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ISSUE 12 | VOLUME 1 | JUNE 2013

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Here We Go Again

After more than four years of low interest rates and multiple rounds of quantitative easing (money printing by the Federal Reserve), clues abound that we've re-entered bubble territory. Although it's true that great wealth can be amassed during bubbles, it's even more typical that tremendous wealth can be destroyed when they pop.

Since our foremost commitment to our clients is to help them preserve their wealth while pursuing long-term growth, we've essentially relegated ourselves to the role of skeptic. We get no satisfaction out of looking for problems and certainly prefer the bright side of things, but we have to keep ourselves grounded in reality and look at the world with an unbiased and critical eye. In doing this, we see some pretty big warning signs that could pose serious problems for the financial markets. The silver lining? We think these problems will eventually lead to tremendous opportunity for those patient enough to wait.

So before we lay out some evidence that in our opinion does more than hint toward the possibility of our being in a stock market bubble, let's first say that the tough thing about bubbles is that they tend to last longer than we'd expect. We reserve the right to be early on this call just as others have been for previous bubbles. However, because the pain can be a lot greater than the previous gain when bubbles finally burst, we'd rather prepare for the possibility months early than a week too late.

For those readers who don't care to dive into pages of charts and investment jargon, we'll outline a summary of our key findings for you here. Feel free to read them before jumping to the conclusion toward the end of the letter. If you're hankering for the detail, well it's in here—just read along. In short, here's what we're seeing that we believe warrants a very conservative and cautious position on things.

- Markets have risen very quickly over the last 6 months. The recent 20% 6-month gain for the S&P 500 historically happens less than 10% of the time. This isn't normal market behavior more than four years after the bottom of the last bear market.

- Analysts and economists are bumping up their estimates as the market continues to rise—a sign of familiarity bias. Basing those estimates on the continuation of record corporate earnings may also be evidence of the "new paradigm" trap.

- Corporate earnings are at historic highs, making the market appear reasonably priced. When they slow or fall, this will require a re-think on whether what was reasonable just became expensive.

- Looking at the current level of the market relative to both 10-year average earnings and economic activity, it appears much more expensive than we'd like. In fact, historically expensive—suggesting market returns over the next 7-10 years could be well below normal.

- Margin debt—or borrowing within brokerage accounts to buy more stock—has grown at a very rapid rate recently, a potential warning sign that investors are growing complacent.

- The cause of all this? Really loose monetary policy by the Federal Reserve here in the U.S. as well as other central banks around the world. Aka., low interest rates and money printing. This is fuel for a bubble at a time when it's likely we still haven't fully recovered from the last one (or even two).

Read on for detail...

Markets Have Risen Much Faster Than Normal

When markets go up quicker than usual, it can sometimes be a clue that risks are being ignored and complacency is setting in – a characteristic of all bubbles. In 1999, we saw a very steep acceleration in the market that ultimately turned into a sharp decline months later. The higher we climb on the ledge, the more serious the injury if we fall. This was evident in Japan recently when it's stock market, the Nikkei, dropped more than 7% in a single day after rising over 40% for the year and over 60% from its 2012 lows. Historically speaking, we have good reason to get a little nervous when returns start coming too quickly.

Even after that nasty one-day fall, the Nikkei is the best performing stock market in the world at the moment. Most other developed markets have experienced rapid growth as well. The S&P 500 recently added 20% to it's value over a six month timeframe which is well above what we'd consider normal. Over the last 60 years, the average six month return for the S&P has been closer to 4%. Statistically, that short term jump of over 20% should happen less than 10% of the time. What we also take note of is that after such a large short term gains in the market, it's fairly common to see a period of underperformance that can bring us right back to our long term average if not below. Ironically, most people feel much more comfortable investing money when the market's doing much better than usual. A better move might be to take some chips off the table.

Excessive Rationalization and the "New Paradigm" Trap

When things are going well in the stock market, people tend to assume that they'll continue to go well. When stock markets are rising, investors want in. It's easy and completely human to focus on what's working while conveniently disregarding the risks. This behavior is due to familiarity bias which suggests that our most recent market experience influences our expectations of the future. When times are good, it's simply easier to envision positive outcomes than nasty ones. This myopic view on things can quickly morph into extreme rationalization as to why things will continue down the same path—good or bad. In some cases we'll go to great lengths to justify why markets will go up regardless of all the possible reasons they shouldn't. This quest to justify the markets behavior can lead to a very dangerous form of logic we refer to as the "new paradigm" trap.

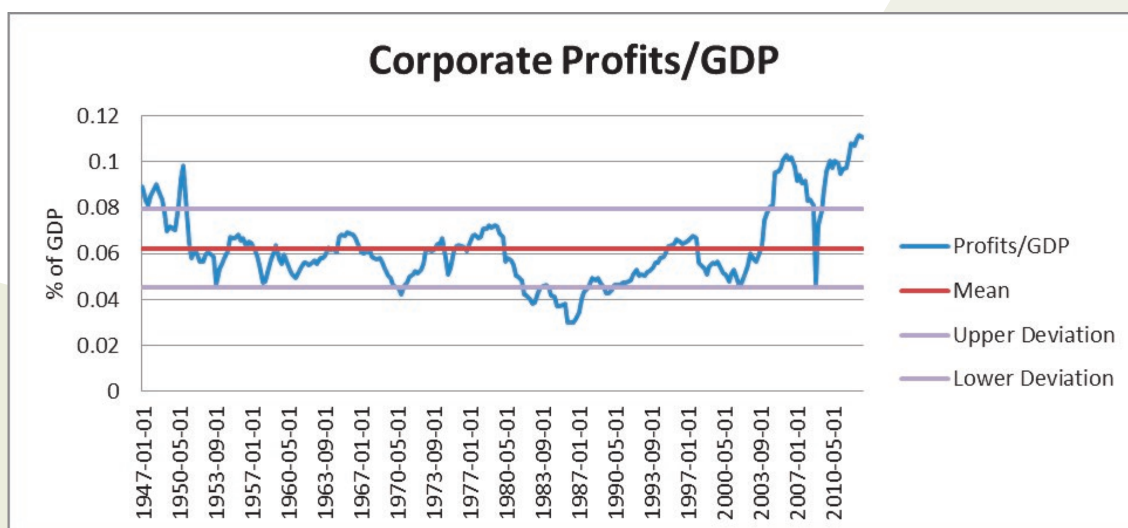
During the tech bubble, market optimists made the argument that stocks should be valued differently due to the new technology explosion – what a company earned didn't matter as much, if at all, under this new paradigm. It was more about what they had the potential to earn five, even ten years down the road if things worked out as planned. During the real estate bubble leading up to 2005 and 2006, some argued that real estate would keep rising due to the fact that "they're not making any more land" and real estate was very unlikely to go down in value as a result. We of course came to realize that even real estate is like all other asset classes—it doesn't go up forever. During the gold run-up more recently, people began thinking it increasingly unlikely that the metal could decrease in price based on both current geopolitical events and the fact that it hadn't had a losing

year in the last ten. Gold has since dropped over 25% from its highs in 2011. Although completely irrational in hindsight, this goofy thinking is par for the course during bubbles.

Are we seeing this type of behavior now? There's a strong possibility. In March, four big banks increased their year-end price targets for the S&P 500 after their best educated guesses from earlier proved to be too low. At least one of them has raised its best guess for where the index will be at the end of the year yet again to 1750, roughly 6% higher than it is now. This is an ideal example of how the market itself can influence expectations simply because it's going up. Even though there are other factors that can and do play into these price target assumptions, they very seldom change dramatically enough over such a short timeframe to warrant the constant changes in price targets.

Is this rationalization morphing into the "new paradigm" trap? It may be. When we look at how experts justify their argument that markets are "fairly valued", it's the high level of corporate earnings and the expectation that they'll continue to rise. Although we agree that the stock market appears fairly priced based on what companies are currently earning, we can't overlook the fact that earnings are as high as they've been in the last 60 years. This is a direct result of corporations cutting costs wherever they can to keep profits high. Since we know expenses can't be cut to zero, it's just a matter of time before earnings growth slows or retracts to more normal levels. This slowdown or outright decline in earnings would make the market look quite a bit less attractive than some think it is.

In the chart below, we can see after-tax corporate earnings compared to the size of the economy. If you look at the right hand side of the chart – today – you'll notice that profits are as large as they've been since World War II. Although this may sound good, things have a tendency to move back toward the long-term average over time, which wouldn't necessarily make for happy times in the stock market. Looked at another way, corporations are taking a bigger piece of the economic pie than they have in the last 60 years, leaving less for the average Bob and Mary. Kind of makes you wonder who's going to buy all their stuff.

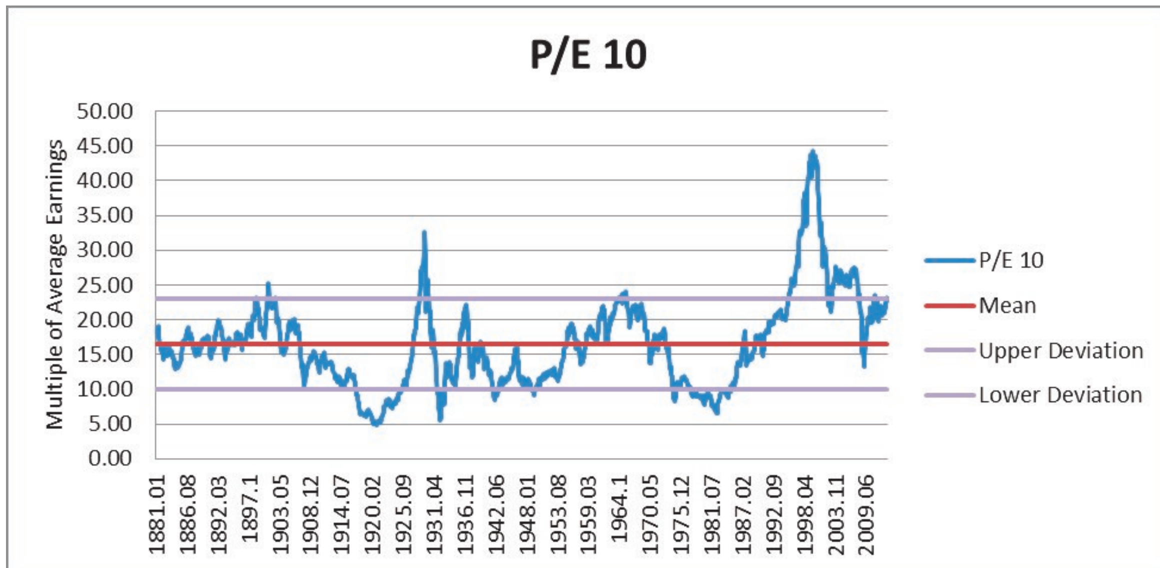


Removing Record Earnings From the Equation

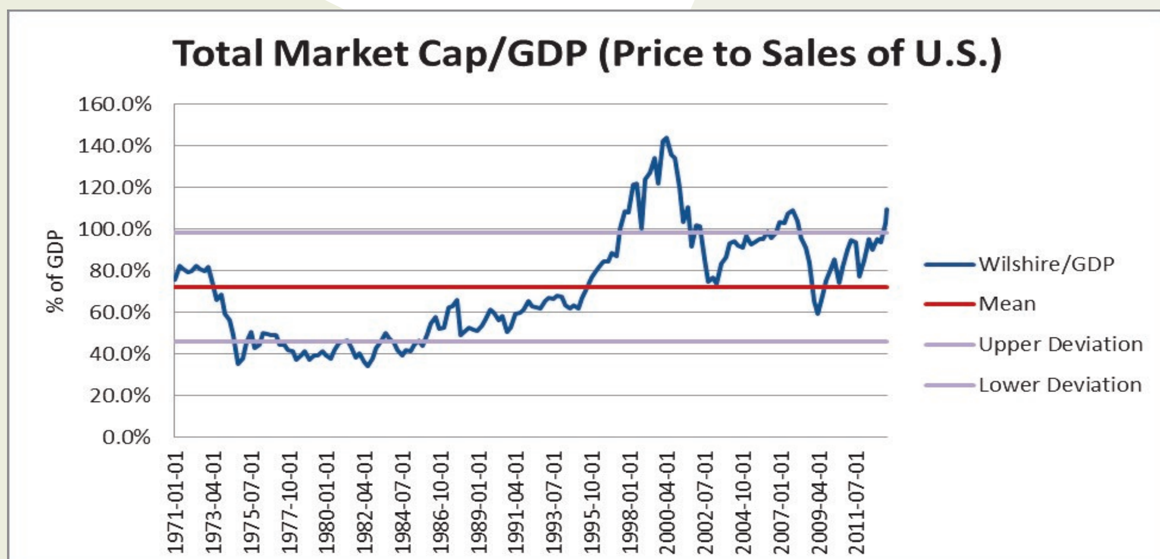
One of the best ways to keep short term trends —that are likely the exception rather than the "new" rule—from influencing our better judgment, is to look at things over a longer period of time. When we take the longer view, trends tend to get smoothed out as natural cycles have an opportunity to play out. When it comes to trying to figure out if the market is attractively priced, expensive, or somewhere in the middle, there are a couple approaches we prefer to use.

The first is to look at the last ten years of corporate earnings instead of only the last twelve months, a technique pioneered by Robert Shiller, professor of economics at Yale University. The idea is that this helps to smooth out the ups and downs in earnings

due to normal business cycles. Looked at this way, the price of the market relative to the average of the last ten years of earnings (10 Year P/E ratio) is a hair over 23 where its long term average is 16.5. That may not sound like a lot, but it's a pretty big difference statistically. The chart below shows just how crazy things got during the late 20's just before the Great Depression and in the late 1990's leading up to the tech bubble. The difference between the two periods however, is that now more than thirteen years after the peak of the last bubble, we're still at "above average" valuations. This hints to us that we may never have fully deflated from the previous tech and real estate bubbles before starting a brand new one. Although valuations have certainly been higher, when you consider how much time we've spent above the average without a serious adjustment back below the average, you start to wonder how long this can continue.



Another method that we prefer to use in gauging the market's attractiveness is looking at how much "stuff" companies within our economy are selling rather than earning. The thinking is that sales are much more stable and won't fluctuate quite so wildly as earnings as we move throughout the business cycle. When looking at the level of the U.S. stock market relative to economic output (sales), we can get a good sense as to where the market is in relation to its long term average. The chart below shows where we are today compared to an average relationship between the two over the past few decades. As you can see, we're well above the average Market Cap to GDP relationship which implies that stocks are priced quite a bit more expensively than they have been in the past.



This method paints a very similar picture as the previous ten year price to earnings analysis. If there's something that we're very confident about, it's that things tend to revert back to their long-term averages eventually. Sometimes it takes a while, but typically there's an ideal relationship that's established over time, based on logic and rational thought, that markets bounce around based on countless factors and variables. When we assume this stock market cap to GDP relationship will revert back to the average over the next 7 years (again it could be sooner or later, but it almost certainly will) and we assume average growth for the economy with the current level of dividends on stocks, the net return on the total U.S. stock market will be below 0%. We think these assumptions for the economy and dividends are more than fair, so there's ample room for a scenario that's a bit worse. Mind you, these types of disappointing returns are typically only made possible during bubbly overpriced markets – not during normal healthy ones.

Global Quantitative Easing (Money Printing)

In our opinion, easy money is the reason for this apparent bubble and will likely be the reason for the next stock market crisis. Rather than experience the downside of a normal economic cycle, our Federal Reserve and other central banks around the world have decided that a weak economy isn't acceptable. Further, they believe that a strong stock market is a necessary component of a properly functioning economy. So in an effort to return the world to prosperity, we're currently undergoing a tremendously vast and unprecedented monetary policy experiment. Either you're left feeling very supported and safe knowing that governments have your back, or you're shaking in your boots. The markets so far have chosen the former, but we don't feel quite so comforted. Call us skeptics, but we tend to err on the side of limited intervention in markets unless we're facing a serious and immediate crisis. We're over four years from one of those—that's a really long time to be flooding the world with cash. Ultimately, all this money tends to find its way into investments that may not necessarily be good long term investments—simply because it has to go somewhere. Just like when a 3-year-old eats a bucket full of Halloween candy, they feel sheer bliss for about 30 minutes, then spend the next 3 hours suffering from the crash. In the end, it's probably pretty clear that the 30 minutes of joy wasn't even close to worth it.

There's a good chance we're in our third bubble in 13 years, where we've historically only seen bubbles every 30-50 years. This to us is very strong evidence that loose money policy leads to excessive risk taking. The belief that central banks will ride to the rescue at the first sign of trouble only further encourages this complacency. Ultimately markets tend to seek equilibrium regardless of how much central bankers are trying to control them. The more out of whack they get, the greater and more painful the adjustment when it happens. This begs the question, what would the markets need to do to find that equilibrium if central banks could no longer intervene?

Conclusion

Our take-away from this is that not only will bubbles occur, but they'll occur with more frequency when central banks engage in policy that creates them before allowing previous ones to deflate fully. Ultimately markets need to ebb and flow naturally around fair value. The reason Japan's market fell so far for so long in the 90's was because the tremendous excess that built up over time had to be removed from the system. Intervention after the fact may have only delayed the inevitable. A healthy re-calibration of risk and return expectations has to occur before markets can begin to function properly once again. We saw a similar cycle in the 1930's after the stock market crash of 1929. This adjustment period and the magnitude of it were consistent with the size of the bubble leading up to it.

Not only has our central bank prevented the necessary adjustment from happening since the tech bubble over 13 years ago, it along with others around the globe is engaging in policy that may be creating another one right now. We've seen this type of movie before and we know how it ends. The difficult part is we don't really know when the credits start to role on this one, but we don't necessarily care to find out. It's a horrible ending that we could certainly do without. Investors need to be very careful not to get lured into a situation where wealth can be lost faster than it's gained. **We need to be cautious, diligent, and nimble until we find a more prudent opportunity to take risk. If there's one thing that's true about bubbles it's that they create just as much opportunity—if not more—after they burst. Patience will likely be handsomely rewarded. When it comes to navigating bubbles, it's often better to begin preparations months early than a week too late.**

What We're Doing For You

Considering our concern with where stock and bond prices may be headed next, and considering how well some investment classes have performed recently, clients often wonder how we intend to position their assets to make money should the run continue, or how we intend to protect their assets in the event of a market correction. Not knowing which will happen next, we do have to position parts of client portfolios aggressively enough to take advantage of continued growth, yet also conservatively enough to protect their wealth in negative environments. Here is how we have been executing on that balancing act:

1 **Taking advantage of a strong market.** Both year to date and over the last twelve months, client assets in our Core Diversified portfolios have appreciated to an equal degree when compared with their appropriate diversified benchmarks. Our Core 50/50 account has earned 10.29% net of fees from May 1, 2012 through April 30, 2013. The appropriate diversified benchmark has earned 10.62% over the same time period without any accounting for investment costs. Year to date, the same Core 50/50 account has earned 6.28% net of fees while the corresponding benchmark account has earned 6.49% without accounting for investment costs.

2 **Protecting against a downward market.** Within our Core Diversified accounts, we have increased our allocation toward risk reduction strategies which are designed to hold up better in challenging environments. Within our Contrarian strategy, assets have been positioned away from the riskier parts of the investment world since last fall. Within our Market Trend strategy, assets which were negatively impacted by the atypical trading environment have benefitted from the market's growth this month, but are tipping toward getting more conservative again. Additionally, we are monitoring the performance of certain market areas and will be ready if need be to replace one or two specific exposures before our next scheduled rebalance.

With allocations toward the Core Diversified, Market Trend, and Contrarian strategies, we have the ability to shift very opportunistically between equities and more defensive asset classes in navigating the current market environment. Our clients will be receiving a mid-year Core Diversified allocation update shortly that highlights our specific positioning within that strategy.

Important Disclosures

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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.