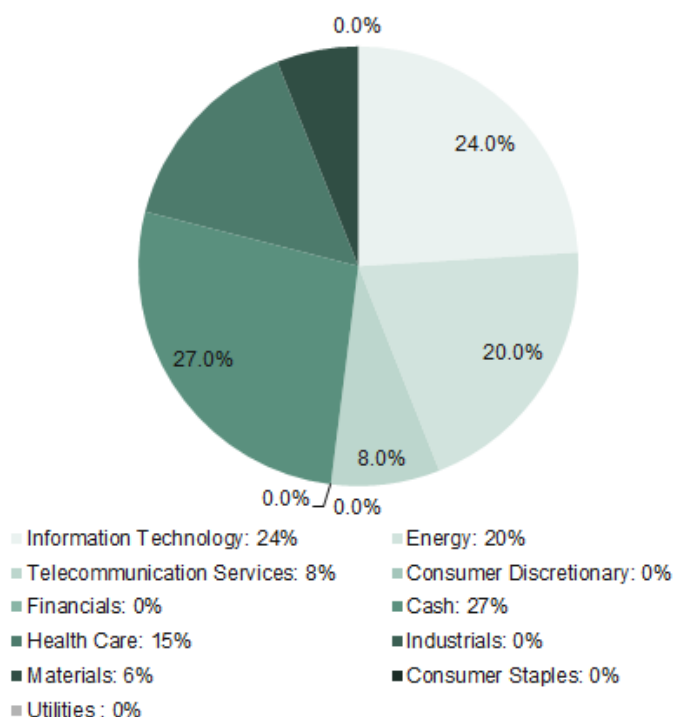
Segment Exposures



- Corporate high yield bonds were eliminated from the portfolio after a sharp rally in prices during March and April.
- Dim Sum (Chinese) bonds were sold on anticipated further weakening of the Yuan by the PBOC to stimulate growth.
- We are targeting BBB-rated bonds in our corporate investment grade allocation using RAFI fundamental weightings.
- We are maintaining durations longer than benchmark durations expecting a flat yield curve to remain.

Equity

Sector Exposures



- New purchases this month in Healthcare with a focus on Bio-Pharmaceutical companies with strong new drug pipelines.
- Small increase in energy exposure as oil prices rise and companies with strong balance sheets benefit.
- Initial earnings reports for Q1 are generally above the revised lower expectations but will likely fall by 6% on a year-over-year basis.
- The Fed has signaled that it is unlikely to hike rates 4 times in 2016 driving higher equity allocations by many analysts.

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