INVESTING "THROUGH THE LOOKING GLASS"

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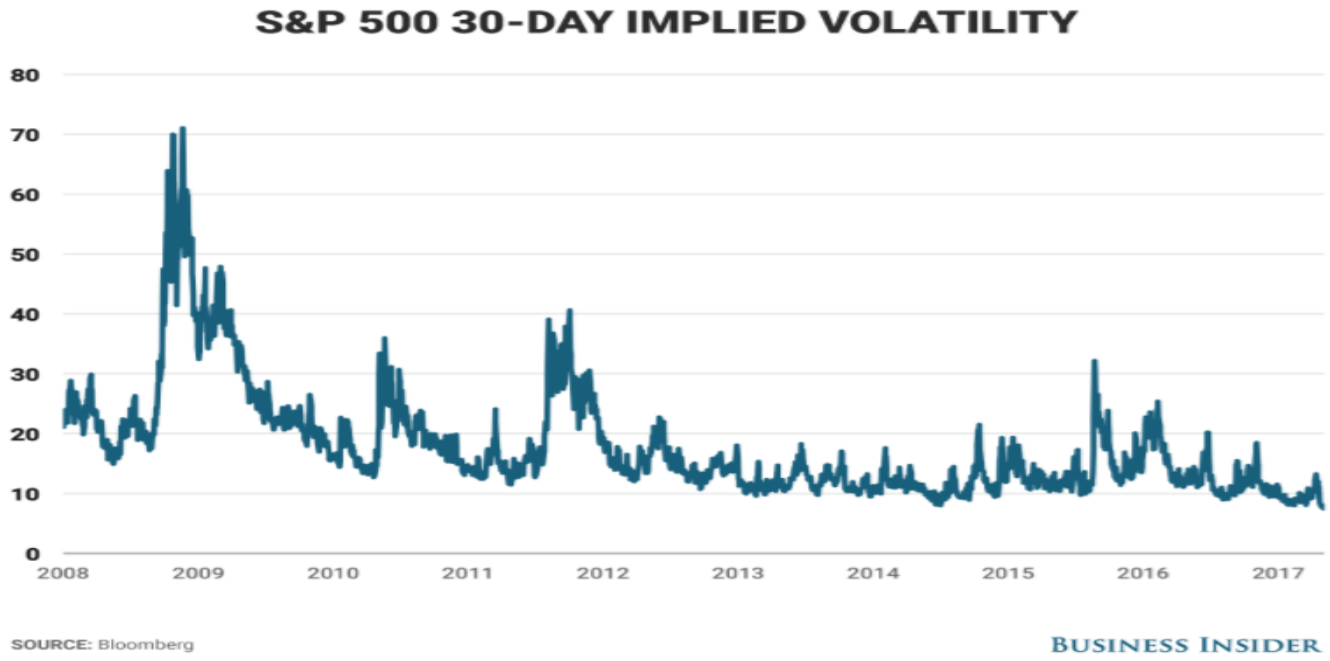
Is it just me, or are the capital markets seemingly oblivious to the "warning signs" I see forming on the investment horizon? Is it the incredible heat we're experiencing here in the desert this summer that is causing market participants to "see" refreshing oases in the near-term horizon, or are they just mirages? As the first half of calendar-year 2017 comes to an end, it's an opportune time to review market and economic conditions as they *are* today, not *as we wish them to be*, and to try to identify "trends" that may impact our clients' capital during the remainder of the year.

As I scan the news for economic data, I see several areas for concern, but the capital markets are either ignoring these concerns, of just plain shrugging them off. Declining auto sales, weak retail sales, and a slowdown in consumer spending? *No problem*. Legislative uncertainty around needed tax reform and infrastructure spending? *Ho-hum.* Falling oil prices and the removal of fiscal stimulus? *Yawn*. Partisan political bickering and investigations of investigations. *Nothing to see here.* Geopolitical military threats from North Korea and Russia? *What? Me worry?* Complacency abounds! As I look at the landscape before us, I confess to more than a bit of astonishment that the domestic equity markets continue their seemingly inexorable rise to record levels, and *with virtually no market volatility*. On June 9th, Wall Street's "Fear Index", the VIX Index, fell to a 23-year low. The chart below shows the market's complacency has reached record lows, post-market crash. That's not always a good thing….



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This year's market volatility is nearly *non-existent*. The chart below shows calendar year (1928 to present) "Intra-Year Drawdowns", or in lay terms, the largest percentage decline the S&P 500 Index recorded in each calendar year, from an intra-year market "peak", to an intra-year market "trough". The "average" calendar year peak-to-trough decline over that period has been (-16.3%). Though we're only half way through the year, if the second half of 2017 is a continuation of the first half, we will have seen the second lowest level of volatility in the domestic stock market in almost ninety years.

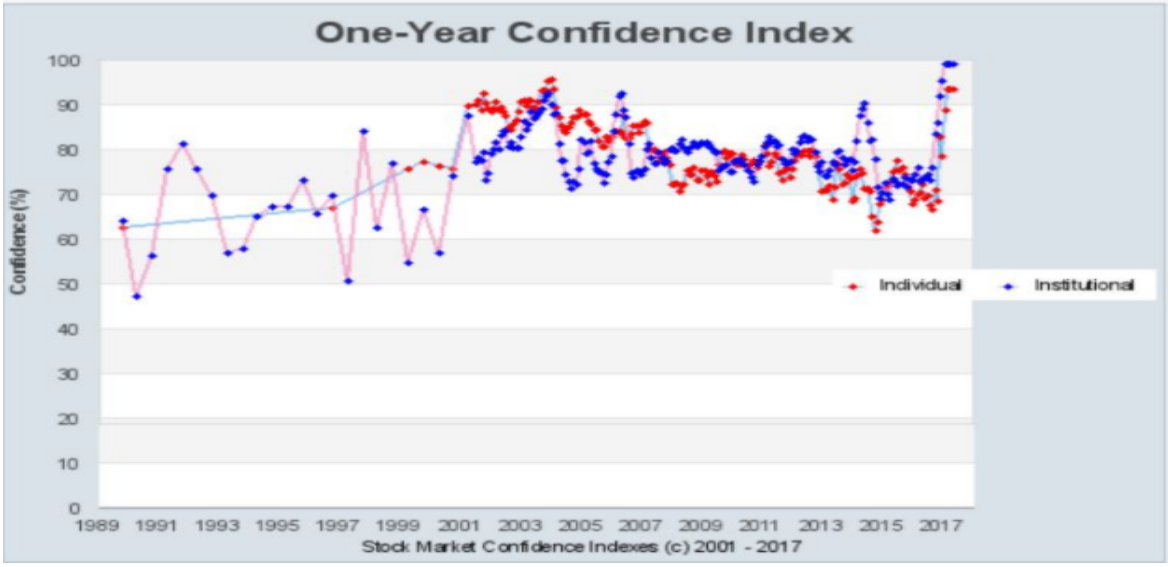
S&P 500: Max Intra-Year Drawdowns (1928 - 2017)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	-10.3%	1946	-26.6%	1964	-3.5%	1982	-16.6%	2000	-17.2%
1929	-44.6%	1947	-14.7%	1965	-9.6%	1983	-6.9%	2001	-29.7%
1930	-44.3%	1948	-13.5%	1966	-22.2%	1984	-12.7%	2002	-33.8%
1931	-57.5%	1949	-13.2%	1967	-6.6%	1985	-7.7%	2003	-14.1%
1932	-51.0%	1950	-14.0%	1968	-9.3%	1986	-9.4%	2004	-8.2%
1933	-29.4%	1951	-8.1%	1969	-16.0%	1987	-33.5%	2005	-7.2%
1934	-29.3%	1952	-6.8%	1970	-25.9%	1988	-7.6%	2006	-7.7%
1935	-15.9%	1953	-14.8%	1971	-13.9%	1989	-7.6%	2007	-10.1%
1936	-12.8%	1954	-4.4%	1972	-5.1%	1990	-19.9%	2008	-48.8%
1937	-45.5%	1955	-10.6%	1973	-23.4%	1991	-5.7%	2009	-27.6%
1938	-28.9%	1956	-10.8%	1974	-37.6%	1992	-6.2%	2010	-16.0%
1939	-21.2%	1957	-20.7%	1975	-14.1%	1993	-5.0%	2011	-19.4%
1940	-29.6%	1958	-4.4%	1976	-8.4%	1994	-8.9%	2012	-9.9%
1941	-22.9%	1959	-9.2%	1977	-15.6%	1995	-2.5%	2013	-5.8%
1942	-17.8%	1960	-13.4%	1978	-13.6%	1996	-7.6%	2014	-7.4%
1943	-13.1%	1961	-4.4%	1979	-10.2%	1997	-10.8%	2015	-12.4%
1944	-6.9%	1962	-26.9%	1980	-17.1%	1998	-19.3%	2016	-10.5%
1945	-6.9%	1963	-6.5%	1981	-18.4%	1999	-12.1%	2017	-2.8%

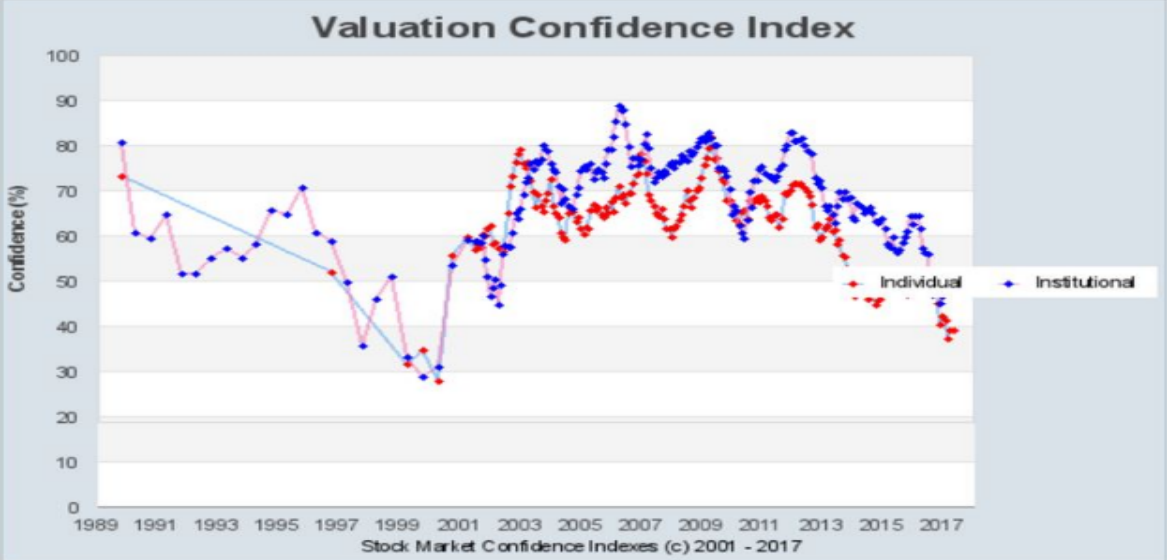
Pension Partners — THE ATAC ROTATION MANAGER — @CharlieBilello

Chart Source: Edward M. Dempsey, CFP – Pension Partners, L.L.C.

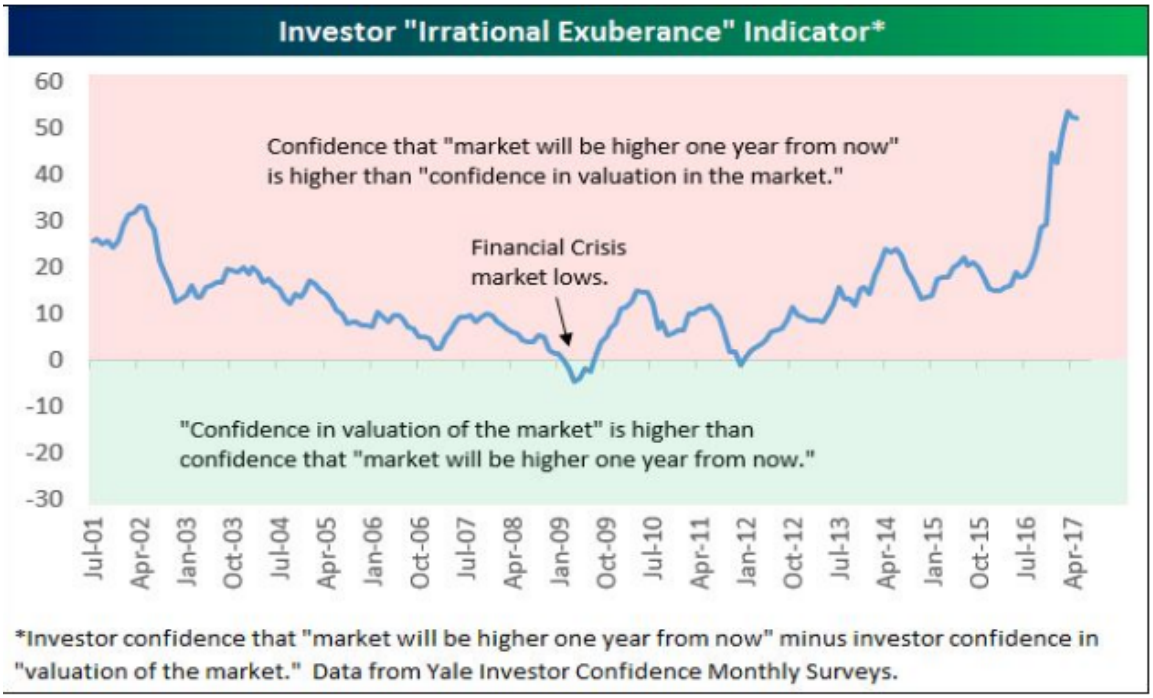
Retail and Institutional investors are *highly confident* the market will be higher a year from now. The last time confidence was close to this high was 2003 – 2007, as the market "bubble" was building…..



Amazingly, while investors are *near certain* the market's advance will continue, they are almost as highly confident that *stocks are over-valued at current levels*. This makes no sense.



This "disconnection" in investor sentiment, wherein investors simultaneously believe both, that stocks are over-valued, and that they will continue to rise, is irrational on its face. In fact, the disparity between the two sentiments hasn't been nearly this pronounced since the turn of the century. Yale University's "Irrational Exuberance Indicator" is sending an ominous signal.



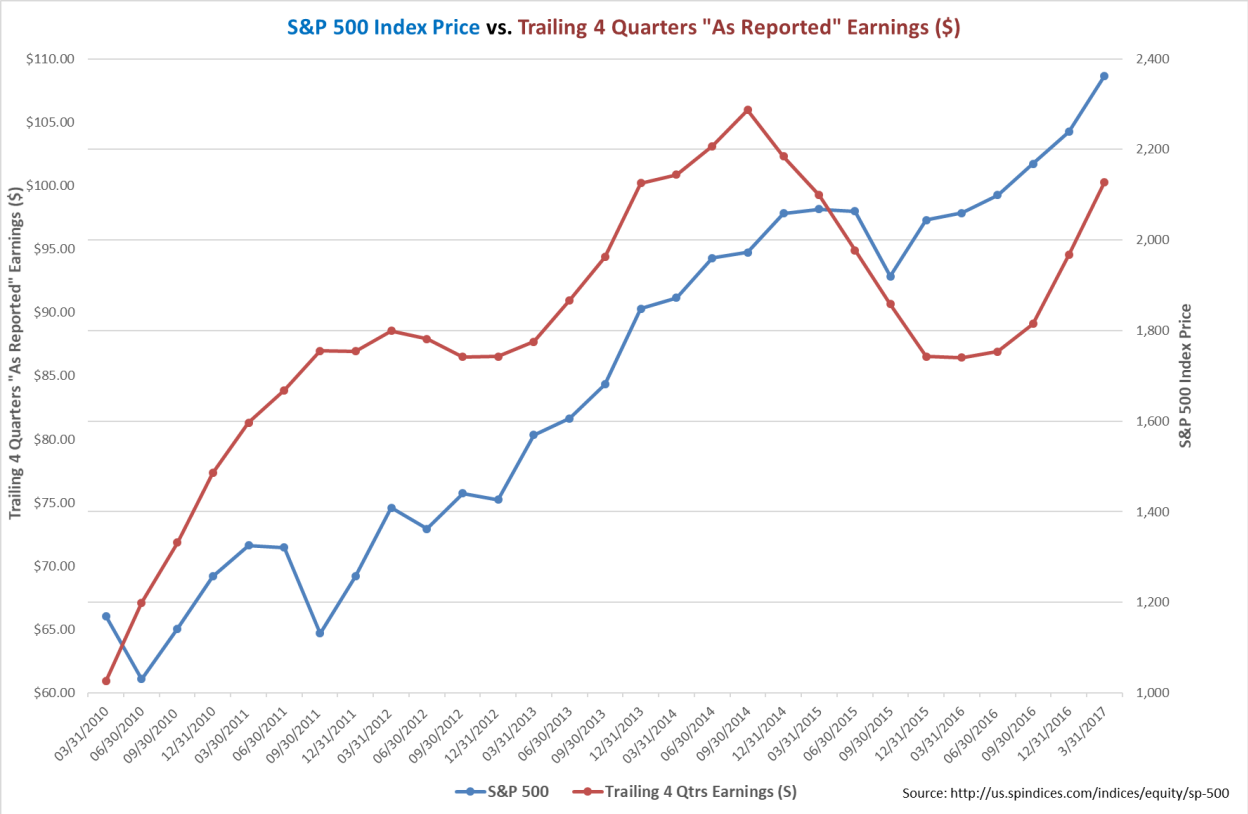
Sources for Last Three Charts: http://www.marketwatch.com/story/this-irrational-exuberance-indicator-could-spell-trouble-for-the-stock-market-2017-06-21

Despite the markets' seeming indifference to clouds forming on the horizon, I see a continuation of some of the more troubling issues I addressed in my March Report to you (*http://conta.cc/2oQ9uC3*), and the emergence of others. The apparent disconnection between *fundamental economic and market conditions*, which are troubling, and *the markets advance*, which seems contradictory on its face, makes capital allocation far more difficult than in more rational times. With due respect to Lewis Carroll's novel, and Alice's wonderment, recently, it feels like we've been investing through the proverbial "Looking Glass". It's like navigating a "Wonderland market", where down is up, left is right, and bad news is good news.

What nonsensical "Jabberwocky" is afoot in this alternative universe? I'm sure it will come as no surprise to regular readers of these missives, that most troubling to me is the lack of….

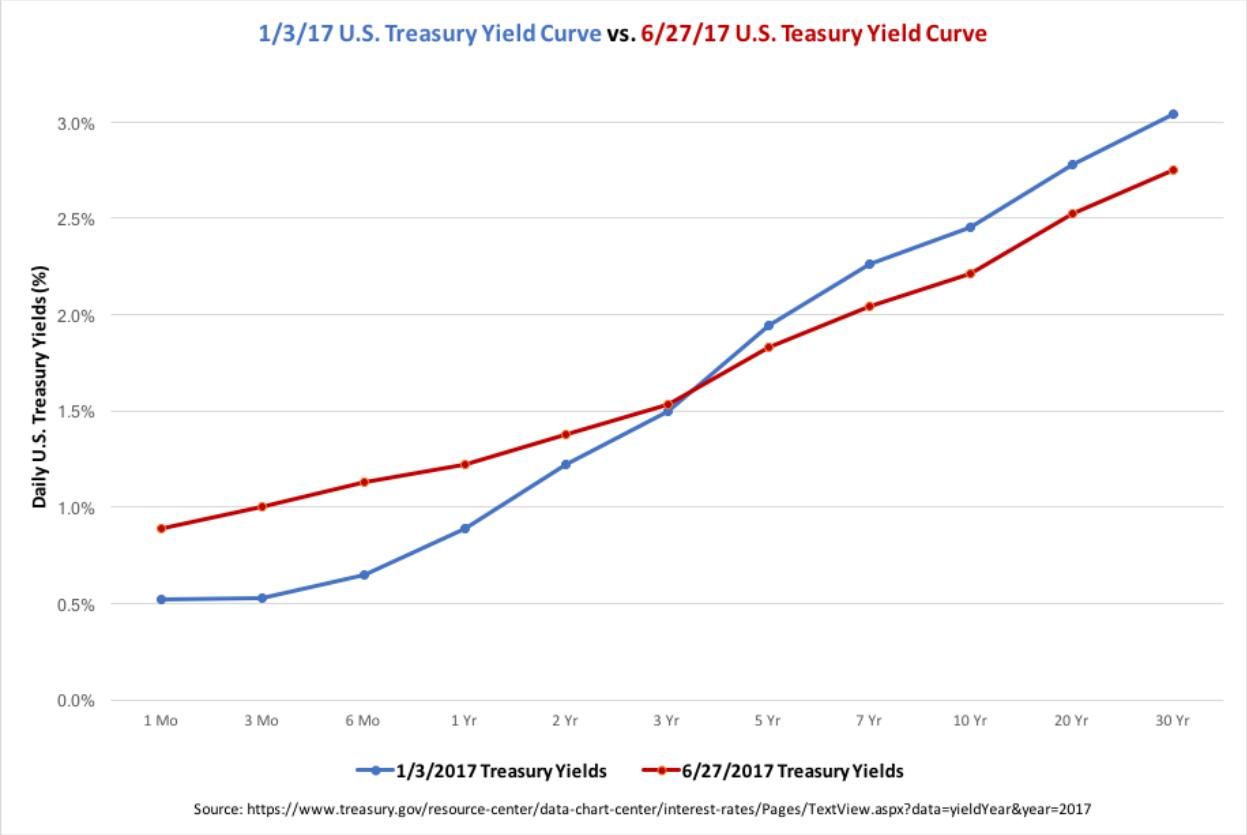
Earnings, Earnings, Earnings…

As I've stated many times, when evaluating the health of the stock market, or the reasonableness of its valuation, I turn my focus to fundamental valuation measures, particularly the Price to Earnings ("P/E") Ratio of the S&P 500 Index. I pay particularly close attention to *trailing* four quarters', "As Reported" Earnings Per Index Share, as it's a real, tangible number, *not* conjecture or projection. While S&P 500 Index earnings *are* improving, with trailing four quarters' earnings growing by +6.07%, to $100.29 per Index Share for the quarter ending March 31st, 2017, from the previous quarter's reading of $94.55 per Index share, the Index Value (or "Price") rose by +5.53% for the quarter. Technically, this caused the P/E Ratio to contract a *bit*, from 23.68 times earnings to 23.56 times earnings, but since the end of March, the Index price has risen *another* +3.20%. Analysts expect second quarter 2017 "As Reported" earnings to rise by just +2.80%, so if the second quarter's earnings come in as expected, the P/E ratio will expand again. Paying $24 for every dollar of earnings the market delivers makes little sense to me.



The Yield Curve is "Flattening"

With the Federal Reserve Bank's decision to raise the Fed Funds Rate to a range of 1% to 1.25% on June 14th, a troubling phenomenon we've observed in recent months, the "flattening" of the yield curve, continues.

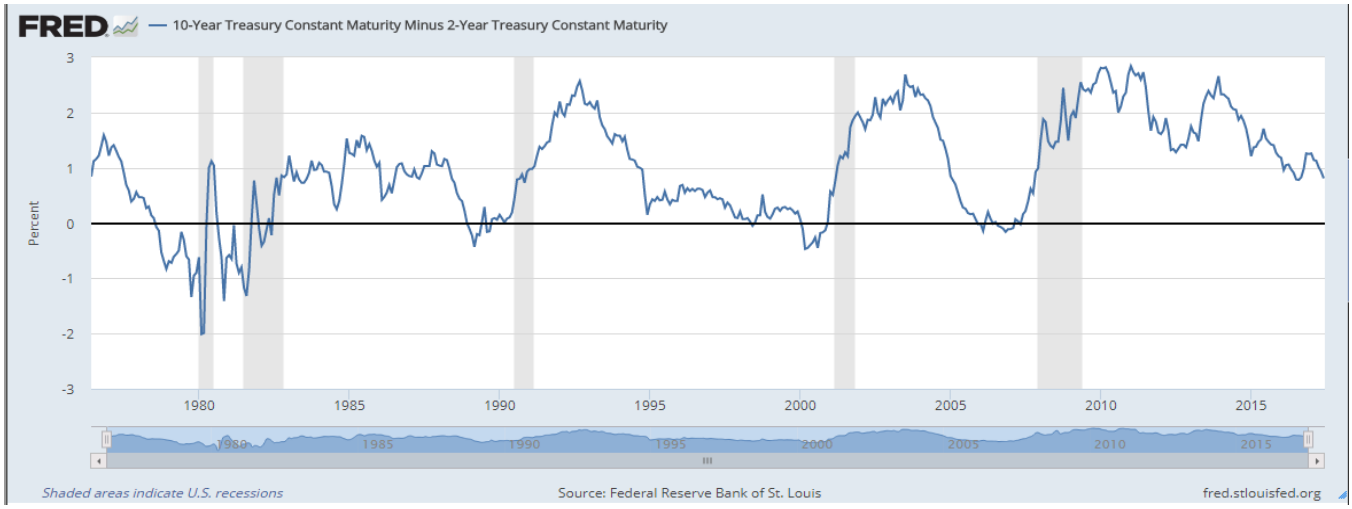


The flattening of the yield curve is typically an indication investors and traders are worried about the macroeconomic outlook. Short-term Treasury yields have been lifted by the Fed's interest rate increase, while yields on longer-dated maturities of the Treasury market have tumbled, as investors grow glummer about the prospects for future growth and inflation. Without boring the reader with all the adverse consequences that come with a "flattening" of the yield curve, at its core, the problem starts with the inability for banks and capital lending sources to profitably "borrow" capital short-term (short end of the curve), and then "lend" it out longer-term (longer end of the curve). With tightening spreads, lenders become less and less willing to lend freely, and in an economy that's limping along at sub-2% growth, banks' reticence to provide corporations needed working capital could have a chilling effect on economic progress.

The difference in yields between 2-year U.S. Treasuries and 10-year U.S. Treasuries, a "spread" that makes up a crucial part of the yield curve tightened in recent weeks, briefly falling below 80 basis points immediately following the Fed's announcement, after both retail sales and inflation data disappointed expectations. Adding to those concerns, the Fed indicated that it plans to raise rates another time this year, in addition to trimming its balance sheet.

This much-watched spread is very close to the smallest yield differential between the two seen since last October, and is less than 7 basis points from being the lowest spread since before the financial crisis in 2007. We are keeping a close watch on this data point, because as the chart below shows, when a flattening yield spread goes "negative", known as an "inverted" yield curve, *recessions* (shaded areas of the graph) *typically ensue*.

10-Year Treasury Yield Minus the 2-Year Treasury Yield (1975 – Present)



We are Awash in Debt

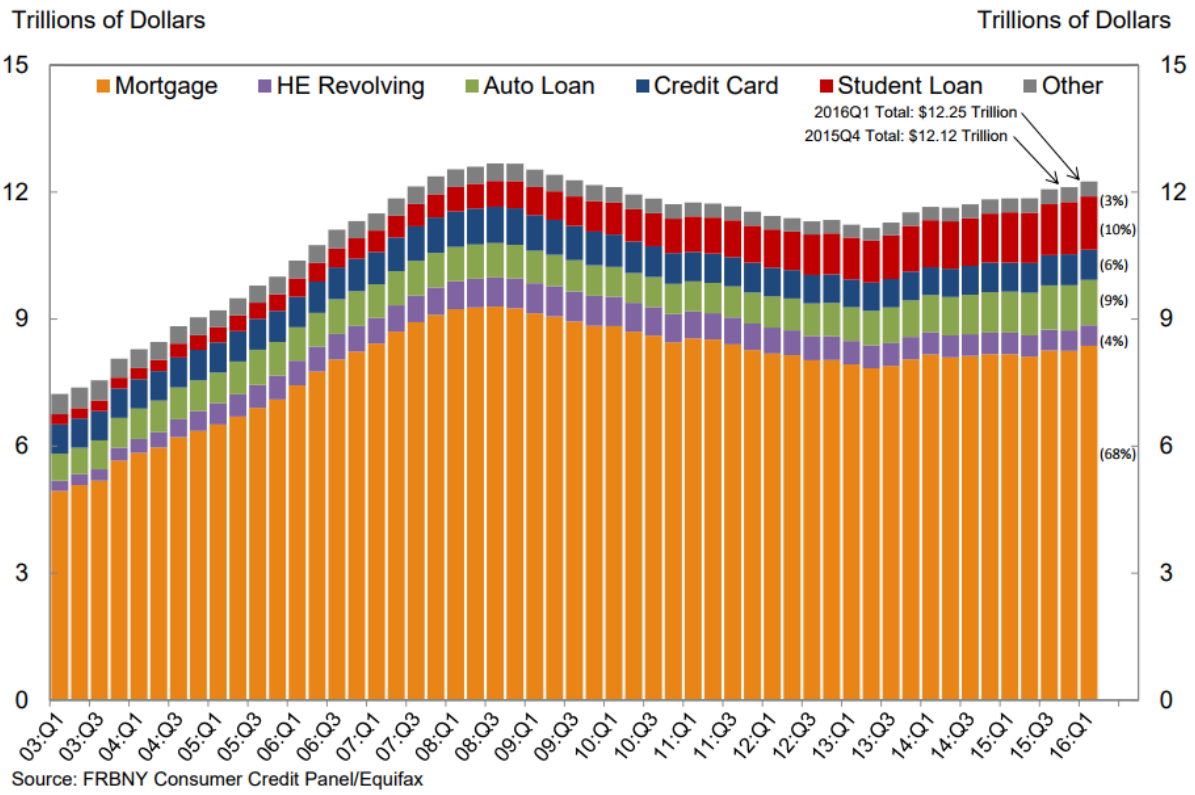
Two of the more troubling indicators I follow relate to *debt*, both Household Debt and U.S. Government Debt, as both are headed in the wrong direction.

After the "Great Recession", Americans did what anyone would do if their income were drastically impaired, they reduced their household debt burden. Household debt peaked at an all-time high of $12.68 Trillion at the end of the third quarter of 2008, and declined by (-12%) to $11.15 trillion by the second quarter of 2013. Over the past four years, however, we have seen debt levels surge again, surpassing the previous record high, reaching a record $12.73 Trillion on March 31st, 2017. Further, delinquencies and defaults are rising. High household debt levels are obviously concerning, and some particularly troubling data from the New York Fed's Consumer Credit Panel Report (May 2017) include:

- As of March 31, 2017, 4.8% of outstanding household debt was in some stage of delinquency. Of the $615 billion of debt that is delinquent, $426 billion is seriously delinquent (at least 90 days late, or "severely derogatory").
- Outstanding student loan balances increased by $34 billion, and stood at $1.34 trillion as of March 31, 2017. 11.0% of aggregate student loan debt was 90+ days delinquent or in default in 2017 Q1.
- Credit card 90+ day delinquency rates have deteriorated, and now stand at 7.5%.

Data Source: https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2017Q1.pdf

Household Debt and its Composition



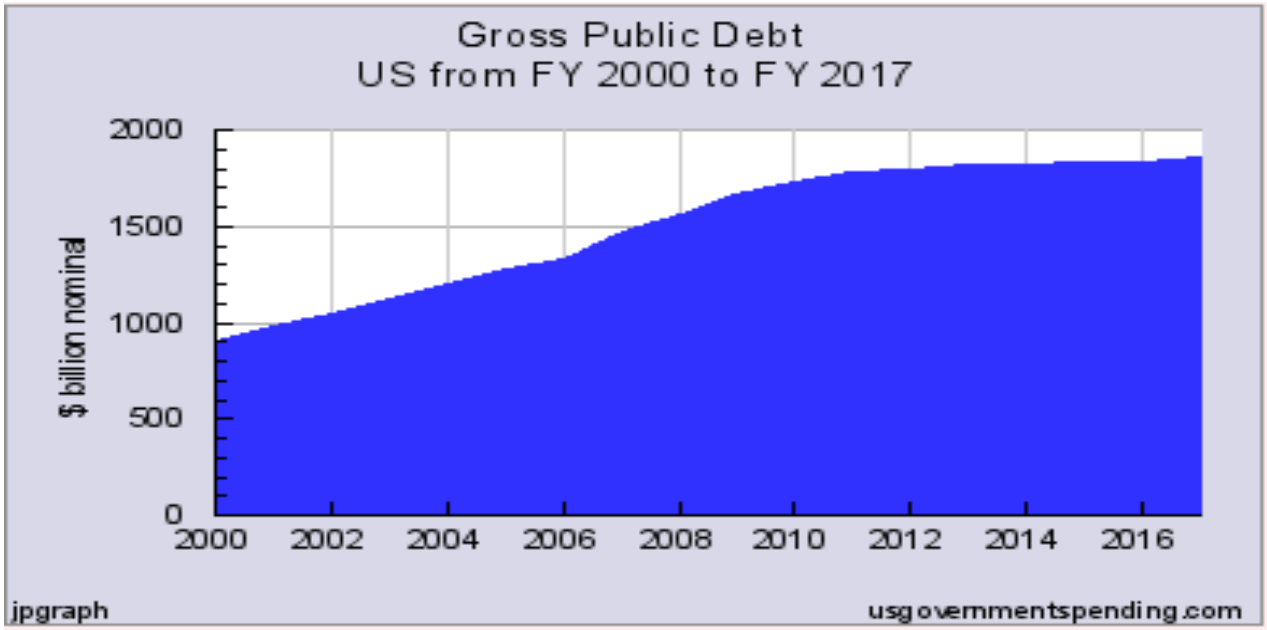
Consumers can justifiably point to their government as a poor "example" of managing one's debt load, as the U.S. Treasury continues to "stack" deficits upon deficits, year after year. The Congressional Budget Office estimates that when the fiscal year 2017 ends on September 30th, we will have stacked another $559 Billion onto the total, bringing the total outstanding U.S. Treasury Debt to $20,355,000,000,000 (that's a LOT of zeros!), and the Debt-to-GDP Ratio is projected to rise to 105.19%.

U.S. Treasury Debt Outstanding as a Percentage of GDP

Of the "G-20" Economies (the world's 20 largest economies), the U.S. Treasury's Debt-to-GDP Ratio (104.17%) is exceeded only by Japan's (250.40%) and Italy's (132.60%), and it is substantially higher than the average of the twenty countries, which is 74.99%.

Data Source: https://tradingeconomics.com/united-states/government-debt-to-gdp

The State and Municipal governments are in worse shape, if you can believe that. We haven't seen a State declare Bankruptcy and default on its obligations, since Arkansas filed in 1933, in the throes of the Great Depression. Bankruptcy is not a legal option available to States today, but it's being discussed as a potential solution for Puerto Rico, which can never hope to pay off its massive $70 billion debt burden. States like California, Illinois, and New York have huge *unfunded* pension liabilities. In addition to the almost $20 trillion in outstanding U.S. Treasury debt we (the U.S. taxpayers) owe, the State and Local Governments owe another $1.85 Trillion. Unlike the U.S. Treasury, which has the ability to sell seemingly endless amounts of Treasury bonds in the global debt markets to finance its debt, States and Municipalities must rely upon the Municipal bond market to meet its deficit spending needs. California has $390.4 billion in debt on its books in Fiscal Year 2017. Texas owes $369.2 billion, and New York checks in at $356.3 billion. Surprisingly, all three maintain Investment Grade Credit ratings from Fitch, Moody's and S&P. Illinois, which carries $141.6 Billion in State and Municipal Debt, holds a BBB- Credit rating from S&P, just one notch above "junk bond" status.



Data & Chart Source: http://www.usgovernmentdebt.us/compare_state_spending_2017bH0C

Dividend Paying Stocks are Out of Favor

Incredibly, but in keeping with the theme of "Looking Glass" markets, dividend-paying stocks are out of favor this year. Don Hagan, CFA, partner at Day Hagan Asset Management, published a research piece he wrote for advisors on June 19th, breaking out the short-term performance of varying sub-sets of stocks, based upon their dividend-payment policy.

He separated stocks in the S&P 500 Index into five "subtypes" and compared them to a "geometric equal weighting" of the S&P 500 index Total Return. Here are their hypothetical returns (and their return ranking) year-to-date 2017 (through May 31st), and for the forty-four plus years from 1972 – May 31st, 2017 (Based upon an initial investment of $100):

	This Year	Last 44 Years
	01/01/2017 = 05/31/2017	*01/31/1972 – 05/31/2017*
Stock Sub-Type	*Value of $100 Investment*	*Value of $100 Investment*
Dividend "Growers" & "Initiators"	$106.55 (2nd)	$7,429.68 (1st)
All Dividend Paying Stocks	$105.28 (4th)	$5,279.64 (2nd)
Dividend Payers w/No Change in Dividends	$100.86 (5th)	$2,474.05 (3rd)
Dividend "Cutters" & "Eliminators"	$106.02 (3rd)	$ 86.78 (5th)
Non-Dividend Paying Stocks	$107.61 (1st)	$ 311.44 (4th)
S&P 500 Index Geometric Equal-Weighted	$105.65	$2,761.67

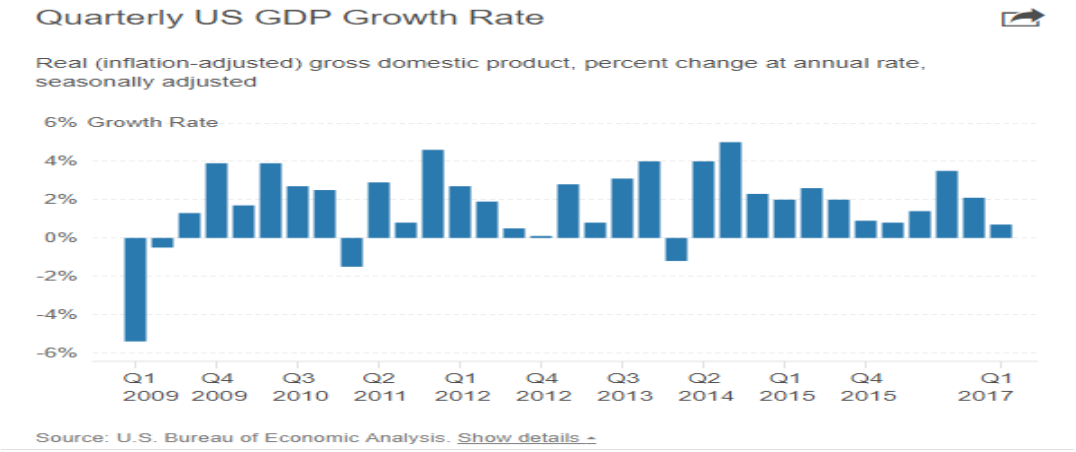
Chart Data Source: Day Hagan Asset Management June 19th E-Mail to Advisors

In our "Looking Glass" stock market in 2017, strong dividend payors who don't cut their dividends are "punished", finishing dead last through May of this year, while *the best performers pay no dividends at all*!!! These recent results are almost *diametrically opposed* to the way markets have historically rewarded companies who return capital to shareholders through dividends. The column on the right shows conclusively, that over the long term, companies who pay dividends, and those who regularly grow, or increase the dividends they pay shareholders, *dramatically outperform companies that pay no dividends, or worse yet, cut, or eliminate their dividend*s. If one had invested $100 in 1972 in companies that cut, or eliminate their dividends, the value of those stocks would have declined to just $86.78 over forty-four years. But for reasons I can find no logic behind, the markets today find no value in returning capital through dividends.

Economic Sluggishness

Domestic economic growth is *decelerating*. In the seventy years since World Wall II ended, U.S. Gross Domestic Product ("GDP"), the "official" measure of the growth in the size of our collective economic output, has averaged annual growth in production of 2.9% a year. It has been many years since we 've "printed" a 2.9% annual growth rate, and in fact, the first quarter of 2017 saw (annualized) growth of just 1.2%, and the trend is clear. We've now gone more than 10 years without reaching that "average" 2.9% GDP, and President Obama is the first President in history to serve an entire two terms without delivering average 2.9% GDP growth in any single calendar year. The "new normal", of more accurately, the "new *ab*normal" is persistently low growth.

This chart show U.S. GDP growth since our last economic recession (early 2009



During the entirety of President Obama's Administration, we "averaged" just 1.5% annual GDP growth, the weakest economic growth under any U.S. President since WW II, but in the "Looking Glass" stock market, this incredibly sluggish economic growth somehow delivered a massive stock market advance. Incredibly, the domestic stock market is in its 100th consecutive month without a "bear market" decline, defined as a "peak-to-trough" decline of greater than (-20%).

This chart shows U.S. GDP Growth by U.S. President.

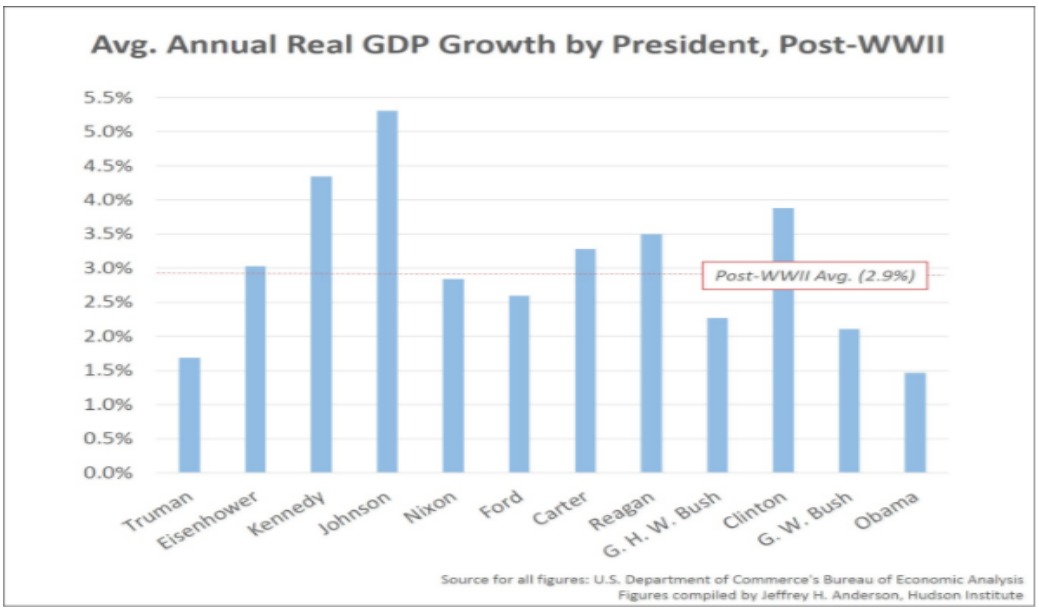


Chart Source: https://hudson.org/research/12714-economic-growth-by-president?ref=patrick.net

Geopolitical Risks are Expanding

I wrote in the March Report that President Trump would be "severely tested" by foreign powers, and I specifically mentioned North Korea, Iran, and Russia as likely antagonists.

No, I didn't have a crystal ball, but I could clearly see that outside forces would test the resolve of the United States. Since I wrote that, Russia has been implicated of meddling in our elections, and taken up arms with the Syrian dictator, Assad, against our rebel force allies. The North Korean dictator, Kim Jong-Un, has tested over a dozen missiles in direct contravention of U.N. Security Council sanctions. The Middle East continues to be rife with conflict.

These and many other potential threats could spiral out of control. Yet given the lack of volatility in the markets today, one would think we were in the middle of the longest peacetime expansion since the end of the Vietnam War led to sixteen years of relative "peace" before the Persian Gulf War.

So, while we wait for the "Looking Glass" market to become "rational" again, we'll leave long-only, unprotected investments to The Mad Hatter, the Red Queen, and Tweedledee and Tweedledum. Like Alice, who wakes in the end to discover it may have all been a dream, we think this alternate universe may right itself--eventually. In the meantime, as always, we will pay close attention to geopolitical risks and international realities and act accordingly.

As always, we welcome your comments and questions.

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