Semiannual Market Update & Outlook
Jan, 2016

There's a time to fish, and a time to hang your nets up to dry…

~Chinese proverb

› The credit and economic cycle are showing signs of peaking
› A shortage of US dollars is wreaking havoc on global markets and creating deflationary pressures
› Why we're actually rooting for a volatile 2016

Dear Clients of RCN Wealth Advisors,

Happy New Year! I hope this letter finds everyone happy and healthy. I would like to say thank you again to everyone for entrusting me with your financial future. I absolutely love what I do and I have you to thank for that.

This letter is largely going to highlight the biggest issues that the global economy and asset markets face, mainly because I feel it's important you understand the precarious environment in which the world finds itself today. It will help to explain the divergence in performance of certain asset classes as well as certain types of companies. It's important to keep in mind, though, that risk and reward are opposite sides of the same coin. Today's risks are creating tomorrow's investment opportunities and since we are long-term investors, we need to remember that short-term volatility is the price we must pay for long-term success. My job is to avoid the long-term catastrophic risks while minimizing the impact of short-term volatility. We also do not know which path the world will take in the years ahead so it's important to remain positioned for multiple outcomes while maintaining the flexibility to adapt, as I will discuss below. With that said, let's get to it.

2015 was a difficult year for the asset markets in general. On the surface, it seemed like a relatively quiet year but if you dive a little deeper you'll see there were some vicious undercurrents. Large-cap US stocks were up about 1.25%[1] (including dividends), small-cap US stocks were down approximately 4%[1], US bonds were up about 0.5%[1], and anything international or commodity based was down anywhere from a little to a lot! Some pretty big cracks on the façade emerged in the second half of 2015 and I think 2016 is going to be a year of transition with some big moves in store for the asset markets.

Some impactful events unfolded this past fall, including:

1. The uptrend in the stock market ended, which I consider transitioning into Phase 3 (see my July, 2015 letter for more on this)

2. China ended its currency peg with the US dollar which ultimately led to the 10% drop in the stock market in one week that we experienced in late August. This was one of the big risks I highlighted in my January, 2015 letter.

3. Some of the best leading economic indicators, like New Orders, Backlogs, Inventory-to-Sales ratio, and the Purchasing Manager's Index, took a turn for the worse.

4. Asset market internals broke down in the form of widening credit spreads, especially in the junk bond markets, as well as negative swap spreads. These are signs of stress and an unwillingness of investors to take risk.

[1]Source: Morningstar

All of the above, historically, have been reliable precursors to a falling stock market. They are signs that the economic and credit cycles are coming to an end, and it's time to bunker down, preserve capital and wait for either more attractive stock valuations or an improvement in the signals mentioned above.

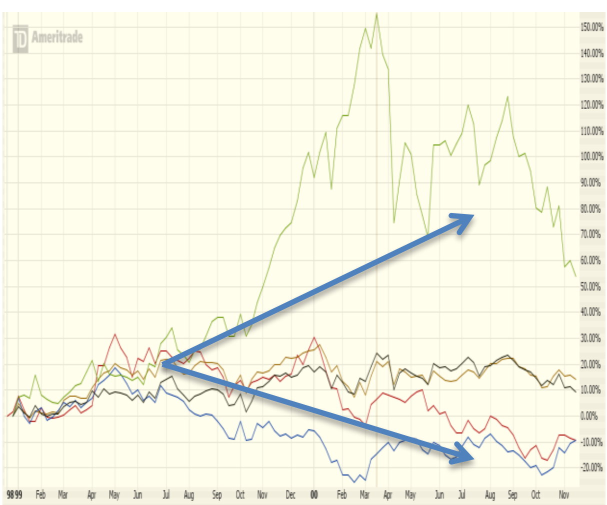
Most, if not all, of the stresses that are popping up in the global financial system can be drawn back to one root cause - **there simply aren't enough US dollars in the global financial system**. The Federal Reserve ended its Quantitative Easing programs at the same time the shale/energy boom was gaining steam in the US which meant we were buying less foreign oil. Both of these led to a quite significant drop in the supply of US dollars entering the global financial system, outside of the United States. This shortage of US dollars is causing the value of the US dollar to rise since it has forced many foreign entities to scramble to buy-up as many dollars as they can. Since most assets, like commodities, are priced in US dollars, a rising dollar leads to falling commodity prices. These are the deflationary forces that have been at work the past few years, and especially so since **July, 2014** (remember this date). As commodity prices fall, producers and miners need to cut back, which then hurts the manufactures and shipping companies, and right on down the line to where global trade is greatly affected.

This is why anything and everything related to commodities, real assets, manufacturing, shipping, and trade has been thrown out the window and underperformed dramatically. All of the money that had been invested in those areas has been squeezed into the few remaining areas (companies) that are still experiencing any growth at all, namely large cap tech (Facebook, Amazon, Google, Microsoft, etc.) and a handful of consumer discretionary related names (Starbucks, Disney and Home Depot).

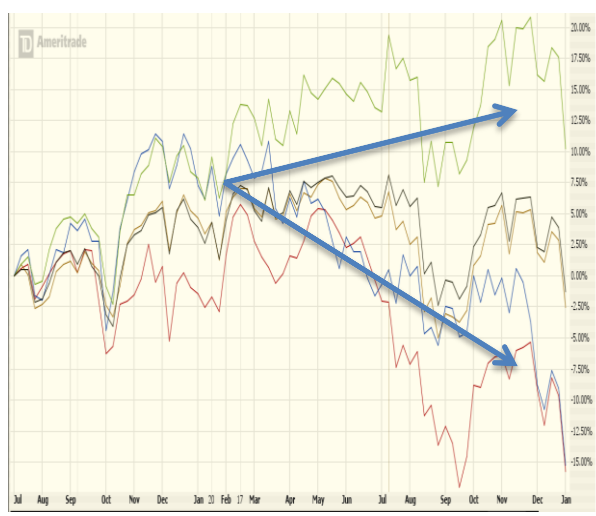
2015 was very similar to the late 1990's, when the manufacturing side of the economy began an early recession following the 1998 Asian Currency Crisis and rising US dollar, but technology stocks kept the party going into 2000. This can be seen in the chart below, where technology stocks (green) went ballistic as everyone funneled their money into this one sector, while you were considered a fool for owning anything else like Materials (red) or Transportation (blue) related companies, with the broad-based averages in the middle (tan and black). I've selected Materials and Transports because they tend to be very prone to early slowdowns in the "real" economy.

Fast forward to today and you see a very similar picture. Tech companies, and specifically the largest ones, have single-handedly held up the broad-based indices while anything related to the industrial and manufacturing based economy are being thrown out as garbage. It's a value investor's nightmare, which is why you can find news stories almost every month about how Warren Buffett has lost his touch. They were saying the same things in 1999 since he didn't chase the tech bubble but guess who had the last laugh…

1999 through 2000



July 2014 through Dec. 2015



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Flat or mildly down years are okay, should be expected and are easy to recover from so I'm not necessarily concerned with what your portfolio return was in 2015. It's the big down years that are so important to avoid since they can take years to recoup. The risks have been building the past two years and lately certain reliable warning signals have been popping up to where I believe it's more important to preserve portfolio values than climb out on the limb of risk by reaching for a little extra yield/return. More importantly, there's a perfect storm of sorts on the horizon, and not of the good kind. I haven't mentioned this yet because, for the most part, it has stayed far out at sea. Over the last six months though, it has become dangerously close to shore, and if it hits it could have the potential to force a change in the design of our global financial system within the next few years.

This might sound very alarming, and to a degree it could be, but it has actually been quite common throughout history. The last major change occurred during the lifetime of some of you reading this letter. It was the Bretton Woods Conference in 1944 where world leaders agreed to adopt a new financial system **with the US dollar at the heart of it as the world's reserve currency**. This is the key to understanding the current issues the world faces. It's also important to understand that our financial system is not something where every last detail was planned with a purpose and it certainly is not fixed, but rather it evolves and morphs over time with new pieces added as short-term "fixes" each time we experience an economic crisis. Each of the crises over the past 50 years is the effect of a flawed system. And each one grows bigger than the last as the system grows and new flaws are exposed. If this "perfect storm" hits, it will make 2008 seem like a walk in the park as none of the issues have been fixed but have only compounded over the past seven years.

The first flaws became evident in the 1960s culminating with Nixon ending the gold standard in August, 1971 to "fix" the issue. This devaluing of the US dollar bought us enough time to make it to the 1990s where emerging market currency crises emerged, including the Mexican Tequila Crisis of '94 and the Asian Currency Crisis '97/'98 – all caused by the US dollar. To deal with these, the Federal Reserve lowered interest rates and pumped the system with liquidity. **You see, at the heart of the issue is that the rest of the world is effectively always short the US dollar since it borrows in, and thus owes, US dollars.** When you are "short" something, you benefit if it goes down in value but you suffer if it rises in value. The only way to reverse a short position is to buy the security that you are short (i.e. the US dollar). From the Fed's perspective, the best way to make the US dollar fall in value is to increase the supply of dollars. This is how it has responded to each crisis of the last 20 years. But each time has only been a short-term fix which has then led to and created the next asset bubble/economic issue, each one bigger than the last. This is where we stand today with the world dramatically short the US dollar, another asset bubble purposely blown by the Federal Reserve in hopes of creating a "wealth effect," and the US dollar beginning to rise fairly rapidly causing severe pain for the rest of the world as they scramble to buy as many dollars as they can.

Below is a table to summarize the recent and potential drivers of the stock market. In short, rational analysis has said to be very cautious of stocks for the past two years, but rational analysis has been wrong because of the unprecedented intervention by Central Banks and there's no reason to believe that it won't continue in 2016. With that said, it would be foolish to ignore the warnings of rational analysis and not plan accordingly…

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Factors Pushing Stocks Higher	Recent Trend
Central Bank Quantitative Easing (QE) Programs	Ended in the US but still increasing in Europe and Japan; US could renew if the market and/or economy stumbles
Central Bank Buying of Stocks	Increasing each year and likely to continue in 2016
Sovereign Wealth Fund Buying of Stocks	Pace slowing and they could become net sellers with lower oil revenues creating budget shortfalls
Corporate Stock Buybacks	Likely to remain positive in 2016 but pace should be less than 2015

Factors that Could Send Stocks Lower	Recent Trend
Rising US dollar, Chinese Currency Devaluation (global deflationary pressures)	Accelerating
Deterioration in the Economy	Leading economic indicators like New Orders, Backlogs and Inventories all pointing to a severe slowdown, hurt by a **rising US dollar**
Loss of Investor Appetite for Risk Taking	Credit spreads have been widening for all grades of corporate bonds and the stock market seems to have broken the uptrend
Global Economy/Trade Conditions	Continues to deteriorate from the **rising US dollar**

The US stock market was essentially flat in 2015 so odds are it will not be flat in 2016. **I currently have you positioned to benefit as long as the stock market moves in either direction**. If socks rise, great. If they fall, even better. I just want to see the stock market move one way or the other, and the bigger the move, the better. Being indifferent to the direction leaves us in the wonderful position of flexibility, ready to capitalize on rising volatility.

At this point, most stocks are simply too expensive to be considered a reasonable investment given the underlying fundamentals and economic trends. Over the last year, I've reduced the amount we have directly invested in stocks. However, given that the factors that have been pushing the stock market higher are still somewhat in place, we want to benefit if the market rises. In place of the stocks I've sold, I have purchased call options that maintain exposure and benefit from a rising stock market. We also own put options, which were purchased this past fall, that minimize the impact of a drop in the market. These options run through the end of 2016 but I do have the ability to sell them at any point if I think it's a good time to do so. For example, if this spring we see a rally in the market but then signs that we're topping out, I can sell the call options to lock in the profit - I don't have to hold them until expiration in December. The worst case scenario for us, and it's not even that bad really, would be for the market to not move at all and post another flat year. In this scenario, our options lose value while our only gains come from dividends and interest (no price appreciation).

A major concern with the investment markets in general is that the Fed has pulled forward much of your future returns and squeezed them into the past 6 years by ~~manipulating~~ pushing asset values higher. There are a handful of valuation techniques that historically have worked very well to project average annual returns in the stock market over the following 10 to 12 years. Some of these include the size of the stock market relative to the size of the economy (Warren Buffett's favorite), Shiller's Cyclically Adjusted Price-to-Earnings ratio (CAPE) which looks at earnings over a ten year period to encompass the complete economic cycle, and John Hussman's size of Non-financial Stocks relative to Gross Value Added. **At current valuations, all are currently projecting approximately a 1% average annual return for US stocks over the next 10 to 12 years**. That is going to make it very difficult to reach your goals when we're hoping for portfolio returns in the neighborhood of 6% to 8% a year. You may be wondering how the market can essentially be flat over a 10 to 12 your period. Just think back to the 2000 to 2009 decade. We're likely going to see some big ups and big downs, most likely ending where we started. We're now at the point where I'm more focused on preserving portfolio values, avoiding risks and waiting for more attractive opportunities. For your benefit, I'm hoping the stock market falls and I hope it falls a lot. Since we are hedged with put options, you should remain relatively insulated from any severe losses, meaning the bigger the drop, the better! This doesn't mean you won't lose money in the short-term, but that you will lose a lot less.

I'm often asked why we don't sell all of our stocks if I'm concerned that the market may fall. To answer this, on December 11th, I wrote a blog post which I think is important understand so I'm going to reprint part of it below. It's discussing the difference between trading and long-term investing, and as a reminder, we are long-term investors looking for good value, akin to Warren Buffett. What is most important to me is for you to be able to achieve your financial goals, many of which are very long-term (i.e. not running out of money in retirement). The absolute best long-term investments are stocks, but only when you're able to make the investment at a reasonable price. Here's the excerpt:

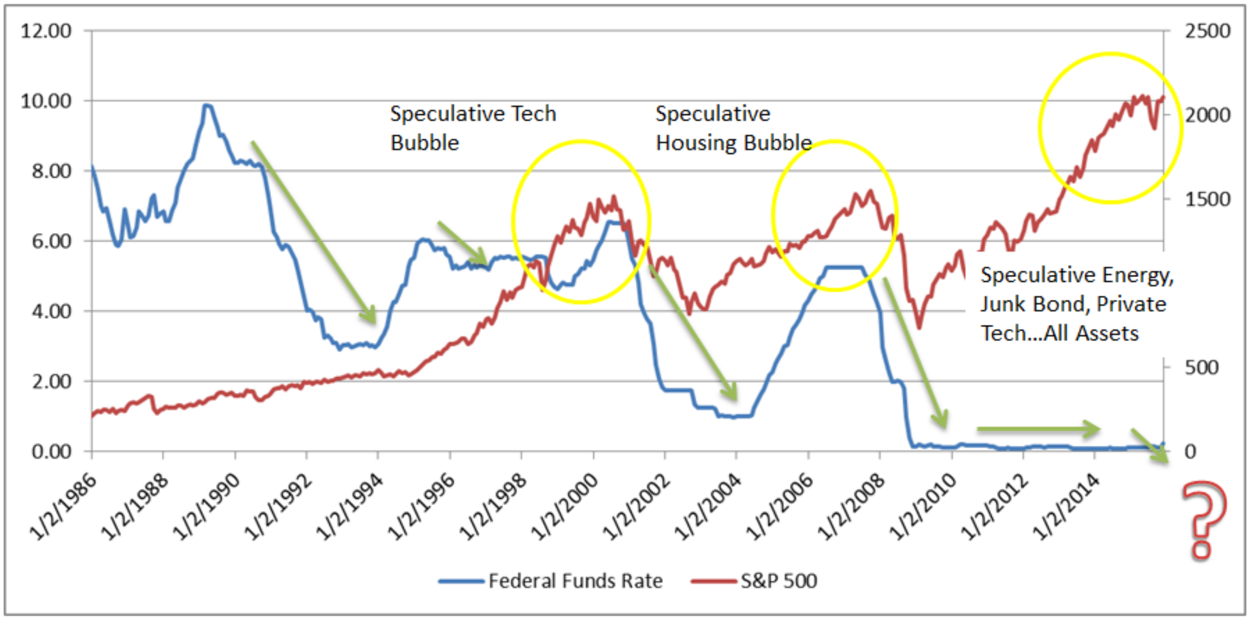
> There's a big difference between trading and investing. When investing, you invest in *businesses*, not *stocks*. The stock is simply the mechanism which represents the ownership of the business. In trading, you buy something "because it's going up." Most people want the stock market "to go up." This is a trading mentality and it's the enemy of sound investing. It also helps explain why so many people "buy high" and "sell low." They chase things that are "going up" and panic and bail on things that are "going down." When in reality, a falling stock represents a better deal when making an investment so long as the underlying *business* isn't falling apart. The shares still represent ownership of the same underlying company. The only difference is the price you pay, and when it comes to investing, **the price you pay determines your future return**. Said another way, if you buy an overvalued, expensive security (buying "high"), it's more than likely going to lead to poor investment returns (possibly negative) over the long haul. If you buy an undervalued security, it's probably going to lead to strong future returns.
>
> When working with my clients, we always start with their financial plan and then tailor their portfolio to match that plan (theirs goals, spending, etc.). This means we're running projections out 30+ years while making assumptions about the geometric average annual rate of return that we'll be able to earn. The issue I have with most stocks today, and certainly the broad-based US market as a whole, is that they're trading at very expensive valuations. Mathematically speaking, it's going to be difficult to earn the assumed rates of return built into my client's plans at current prices (i.e. current valuations are predicting low future returns over the next decade). A company's future profit potential is what it is – it's just a question of what you're willing to pay to have an ownership right (shares of stock) to those profits. When buying stocks today, you're simply paying too much in relation to the amount of future profits. This is why I want the stock market to fall. I would like to buy ownership of all of the great companies out there at *cheaper* prices. It will improve the likelihood of success of a financial plan. That is, as long as you're not already fully invested and unable to take advantage of lower prices.

The takeaway is that we don't sell *stocks* because they might fall. We sell the *stock* of a *company* if that *company* is seeing its business deteriorate. The companies that I have you invested in all have very bright futures so I want to remain a long-term owner (investor) of them. I'll manage short-term volatility through other means, like using options, and if the stock of our great companies gets knocked down enough, I'll gladly buy more.

The Current Market & Economic Environment

Here's a chart to illustrate the effect of Central Bank intervention over the past 30 years. The blue line shows the short-term Federal Funds interest rate and the red line is the S&P 500 Index. Extremely easy monetary conditions (i.e. cheap financing in the form of low interest rates) will always encourage speculation. If you make the cost of capital cheaper than it otherwise should be, a company is able to take on higher risk because they can accept a lower return but still remain profitable. This leads to debt-fueled asset booms that unfortunately never end well. After the past two market crashes, the Fed has responded with even easier monetary conditions than the last trough. Each cycle requires even more force to re-inflate because the marginal effectiveness continues to drop. During this current cycle, interest rates at 0% weren't even enough. The Fed then had to respond with 4 different Quantitative Easing (QE) programs of direct asset purchases to keep things afloat. The million dollar question now is: What will the Fed have to do during the next down-cycle? Next stop, negative interest rates!? Bonjour, Europe! As well as some additional QE added in for good measure, I would bet.

Federal Funds Interest Rate (blue, left-hand scale) vs. S&P 500 Index (red, right-hand scale): 1986 to Present



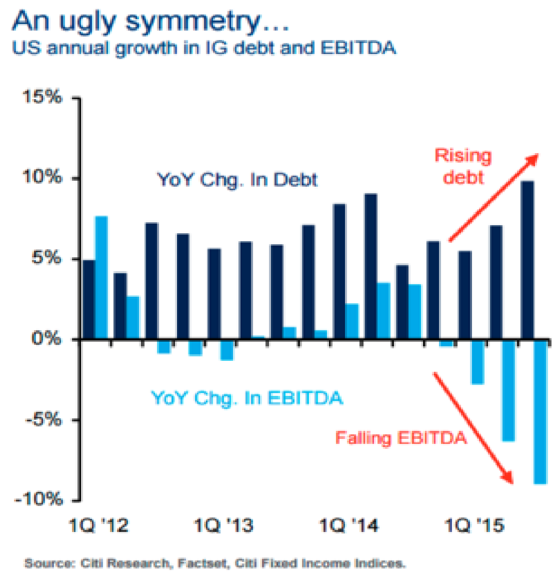
We've squeezed every last drop out of the system during the last 30+ years by lowering interest rates, accumulating debt, monetizing assets (i.e. QE programs where Central Bank's buy assets by printing money) and essentially pushing off having to actually deal with the problem of a flawed financial system. Our government leaders and Central Bankers have chosen the path of a death by a thousand cuts. That is, to slowly debase currencies and inflate away debt over time because it's not as noticeable by the general public. The world is now under so much debt that this slow approach is no longer working. It has successively lost its effectiveness like a person that has taken so many antibiotics that they're no longer effective. The only course of action remaining, in my view, is a coordinated reset where all currencies are cut simultaneously through the upward re-pricing of assets. This is what they did back in 1933, when we were on the gold standard, at the depths of the Great Depression. President Roosevelt signed Executive Order 6102 "forbidding the hoarding of gold coins, gold bullion, and gold certificates within the United States." After everyone turned in their gold at a price of \$20.67/oz., the government re-valued it to \$35/oz. which was essentially an overnight debasement of the currency. This is attractive to policy makers because it has the effect of turning back the clock a few decades because you've essentially cut your outstanding debt (because it is priced in dollars that are now worth less) by the percentage of the reset, thus allowing them to continue their ~~reckless spending~~ thoughtful policy. There's always a cost though, and the cost is paid by those unfortunate people not in the know. In this event, you want to own as many physical assets as you can – both true ownership (like real estate) as well as equity ownership (stocks) of companies that own physical assets. We won't get to this point until we've already exhausted all other measures in the Central Banker's toolkit but it's starting to feel like we're getting close. Negative rates in most of Europe and billions of dollars of QE each month is pretty extreme. These things tend to take years longer than one would imagine though so I wouldn't expect something this drastic for another few years at least. First, we would have to see asset values fall significantly and the markets lose faith in our Central Bank's ability to "manage" the economy.

Corporate Activity, Mergers & Acquisitions (M&A), and Debt

Another sign of concern is to watch the level of corporate activity, like Mergers and Acquisitions (M&A), as well as the amount of debt being issued. Debt is a funny thing. No one seems to mind it during the good times but any boom fueled by debt will end badly. And Wall Street always has a short memory. In 2006 and 2007, the top of the last cycle, corporations issued \$700 billion of new debt over the two year period. 2015 alone is slated to be more than \$1 trillion of new issuance – 50% more than the 2-year period at the top of the last cycle.

Here's a chart illustrating the recent trend between debt issuance by Investment Grade rated companies and EBITDA (Earnings Before Interest Taxes Depreciation & Amortization). EBITDA is a way to evaluate the earnings of companies on a level playing field. You can basically think of it as pre-tax gross profits before tax deductions. As you can see, EBITDA has dropped quite a bit in 2015, but the debt train keeps on rolling!

YoY stands for year-over-year percentage change (i.e. growth).

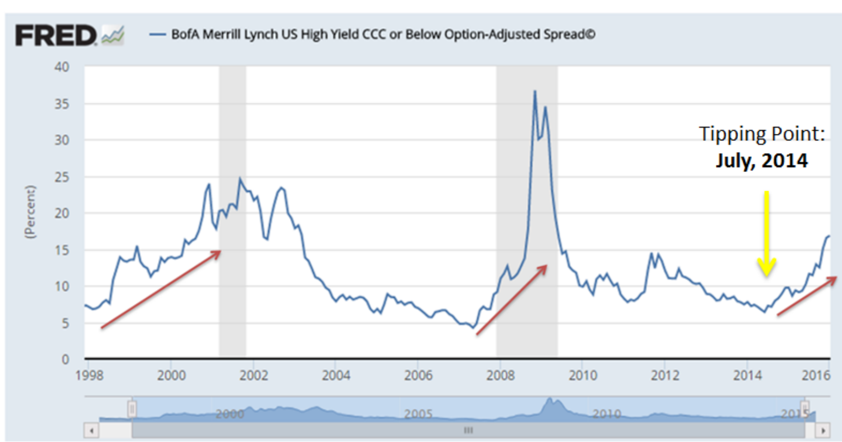


Much of this debt has been taken on to buy back stock in an attempt to improve year-over-year earnings per share since revenues and earnings have both fallen this year. I'm very concerned about companies with too much debt, something I've written a lot about on my blog over the last year, and have sold all companies that I think are going to be facing some tough times ahead. At this point, **more than half of the companies in which you own stock have net cash on the balance sheet** - meaning either no debt or more cash than debt giving them the ability to pay off the debt in full if they wanted to.

Economic Deterioration Warning Coming from Junk Bonds

Junk bonds are the lowest rated corporate bonds because the underlying company borrowing the money is usually in a very tough financial situation, making it a high risk to lend them money. Companies that are strapped for cash or have too much debt are usually the first ones to run into trouble and face the risk of bankruptcy once the economy begins to slow. Therefore, investors are quick to pull the shoot at the first sign of the economy slowing which makes junk bonds a great indicator of both economic weakness ahead and a waning appetite to take risk by investors. Since bond yields and bond prices move in opposite directions, rising yield spreads (the difference between the yield on Junk bonds and the yield on Treasury bonds of a similar maturity) indicate that investors are nervously selling their higher-risk Junk bonds to buy a safer asset like Treasury bonds. Notice how spreads will widen/increase as the credit cycle and economy begin to slow, indicating a recession is probably right around the corner (shaded areas indicate recession, which usually means bad news for stocks).

CCC-rated High Yield (Junk Bond) Spreads over Treasury Bonds



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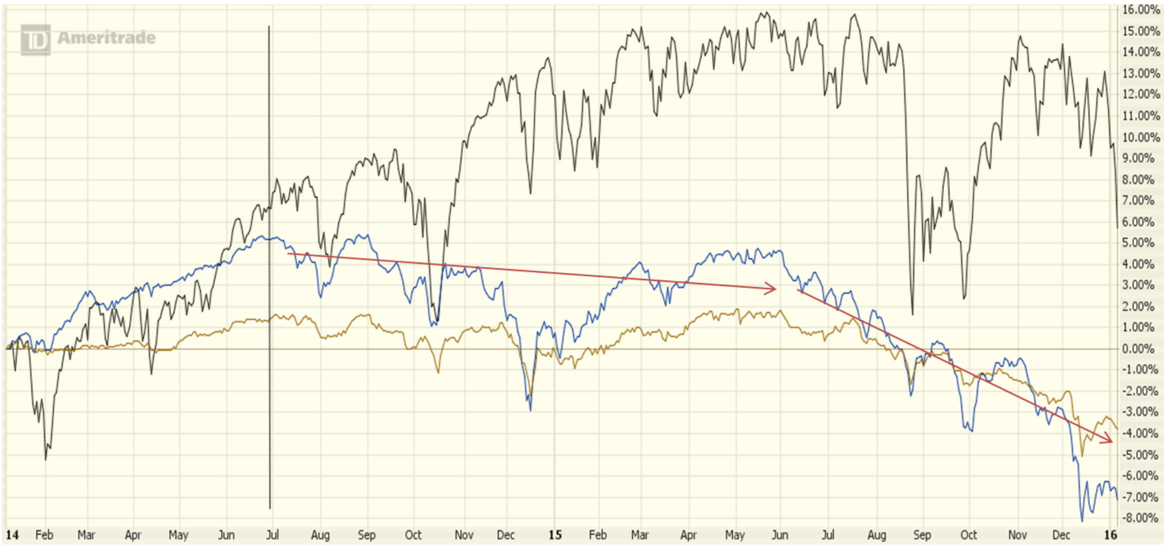
While junk bonds are often an early indicator of trouble ahead, the stock market is typically the last asset class to react. This offers us a very reliable warning signal. We can see that the divergence between the stock market and various types of high-risk junk bonds began in **July, 2014** but really started to accelerate in the second half of 2015.

S&P 500 (black) vs. Junk Bonds (blue) & Bank Loans (tan) – 2014 to Today



Over the past couple of months I've actually been buying US government treasury bonds in both our Income and Growth allocations, as I currently view them as one of the more attractive asset classes. I'm using Exchange traded funds (ETFs) to pick up this exposure. The reason is twofold: First, I don't plan to hold these to maturity so we don't necessarily need individual bonds to mitigate interest rate risk (I'm actually taking on the interest rate risk right now). Second, the ETF's allow me to purchase smaller amounts over time where I can be opportunistic and buy the most attractive part of the yield curve in terms of duration. I'm sure you are wondering what's attractive about a 2% or 3% yield… Well, I'm thinking we'll make more than that. Deflationary pressures from the rising US dollar are starting to overwhelm the global economy. You only have to look at the price of commodities like oil and copper as evidence. So if the inflation is actually negative for the next year, you're real yield is higher than the stated nominal yield. Additionally, and more importantly, it appears as though the credit cycle is turning and the global economy is slowly slipping into recession. I believe we will actually see intermediate and long-term interest rates fall, not rise. If they do, not only will you earn the interest on these bonds but you'll also gain from the price appreciation (bond prices rise when interest rates fall).

I'm also coupling our position in long-term treasury bonds with a position in the US dollar index. Why it works to do this is simply that in the short run, the dynamics of the market suggest that losses in one should be offset by gains in the other. However, in the long run I believe that they both will make money as these deflationary pressures lead to a further rise in the US dollar as well as lower bond yields.

We're facing some challenging years ahead and all investors are struggling to find growth and reasonable yields. The bright side is that these are the years where fantastic opportunities are created for those investors in the position to capitalize on them. It's my nature to invest in a manner that leaves us with plenty of flexibility and in a position of control. In investing terminology we can call this optionality, meaning we have several options inherently built into our plan so that we are able to adapt as conditions change. I can say with confidence that you are currently positioned very well to not only weather the storm I see coming but to also seize any opportunities created.

I wish you and your family all the best in 2016.

Nicholas Lumpp
President, RCN Wealth Advisors

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