STRATEGIC WEALTH PARTNERS INC.
Partners in Protecting Your Capital

"The function of economic forecasting
is to make Astrology look respectable."
-John Kenneth Galbraith

Quarterly Report- Midyear 2014

On the Markets...

According to the philosopher Mike Tyson, "Everyone has a plan- until they get punched in the face" -to which we might add- "or stunned with an unexpected kiss!" -in either case, one is left dazed and confused, and in need of a new plan...

-In all, a fitting description of this shape-shifting market, this has consistently defied consensus expectations- kissing only the alert and patient investor who ignored the forecasts of "the experts," (a flamboyant and rather immodest club which we have never thought to join.)

U.S. equity markets have continued to move higher for the last 5 years, since bottoming in March, 2009, following the global debt crisis and the Great Recession. We have been neither cheerleaders nor doomsayers, but resolute and disciplined tacticians, and we remain cautiously optimistic and constructive on the market's course.

The chorus of Cassandras* confidently predicting a painful market decline has been loud, relentless and increasingly difficult to ignore. Here is what they say:

> -the market is already up more than 185% since the March 2009 trough, despite a lagging economy.
> -the market is trading at historic highs - driven to these levels only because of the intervention of the Federal Reserve.

*In Greek mythology, Cassandra was the princess of Troy. Apollo gave her the power of prophecy in order to seduce her. When she refused him, he gave her the curse of never being believed. - The Greeks knew something about irony.

-the market is overvalued because of risky & speculative excess- a result of investor complacency & overconfidence. This can be seen in the irrational prices attached to glamorous growth-story stocks like Tesla, 3D printing companies and social media stocks, like Facebook, Twitter & Linked-In.

-the "bull" market has run longer than 5 years, and has not experienced even a typical 10% correction in nearly 3 years- despite historical averages.

CONSEQUENTLY: the end is near & it will all turn out badly. The clock has been ticking for a while now and the next bear market is overdue.

Let's be clear. Historically, bear markets have been the result of either a recession (2 successive quarters of economic contraction) or a financial crisis. **

The business cycle has not been repealed, but the leading indicators of an economic recession have not emerged; no doubt they will, but credible quantitative analysis calculates the probability of a recession in the next 9 months as no more than 5%

As to an impending financial crisis, the present state of our credit markets is reassuring. Corporate balance sheets have low debt, refinanced at low rates and are heavy with cash. Consumers have significantly deleveraged, home prices are in recovery & all categories of borrowing have declined with the exception of student loans. Banks have been recapitalized (at generous, taxpayer expense) and must comply with more rigorous oversight & capital requirements.

We see no evidence of a bear market on the near-term calendar and we continue to anticipate, but not to fear, an inevitable market pullback, on the order of 5-10% which we would regard as normal. As Peter Lynch, widely regarded as one of the most consistently successful portfolio managers of all time, pointed out, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves."

**The crisis usually reflects severe weakness in the banking system, involving excessive debt levels, over-extended asset prices driven to unsustainable levels- against which significant loans have been made- unsupported by intrinsic valuations, or, mass panic selling of a richly-priced, widely owned asset class. Our most recent thrill-ride in this carnival (2008-2009, with lingering after-effects) neatly managed to capture all 3 of these elements.

We view the market as fairly valued at these levels. Naturally, there will always be some companies whose prices reflect an excessive optimism that would require many years of revenues to adequately “grow into” and justify the current stock price. Although some have made the comparison to the overheated market of the late 1990’s, we do not see the same alarming levels of M&A activity or IPO activity in 2014.

However, we do see many reasons for continued optimism-

-U.S. companies are raising earnings guidance. If critics flinch at high p/e multiples we recognize that these are backward-looking and are reassured by expected earnings going forward which look much more reasonable on a historical basis.

-Improving employment trends are a critical element in a full economic recovery and the last 5 monthly reports reflect that. Fewer people are unemployed despite more people entering the work force *and the number of people not counted in the unemployment rate because they have become so discouraged that they stopped looking for work, but would like a job* -also decreased.

-Auto sales have maintained a positive trajectory for the past 18 months confirming a strengthening consumer confidence. This is essential since consumer spending represents roughly 2/3 of the U.S. economy.

-Housing is a trailing indicator, but provides an essential read-thru to the health of the economy. Concern has been raised about its slow recovery and attention has focused on the reduced rate of new household formation. Demand is stimulated as young people traditionally look to move into an apartment or purchase a first home. Contrary to widely mis-reported census data about “boomerang kids” and Millennial’s still living with mom & dad, it now appears that the statistics have been distorted because they failed to identify that “...almost 1/2 of young people ‘living with their parents’ are in college...including those in campus housing...” according to a recent article by Derek Thompson in The Atlantic. ***

-The bears are correct when they identify our Federal Reserve and central banks around the world as positively influencing equity markets.

***This brings to mind Mark Twain’s oft-quoted observation that “-there are lies, damn lies, and statistics.”

They have adopted an aggressively accommodative monetary policy and artificially pegged interest rates (including long-term rates) at extremely low levels. They have deliberately created an environment in which individual and institutional investors have been herded into riskier terrain in which to hunt for returns. As Walter Wriston's, the former Chairman of Citigroup declared, "Capital will go where it is wanted and remain where it is well treated." Investors who formerly owned CD's and bought conservative bonds have seen their principal erode and have reached for "yield" in equity securities.**** Corporations have been actively buying back their own stock. Last year alone, these corporate purchases totaled almost half a trillion dollars, with another $160 billion in the first 3 months of this year.

-Now it appears that a third source of substantial demand has surfaced. A report released last month by the Official Monetary and Financial Institutions Forum (OMFIF) reveals that central banks are themselves following the crowd into riskier assets in an attempt to earn greater returns by allocating reserve capital to stock purchases. David Marsh, co-founder and Managing Director of the OMFIF described this as an investment policy that had formerly been pursued by a limited number of the largest central banks. However he described the practice spreading widely and at an accelerating rate- an observation confirmed by the Bank for International Settlements which includes 60 central banks from around the world. "On a world-wide scale," Marsh said, "this is relatively new...and therefore really worth taking heed of...because it appears to be part of a longer-term trend...central banks tend to be rather herd-like creatures. They will look at these markets for a number of years...and then once they've discovered a taste for these markets, they will stay there."

All markets run in cycles and interest rate cycles have a particularly long duration. The last cycle began with rates peaking in 1981: 33 years ago. All of which suggests there could be prolonged, substantial support for the equity markets as massive capital is committed by large, committee-driven, group-think institutions. That would certainly provide significant and sustained buying power to fuel a secular bull market. Secular bull markets, by the way, run in cycles too. The median length of a secular bull market is 200 months, which is more than 16.5 years.

****Evidence of this is right at hand: Utilities have been the best performing sector year-to-date, and by a substantial margin: they have rallied over 16% and trade at a richer multiple than the market itself.

But we are not in the prediction business; we are in the observation and analysis business- because our primary objective is managing risk.

So here is what we see. Stocks are still under-owned, and this despised bull market continues to engender skepticism and distrust. We are comforted by this contrary sentiment indicator, and by market action. For 5 years now, every pullback has remained orderly and small because it drew in buyers which pushed levels higher.

The market technicals remain encouraging. There is broad sector participation, not narrow leadership, and financials are finally beginning to act well again.

We anticipate that interest rates will rise as this would validate our expectations for improving economic growth trends. We are comfortable that stocks and bonds can both move higher as long as the benchmark10 yr. Treasury stays below 5%. It currently trades at 2.55%.

The markets lend themselves to complexity and confusion. Try not to be distracted with media comments which are designed to draw you in with “experts” and attention-getting narratives.

In your portfolios we continue to hold large, U.S. multinational companies with strong global brands that pay nice dividends. We are adjusting the allocation to increase our exposure to better valuations and improving growth overseas. We continue to add income and portfolio protection with option premium, where appropriate. We continue to re-examine, re-evaluate and re-adjust. We remind ourselves of the remarks of General Eisenhower- “In preparing for battle I have found that plans are useless but planning is indispensable.”

If we experience the market correction that we fully expect, we will respond tactically to become more defensive and protect the portfolio. A 100 point drop in the S&P500 will feel quite alarming- especially after a prolonged rise in a low-volatility market- but it would still be a historically mild pullback on the order of 5%. Markets do not go straight up and we must be prepared for that.

We actively encourage your questions, comments and suggestions. We want to be helpful and informative. We love feedback. And we remain committed to you, our partners.

Thank you,

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