

Roundtable Special Edition

This month, Peak Capital offers a unique perspective by providing answers to some pressing questions based on the conversations we have with the readers of the PCM Report.

We are fortunate to be joined by a luminary in the financial industry, Adam Schenck of Milliman in addition to PCM's Chief Investment Officer and Head of Research. All three will weigh in on where the markets and economy are headed including growth, inflation, and mid-term elections. Highlighted are some great calls from this year and a sense of where they are positioning for the future.

Roundtable Contributor Biographies



Brian Lockhart, CFP
PCM Founder &
Chief Investment Officer

Brian Lockhart is the founder and Chief Investment Officer of Peak Capital Management, LLC (PCM). With over 20 years of portfolio management experience, he has led the company through exceptional growth since its inception.

Brian directs the company's tactical allocation of PCM's unique investment models including their Income Opportunity strategy, a model that dynamically navigates the fixed income market. He has been crafting ETF strategies for nearly a decade, making PCM an early adopter of ETFs.

Brian is routinely quoted in major financial media outlets including Barrons, Forbes, Bloomberg Businessweek, Fortune, Investment News, and ETF.com and is frequently requested to communicate on a national level on topics ranging from portfolio and risk management to opportunistic fixed income solutions



Clint Pekrul, CFA
Head of Research

Mr. Clint Pekrul, CFA, serves as a consultant to Peak Capital in the capacity as Head of Research at Peak Capital. Clint is responsible for portfolio management and design.

Mr. Pekrul is currently employed by Curian Capital a Registered Investment Advisor, where he has managed portfolios for 13 years. Prior to joining Curian, Mr. Pekrul worked at Merrill Lynch Private Client for 3 years.

Mr. Pekrul holds a BA in Business Administration from the University of Oklahoma, and is a Chartered Financial Analyst.

Ben Fulton, CEO
Elkhorn

Described as a founder of the exchange-traded fund industry, Ben Fulton has been contributing to the definitive history of the global financial services industry for over 30 years.

In 2013 Ben formed Elkhorn to pioneer a new chapter in investment design by forming strategic partnerships with world-class research firms to develop research-driven products.

Prior to forming Elkhorn, Ben served as Managing Director of Global ETFs at Invesco PowerShares, where he grew the firm into the fourth largest ETF issuer in the world.

Before Invesco PowerShares, Ben was President and Founding Partner of Claymore Securities, Inc. (Guggenheim Investments) and served in senior leadership positions at Nuveen Investments and Nike Securities (First Trust).

Ben received his Bachelor of Arts in Business Administration from Taylor University in 1984.

Q: How do you see Global GDP shaping up for 2016 and where do you anticipate strength and weakness?



I can start by saying worse than what I would have projected just one month ago. I think Fed Governor Richard Fisher's recent statement is true referring to all major Central Banks. *"The Federal Reserve is a giant weapon that has no ammunition."*

The Grand Experiment being implemented by the Fed, European Central Bank, and the Bank of Japan with Quantitative Easing clearly delivers less economic growth than the central bankers had counted on.

The risk of global recession has risen significantly since the beginning of 2016 and that weighs on my forecast for global GDP. The slowdown being experienced in the U.S., Europe and Asia will give central banks confidence to keep pulling the stimulus trigger even if they are only firing blanks.

I expect somewhere around 2.6% global GDP this year as there are still pockets of strength in the global economy. I anticipate that India will take over as the new global growth engine and will likely stay at the top of the fastest growing major economies for the next decade. I think Mexico could also surprise in terms of growth also I worry about the peso.

As far as weakness is concerned, I am below current consensus for both Japan and Germany primarily because these two economies have the most exposure to the emerging market economies that are in the worst shape.



The global view is fragmented. I would expect the U.S. to continue to grow but at a rather lackluster pace. China could finally bottom, which would be a benefit to those countries selling to China and include many commodity producers. This bottoming could be a multi-year event, but would eventually curb the recent free-fall in commodity prices.

From a macro standpoint, I expect more sluggish growth from the U.S., and better prospects here relative to the global economy. Consumers should benefit from lower gas prices heading into the year. We've also seen solid gains in the job market and rising home prices in general, which should help consumer confidence.

In Europe, quantitative easing continues with the ECB cutting rates further and expanding its bond purchases. This could ultimately prove to be stimulative this year. With QE and a weaker euro currency, I would expect GDP in the euro zone to grind ahead, but at a slower pace than in the U.S.

China was fairly active with stimulus last year. The consensus is that their economic growth will continue to slow over the next year, but again, if they can hit a bottom or sorts, this should reverberate across the broader economy and help other emerging market economies in particular.

The outlook remains bleak in emerging market yet continued stimulus in Japan and Europe are bullish signs for their equity markets. China's slowing economy, falling commodity prices and the potential for further rate hikes in the United States may create further headwinds for emerging markets and Global GDP.



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Q: Narrowing the scope, what do you expect from the U.S. economy this year?



Slower growth with pockets of opportunities. Continued uncertainty with the Fed along with progression along the market cycle may create dispersion within U.S. equities. Cyclical sectors tend to have stronger performance in the later stages of economic recovery as well as in rising rate environments. A stronger dollar has helped push down food and energy prices which may entice consumers to increase spending which would benefit discretionary areas of the market. From an investment standpoint we think investors will begin shifting towards firms focused on creating long-term value as opposed to short term objectives like stock buybacks.



Job gains have been a driving factor for economic growth in the U.S. over the past several years. I would expect more job market improvements in 2016, but the pace of job gains will likely slow as we move through the natural progression of the economic cycle. October and November of last year delivered some solid payroll numbers, and job opening have increased almost exponentially since the bottom of the credit crisis. However, many

of these jobs were added in the energy sector, which was doing quite well when oil was trading at \$100 per barrel. With energy prices cut by more than 70%, the energy sector will continue reducing its workforce as operations are trimmed back. Overall, the pace of job openings might slow from the robust pace of recent years.

On the wage front, the percentage change in hourly year-over-year earnings finally broke above 2%. This is due to the overall tighter labor market conditions. As a result, employees now have more pricing power. While higher wages means a greater cost for employers, I expect that consumers overall will be in a better position. And with consumption representing 70% of U.S. GDP, a stronger job market and increasing wages will drive the economy forward in 2016.

Are there any specific risks to your outlook?

Obviously, low energy prices are a challenge for the energy sector, and as I mentioned before, layoffs in this sector could be a potential headwind for the labor market. But for the broader economy, lower oil costs should be a boost to the bottom line, as consumers can spend their disposable income in other places rather than at the pump.

Rising home prices have increased the wealth effect for homeowners, who were hit hard in the crisis. Much of this is due to the affordability of credit, as mortgage rates are still low by historical standards. But, with the Fed on a path of increasing interest rates, this affordability could certainly be adversely impacted.

Adding a few basis points to the cost of a mortgage could

translate into hundreds of extra dollars on a monthly payment. Potential new homeowners could find themselves priced out of a home loan, which will ultimately impact housing prices. However, higher wages and a robust labor market could absorb much of any shock.



I frankly cannot remember when the last time I saw so much disparity among growth forecasts as what we have in the U.S. right now. The Fed has flooded the financial system with so much excess liquidity over the last 6 years making it very difficult to forecast the impact of even marginal tightening.

Research firms we place a high degree of confidence in, Gavekal and Ned Davis Research, both have recession indicators that suggest a recession will occur in 2016. I would not bet against them!

Manufacturing and Industrial production are already in a recession (consecutive quarters with negative growth), the real issue is whether or not the service sector is dragged down as well. To answer that question you have to determine whether or not consumers will start spending some of the savings at the gas pump or if aggregate savings will continue to climb as it did last year going from 4.75% to 5.50%?

I think we could see negative growth Q4 of 2015 and Q1 and Q2 in 2016 before growth resumes in the 2nd half of 2016. If that takes place, I would peg GDP to be a positive 1.2% after a relatively mild economic contraction.

Are there any specific risks to your outlook?

I see an upside risk if consumer spending dramatically increases during the first half of the year. Given the weakness in consumer confidence, this seems like a

long shot to me. It is very possible the expected consumer spending boom from sub-\$30/barrel oil proves to be as elusive in 2016 as it was in 2015.

The crisis in the energy sector is very different than the crisis in housing in 2008. Nearly 70% of Americans were homeowners in 2008 meaning the collapse in housing impacted almost everyone, particularly if you had a significant mortgage. The vast majority of Americans are "short" oil, meaning they benefit from lower oil prices.

The negative surprise would be the Fed stubbornly sticking to their plan to hike rates twice in the first 2 quarters and the rally that ensues in the U.S. dollar takes manufacturing even lower and spreads to the service sector. I don't expect this to occur as true conviction at the Fed is as unlikely as Tom Brady playing quarterback for the Denver Broncos next year (sorry, I could not resist).



Q: Volatility in the stock market is at historically high levels to begin the year, where do stocks go from here?

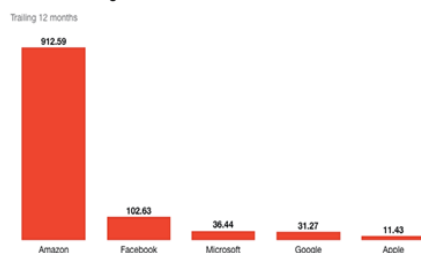


Stocks are headed lower, at least for the first half of 2016. The unassailable Art Cashin recently referenced a statistic that cannot help but get your attention. The stock market has experienced a 10% or greater correction twice in a 6-month

period on only 3 occasions in the last 100 years before this year. Those other periods? 1929, 2000, and 2008.

Research from the aforementioned Ned Davis Research shows that 50% of stocks today are already experiencing a bear market, off 20% from their previous highs. This market is very reminiscent of 2000 when a handful of mega cap technology stocks masked the deterioration taking place with most stocks. As the chart below shows, the surge in Amazon, Facebook, and Google (now Alphabet) have taken these companies to unsustainable levels and when profit taking starts in these names look out below.

Price to Earnings Ratio



Source: Thomson Reuters

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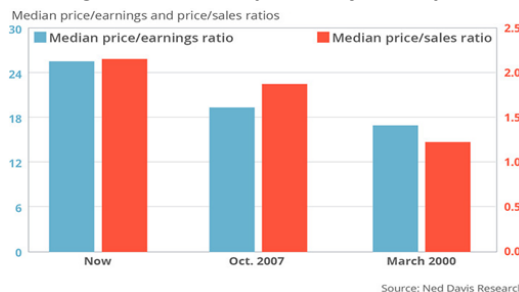
I think companies with very strong balance sheets (low debt levels) who can continue to grow free cash flow will best survive the bear market that is just beginning to take hold of the market.

Opinions on valuations really vary among analysts, are stocks fairly valued or overvalued today?

At this point I think you have to be a sell-side analyst to suggest stocks are not overvalued. Market multiples are highly correlated to expectations for future results making it impossible to think multiples could expand from current levels. FactSet data suggest EPS (earnings per share) could fall between 5% and 6% based on current estimates. Maintaining a P/E ratio above long-term trends

in a slowing, and possibly contracting, economy is hard to imagine.

While I tend to be in the camp that believes statistics can be manipulated to tell any story you want to tell, there are data points I believe are often missed by the investing public (and talking heads in the financial media). Overlooked data points today include the median price/earnings and price/sales ratios on the S&P 500. If you can remain bullish in this market knowing that the median valuation on stocks are higher today than in 2000 and 2007 you might have lost your objectivity.



Source: Ned Davis Research



The often sighted VIX index, which measures the expected volatility of U.S. equities over the next 30 days, historically trades around 15. This year it has traded as high as 40, which is essentially a reflection of greater uncertainty about the global economy. And to be sure, economies are more linked today than they have ever been.

Over the long term equity prices reflect underlying fundamentals, and given where interest rates are today and their expected path higher, I would still favor equities over bonds. But that's not to say we are going to get double digit, or even high single digit returns from stocks. Look at 1994 and 2004 as examples. Not spectacular years for either stocks or bonds as the Fed began raising interest rates. But, with my view that the economy will continue to grow through 2016, I believe there is more

upside potential with equities than with fixed income.

From a portfolio standpoint, a tilt to lower volatility or more defensive stocks might be in order, because I think higher volatility will persist. Conversely, momentum or higher beta names could underperform this year.

Opinions on valuations really vary among analysts. Are stocks fairly valued or overvalued today?

Valuations have risen over the past couple of years. We've gone from a PE on the S&P 500 of roughly 13 back in 2011 to roughly 18 today. Much of this rise in the PE ratio has been a meaningful drop in earnings from the energy sector. Plus, the run up in the FANG stocks (Facebook, Amazon, NetFlix and Google), which are mega cap companies, have pushed the PE ratio higher as well.

Overall, a PE of 18 might seem a bit rich for long term sustainability. However, this opens the door for alpha possibilities by positioning portfolios across different factors, which might materially diverge much like they did in 2000-2002.



Volatility tends to be mean reverting, and only in extreme down markets does it stay at elevated levels for extended periods of time. Barring an extreme market sell-off, heightened levels of volatility in the market have typically coincided with opportunities to re-enter the stock market.

Q: Looking at fixed income, the market expects two rates hikes in 2016 while Fed policymakers are signaling four hikes. Who will be right?



The bond market will more accurately capture what is actually transpiring in the global economy than the policy makers at the Fed, in my opinion. What could happen is a further steepening of the Treasury yield curve. The long end could remain steady if predictions about global GDP materialize, while the short end of the curve continues to move up from zero as the Fed tightens. This would flatten the yield curve.

One surprise asset class to the upside for 2016 could be long duration bonds, for those who have an appetite for risk in the fixed income market. For those investors who assumed long-term rates were going to return to post crisis levels after the taper tantrum, and thus removed duration from their portfolios, were disappointed over the following 12 months. Long-term Treasuries outpaced stocks in 2014 as interest rates fell back to levels that truly reflected the state of the global economy, and not the views of a Fed policy maker.

The high yield bond market is in distress. Is it too early to be buying junk bonds right now?

Much of this obviously depends on oil and the overall energy sector, whose debt represents about 20% of the junk bond market. For investors looking for extra yield, it's critical that they size their positions accordingly in terms of their risk exposure.

Investors, who have held high yield bonds for the past several years at a 10% or 15% exposure in their bond portfolios, now have a considerably higher risk concentration to junk bonds which could ultimately derail their portfolios. It's important to size the risk you are taking and make sure you are comfortable with principal

losses that could mount to -15% to -20% or more. I'm not suggesting you abandon high yield altogether (spreads have widened out considerably from an income perspective), but rather balance the higher yield with your tolerance for principal losses.



Over the last few years, Fed rate policy has tended to be overly accommodating. They have historically disappointed in rising rates and we would expect this tone to continue in 2016.

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Spreads on high yield bonds are at historically high levels, rivaling those of 2008. Higher than normal spreads may present a unique opportunity for investors, yet flows into the space say otherwise. Over the last three months, the iShares High Yield ETF (HYG) and SPDR High Yield ETF (JNK) have experienced outflows of over \$2.3bln. The meltdown within the energy sector may have exaggerated the selloff in the overall high yield space, creating opportunities in other high yielding sectors.



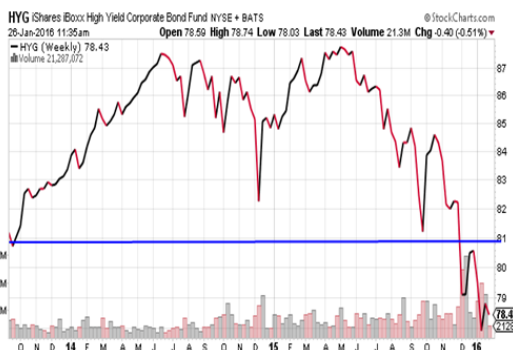
This is a softball question if there ever was one. The Federal Reserve, the group responsible for setting interest rate policy, has a worse track record for forecasting the future path of interest rates than Terry Bradshaw has of picking NFL games. Remember, Terry Bradshaw stated he had a 4.0 cumulative GPA during his 4 years at Louisiana Tech, meaning a 1.0 GPA for 4 consecutive years.

The market is going to be right on this one and I am not even convinced the Fed will hike rates twice this year based on the latest data that shows first time unemployment claims rising above expectations.

In last month's PCM Report, I

suggested the 30-year U.S. Treasury bond could be the surprise winner in 2016 and nothing has changed my opinion. First, a strong U.S. dollar and plunging commodity prices are doing the Fed's heavy lifting for them in terms of moderating economic growth and containing inflation.

The spread between Baa bonds and U.S. Treasuries are expanding which suggests we are rapidly moving towards a risk-off environment and slowing economy. I believe now is the time to shift fixed income portfolios to exceptionally strong credit quality and take on duration risk for those willing to speculate in the bond market. When you compare the 10-year U.S. Treasury bond to Germany, Japan, or the U.K. it is clear we could fall another 50 basis points to 1.50% or lower.



The high yield bond market is in distress, is it too early to be buying junk bonds right now?

One of my favorite Wall Street adages is that "it is risky to try and catch a falling knife." If you buying high yield bonds today, please make sure you have plenty of band-aids close by.

That is not to suggest that all the pricing in the high yield bond space today is rational, only that prices are likely to fall further in my opinion. Energy represents approximately 20% of the high yield bond market and nobody knows when oil prices are going to stabilize. Estimates are very far ranging but I believe sustained prices below \$30/barrel of oil could lead to a dollar-weighted default

rate of over 40% or more in high yield bonds during 2016. Outside of energy-related high yield, there are very compelling values but you are going against strong sentiment to be buying today.

The good news for holders of high yield bonds is that maturities in 2016 are extremely low. Less than \$1 billion of distressed debt matures this year according to research published by the Financial Times. That number balloons to \$13 billion in 2017, \$25 billion in 2018, and \$50 billion by 2021.



Research by McKinsey & Company suggests global non-financial debt exceeds \$200 trillion today, more than 3 times global GDP. Defaults, much higher than most analysts are forecasting, are likely to occur to restore global solvency and hit the reset button for high yield debt.

Q: What is the best piece of advice you can give investors today?



Stay the course. With the market steadily trending higher over the last few years, the recent bout of volatility may unnerve investors. The worst thing to do is panic. Research has shown investors tend to pull money out of the market at the wrong time. The U.S. market has dropped almost 13% from its 2015 highs, which historically is nothing more than

a healthy market correction. Emotions can often get in the way of sound investing. For this reason, we like passive investments because they can help remove the emotion from decision making.



Understand the risk you are taking in your portfolio. Don't just assume that what happened in the past is going to repeat itself. Assets that were uncorrelated in the past might be highly correlated going forward, especially across stocks and bonds.

Have a plan of action if you observe that market dynamics are changing. This could be a rotation across equity and fixed income exposures (e.g. shift across factors for stocks, or adjust the credit profile and duration of your bond portfolio), or a temporary move to cash or a short position to broad equity beta to manage the overall risk of your portfolio.

I believe 2016 will be a volatile year, and it's critical to keep an eye on correlations. My guess is that equities at times will move in lockstep, regardless of size, style or geographic location. And the factor that could make fixed income quite volatile – the prospect of rising rates – could drive equity volatility as well. Cash or a tactical short position could be an important piece of the overall allocation puzzle this year, and help smooth overall performance.



That is difficult to answer as generic investment advice can be as dangerous as it is helpful depending on who is receiving it. What is universal in today's market environment is the need to hedge equity risk if the economy is in fact headed towards recession.

Recessions are part of the normal business cycle and a healthy way for excesses to be eliminated in an economy and market. What concerns me is that after 6 years of Fed-manipulated negative real interest rates the misallocation of capital is at historically high levels making unwinding exceptionally dangerous.

I would also advice to be wary trusting in the traditional diversification benefits of stocks, bonds, and commodities. In 2008/2009 we witnessed correlations on all risk assets moving towards +1 whether the risk was in the equity, fixed income, or overseas markets.

Dynamic risk hedging strategies have become greatly enhanced over the last several years. Be sure to have a plan not only to navigate the volatility still to come but how to ultimately benefit throughout the full market cycle.

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