

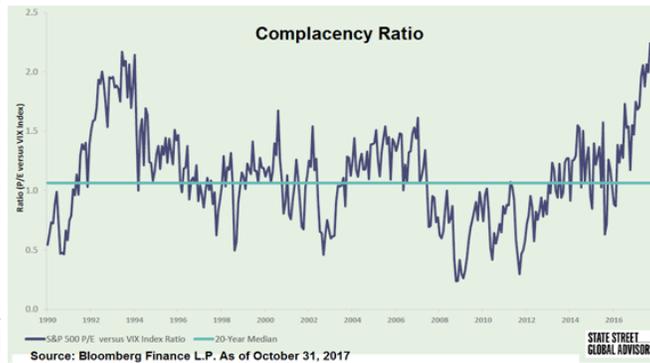
For those unaware of the story of Icarus in Greek mythology, he was the son of a master craftsman named Daedalus, the creator of the Labryinth. When Daedalus was imprisoned he fashioned a set of wings out of feathers and wax so that he and his son could escape Crete. Before giving Icarus his wings Daedalus warned Icarus not to fly too close to the sun because the wax would melt. When Icarus put on the wings he was overcome by giddiness at the ability to fly and soared too close to the sun melting the wax and falling into the sea and drown.

There is the appearance in today's market of the same level of giddiness among equity investors who are pushing the market's closer and closer to the sun. There is certainly plenty of good news; we see synchronized growth in the U.S., Europe and China, while structural forces are suppressing inflation allowing interest rates to remain at historically low levels. Optimism over the Trump administration policies of tax cuts, infrastructure spending and deregulation has remained even after the failure to pass comprehensive healthcare reform. However, while U.S. GDP has grown a total of 26% since the 2008 recession the S&P 500 index has surged more than 200% causing many to question if we have gotten too close to the sun.

It is often repeated on Wall Street that valuations do not matter until they do and that is true today. There are only a handful of times when trailing earnings have been priced so richly and according to FactSet data the S&P is trading at 2.1 times trailing revenue today. Only in September 2000 did the market trade at a higher multiple to revenue when it hit 2.2 times. There are compelling signs that market vulnerability is increasing.

1. Complacency
2. High Debt Levels
3. Fed Tightening
4. Rise of Quant Strategies

1.) Starting with Complacency, you can see from the chart provided by SSgA the complacency ratio is the highest in over 20 years. The ratio is calculated using the Price/Earnings ratio of the S&P and the Volatility Index (VIX). Extreme low volatility and high P/E ratios are a combustible combination and could lead to a sharp reversal in equity prices.



2.) High debt levels also contribute to the current risk level. A large scale default could become a trigger for a market

“Fed policy reinforces the rise towards the sun by predominately focusing on consumer prices instead of asset prices.”

correction but it is more likely to increase the severity or length of the downturn. Household leverage recently climbed above 2007 levels but no where is the problem of too much debt bigger than in China. Debt in China is a ticking time bomb that could lead to the next global financial crisis.

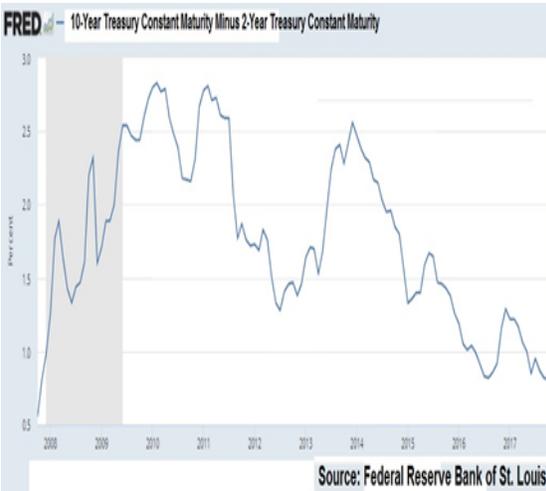
3.) Rate hikes by the Fed are another risk for investors. QE (quantitative easing) has been responsible for the excess liquidity that has driven risk assets higher and has now been replaced by QT (quantitative tightening). As a result of short-term rates moving higher the yield curve has flattened and risks inverting if the Fed continues to push yields higher. An inverted yield curve is the most reliable signal for a recession and bear market.

4.) Lastly, the meteoric rise in Quant-based strategies poses a threat to the markets. Quantitative strategies like Portfolio Insurance were responsible for the Black Monday crash in October 1987 when the S&P fell 22% in a single day. Bloomberg research suggests more than \$500 billion in "smart beta" strategies and Hedge Fund Research recently reported that more than \$1 trillion in assets are in quant strategies of the approximate \$3 trillion in hedge funds. Many of the quant strategies access markets with limited liquidity that will see the exits shrink when investors try to sell.

Fed policy reinforces the rise towards the sun by predominately focusing on consumer prices instead of asset prices. Targeting stable prices instead of financial stability will ultimately result in equity prices falling more dramatically according to many analysts.

The glide path for the markets looks sustainable in the short-term, especially if a package of tax cuts get through Congress with lower corporate rates. Any further rise in stock prices, however, are likely to end like Icarus plunging straight down when confidence melts away.

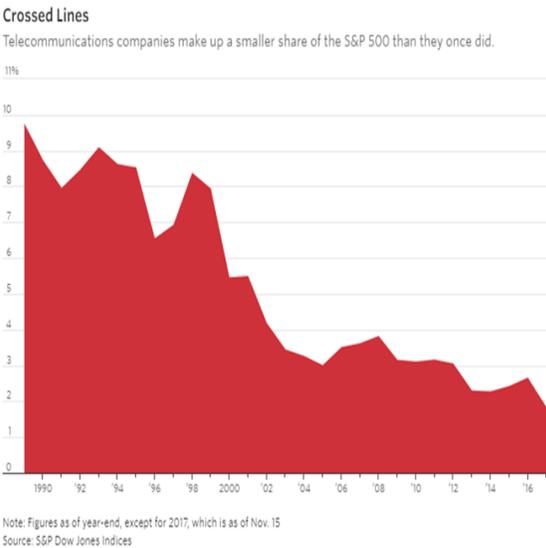
How Flat Can It Go?



The yield curve is often viewed as a proxy for how healthy or efficient an economy is operating at. When the Fed began their rate hike cycle in late 2015 they hoped the long end of the curve would rise proportionately to what they were doing on the short end. That has not happened as the 10-year U.S. Treasury bond yield is lower today after 4 rate hikes since December 2015. Long yields are determined by the natural real rate (full employment and stable prices), inflation expectations, and the term premium or how much investors insist on getting paid for holding long durations. Many see the Fed's hands being tied if long rates remain subdued as the Fed would not risk starting a recession by inverting the yield curve.

- The yield on the 10-year Treasury was over 2.50% in December 2015 but is currently yielding 2.30% today and the 30-year Treasury has fallen .25%.
- The yield curve was extremely flat during the 2nd half of the 1990's when GDP growth was very high and the market hit record highs before inverting in 2000.
- Many analysts believe the Fed is too transparent in its policy causing the term premium to shrink and resulting in the Fed having less flexibility to execute monetary policy.

Passive Flexing Its Muscles

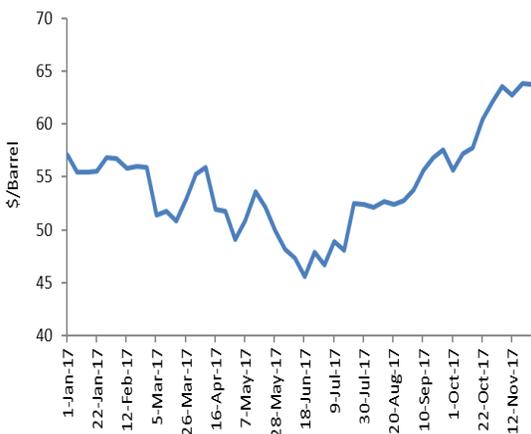


Credit Suisse recently remarked that passive investments could make up half of all U.S. equity retail flows in 2018 and 2019 (Barrons). The flood of assets in to passive investing through indexes has given index providers like S&P Dow Jones and MSCI a seat at the table among market strategists, especially when index providers outline upcoming changes to indexes. Both firms will make changes to the telecommunication sector to include communications. The change will include advertising, publishing, and interactive media companies. The consumer discretionary sector will also include e-commerce companies that have traditionally been included in the technology sector. Companies likely to create the greatest impact in the changes include Netflix, Alphabet, and Facebook.

- The telecom sector made up 9.8% of the S&P 500 in 1989 vs a current weighting of 1.8%, holding just 3 companies (S&P Dow Jones Indices)
- Specific companies impacted by index updates will be published in January while changes to the indexes will go in to effect in September.
- The new sector, titled Communications Services, will represent approximately 10% of the S&P 500's market capitalization (Wall Street Journal)
- The current sector is comprised of three companies, AT&T, Verizon Communications, and Century Link.

Message from Energy

Brent Crude



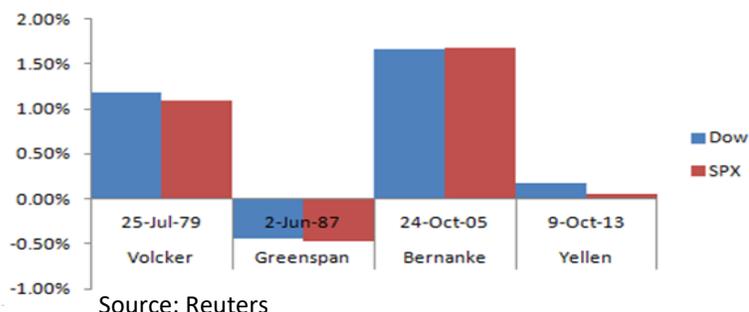
As we close out the year, we've seen a meaningful rise in energy prices. Back in June, oil futures (brent crude) traded around \$45/barrel. Today, oil trades around \$63/barrel, which translates into a rise of roughly 40% in a fairly short time. This gain might be a reflection of a market view that global economic growth is likely to continue to expand, perhaps by 3% to 4% annually. Conventional wisdom holds that a growing economy will demand more energy, which in turn pushes prices higher. In part, the recent rise in oil could also be attributable to geopolitical risk from the Middle East. From an inventory standpoint, OPEC is expected to curtail output, which would tend to support prices.

- From a macro perspective, if a new upward trend in energy is indeed underway, it could have implications for inflation expectations. This, in turn, could push longer-term interest rates higher (historically, long-term yields are mainly driven by inflation expectations). Higher rates could reprice assets lower.
- Energy prices are notoriously difficult to forecast. Increases in output from outside OPEC (i.e. the U.S.) and any downward revision to global growth rates could prevent energy prices from rising much further in the near term.

Macro View – The Post Yellen Era

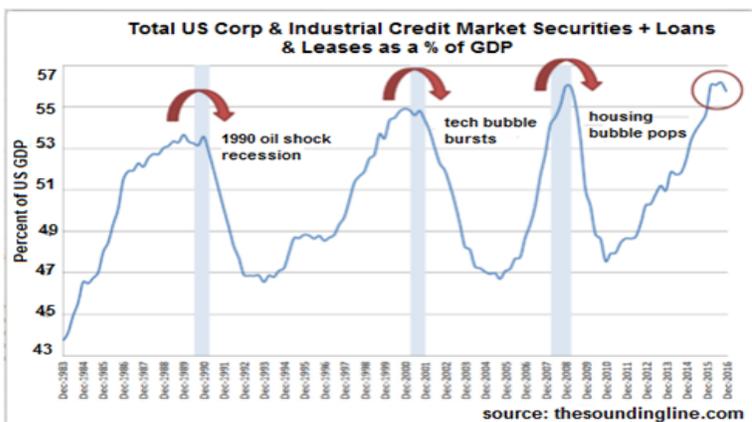
Jerome (Jay) Powell is expected to sail smoothly into the position of next Federal Reserve Chairperson, leaving many investment managers believing the market will respond positively as a result of consistency in recent Fed policy. Charles Plosser, former President of the Federal Reserve Bank of Philadelphia, proclaimed, “I would be surprised if Mr. Powell walked away at the end of his term with a huge stamp of reshaping the Fed. He’s not likely to lead Federal Reserve reform and innovation on monetary policy, but that does not mean he won’t be a good chair.” Powell’s views on economic and monetary policy are consistent with both Yellen and Bernanke with a personality that is marked around pragmatic decision making. It is likely that, if necessary, the Fed will continue to take advantage of bond buying and interest rates to manage unemployment and inflation.

Market Performance on Nomination



Fixed Income - C&I Flashes Warning Sign

Corporate borrowing has always been a key indicator of economic health and has traditionally followed predictable long-term trends. Each of the last 3 recessions were marked by a peak in Corporate and Industrial Loans as a percentage of total GDP and loan growth dropped precipitously when economic growth is in decline. The chart shows a clear turn lower from the level of prior peaks suggesting the economy may soon reflect contraction. Two factors may result in the trend turning back higher. First, the cut in corporate income taxes includes a provision to accelerate depreciation on capital purchases typically acquired with debt. Second, profit repatriation could lead to higher capital expenditures and increased demand for debt. If tax reform is not passed, it is difficult to see anything on the horizon that would provide incentive for corporations to increase their borrowing.



Taking Stock – Non-GAAP Earnings

If you have been a long time reader of the PCM Report, you are familiar with comparisons between GAAP and Non-GAAP earnings. Many feel that Non-GAAP earnings give a more accurate depiction of earnings because certain aspects of operations are included in Non-GAAP earnings but not GAAP earnings. Using Non-GAAP earnings gives companies more flexibility in the earnings reported as a result of not following GAAP standards. For Q3 2017, 21 (or 70%) of the 30 companies in the DJIA reported non-GAAP EPS in addition to GAAP EPS for the third quarter. Of these 21 companies, 16 (or 76%) reported non-GAAP EPS that exceeded GAAP EPS. Over the past six quarters (Q1 2016 – Q2 2017) 68% of the companies in the DJIA reported non-GAAP EPS in addition to GAAP EPS and 80% of these companies reported non-GAAP EPS that exceeded GAAP EPS (Factset). The table below shows the % difference in EPS among the top five Non-GAAP companies in the the DJIA.

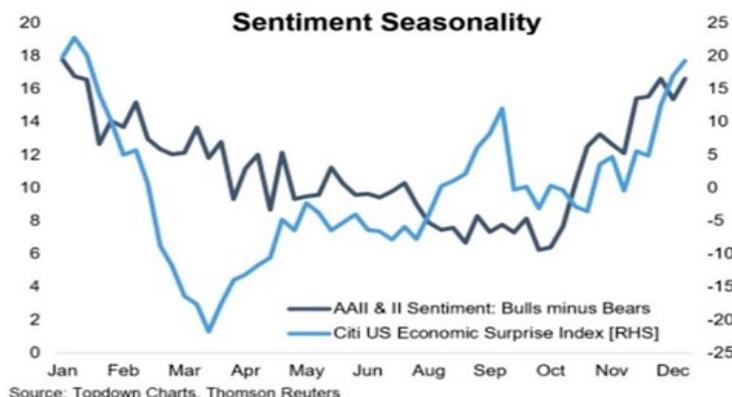
DJIA: Top Five Non-GAAP EPS > GAAP EPS* for Q3 2017 Source: Factset

COMPANY	TICKER	NON-GAAP EPS	GAAP EPS	DIFFERENCE (%)
Merck & Co., Inc.	MRK	1.11	-0.02	5650.0%
Wal-Mart Stores, Inc.	WMT	1.00	0.58	72.4%
DowDuPont Inc.	DWDP	0.55	0.33	66.7%
Coca-Cola Company	KO	0.50	0.33	51.5%
Pfizer Inc.	PFE	0.67	0.47	42.6%

*Non-GAAP EPS and GAAP EPS from continuing operations were used when provided

Technical - Excessive Optimism

Recent data from Ned Davis Research suggests that the market sentiment indicator has turned bearish as a result of excessive optimism. Their Crowd Sentiment Poll uses data from the American Association of Individual Investors, the CBOE Put/Call ratio, Investors Intelligence survey of investment newsletter writers and other surveys and has been instructive in identifying short-term inflection points for stocks. The index remained above 70 after Thanksgiving week, a level that suggests negative forward equity market returns. What seems remarkable is that positive sentiment has driven the markets to highs while under threat of nuclear war with N. Korea, excessive partisanship in Congress remains, and no one knows who will be the next celebrity or politician named in a sexual harassment/assault claim. As John Lennon famously sang in his hit, "Nobody Told Me", strange days indeed.



Choosing an ETF Strategist

Clint Pekrul, CFA

According to data from Morningstar, the number of ETF strategist, or financial advisory firms who develop and build investment portfolios using exchange-traded-funds, has grown from roughly 370 in 2011 to 670 today, or a rise of roughly 80%. With this exponential growth in strategists, it's become quite a daunting challenge for investors to decide which one is right for them and their specific needs. Below, we summarize some of the due diligence questions we feel that investors should ask before choosing an ETF strategist.

First, are the decision makers (i.e. owners, principals, portfolio managers, etc.) seasoned in the industry? There can be quite a difference in background and experience across the people who develop and manage ETF portfolios. How long have the decision makers been managing portfolios, and has this experience spanned both bull and bear markets?

Next, do the decision makers eat their own cooking (i.e. do they invest their own money in the strategies they provide to the investing public)? To us, it's a red flag when the providers of ETF portfolios have no skin in the game. That is, they don't invest their money alongside yours. How much of the decision maker's personal wealth is allocated to the strategies they deliver?

Additionally, what's the investment process that underlies the strategies? This question is perhaps the most critical one an investor should ask. There are good strategies that are based on well designed, thoroughly researched ideas, and there are bad strategies that are not based on sound investment theory. How does the ETF strategist decide which investments to hold, and what is the rebalance (buying and selling) policy?

Next, what is the strategy's track record? Keep in mind that many of the new ETF strategist that have come to the market recently might not have an actual track record to support their investment thesis. It's important to differentiate between a live, actual track record and simulated, or back-tested, performance. In our experience, we've never seen a bad backtest. They are often used to illustrate how well a model or algorithm would have done in the past. But as we know, past performance is not indicative of future returns. Furthermore, back-tested returns don't actually reflect the ETF strategist's ability (or lack thereof) to manage money. How long has the strategy been running with live money, what is gross and net performance, and what are the total assets?

Furthermore, what resources does the ETF strategist have to support their strategy? In general, there are two broad categories that define an investment strategy – quantitative and qualitative. Quantitative strategies tend to use mathematical algorithms to determine what securities to buy and sell. These algorithms require a high degree of infrastructure (e.g. IT systems, programming and coding, stress testing, etc.). Conversely, qualitative strategies rely more on fundamental research to buy and sell securities (i.e. they are not necessarily driven by an algorithm). Qualitative strategies require in depth and thorough research, which generally requires a staff of analysts and access to research databases. How is the ETF strategist positioned to effectively implement their portfolio?

Next, what is the organizational structure of the ETF strategist? In some cases, a strategist might be one or two people that wear multiple hats. That is, a single person might be required to handle not only the management of the portfolio, but also the operational, compliance, marketing and sales tasks of the organization. In our view, wearing multiple hats can be a distraction. A portfolio manager should have a singular focus on the implementation and delivery of the strategy, and not be tasked with other aspects of running the business. How dedicated are the roles of each individual within the organization?

Lastly, does the strategist deliver results that are consistent with expectations? One of the most frustrating experiences for an investor is when their expectations are not aligned with the strategy's results. A clearly defined investment process can help overcome this frustration. A strategist should be able to effectively communicate how their portfolio will respond to different market environments, and the rationale for any changes they make. How aligned are the investment management decisions and the investor's expectations.

In our view, if you ask these questions, you can effectively navigate the ETF strategist universe, and separate quality investment managers from those managers that might not be able to fulfil your investment objectives.

ETF Strategist – Check List
Does the ETF strategists have experience in the industry?
Does the ETF strategist invest in their strategies (ownership)?
Does the ETF strategist have a track record?

Q: Is High Yield a Trap?



It would be easy to make the argument that there is more speculation going on in the high yield sector of fixed income than in the equity markets today. No where is this more true than in Europe where equity valuations are attractive but the spread between non-investment grade bonds (junk bonds) and sovereign debt remains near unthinkable lows. Spreads, as measured by the BofA Merrill Lynch European High Yield Option-Adjusted Spread index, dropped briefly below 2.50% before climbing to the current level of 2.65%. It is an irrational world when investors will buy junk bonds and accept only 2.5% in excess return from government guaranteed bonds. The spread in the U.S., while not as low as Europe, is only 3.67% just off its lows.

Financial repression is predominately responsible for the unsustainably low yields on high yield. The ECB asset purchase program has eliminated perceived risk across the fixed income spectrum resulting in rampant speculation in investor search for yield. In the U.S., nearly one-third of the high yield market is comprised of energy-related debt. Spreads exploded when oil prices below \$30/barrel as much of those junk bonds were in technical default of loan covenants. With oil remaining between \$50-\$60 a barrel that debt looks far more secure. However, low spreads and light covenants are a recipe for pain for high yield holders.



This is an interesting question. In an environment where investors are starved for income, they naturally turn to asset classes that pay the highest yield. After several years of zero interest rates, investors have flocked to high yield bonds, which in turn have pushed prices higher and yields lower. What's concerning is that investors might be throwing caution to the wind and ignoring, or at least discounting, the credit risk associated with these investments. Historically there has always been a balance between the credit risk that investors assume, and the yield they earn to compensate for this risk. To be sure, default rates are low now based on historical averages, but this can quickly change. A slight tremble in the credit markets can turn into tsunami, so be mindful of the risk you are taking and size your position accordingly.

Q: Where do you see value in global equities?



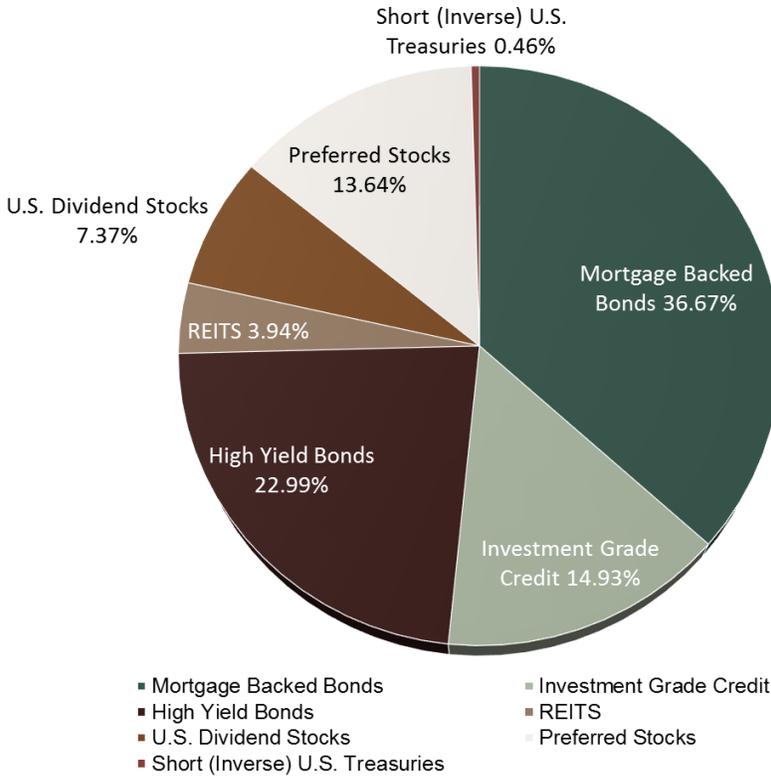
Potentially everywhere except the small cap Russell 2000 that according to Wall Street Journal data suggests small caps are trading at 112 times earnings! It is difficult to find a market that looks undervalued based on a risk-adjusted analysis. The Nasdaq trades at 26 times earnings while the S&P 500 trades at 24 times last year's earnings. Germany, Japan, and broad Europe is trading between 16 and 17.5 trailing earnings while the U.K. FTSE is around 24 times. Even Mexico, with a lot of uncertainty, is managing to trade at 20 times trailing 12 month earnings.

When you cannot find compelling value in either domestic, emerging, or developed markets focus shifts to expectations for currency changes. An analysis of commodity pricing including oil suggests the U.S. dollar is vulnerable to further declines and could depreciate another 15% against the major global currencies. The biggest beneficiary of a lower greenback should continue to be emerging markets. The relative performance between emerging and developed markets depends on the time horizon you are comparing. Emerging has doubled the return of developed over the last 1 and 2 year time periods but has generated only one-half the developed market returns over the last 5 years. If you can handle some volatility, emerging markets should outpace U.S. and developed market returns.

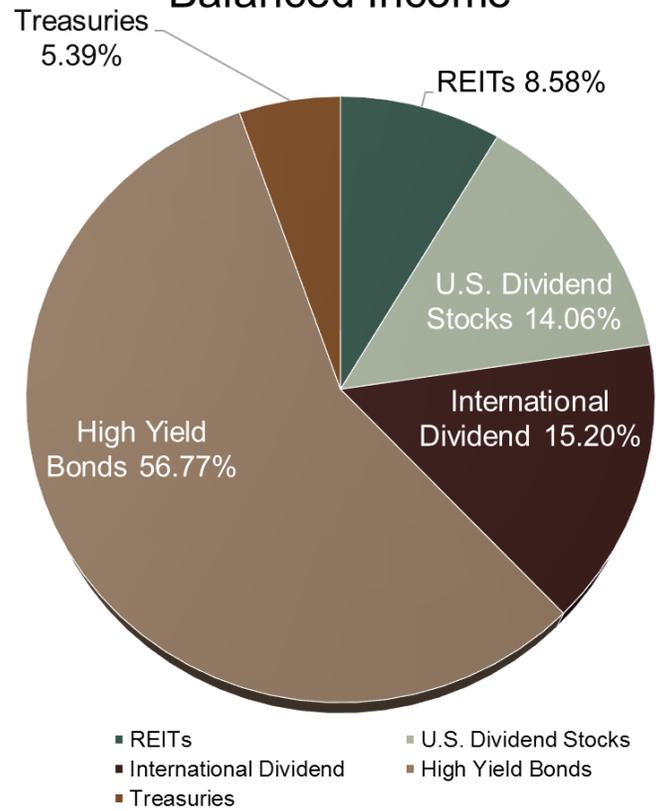


After years of outperformance from domestic (U.S.) equities, investors have begun to turn to international stocks. This is perhaps a mean reversion trade. If you look at the price-to-earnings ratio in emerging markets, you get something around 16 times, compared to roughly 23 times earnings for the U.S. This plays out on developed markets as well, where price-to-earnings ratio is roughly 18 times. You can also look at other value metrics such as price-to-book and you get similar results. To me, if the global economy does continue to expand at a 3% to 4% rate, this should be of particular benefit to emerging markets. But as always, you need to consider the currency impact of investing overseas. The dollar has been weakening lately, but a reversal would eat into any unhedged returns.

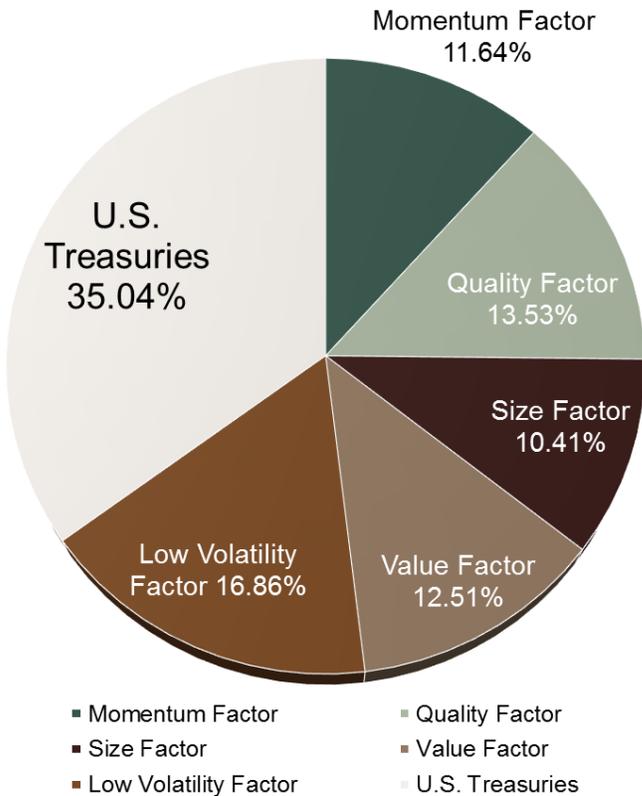
Income



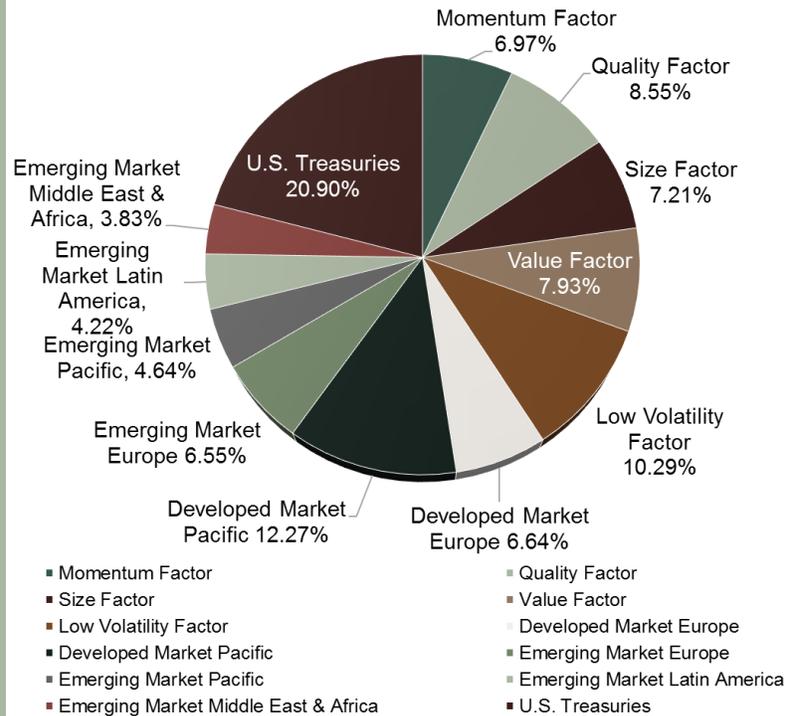
Balanced Income



U.S. Growth



Global Growth



The following pie charts are as of 10/31/2017 and may not total 100% due to rounding.

PCM

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