STRATEGIC
WEALTH
PARTNERS INC.
Partners in Protecting
Your Capital

Quarterly Report-3rd Quarter 2016

"OCTOBER: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February."- Mark Twain

On the Markets...

Bill is fond of saying that good judgement comes from experience, and experience comes from exercising bad judgement. To borrow from the [furniture] design philosophy of Florence Knoll, we believe that good portfolio design results from the ability to analyze and solve problems by organized thinking, deeply assimilated experience and imagination. Perhaps the most important lesson we have learned over several decades is this: Successful asset management requires a keen & primary focus on managing risk.

Notice that I did not say "creating returns." Because as we manage portfolios against the potential of long-term impairment of capital, the creation of returns becomes a natural byproduct of that effort. That is why we say, in all seriousness, that we are "partners in protecting your capital."

"Risk" can be especially difficult to evaluate properly. For example, bonds, particularly government bonds, have historically been regarded as conservative, low-risk investments. Mexico has issued 100 year government bonds with a 5.75% coupon. Now it is an interesting fact that as you lengthen the timeframe, the risk of bonds increases while the risk of losing money in stocks diminishes. But in the current, extremely-low interest rate environment, this issue was met with such enthusiasm that these bonds now trade at a premium, that is, for more than the initial offer price. As a result, the yield to maturity (presumably for your great grandchild) has dropped to 5.4%. While institutions have to own certain asset classes through all market conditions, we don't. And we feel you shouldn't, especially when prices are this detached from reality. Our perspective is necessarily shaped by our experience. By contrast, we remember U.S. Treasury bonds issued in 1990, with a 10 year maturity, paying 8.21%

We expect that as interest rates rise in a meaningful way, over time, they will again find a suitable place in our portfolios. But at present, there are very few bonds you want to own when the world thinks 5.4% is a good deal on century-long, emerging market paper. In our view, that “attractive” yield is unattractive because it thinly conceals extreme risk.

In the midst of this dramatic political season, we are reminded of James Carville, a leading strategist of Bill Clinton, who famously said that if reincarnation is real, he’d like to come back as the bond market because “you can intimidate everybody.”

Many say that the market is alternately driven by fear and greed; we disagree. It is all about fear: the fear of losing, and the fear of missing out. Like Thalia and Melpomene, the two masks of theatre, Risk has 2 faces: the loss of capital and the loss of opportunity.

It is also said that beauty is in the eye of the beholder. We won’t disagree here, but we are quick to add that it is just the same with risk. Ironically, those 1990 Treasury bonds were not a particularly attractive issue at the time. The U.S. equity markets had bottomed in 1982 and had more than doubled in value by 1990. Investors were chasing stocks, now, not bonds. They couldn’t know it at the time, but they were only 8 years into a massive 18 year secular bull market which would move the index more than 3X higher. Then, in 2000, about the time those 10 year Treasury bonds were maturing, the dot-com, overpriced market collapsed and it was another 15 years before the S&P 500 recovered its previous level, Jim Cramer, notwithstanding.

Enough nostalgia, let us return to the present. We are currently in year 7 of a bull market which has recently become the 2nd longest bull in U.S. market history. Recently released data from Putnam Investments shows that from 1949 until now, the average bull market has averaged 44 months. This leads many to argue, as they have for several years now (!) that the market is on the brink of collapse. But bull markets do not come with a time-stamped, sell-by date.

Instead, they follow their own cycle. The challenge, of course, is to adequately identify the current (approximate) location within that cycle. Unfortunately, as Google maps and navigation have no apps for this function, we rely on several co-relevant indicators that have proven to be truly useful.

There are technical indicators we monitor: moving averages which gauge momentum and rate of change, and measures of market breadth which identify the internal strength of the broad market, and these are far more revealing than the superficial price change of an index. But if you have read this far, you deserve something much less wonkish. So let us just say that from a technical standpoint, we are getting predominantly green signals, with some yellow “cautions.”

We pay keen attention to investor sentiment as a “contrary” indicator. Sir John Templeton said it best- “Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." Bear markets typically begin following a sharp period of euphoric bullish sentiment. In the past 3 bear markets, we have seen bullish sentiment readings exceeding 55% within 12 months of the market top. While some sentiment surveys measure solely bulls vs. bears, the AAII Weekly Investor Sentiment Survey measures bulls, bears and neutrals. This means that in a perfectly even market, each would have readings of 33%. Readings above 55% are quite rare. Where are we today? Current market sentiment is predominantly bearish with less than half of the bulls present as in past market tops. The most recent sentiment read is only 24% bullish.

In short, if you will pardon the pun, there is no euphoria. Quite the opposite, in fact, as bearish sentiment in the most recent week registered at 37%. And as has been the case for more than 18 months, the largest percentage of active investors remain confused/uncommitted. This is corroborated by other sentiment indicators as well. Despite the S&P 500 trading within 2% of its record high at month's end, Citigroup's Panic - Euphoria Model had sentiment dip back into the negative 0.21 "Panic" zone. And the most recent CNN Fear/Greed Index registered "37" - where a reading of 50 is the neutral mark on a scale of 1-100. There is still a deep and pervasive lack of investor confidence, a nervous distrust of the market itself, and a persistent anxiety- a legacy of the painful market declines that traumatized investors in 2000 and 2008.

As a result, we are maintaining an alert, but cautiously optimistic profile. There continues to be a severe disconnect between the state of the overall U.S. economy and the strength of our equity markets. While the market has more than doubled in value since its 2009 trough, and is currently trading within near-reach of all-time highs, the overall economy in general, and average Americans, in particular feel left behind. Prevailing data on consumer spending throughout this "recovery" has been disappointing, largely, we suspect, due to weak or non-existent real-wage growth. The country has dramatically shifted from a manufacturing economy to a service economy with lower average wages. Global competition is part of the story; so is the impact of a progressive technological revolution which increases productivity and eliminates jobs. Uber, anyone?

The ongoing trend of weak industrial production continues and industrial output contributes less to GDP; business inventories and sales remain weak; Import and Export price indices are still deflationary. The Federal Reserve, in a report issued in mid-September, explicitly states that "America has never suffered a longer decline in US Industrial Production without being in recession... "

Has the behavior of the economy and the markets been distorted by aggressive intervention by the Federal Reserve, as some complain? Perhaps, but as Eddy Elfenbein opines, "What the stock market wants is actually quite simple—money. Or more specifically, the net present value of all future cash flows. A strong economy obviously helps, but even the relationship of the market to the economy isn't always so close. The markets rely on a mystical combination of faith, confidence and patience."

The fact that the current bull market has lasted this long and now sits near all-time highs can have a powerful if irrational effect on the psyche of an investor, creating fear of an

imminent correction, and the pain-avoidance for another bear market. But as Peter Lynch, the legendary manager of Fidelity Magellan observed long ago, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."
Neither hope nor worry has ever proven to be a successful investment strategy. We continue to monitor and re-evaluate your holdings on a daily basis, with confidence in our fundamental process. Once the proper goal of your portfolio has been chosen- the appropriate mix of securities, selected to achieve income, growth and defensive hedging- the operative question becomes: which assets shall the portfolio hold and in what proportion? The critical skill in portfolio management is in establishing and continually re-balancing that mix of assets in order to prudently manage risk.

The Fed not only left interest rates unchanged in September, they lowered their dot-plot, rate forecast by 30% for the next 3 years. This was quite sobering and completely unexpected. They meet again in November, but we feel it is unlikely that they decide to raise rates until December, after the election.

Looking out over the next 3-6 months, we believe the direction of the market will be guided by the outlook for both earnings and the economy, as well as the state of Fed policy. The 2016 election is shaping up to be historic, similar to the 57 previous ones we've had going back to 1789, although, arguably more histrionic. For what its worth, the average stock market return during a presidential year is 11.2% and the median is 13.5%. Of the 22 presidential elections since 1926, stocks were down in only 4 of those years; 1932, 1940, 2000 and 2008.

So we remain vigilant in this season of uncertainty, appreciative of your trust and proud of the partnership we have with you, our clients and friends.

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