

There is a headline you will not often see! While few investment advisors would promote their strategies as Crystal Ball Investing, that is often what their clients receive. We are inundated with financial media, akin to financial porn, that fills our heads with forecasts for the economy and the equity or bond markets. The question that rarely gets asked is: "Are these forecasts ever consistently accurate?"

Economists to Central Bankers have demonstrated they have no ability to forecast the future whether it is GDP growth, inflation, or direction of the stock market. The Fed, whom we all assume have access to the most reliable data possible, has an abysmal track record of forecasting. According to Forbes using data from 2013-2018, the Fed margin of error is over 100% in forecasting 3-year forward Fed Funds, a rate they set themselves (Forbes, April 25, 2018). The supposed Blue Chip economists have forecasted 6 of



the last 2 recessions. Regardless of data that demonstrates the forecasts, or psychic impressions, of future economic results are worthless they are still closely followed and investment decisions influenced by them.

Ray Dalio famously quipped: **"He who lives by the crystal ball will eat shattered glass."** If forecasting has proven to be so unreliable in delivering results do we need to conclude that the stock market is simply random? Not at all, we just need to create a framework for using data that enables better decision making when it comes to investing and understand what can and what cannot be controlled with the markets.

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At its most basic definition, investing is putting capital at **risk** with an **uncertain** future. Notice the italicized words in the previous sentence. The mistake many investors (and portfolio managers) make is failing to understand the difference between Risk and Uncertainty. Risk is quantifiable and can be managed in a disciplined or systematic manner. Uncertainty, on the other hand, cannot be quantified or managed. Strategies that attempt to make portfolio allocation decisions based on uncertainty (crystal balls) eventually fail.

Managing risk can be accomplished by identifying the relative appropriateness for risk taking. There are certain environments when historical data suggests it is favorable for risk taking manifested as above average equity allocations. Other environments have demonstrated unattractive periods for accepting market or systemic risk. This framework will

never allow you to identify a market top or bottom and cannot be failproof but can serve as a guide in managing portfolio and risk allocation.

Living in Colorado the weather changes often and rapidly as we sometimes experience all four seasons in a single afternoon. If you are driving on I-25 in a blizzard with snow accumulation and limited visibility, it makes sense to slow

down to make sure you arrive at your destination, even if a little later than planned. When the skies are blue and roads dry it is easy to drive much faster and thus arrive sooner. Managing risk in equity allocations is simply understanding the current environment to know how fast you can safely drive (size of equity allocation). You might decide to drive 80 mph on snow-packed roads and arrive to your destination safely but that does not mean that is a smart strategy and will likely result in failing to arrive at some point in the

future.

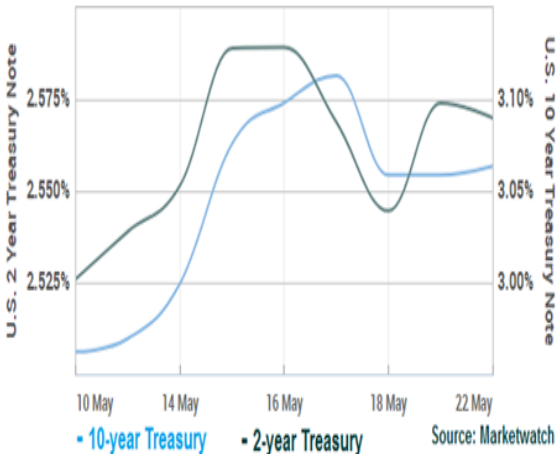
Making portfolio allocation decisions using a risk framework is designed to improve the likelihood of getting to the desired destination. Uncertainty will always exist in the markets because of human behavior. We are all prone to certain biases that influence how we make investment decisions. If we can identify the risks associated with different behaviors such as herding, recency or confirmation bias, we might manage volatility more effectively in equity portfolios.

There are metrics like valuations or earnings growth that can be helpful in identifying the relative attractiveness of asset classes like equities but demonstrate a large margin of error and are sensitive to other factors like interest rates that can be unpredictable. Gold will often trade inversely to the U.S. dollar that is interest rate sensitive. Interest rates meanwhile are typically highly influenced by future inflation expectations. The problem is that these expected relationships may often break down even for long periods of time.

There is no perfect portfolio allocation strategy. Strategies will shine at times and lag during other periods. The best strategy remains to follow what Benjamin Graham wrote in his 1934 tome: **"The essence of investment management is the management of risks, not the management of returns."**

## The World is Flat

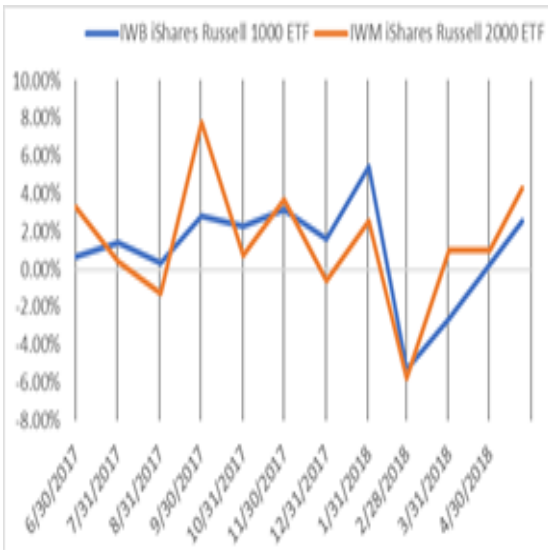
Yield Curve Watch



Thomas Friedman, in his best-selling book *The World is Flat*, argued that globalization in the 21st Century is creating a level playing field that will raise the standard of living for many living in extreme poverty. The bond market has adopted the same flat world mentality. The difference between yields on short-term and long-term debt instruments has continued to narrow providing the flattest yield curve in a decade. Economists and portfolio managers track the yield curve as closely as any data point because an inverted yield curve, where short-term rates are higher than long-term rates, is the most reliable indicator of a pending recession. When the 2-year Treasury had a higher yield than the 10-year Treasury in December 2006 it was a sign of the imbalances that preceded the Great Recession.

- The current yield spread between 1-month T-Bills and 1-year T-Bills remains steep at .60% but the spread between the 5-year Treasury and 30-year Treasury has narrowed to only .25%.
- The most tracked spread between the 2-year Treasury and 10-year Treasury is at .48% today and suggests that if the Fed hikes by .25% twice more the yield curve could invert.
- Banks are negatively impacted by an inverted yield curve because they pay interest based on short-term rates and lend on long-term rates meaning their spread evaporates.

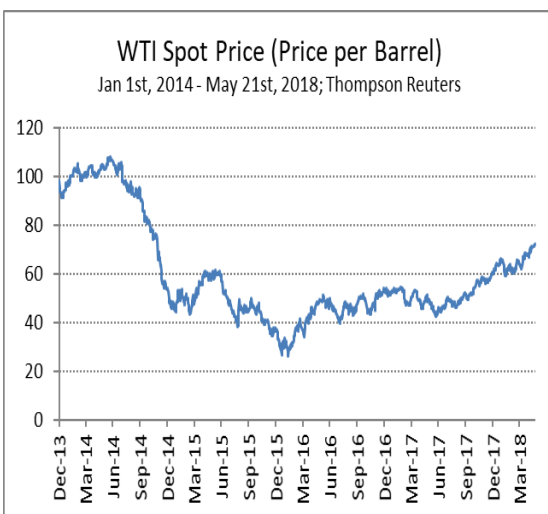
## Small Caps Rising



Small cap companies have quietly been outperforming large cap companies through 2018. The 1 year chart below compares the Russell 1000 Large Cap ETF, IWB, in black versus the Russell 2000 Small Cap ETF, IWM, in gold. Many analysts feel that assets flowing in to small caps and positive performance is driven by tax reform benefiting small companies. Geopolitical tensions and the threat of a trade war may have also created a rotation out of multinational large caps emphasizing exports to small cap companies. Continuing this reasoning, analysts that believe the dollar will strengthen also expect the stronger dollar to bolster small cap companies. Finally, fundamentals may also drive small cap performance given that consensus 12 month forward earnings on small caps are over twice that of their large cap counterpart.

- Consensus 12 month forward earnings expectations for the Russell 2000 Index are 26% while the Russell 1000 Index forward earnings are 11% as of April 24, 2018 (FTSE Russell).
- Trailing one year performance of small caps as of May 23, 2018 have demonstrated outperformance with a surge in outperformance during the month of April.
- Among sectors, large cap performance over small cap performance has been driven largely by technology.

## Oil is Gushing

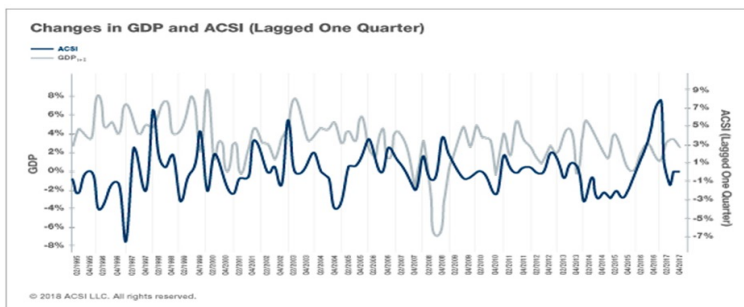


Back in late 2014, the price of oil, as measured by WTI, traded over \$110 per barrel. Then, in 2015, prices collapsed based on oversupply, and WTI traded back down below \$30 per barrel, or a decline of roughly 70%. But since 2015, WTI has steadily risen to over \$70 per barrel, which has raised some eyebrows. In particular, what could be the ultimate impact of higher energy prices on equity valuations, and how will higher gasoline prices at the pump impact the American consumer? The energy sector today as a percentage of the U.S. equity market is smaller than it was in the past, so the overall market should be less sensitive to movements in energy prices, while higher prices at the pump may discourage holiday travel.

- Companies dependent on energy based raw materials might be in a better position today to absorb rising costs. While still relevant, the price of oil will likely have less of an impact on equity prices than other factors, such as interest rates and inflation expectations.
- Higher gasoline prices are like an added tax on consumers. For every extra dollar spent at the pump, there is a reduction in discretionary spending on other items. However, the U.S. economy seems to be on solid footing and recent tax reforms have added dollars back into the consumers' pocket.

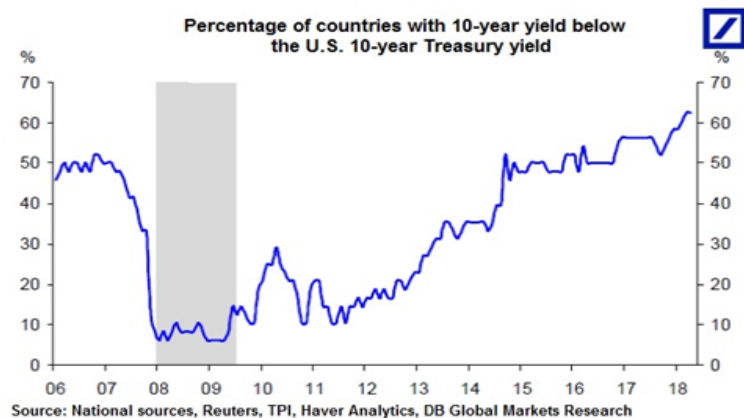
**Macro View – Measuring Customer Satisfaction**

There is a lesser known index to the University of Michigan Consumer Sentiment Survey called the American Customer Satisfaction Index (ACSI), also born out of the University of Michigan. ACSI approximately 100,000 surveys, evaluating customer satisfaction. The results are viewed as providing a potential leading indicator based on the demonstration of where consumers are spending money. Consumer spending accounts for 70% of US GDP. This creates a correlation between changes in customer satisfaction and changes in GDP. GDP can be described as a measure of the quantity of economic output while ACSI measures the quality (www.theacsi.org). The chart below shows changes in ACSI in blue (lagged one quarter) measured on the right y axis with changes in GDP in grey measured on the left y axis from 1994 through 2017. Research from the University of Michigan would make the case that economic growth is dependent on producing more products but also better products and services that consumers are happy to produce or consume.



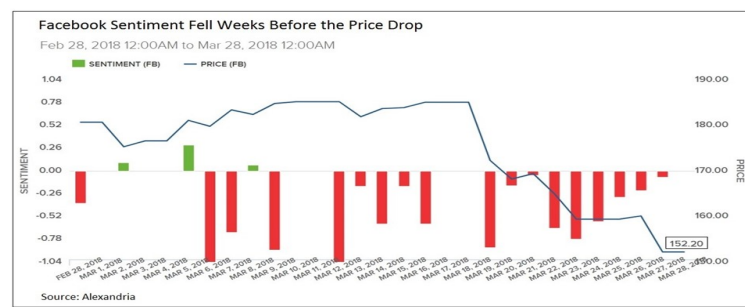
**Fixed Income - Strange Days Indeed**

John Lennon famously crooned in his hit Nobody Told Me there would be “strange days indeed”. Any analysis of the global fixed income markets likely comes to the same conclusion. According to Deutsche Research, more than 60% of the developed world have a yield on their 10-year government bonds below the U.S (Deutsche Bank Research Note, May 18, 2018). Given that U.S. remains the world’s reserve currency and is generally believed to have the strongest economy today, many are searching for reasons why. There is typically a somewhat linear relationship between yield and risk that is clearly broken when the yield on Italian debt is 100 basis points lower than a comparable U.S. bond as of early May. I do not think the head-scratching pricing on bonds is indicative of the U.S. losing its safe haven designation as much as the volatility surrounding changes in currency valuations.



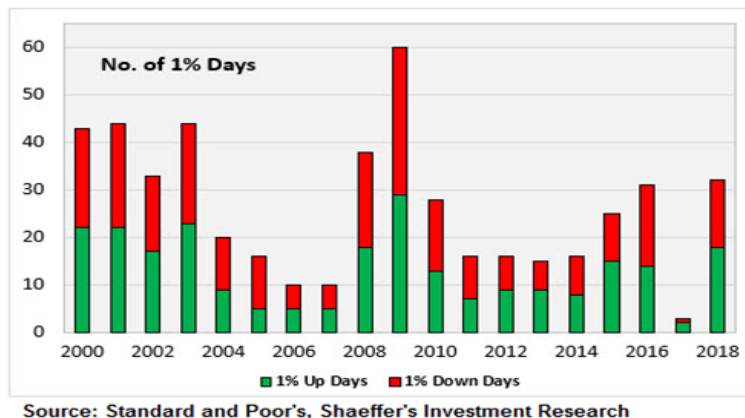
**Taking Stock – Sentiment Readings on Stocks**

Real time data analytics and data mining have changed the world from politics and elections to sports and equities. For example, Deutsche Bank studies the most searched words for given periods of time and begins to extrapolate data from the google searches. In 2017, healthcare topics were some of the most searched items on Google. 2018 has been driven by searches on Mueller, immigration, and gun control (Deutsche Bank Securities, May 22, 2015). Factset cites a company, Alexandria, that tracks news stories on the internet to identify potential threats to companies demonstrating that the old adage “Buy on the rumor and sell on the news” predated the internet and big data analytics. Alexandria’s analytics reads, analyzes and applies a sentiment score to thousands of news stories. The chart below demonstrates that Alexandria found that Facebook’s sentiment based on news stories dropped prior to the stock prices dropping with the blue line representing the Facebook stock price and the green and red bars representing Facebook sentiment.



**Technical - Trending Volatility**

The equity markets are well on their way to exceeding the volatility of 2009 based on the number of days the S&P 500 traded higher or lower by 1% or more in a day. Through May 23rd there have been 40 days in 2018 where stocks were up or down by more than 1%. That is compared to only 8 such days in 2017. It seems a given we will exceed the 58 times that occurred during 2009. The days have been mostly evenly split between being higher or lower so far this year. March was particularly volatile with 11 days seeing a change of more than 1% in the 21 trading days of the month. It is easy to identify that volatility is trending much higher this year but those trying to capitalize on the volatility trade need to exercise caution. The early February spike in volatility erased more than \$2 trillion in equity according to the WSJ (Wall Street Journal, February 6, 2018).





## The State of Housing

Clint Pekrul, CFA

Given that mortgage rates are tied to Treasury yields, it's worth asking how the recent rise in the 10-year yield might impact home affordability. At first glance, we might assume that higher mortgage rates would slow, or perhaps put downward pressure, on changing home prices. After all, higher interest rates mean that it's more costly to finance a home purchase. So we might make the casual assumption that home prices are set for a general decline. However, the issue of home affordability is more complex as there are several factors to consider.

We have to understand why interest rates are rising. In general, the cost of borrowing money goes up when the economy is doing well. That is to say, when unemployment is low and consumer confidence is on the rise, interest rates

tend to increase. All else equal, potential homeowners can absorb a few percentage point increases in mortgage rates, and as a result, home prices should not be adversely impacted. According to the National Home Builders Association (NHBA), continued job growth, rising wages and increased consumer confidence are fueling housing demand. In other words, potential buyers have absorbed marginally higher borrowing costs. Furthermore, the NHBA forecasts more buyers entering the housing market in the coming months (World Property Journal, May 14, 2018).

Some historical perspective is in order, however. While we've seen the 10-year Treasury yield go from roughly 2.4% at the beginning of the year to just over 3.0% today, we are still at historically low levels for interest rates. Sure, yields have jumped 25%, but that only translates into 0.6% absolute move. For example, a mortgage payment of \$2,400 at the beginning of the year would now cost you \$3,000. The added interest cost of \$600 might not be that onerous for the average household. So far, we've seen a slight uptick in yields with no impact on overall affordability.

But suppose interest rates begin to accelerate upward. This scenario could happen for many possible reasons. The long-term average, or normalized 10-year yield is approximately 5%. We are about 2% away from this long-run average. Going back to our previous example, the \$2,400

mortgage payment would now be \$5,000. If wages did not rise in lockstep, it's doubtful the average household could absorb this added cost. It's under this scenario that we would likely begin to see downward pressure on housing prices. To reiterate, a slow, steady rise in mortgage rates won't likely pose a serious threat to housing prices, but an upward acceleration in rates could be problematic.

Ultimately, there are factors that determine home affordability beyond interest rates. According to the

**“Continued job growth, rising wages and increased consumer confidence are fueling housing demand.”**

NHBA, home builders face numerous headwinds that could adversely impact affordability, such as chronic labor and lot shortages, rising prices for building materials and excessive regulations. According to the NHBA, home construction firms simply can't fill open positions

with qualified labor. As a result, it takes longer on average to build new homes, which adds to overall costs. Likewise, the cost of materials is on the rise. Based on data contained in the Producer Price Index, the average cost for construction materials, such as lumber and concrete, has been on the rise.

According to the Labor Department, the producer price index for inputs to construction industries — a measure of all materials used in construction projects including items consumed by contractors, such as diesel fuel — rose 1.0% in April and 6.4% over the past 12 months. The year-over-year increase was the steepest since 2011. According to the Associated General Contractors of America, contractors have begun to increase the prices they charge to undertake projects, but are falling further behind on the cost of materials they buy. As a result, their profit margins will shrink or they won't take on new projects.

In summary, higher mortgage rates are a bit of a headwind, but not the overriding factor for home prices (at least for now). Today it's a question of supply. There's healthy demand for single family homes, but profitability on new construction is under pressure due to higher input costs and labor shortages. As a result, existing home prices get bid up often beyond the reach of affordability. Eventually the market will find an equilibrium, but for now housing prices are likely to continue to rise.

## Q: Are Facebook and Google in government crosshairs?



Yes, I believe these public companies as well as a number of private companies who deal in “big data” are in the government’s crosshairs. When Mark Zuckerberg, CEO of Facebook, testified before Congress about how his company was manipulated by Russian and others during the 2016 Presidential election it provided a lot of fodder for late night comedians. Some of the questions being asked by legislators, slightly beyond middle age, revealed that they know very little about how social media works or its impact. I expect Congress to come out with new legislation attempting to make social media or data platforms like Google or Palantir more responsible for how their data is utilized, especially by foreign entities.

The bigger question is whether or not such legislation will withstand the First Amendment challenges that will ensue. We live in an interesting time because the massive amounts of data these social media goliaths have accumulated is not been the result of illegal hacks or nefarious acts, people are freely giving their data to the companies and signing agreements that stipulate Facebook, Google and others can use it however they want. Few people understand that when you click I AGREE to open a new Gmail account you are authorizing Google to read and archive every email you send or receive. I do not think change will come as a result of legislation but rather when enough individuals delete their social media or email accounts and demand that they retain control over their privacy before signing up for a new service.



It sure seems so, but I’m not sure regulators will actually do anything meaningful to change their business models. We’ve seen recent headlines that Congress will use antitrust laws to break up the big tech giants, which also includes Amazon. But I don’t see how this can happen. Antitrust laws are designed to protect the consumer from monopolies that drive out competition and then jack up prices for goods and services. But this scenario is not happening. Consumers are paying less because new technology is replacing obsolete technology, which does not violate antitrust laws. I do think Congress could impose new regulations on how these companies use consumer data. There might be new disclosure requirements. In the short run this might be disruptive to their businesses, but in the long run I think greater transparency is a good thing.

## Q: Who benefits most from increased exports to China?



I think everyone is going to benefit from the direction that trade talks with China are headed. At the conclusion of the latest talks, China has agreed to reduce some of the tariff’s on imported products such as cars, beef and agricultural products. This is a huge step in increasing global trade instead of reducing it through tariff’s. U.S. car makers will be the immediate beneficiaries of the lower Chinese tariff’s. Last year, despite the 25% tariff, U.S. companies sold \$10.5 billion worth of cars to China. That figure was \$1 billion just 10 years ago. While the increased sales will drive profits of GM and Ford higher, the impact on jobs will be minimal because a large number of the cars sold in China are manufactured in China.

While less talked about than the reduction in automobile tariff’s, the changes in exports to China of LNG (liquified natural gas) may ultimately have the greatest economic impact as it is likely to put upward pressure on natural gas prices. The amount of LNG in the gulf is staggering and the U.S. is in the early stages of monetizing the energy product. China’s demand for LNG will continue to grow exponentially meaning demand for U.S. produced LNG will remain strong. Strong demand should mean higher prices which may be a windfall for companies poised to export LNG.



At first glance, I think agriculture and energy are the biggest winners. I think it’s fairly well understood that the U.S. trade deficit with China is a hot politic topic in the Trump administration. China has recently vowed to increase their purchases of goods and services made in America to help narrow the trade deficit. Specifically, they mentioned increased imports of agriculture and energy products. From an industry perspective, this should help oil and gas exploration and production and basic materials. China also committed to increasing their imports of American manufactured goods, which would benefit a wide range of industries. However, China was purposefully vague about the terms of their agreement. They didn’t reference exact dollar amounts. I think their agreement to increase U.S. imports might be a tactic to delay further tariffs. I wouldn’t necessarily trade or rebalance a portfolio based on China’s statement.

All weights as of May 23, 2018

<b>Income</b>	
Mortgage Backed Bond	35.76%
Investment Grade Credit	17.41%
High Yield Bonds	12.59%
Preferred Stock	18.23%
US Dividend Equities	5.18%
US REITs	5.84%
Short (Inverse) Treasury Bond	5.00%

<b>Balanced Income</b>	
US Dividend Equities	12.90%
International Dividend Equities	16.42%
US REITs	14.89%
High Yield Bonds	34.88%
Long Term Treasuries	15.91%
Short (Inverse) US Equity	5.00%

<b>US Growth</b>	
Low Volatility Factor	16.74%
High Quality Factor	14.11%
Small Cap Factor	13.87%
Value Factor	14.44%
Momentum Factor	11.14%
Long Term Treasuries	19.60%
Short (Inverse) US Equity	10.10%

<b>Global Growth</b>	
Low Volatility Factor	9.18%
High Quality Factor	7.42%
Small Cap Factor	7.34%
Value Factor	7.67%
Momentum Factor	5.80%
Developed Market Equity	16.97%
Emerging Market Equity	16.39%
Long Term Treasuries	19.11%
Short (Inverse) US Equity	10.10%

Weights are approximations only and subject to change.



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