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# Cadence clips

FOCUSED ON WHAT MATTERS MOST.

## Sprinting Isn't Always Winning

Every sprinter eventually tires out and has to slow her pace. Science dictates this. Some may last a few seconds longer than others at maximum speed, but they all succumb to the limits imposed by the various systems making up their bodies. As even a recreational runner knows, the faster you run, the faster you tire, and when you do, recovering requires that you slow dramatically if not stop outright.

### Stocks

It seems the markets have hit their short-term limits as well after springing from the blocks back in March of 2009. When considering an average of all the major stock indices, stocks are basically flat for the year. There have been plenty of ups and downs, but all within a very perceptible trading range that has limited both gains and losses. The question really, is whether this sprinter has exhausted completely and is ready for some R&R or can surge for a bit longer.

### Bonds

Before delving into our outlook for the back side of 2015, let's first review what's happened with investments other than stocks. With respect to bonds, after having a solid first quarter, performance fell off rather dramatically in the second as interest rates spiked. This resulted in most bond categories registering negative returns with high grade bonds down nearly 5% and 20-year government bonds down almost 7%. For investors thinking they were playing it safe in high quality fixed income, this would have been a shocker. It's worth noting that this type of downward move in traditionally conservative investments contributes to otherwise risk-averse investors wandering into more aggressive investments without a real appreciation for the dangers of their migration. A good example of this and an even better segue into our next category is gold.

### Following the Gold

From the early part of the bear market of 2000-2002, gold began its 10.5 year ascent with few interruptions along the way. It averaged over 20% per year and gained fans and new investors at a record clip in the final few years of its upward charge. On August 19, 2011, with gold at over $1,900 per ounce, the SPDR Gold Trust ETF (GLD) surpassed the SPDR S&P 500 Trust ETF in becoming the largest exchange traded fund in the world with over $77 billion of investor assets. In an investment so adored by

so many and with such good results in generating consistent wealth for investors, what could possibly go wrong? Gold was the new "safer" alternative to stocks, and if you wanted proof, all you had to do was look at the track record since 2001. There were very few bumps in the road to riches - a beautiful thing to behold.

However, as we know all too well, markets work in both directions and anything that has the ability to gain 20% per year also has the capability of falling just as impressively. Since its peak in September of 2011, gold is down 43%. That's nearly 4 years of not only no gain, but significant loss, which has served to bring the average annual return since 2001 down to 10%. Gold's longer term average has been much lower than that even. From the peak in 1980 to that in 2011, gold has averaged just under 3%. Whether we get back to that long-term average or not, the point is investment assets ultimately revert back to a long-term return that's reasonable and realistic, and that tends to approximate their longer term averages. This drop wasn't any surprise to us and we wouldn't see it as at all unusual if gold continued to work its way lower over time – closer to its longer run average.

**Commodities and China**

The rest of the commodity space has also come under pressure lately. In looking at the Powershares DB Commodity Index (DBC) – a balanced index of commodities ranging from oil and natural gas to precious metals and agricultural commodities – returns for the year are a negative 13%. In our estimation, this decline in price – which has been taking place broadly for years – is likely the result of a decline in true demand for these resources. There isn't any clearer example of this currently than in China, where as a result of overbuilding everything from roads to cities and airports in the past, demand for materials has fallen off a table as the global economy slows. We've been talking for some time about deflationary pressure being the underlying theme across the global economy, and this is evidenced very clearly across the commodity complex. Oil, in particular has resumed its drop and is sitting near price levels not seen since 2009 in our opinion due not only to excess supply, but also lack of demand. Regardless of how much central planners (central bank officials) want us to believe inflation is just around the corner if not here already, commodities are telling a different story – the real story. Deflation is the natural force acting on markets at the moment and absent artificial and interventionist actions to the contrary, it tends to bring them down.

While we're on the subject of China, it's important to note that while their stock market has more than doubled over the last year despite an economy that has been noticeably slowing, it has finally shown signs of cracking. From the Shanghai Composite's high on June 12, it fell more than 30% in less than a month. Given that most participants in China's mainland stock market are local retail investors, most of whom have borrowed money to invest alongside their own in order to maximize returns, a 30% drop is completely fear-inducing and quite potentially life changing. Whether this bubble continues deflating now or a bit farther down the road, it will undoubtedly throw a wrench in the government's plan to move China from a producer nation of cheap exports to one comprised of healthy consumers. Potentially more important, with so many Chinese citizens invested in real estate at sky high prices, and on the hook for the corresponding mortgage payments, this stock market collapse also has the potential to catalyze a real estate meltdown that authorities have worked so hard to prevent. This development could certainly have knock-on effects globally which raises the risk profile of stocks, commodities as well as some bond categories. Unfortunately, we don't operate in a vacuum here in the U.S.

**The Crowd Favorite**

For anyone with an ear turned toward business television – and we won't name names because we realize CNBC isn't the choice for all boob-tubers these days (ah shucks we did it again) – the urge to jump on the bandwagon and ride this over-aged bull all the way to Dreamville is almost irresistible. After all, interest rates on bonds, CD's, and bank savings continue to be punitively low. Add to that most economist's pledge that the next set of economic numbers will finally start to reveal the true strength within our economy, while the perpetual claim that the

numbers in the rear view mirror had some sort of seasonal or accounting issue about them will finally fade away. Additionally, corporate margins are good, Greece isn't part of the United States, so no worries, and the Chinese fallout won't affect us just because, and oh yeah, we continue to have team Yellen at the Federal Reserve pulling for us. How could she possibly fail at her job and allow markets to fall? Although her mandate is price stability and "full" employment, her actions have led investors to believe that the Federal Reserve will act on their behalf and with their best interests in mind, indicating the existence of a third, unofficial mandate to keep the markets moving in the right direction. In Yellen's defense, the two Fed chairs before her behaved the same way. In the late 90's this was referred to as the "Greenspan Put", after a put options contract that is designed to protect you when the market goes down.

So given all this, the majority of Wall Street proclaims there are only good reasons to stay invested. Any conflicting data is turned upside down and used as additional fodder for bullishness from a contrary perspective. I.e., if the Greek crisis poses risks to our markets, then that means everyone's scared, which means it's a great time to invest. Sometimes these contrary positions are reasonable, but when they're applied indiscriminately across the board, it gets a little tiring. According to Investors Intelligence, investment advisors who are bearish or negative on the outlook for stocks are currently under 16%, a very low reading historically. The overwhelming message from the experts is very clear, "stay invested" and "buy any dips". Unfortunately, we know that when too many people are thinking the same thing, it's the other thing that could be about to happen.

**Our Opinion**

Our message is clear. If you choose to ignore over 100 years of history and venture into stocks thinking the coast is clear and that any downturn will present you with a great buying opportunity, do so at your own peril. The fact remains that by a host of measures that historically have been very accurate in predicting long-term stock returns, the market remains tremendously over-valued. We've delved into the Schiller CAPE model, Market Cap/GDP, and others in previous months, so we'll spare the diatribe this time, but suffice it to say that valuations have only gotten more extreme in recent months. Regardless of how good Apple's earnings are or how many new subscribers Facebook has roped in over the last reporting quarter, math is math and it's as simple as that. The price you would have to pay to invest in the average stock trading on U.S. markets is way higher than it has been on average over the past 100 years, which is to say that as that price adjusts, which it most assuredly will, losses will be incurred. These losses may come after additional price gains, but that argument is moot, as the "buy the dip" mentality will have you buying rather than selling during the first leg down of the inevitable bear market.

As we've mentioned before, based on current stock prices, getting back to normal would mean an investor's lucky if they average anything above 0% over the next 10 years. It's important to note that averaging 0% doesn't mean hitting the pause button and being at the same level for the next 10 years. Rather, it involves a series of ups and downs or cycles along the way which reflect moments of euphoria and fear and changes in market psychology which always drive market movements over short to medium-term timeframes. It's euphoric, risk-shunning sentiment that drives markets to positive extremes (where we are now) and the flip side, fear and panic that ends them and ultimately drives markets to the other extreme. As long as human beings make the decisions (and yes, we still make the decision to listen to the computers that we've programmed to do all the high speed computer trading), markets will experience cycles that entail extremes on both ends.

**Under the Surface**

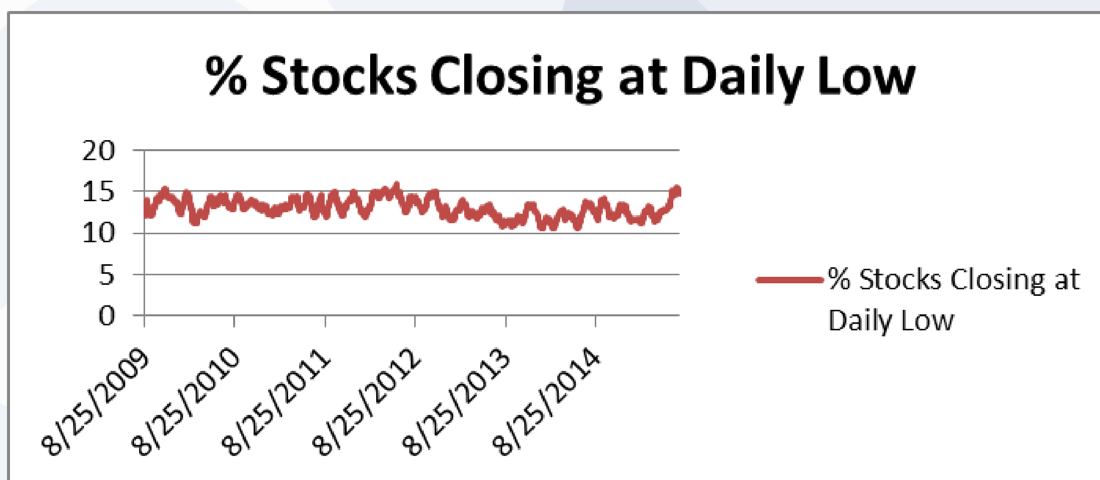
Over-valued markets alone aren't enough to signal a downturn just around the corner. As we're well aware, we have to move through "expensive" to get to "extreme", just as we did in 1997, 2006, and even 2-3 years ago. Over and under-valuation can go on for quite some time. So although not a great indicator of specific market turning points, broad valuation methods can tell us what we can reasonably expect to earn over a longer time horizon (like we said,

in this case around 0%). For a long-term risk-averse investor, that may be enough. But for most investors, sitting it out for too long while everyone else is having fun and making money is easier said than done. So maintaining some exposure to stocks is usually a good idea at least until we start to see deterioration in market technical and internals.

When the momentum of the market starts to wane and further gains become more labored and challenging, this could indicate a market turning point. Additionally, when the market is being lifted higher by fewer stocks or on lighter volume, we've often seen trend changes in the offing. That said, we're seeing both very weak market technicals and internals at the moment. This at a time when valuations are sky high and advisor sentiment is unusually complacent – not a very comforting development. Here are a few of the things that have gotten our attention recently:

- While the Dow Jones Industrial Average was holding up relatively well for the year, the Dow Transportation Index was off about 10%. This could indicate inventory build-up as goods are still being produced, but aren't being moved. Dow Industrials have followed suit and weakened over the last two months.

- The number of stocks closing at their lows for the day is as high as it's been since mid-2012. (chart below)



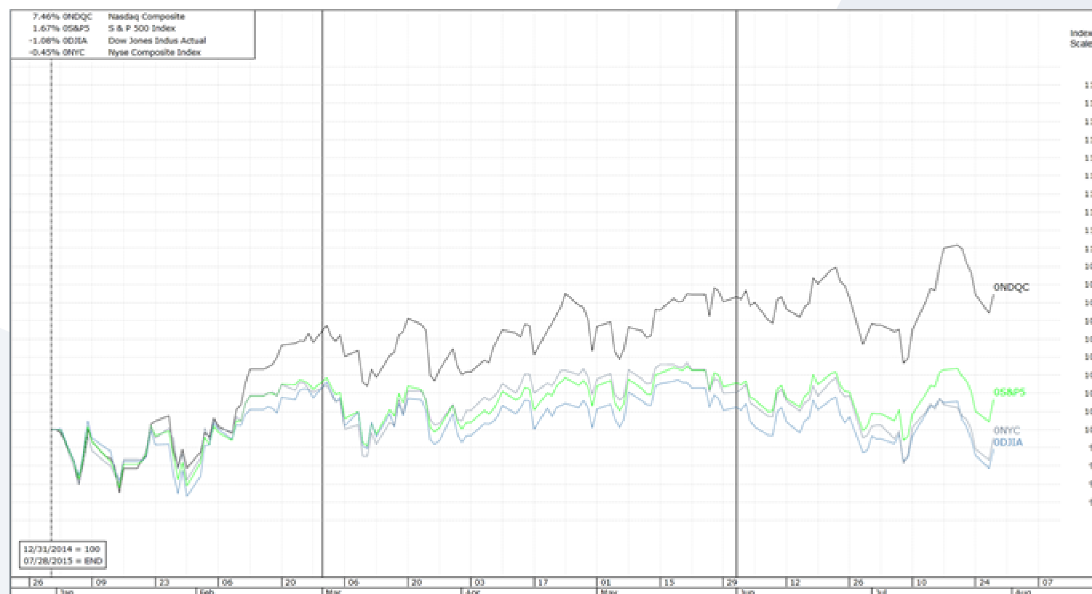
- The on-balance volume of the S&P 500 (as measured by the ETF SPY) has diverged and weakened considerably relative to the price of the S&P 500. We wrote about this in June's "Stocks Over Bonds – Think Twice".

- For the last three months, declining stocks have outnumbered advancing ones on the NYSE, while the S&P 500 has held about even.

- According to John Hussman at Hussman Funds, fewer than 60% of stocks in the S&P 500 index are currently trading above their 200-day moving averages. Again, fewer stocks doing more work keeping the averages up.

- Six firms – Amazon, Google, Facebook, Apple, Netflix, Gilead – account for half of the value added to the Nasdaq this year. ( Wall Street Journal)

- Although the Nasdaq is making new highs this year, most recently on July 20, the other major indices are struggling to do the same. The NYSE and Dow are currently in well-defined downtrends since their highs in May.




It's important to note that when historically pricey markets are met with deteriorating market technicals and internals, very unsavory market conditions have typically followed. This was true in 1972, 1987, 1999 and 2007, and bares serious consideration now in the event it proves true for 2015. If the items we've outlined above improve, then it's certainly possible that stocks resume their uptrend. If not, it's just a matter of time before the significant number of stocks comprising U.S. markets that are experiencing weakness bring down the rest. When considering the very tepid economic picture globally (with deflation being the underlying current), falling commodity prices, stocks perched on a very high branch, and deteriorating technical and market internals, this would not be a smart time to take unnecessary investment risks. Based on lessons learned from the past, where if we're being honest, times weren't really that different, now should be a time to prioritize principal preservation over growth.

**How to Prepare**

More principal preservation, less growth – is where the focus should be. This means less than usual in stocks, commodities, real estate, and non-investment grade bonds. If markets roll over and get into trouble throughout the

remainder of the year, investors should be much better served in cash and higher quality bonds. We also continue to feel strongly that the right mix of alternative investments can help reduce overall portfolio risk and the amount of any loss when markets do correct. Of course there's no telling how any given investment category or strategy will hold up when markets come under pressure, but the key is to prepare as best we know how. Investments and strategies that historically have done a good job of limiting losses and preserving capital while still providing for potential gain over time are a good place to start. **For our clients, this is something we've already implemented.**

The old saying "buy low and sell high" is harder than it sounds to actually do, but the best way to attempt to do it in our opinion is to buy when the price of an investment offers compelling long-term return potential and sell when it doesn't. Right now based on aforementioned valuation measures, which have historically been very accurate in predicting forward returns for stocks, we are facing one of the worst long-term return outcomes that stocks have ever seen. Given this, and the fact that markets are currently showing signs of stress under the surface, it's possible this sprinter has started hitting her limit. The rest is science.

**Key Takeaways:**

- Stocks are about flat for the year, while bonds are mildly negative and commodities are solidly negative.
- Stocks continue to be more expensive than all but one or two other times in history, and as a result offer paltry long-term return prospects.
- Market technicals and internals have weakened over the last few months meaning that fewer stocks are keeping the market afloat than normal. This historically has been witnessed near market turning points, aka, as bull markets change to bear markets.
- Keep larger allocations to high quality bonds and cash than ordinary. Stocks, commodities, real estate and non-investment grade bonds should receive lesser weightings than usual as they're more likely to experience losses when markets turn.

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# Back To School—The 1970s Versus Today

It seems that the school season has just ended (and with the brutal winter we've had it basically just did) and yet we are beginning to see all of the back-to-school ads. So as we prepare for another school year and hope for a sales tax holiday to help with our purchases, we wonder what the typical going back to school list looked like forty years ago and how it compares to today's?

**1970s**

Forty years ago, there was a lot of emphasis on the bicentennial for the '75-'76 school year and this even worked its way down to the special 'bicentennial themed' metal lunch boxes. This would be the lunch box we would carry all

year long and was one of the few back to school choices we actually needed to make. Would we go with The Six-Million Dollar Man themed lunch box, Holly Hobby, Scooby-Doo, Wonder Woman, Happy Days, or Star Trek (the first Star Wars movie was still a little over a year from happening)? Once lunch was all taken care of, it was then onto the first day of school outfit. This was usually a new pair of jeans and whatever shirt type was in style then, usually something striped shifting to a velour or disco themed shirt as the 70's progressed. Maybe a new pair of sneakers: Puma, Converse, Adidas, or Kmart brand, wrapped up the clothing list. Finally the "other" important school supplies (stuff we actually used in the classroom): A box of #2 pencils (always #2) and notepad with double lined paper. That was basically it. Trapper Keepers came along in 1978 thanks to Mead – a great product that basically included all that was required for the school year. Average family cost was around $43.00. Oh, and we couldn't forget to save a few paper grocery bags to use as book covers for the textbooks we received on our first day of class.

**2015**

Forty years later, the landscape has changed. With township and school district budgets strapped, children and teachers are being asked to provide much, much more.

Here is a brief list for a local school's suggested 6th grade supply list:

- 1.5" durable 3-ring blue binder
- 1- Blue pocket folder with 3 holes
- 1 – Avery index divider 8 – tab colored
- 2 – Mead composition book (wide rule) black marble 100 ct. 9.75 x 7.5
- 1 – Purple 2 pocket folder without clasp
- 2 – Purple spiral notebook 3 subject wide ruled
- 1 – 2" durable 3 ring red binder
- 1 – 2 pocket folder paper without clasp red
- 4 – Avery index divider 5 tab colored
- 1 – Sheet protectors top loading standard 25 count
- 2 – Index cards ruled white 100 count 3 x 5
- 1 – 1.5" durable 3 ring binder white
- 2 – Spiral notebook one subject wide ruled orange
- 1 – 2 pocket folder 3 hole punched paper orange
- 5 – Self-stick notes yellow 100 count 3 x 3
- 1 – 1.5" durable 3 ring binder green
- 1 – 1" durable 3 ring binder black

- 1 – Pencil #2 yellow woodcase sharpened 12 count
- 2 – White pocket folder without clasp
- 1 – Index card binder or box

Additional: #2 pencils, erasers, lined paper, glue sticks, pencil pouch, colored pencils, highlighters, and pencil sharpener.

Now combine these supplies with the necessary back to school clothing, and the average family spends $669.28.
(Source: Prosper Insights & Analytics™, Monthly Consumer Survey, JUL-14)

The extensive and exhaustive list above helps explain why spending was estimated to be around $26.5 billion for the 2014 back-to-school shopping season according to the National Retail Federation. No wonder we see so many back-to-school ads compared to forty years ago! However, take comfort, the more things change the more they stay the same. With Disney's re-boot of Star Wars coming out this holiday season, we may find that Star Wars themed lunch boxes are back on the store shelves!

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