

We all grew up hearing the phrase, “Don’t put all your eggs in one basket.” Some have referred to this principle of diversification as Investment 101. Investing involves uncertainty and a primary way to manage volatility is by combining assets that have different risk profiles. Portfolio construction typically involves mixing low or uncorrelated assets classes with varying risk/return profiles so that the overall portfolio exhibits the desired balance of risk and return potential.

Historically, bonds have been the preferred asset class for reducing portfolio volatility. Bonds provide regular income and a specific timetable for returning your principal. If held to maturity, the only way to lose money investing in bonds is for the issuing company to default, something that is rare among investment grade bonds.

In a low interest rate environment like we have been in, short duration bonds of quality companies provide very low nominal yields. They are barely above the rate of inflation we have been experiencing. We are likely entering a period where the “safe” part of a portfolio carries more volatility and potential downside risk, than the more aggressive growth part of the portfolio.

The chart shows the performance of long-term U.S. Treasury bonds (tan line) and the S&P 500 over the last 3 months. While stocks have been flat, government-

Fed can, and will, maintain stability in the bond market may be in the process of being shaken. After more than 6 years of near 0% fed funds rate, Ms. Yellen and her cohorts must figure out how to normalize interest rates without harming the economy or creating panic in the bond market. If the last two months are any indication, the Fed is likely going to struggle to achieve its goals.

“...the Fed is distorting financial markets and creating incentives for managers and market players to take increasing risk, some of which may result in tears.”

We view fair value yield on the 10-year Treasury bond to be around 3.50% (currently 2.48%) based on our forecast for 2.0% GDP growth plus 1.50% inflation.

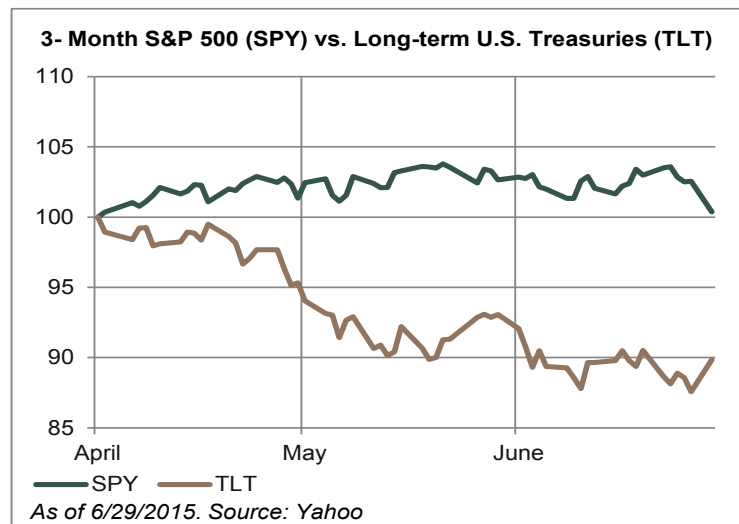
What has been surprising to us is the rapid rise in yields on long duration bonds in the wake of the pending Fed rate hike. The yield curve has actually steepened when a flattening would typically be expected. Fed Governor Fisher probably said it best in 2014:

“I fear that we are feeding imbalances similar to those that played a role in the run-up to the financial crisis. With its massive asset purchases, the Fed is distorting financial markets and creating incentives for managers and market players to take increasing risk, some of which may result in tears. And all this is happening in uncharted territory. We have aided creation of massive excess bank reserves without a clear plan for how to drain them when the time comes.”

Does this mean that stocks are the new “safe” investment? Absolutely not! While Fed policy continues to favor owning risk assets like stocks, the day will come when owners of stocks experience the type of risk that makes diversification necessary, probably sooner rather than later.

There continues to be plenty of opportunities to prudently invest in bonds today to lower overall portfolio risk. We believe the market has priced in the first two Fed rate hikes with the first occurring in September so we do not expect yields to continue to rise steeply. We are favoring shorter durations in fixed income and continue to believe the municipal bond market represents the most compelling values. We continually monitor the credit risk premium in the bond market which is only slightly positive at current levels. This favors holding bonds of higher quality in our view as the compensation for owning poor credit quality is insufficient for the default risk being assumed.

Bonds are likely going to demonstrate high levels of volatility as the 30-year trend of falling yields reverses itself. Prudent advisors and investors will continue to allocate to bonds given the need to provide current income and given the potential diversification benefits they provide amid relatively low correlations to growth assets like stocks.

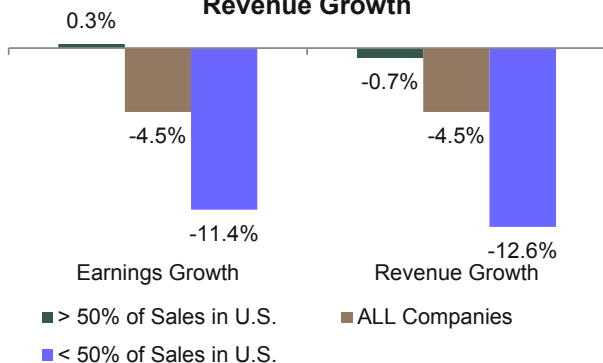


guaranteed bonds maturing in more than 15 years have fallen over 12% in the same period. This demonstrates the risk associated with “risk-free” bonds, showing nearly 6 years of interest income on the 10-year U.S. Treasury were wiped out in about two months.

For too long fixed income traders have depended on what we refer to as Fed omnipotence. The assumption that the

Earnings-Driven Correction

S&P 500 Projected 2Q15 Earnings & Revenue Growth

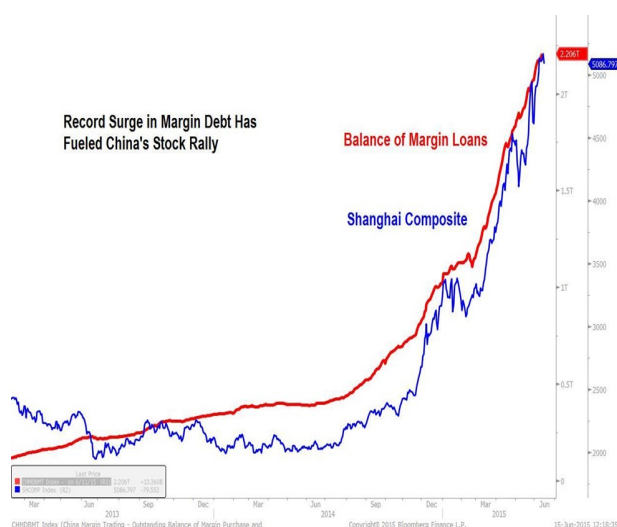


Source: FactSet

We have been forecasting that earnings on the S&P 500 would experience a recession defined as at least 2 consecutive quarters of falling earnings. According to FactSet data projecting Q2 earnings and revenues, it appears as though we are about to experience a second straight quarter of negative earnings growth. On a broad basis, both earnings and revenues are forecasted to fall 4.5% the quarter ended June 30. Interestingly, companies that report more than 50% of their sales from outside of the U.S. are projected to see a far greater correction in earnings.

- Since 1965 there have been 19 stock market corrections not involving recession with the median fall in prices of 14%.
- The last 5 Fed rate hike cycles has seen the P/E of the S&P 500 contract by an average of 4.2 times reported earnings. If this average contraction holds this time around, we would likely see a potential correction in stocks greater than the 14% median.
- If the U.S. Dollar resumes moving higher, as we expect with rate hikes, companies relying on exports for sales will struggle even more and drag earnings lower.

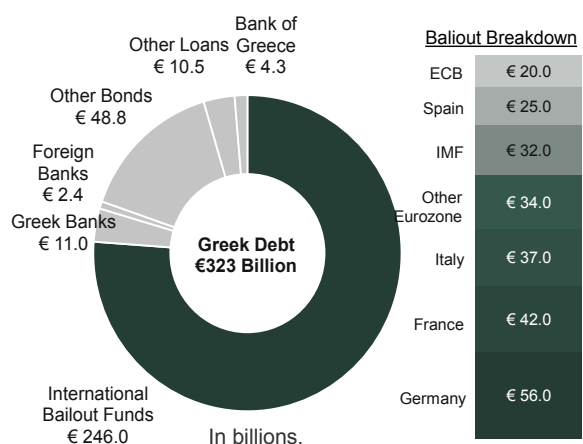
China and Emerging Markets



The People's Bank of China (PBOC) continues to play puppet master, impacting Chinese markets and the emerging economies that are largely dependent on the Chinese economy. Another form of QE flooded the market with liquidity in the form of lending trillions of yuan marked for investment in Chinese equities. The chart (Bloomberg) shows margin loans increased exponentially since the year began. This helped drive a 60% gain in the Shanghai Composite Index from the start of the year to its mid-June peak. The recent sharp correction in equities created margin calls, stirring panic selling among the retail buyers that had poured into equities. retail buyers that had poured into equities.

- Emerging markets, year to date were up over 10% prior to the sell off, leaving investors largely flat on the year.
- MSCI estimates that adding A-shares to the Emerging Markets Index would draw \$20bb to China's markets and, over time, \$400bb (Wall Street Journal).
- Dominant index provider, MSCI, concluded not to incorporate China's mainland listed shares in their global benchmarks, continuing to limit investment and exposure among emerging market allocations.

Greece is the Word...Again



Source: Greek Public Debt Management Office

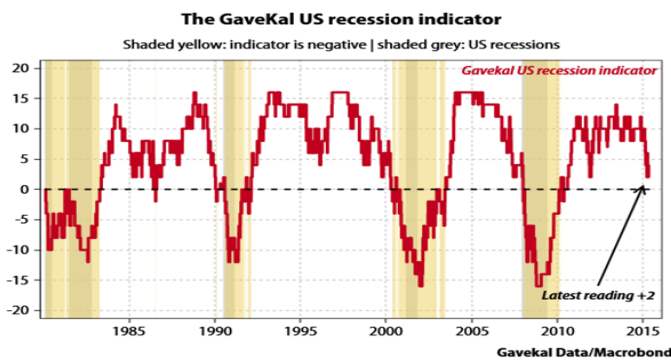
The seemingly never-ending Greek tragedy took more twists and turns in late June, with talks between Greece and its creditors collapsing. Greek's debt totals only €323 billion with €246 billion provided as part of its bailout package (see chart). The Syriza-led Greek government decided to put up for a public vote the terms offered by Greek's creditors. The referendum is scheduled for July 5th, which poses a challenge because the current bailout program expired on June 30th and Greece had a payment due to the IMF on that same day. Greeks and investors could be in for a wild ride in early July as this drama starts a new chapter.

- The proverbial run on the banks occurred in late June.
- Investors resigned to accept a "Grexit" so long as it is orderly and not contagious.
- We see risk that such an event could spark other fiscally challenged countries, Italy and Spain, to balk on their reforms.
- The people of Greece will be given the chance to accept greater austerity or face greater economic uncertainty.
- We think the referendum is a vote of confidence in Syriza and a vote for the creditors' terms is a vote against Syriza.
- Expect greater volatility in equity markets and potential buying opportunities for European stocks when the dust settles.

Macro View— Warning Signs

Economic data for the U.S. reported in the previous month was stable and in some instances, relatively strong. Nonfarm payrolls increased ahead of consensus expectations. Unemployment ticked up from 5.4% to 5.5% as a result of a slight increase in the participation rate. Manufacturing showed firm ground as the ISM manufacturing index improved to 52.8 in May from a two year low of 51.5 in April. The index also posted above consensus estimates. Existing home sales increased 5.1% month over month. This showed the highest level of home sales since November of 2009. First time home buyers accounted for 32% of sales, the highest level since 2012 (Factset).

Gavekal Research has aggregated many of the macro indicators tracked by Peak Capital and applied them to a U.S. recession indicator. As the chart demonstrates, the economy continues outside of the recession zone, but the sharp trend downward towards a recession gives us tremendous reservation.



Fixed Income— Opportunity or Trap

There are many ways to invest in muni bonds: individual bonds, mutual funds, ETF's, and closed-end funds (CEF's). CEF's often carry more volatility than the other vehicles because they have the ability to carry leverage and prices are determined by supply and demand instead of the actual value of the bonds. With investment grade muni bonds trading at 7-8% discounts to net asset value and yielding above 6%, they are a compelling opportunity for fixed income investors in our view.

Fund / Ticker	Price	YTD Chg	Discount to NAV*	Yield
Nuveen Municipal Opp./NIO	\$14.34	-3.5%	-7.0%	6.1%
Nuveen Premium Inc. 2/NPM	14.18	-4.3	-8.1	6.1
BlackRock Target Term/BTT	20.88	-7.6	-6.3	5.4
Nuveen NY AMT-Free/NRK	13.65	-6.7	-6.4	6.1
BlackRock Muni CA/MUC	15.10	-4.6	-4.9	5.7
Invesco VK CA Value/VCV	12.49	-6.5	-6.4	6.3
Nuveen AMT-Free Muni/NEA	13.49	-5.8	-8.2	6.1

* Net Asset Value

Source: Bloomberg, CEF Connect

Taking Stock— New Leadership?

With valuations stretched and the bull showing fatigue, we thoroughly monitor risk levels yet continue to see opportunity. As rates begin to tick up, one beneficiary becomes banks. This is largely a result of changes in Net Interest Margin (NIM). NIM is the difference between the interest income banks generate versus the interest paid out to those borrowing from them. Mutual funds and hedge funds are also responding to the impact rising rates have on banks as they shift from being heavily underweight banks and financials to overweight positions. The data from Lipper shown below indicate the dramatic underweight in financials. Institutional flows into the banking sector may bode well for appreciation in a rising rate environment.

Exhibit 2: Aggregate fund over/(under)weight positioning vs. benchmark as of March 31, 2015; Russell 3000 used as hedge fund net exposure "benchmark"

Sector	Mutual funds			Hedge funds
	Core	Growth	Value	
Industrials	169 bp	(292)bp	(33)bp	(0)bp
Health Care	148	562	203	7
Consumer Discretionary	109	226	483	681
Materials	44	(100)	(33)	284
Consumer Staples	13	(502)	(31)	(380)
Telecom Services	(32)	(180)	18	(213)
Financials	(80)	365	(701)	(601)
Energy	(86)	(68)	(139)	683
Info Tech	(122)	(8)	557	(263)
Utilities	(164)	(3)	(325)	(199)

Source: Lipper, LionShares, FactSet, and Goldman Sachs Global Investment Research.

Technical— On the Margin

The last two major stock market crashes, 2000 and 2008, were preceded by spikes in market debt as a percentage of GDP. Margin debt on the NYSE has increased by over \$60 billion in the last quarter and nearly 15% higher than where it was at the beginning of the year. When speculation increases to extreme levels the likelihood of panic selling is greatly increased. With contracting earnings, the start of a Fed rate hike cycle, and record levels of stock market speculation, we think the probability of a sharp correction is elevated.

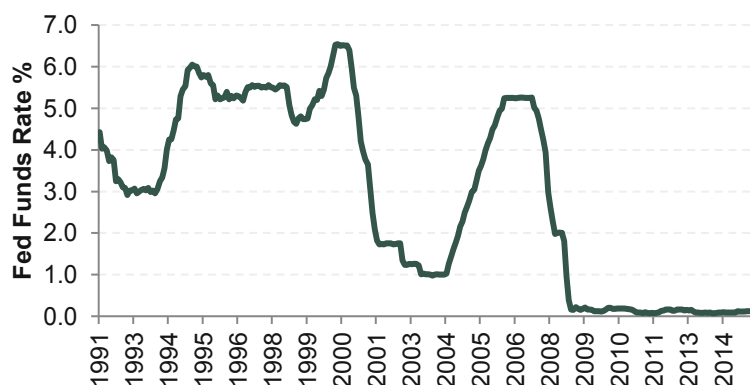


1994 Revisited?

In April, we briefly discussed our thoughts surrounding the potential timing and pace of monetary-policy normalization the U.S. Federal Reserve is likely to take. We opined that the first hike was likely to take place in September or later and that the pace was not likely to mirror the string of rate hikes we saw in 1994, 1999 and 2004. We continue to believe that the Fed will be very measured and patient in raising their target interest rate. We see a very gradual period of normalization unfolding with the potential for some relatively long pauses. That is if the U.S. economy continues its uneven growth pattern, which we think it will.

Inflation is still relatively benign, though wage pressures seem to be on the rise. And debt levels remain quite elevated, which tends to pose a greater risk of deflation resurfacing. With the unevenness of the U.S. economy and the notion that it may have entered into a structurally slower phase of growth, we see the fed funds rate topping out at a much lower level than in the past few cycles. For instance, the fed funds rate maxed out at 6.1% in April 1995, 6.5% in January 2001 and 5.3% in August 2008 (see chart). We see a fed funds rate above 3.0% highly unlikely given the fragile nature of the economic recovery. With this said we thought we'd compare some key economic and market data points across the recent rate hiking cycles.

So how did the economy, stocks and bonds perform over the last three rate-hiking cycles? During the 1994 rate-hiking cycle, U.S. Real GDP grew at an average annualized rate of 3.2%. From January 1999 to the end of 2000, GDP grew 3.7% on average. The growth rate was noticeably lower during the 2004 to 2007 cycle; averaging only 2.7%. Over the last eight quarters through 1Q15, GDP has averaged 2.4%. This suggests to us there is little reason to think rate hikes will come fast and furious.



Source: St. Louis Federal Reserve and Board of Governors of the Federal Reserve

The unemployment rate was a relatively high 6.0% on average from January 1994 to April 1995. It was a much lower 4.1% on average from February 1999 to December 2000. From July 2004 to July 2007, the unemployment rate averaged 4.9%. May's unemployment rate stood at 5.5%, which is towards the high end of recent history. The widely discussed participation rate remains a concern given what it could mean for sustainable economic growth. While it's relatively low reading may be related to baby boomers retiring, we think it remains something to watch. During the 1994, 1999 and 2004 rate-hiking cycles, the participation rate was roughly 66- 67%. May's number came in at 62.9%, markedly lower. We think this represents a key difference and suggests to us a structural impediment to growth may have emerged. Turning to core inflation, from January 1994 to April 1995, the U.S. Core CPI averaged 2.9% on a year-over-year basis. It was roughly

2.2% for the 1999 and 2004 rate-hiking cycles. The year-over-year change for the core CPI in May was roughly 1.8%. In short, growth is much slower, and inflation is relatively benign. This does not suggest to us we are in for an aggressive string of rate increases.

Asset Class Total Return Comparison			
	1994 Cycle	1999 Cycle	2004 Cycle
Start Date	12/31/1993	12/31/1998	7/31/2004
End Date	4/30/1995	12/31/2000	7/31/2007
<u>Barclays Capital U.S. Aggregate Bond Index</u>			
6 months	-3.9%	-1.4%	3.8%
12 Months	-2.9%	-0.8%	4.8%
Entire Period	3.4%	10.7%	12.3%
<u>S&P 500 Index</u>			
6 months	-3.4%	12.4%	8.2%
12 Months	1.3%	21.0%	14.1%
Entire Period	14.5%	10.0%	39.6%
<u>Russell 2000 Index</u>			
6 months	-6.5%	9.3%	13.9%
12 Months	-1.8%	21.3%	24.8%
Entire Period	5.0%	17.6%	45.8%

Source: Corinthian Investment Research, St. Louis Federal Reserve, Standard and Poor's, Russell and Barclays Capital

How did stocks and bonds perform over the previous three rate-hiking cycles? The table above summarizes the returns six and twelve months after the initial rate hike. It also includes the returns realized through the end of the rate increases for each of the three cycles.

As expected, bonds performed relatively poorly, posting negative returns for the six and twelve month periods over the 1994 and 1999 cycles. Meanwhile, stocks held up fairly well across all cycles. Small-cap stocks suffered larger losses during the 1994 cycle but outperformed over the last two cycles. We would expect relative returns to be similar this time around, meaning stocks are likely to outperform bonds. We would also point out one important difference this time around relative to the three previous Fed rate-hiking cycles. And that is the very low level of interest rates. Because this cycle is starting out at unprecedented levels, we believe greater bond market volatility and weaker performance than the previous cycles is highly likely and that investors should be prepared for a bumpy ride.

Lowering bond exposure by either holding more cash or increasing weightings to dividend stocks and/or REITs may not necessarily be the best option for investors seeking high levels of income. Such a strategy involves more risk given the nature of the asset classes involved. Advisors have already moved their clients out on the risk spectrum in order to meet income needs. This has involved taking greater credit risk. We think there are other options that could help, particularly if the other options are less correlated to interest rate movements. Tax lien strategies can be a viable option in our view because of a number of reasons. They represent the first lien position on a property and they are typically very small relative to the overall value of the house to which the lien is attached. This results in relatively low default risk with a high recovery rate. In addition, the yields on a diverse portfolio of tax liens can be quite attractive relative to bonds and other alternatives. We think the overall risk/return characteristics of tax liens make them an attractive alternative for fixed income investors.

Q : Will a Grexit occur?



For readers not captivated by the latest news emanating from Europe, Grexit refers to a default by Greece on debt owed to the IMF and others resulting in an exit from the euro. What makes answering this question so difficult is that Monday morning June 29th fireworks are expected. Greece's leaders rejected the terms their lenders offered and chose to put the terms to a referendum of the people. The Athens stock market will not open Monday and banks are closed as the government implements policies to try and contain the massive capital flight occurring.

The ultimate answer is yes. Greece will default and leave the euro as that seems unavoidable at this point. Whether it happens this week or next year, Greece simply cannot continue to be constrained by the requirements of the ECB and have costs that cannot be managed while part of the euro currency.

Nobody knows what the ultimate impact of a Grexit will be but I assume it is the first domino in the total failure of the euro currency. Italy, Portugal, and Spain also have severe debt issues and struggle to compete with the more efficient economies of northern Europe (Germany). The immediate impact will be a rise in the U.S. dollar and likely funds flowing into U.S. Treasuries as a safe haven.



Greece continues to be an interesting case study for what may lie ahead for other over-indebted nations, including the U.S. It fascinates me on how obtuse Greek's Prime Minister Alexis Tsipras is being. I think his move to propose a public referendum is simply political CYA'ing at worst and leading from behind at best. But he seemed to be gaining support for the referendum across the country as June came to an end. Greek's want a say in what happens next and that is to stay in the Eurozone or not to stay and go it alone. The latter will be even more painful for Greece than the former. So it becomes a question of how informed the average Greek voter is.

I think most analysts see a Grexit or default as inevitable at this point and are looking at ways the ECB and IMF might contain the fallout. My biggest concern is what a Grexit could mean for other struggling nations, like Italy, Portugal and Spain. Spain and Italy have seen calls for similar referendums on remaining in the Eurozone. So it would seem the risk of a Eurozone breakup grows with a Grexit. A reset of the entire European economy is at risk in my view if other nations follow Greece's lead. I don't think we are there yet. Losing Greece would not necessarily end the euro in my view. It's the potential reverberations that can get ugly and remain something to watch.

Q : Does Shark Tank have a bite?



I am actually a big fan of Shark Tank and find the program to be entertaining as would-be entrepreneurs try to convince billionaires to invest in their companies. I think it is very telling about the U.S. that a show of this type would have the type of popularity among many different age and socio-economic groups.

Having traveled to many countries, starting a business is not something people dream of as they grow up or even thinking about in other cultures. Something about American values instills in people the belief they can succeed in business no matter what their background is. Crowd funding sites like www.gofundme.com are achieving phenomenal success where ordinary people, not investment banks, determine which ideas are worth funding.

Children are learning more about business and investing watching Shark Tank than most schools are able to teach them. The Sharks, in addition to being entertaining, are extremely savvy and force those wanting to be funded to defend not only their idea or concept but also their business plan and valuations.

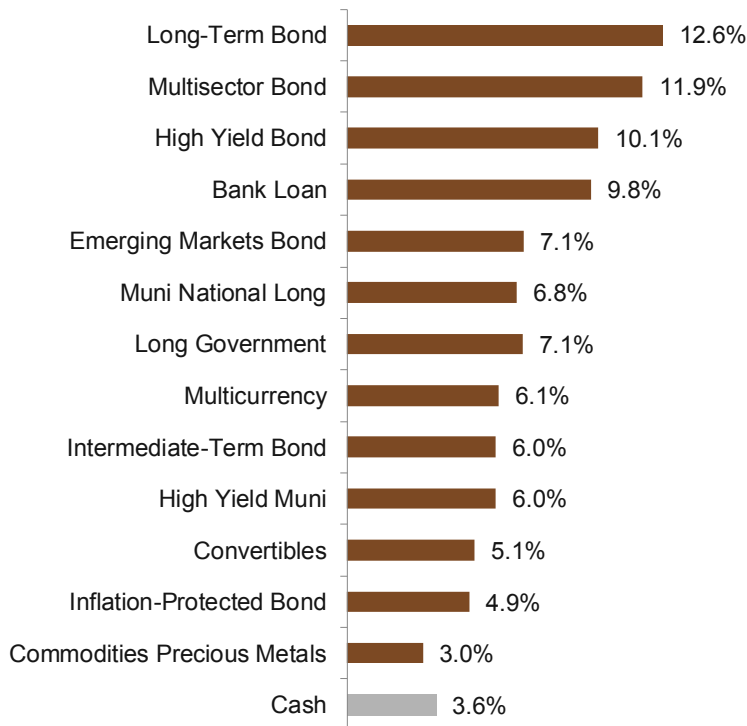


I remember thinking in 1999 and 2000, as Internet company after Internet company went public on nothing but clicks and "eye balls," that a big part of the business creation process was being skipped. The IPO market was functioning as the venture capital market instead of playing its traditional role as part of the exit strategy for venture capitalists and angel investors. In addition, the valuations defied common sense in most cases. I could not believe the companies that were going public and the valuations they were receiving given very little revenue and no earnings to speak of. Many business models were unproven and too early in their development for investors to know what valuation was appropriate. How many investors knew to ask about or consider a start-up's burn rate? Not many. In essence, retail investors were being recruited as venture capitalists and most of them were playing a game they did not fully understand. We all know how ugly that ended.

Today, a show like Shark Tank portrays what I would say is the early stage of venture capital investing. And it does it in an entertaining way. Entrepreneurs with a good idea need a little help to take their business model to the next level. Whether its mass production of a product or the expansion of a franchise, the business moguls on the show are really acting as angel investors that are willing to risk small amounts of capital to see if a particular idea can work. I'd love to hear about the success rate for each of the Sharks on the show. There is a lot of risk involved, but at least these are wealthy and well versed business folks with a keen understanding of what it takes to be successful. I'd rather see caution thrown to the wind on the show than see retail investors being sucked into playing the venture capital game again. I think most investors have learned a lot since 2000, which to me gives a show like Shark Tank some bite.

Fixed Income

Segment Exposures

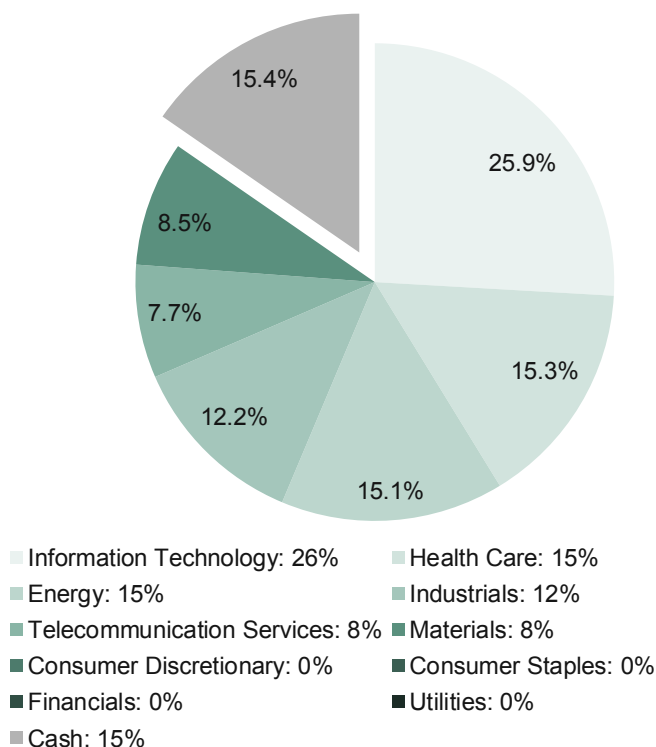


- Continue to find greatest value in intermediate to long duration muni bonds
- Current yield is approximately 4.2% with average duration of roughly 6.3 years
- Holding duration steady amid our view that Fed interest-rate hike already priced in
- Increasing credit quality in response to tight spreads and low risk premium

As of 05/31/2015

Equity

Sector Exposures



- Maintaining our more defensive portfolio positioning amid slumping earnings and uneven economic growth
- Building our cash position in anticipation of material equity market correction
- Current portfolio yield is approximately 2.3%
- We are in late stage review of some potential new additions to the portfolio in the information technology sector

As of 05/31/2015

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