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Not a Tradable Market - *too early to buy*

Recent headlines have been touting the success "some" traders have had buying a couple of weeks ago "at the bottom." These headlines are exciting, but hardly the norm, or good investment advice. History shows the current market action could be a warning of further declines. (For those of you that didn't listen to your Mom about putting your hand on a hot stove, you can stop reading here.)

Contrary to what you may have heard on TV, the stock market is not a gambling casino and it is not a baseball game. It is not about who scores the most runs or is the bravest by buying when the market is dropping.

Investing is a long term, methodical, rational endeavor that utilizes sound fundamental and technical research to achieve its ends. Done right, it is rather boring.

It is not about buying at the bottom and selling at the top.

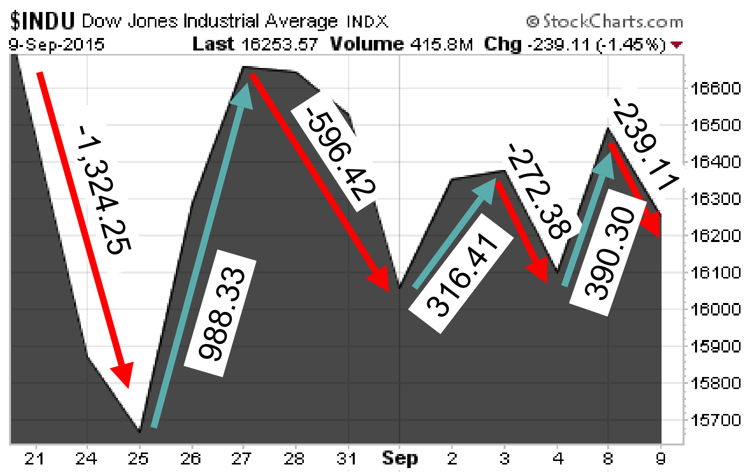
It is not about who can make the most money in a couple of days, weeks, or months.

It is not about who can take on the most risk and get away with it.

The chart at the top of the next column shows what the past couple of weeks have looked like.

Down a thousand, up a thousand, down several hundred, up several hundred.....

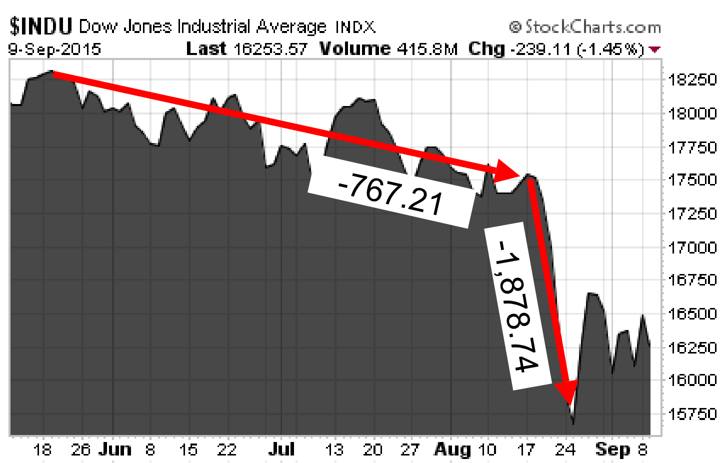
Who can make sense of it? No one can. And that is the point. Short term moves in the market can be random.



Anyone that says they have a sure-fire way of predicting the day to day moves is selling snake oil.

But, could someone have predicted the sharp selloff?

Let's put the last couple of weeks into context by looking at the Dow Jones since May 2015.

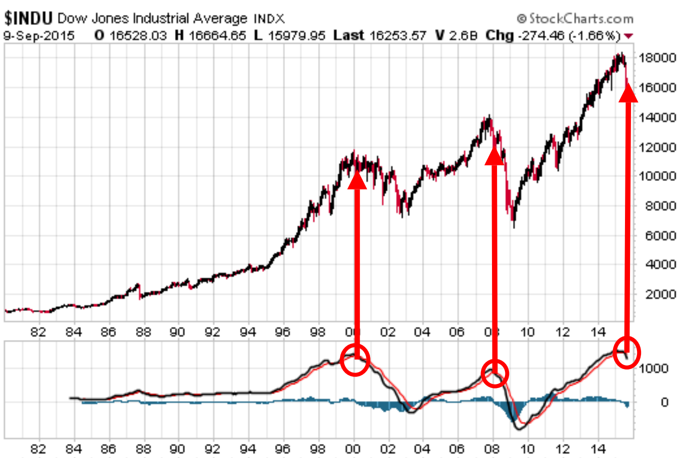


The Dow Jones peaked in May of 2015 at about 18,312 according to Yahoo! Finance. The chart shows that from May 2015 through August 2015, the Dow dropped about 767 points.

Yes, there were some rallies, but each rally failed to make a new high and each decline made a new low. This pattern set up the decline that followed, when the Dow Jones dropped almost 2,000 points in just a few days. Some blame it on the Chinese, others the Fed and others on who knows what.

What we find most disturbing is the number of expert analysts and Wall Street types that now claim the bottom is in - that's it - its onward and upward from here.

They fail to see the current moves in the longer term context. On the next page is a very long term chart of the Dow. It goes back 35 years, to 1980.



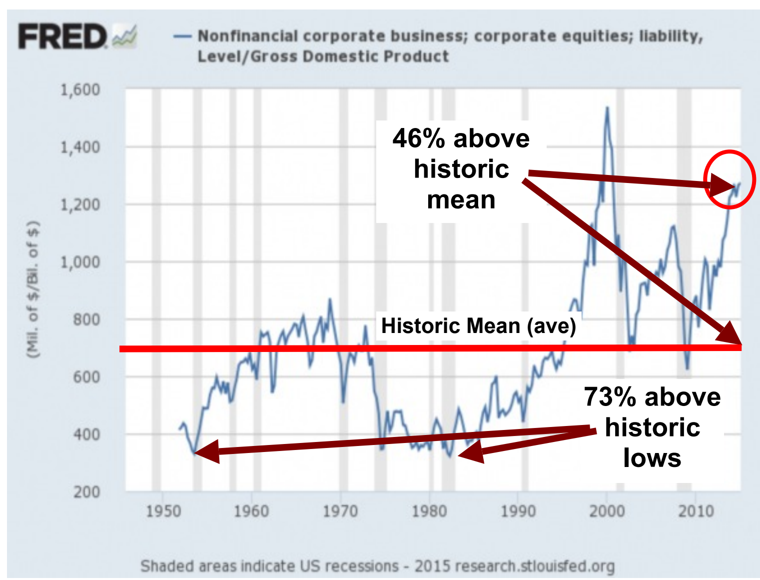
As you can see, in the last 2 decades, there have been 2 very clear sell signals. (This sell signal uses a technical indicator called MACD. It stands for Moving Average Convergence & Divergence. When the longer term line, the black line, drops below the shorter term line, the red line, it signals that the long term moving average is declining faster than the short term moving average, which would be a sell signal. The reverse can be a buy signal.)

One such signal happened at the beginning of 2000 and one in early 2008. Had investors heeded these signals, they would have avoided the massive declines from 2000 through 2002 and 2008 through 2009, each wiping about 50% off the market.

Today, the market is giving the same sell signal. It is important to note the the previous sell signals were warnings of much worse declines to come. The signal itself isn't what investors should avoid, it is what happens afterwards. It is a signal of much worse declines ahead. (No, of course technical analysis sell signals are not 100% guaranteed, however, if it walks like a duck...)

Why are we confident in the potential for further declines? At their core, the markets are based on fundamentals. No matter how much the financial channels want to behave like ESPN, when you boil it all down, fundamentals are what matter most. Long term fundamental trends don't change day to day, week to week, or month to month. They are not sexy and don't attract attention.

Here's one of the most important fundamentals investors should be aware of - the relationship between the markets and the economy they represent. It has been said that the stock market is just a call on the economy. If that is so, then there should be some fundamental relationship between the stock market and the economy. As the economy does well, so should the stock market. (Not the other way around.) Below is a chart from the Federal Reserve that compares the market capitalization to the economy. (Market Cap/GDP)



US. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/GDP/, September 13, 2015.

Mean reversion is a basis for our understanding of market cycles and our outlook on various markets. "Mean reversion" is the tendency for cycles to revert back to their average. In practice, cycles tend to overshoot their average (mean) and swing well above and well below the mean.

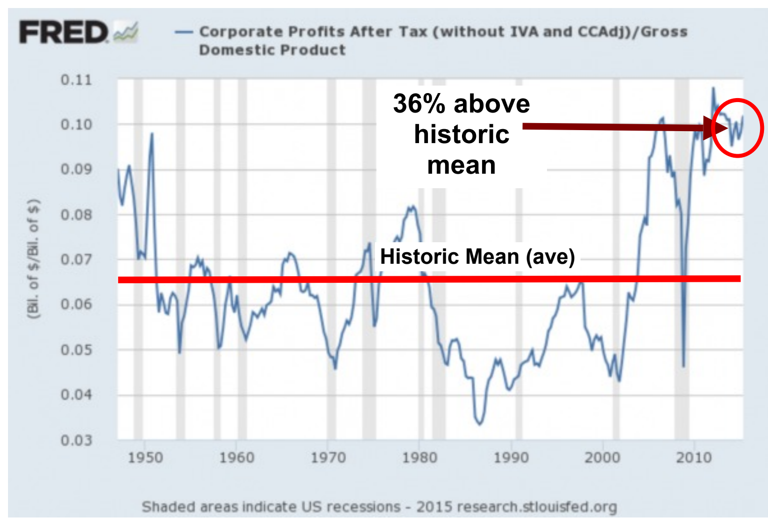
This means that at some point in time, the Market Capitalization/GDP should revert to its mean valuation. At this point it is 46% above its mean value. In order to return to its mean, the market cap to GDP would have to drop 46%.

But that is not the historical norm. Cycles swing to undervalued, so the market cap to GDP could drop well in excess of 46%, history suggests as much as 73%.

Since this is a ratio, either of the 2 numbers could move to change the ratio. The stock market could drop significantly, or the economy could suddenly grow considerably. Given the high PE multiples we have discussed on previous comments, our belief is that the market is overvalued and fragile.

Some internal numbers, that are rarely discussed, are also vulnerable to a reversion to the mean.

Corporate profit margins are near an all time high, as measured by the Corporate Profits/GDP. (Chart to the right) Prior to the 2008 decline, corporate profit margins were just as high as they are today.

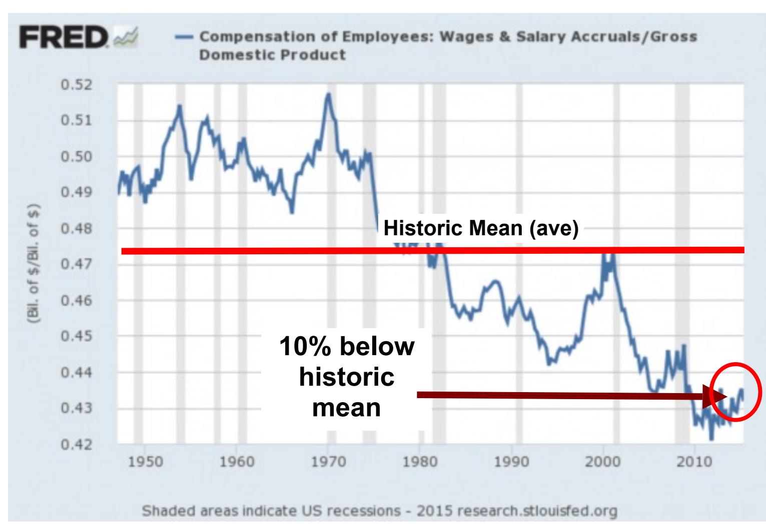


US. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/GDP/, September 13, 2015.

A decline to the historic mean would be a 36% decline in profit margins. This would translate into a tremendous decline in real profits. With PE Ratios already extended, a decline in earnings would likely send the market much lower.

Another data point largely ignored is the Compensation of Employees/GDP ratio. It may not seem like much, but it is near an all-time low, 10% below the mean. Employee Compensation (Wages) is an important component in a company's cost structure. An increase in wages would hurt corporate earnings. Wages are also part of the calculation for measuring inflation, a rise in wages could translate to a rise in inflation.

Wage increases could lower profit margins and real profits for companies. Lower profits is not good for stock prices.



US. Bureau of Economic Analysis, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/GDP/, September 13, 2015.

An important thing to note on these charts is the amount of time the Market Capitalization/GDP and Corp Profits/GDP ratios spent below the mean. They each spent decades below the mean line. So yes, the market could go down and stay down for a long time. It has been down before and there is no reason it couldn't happen again.

Back to what we started at the beginning of this commentary. The recent market action has caused some strategist to declare the market decline is over and the stock market is cheap. As you have already seen, it is not cheap and as for the bottom being in, since it never got to "cheap" valuations, we don't understand how it could be called cheap.

However, we have seen this type of action in the market before. The market peaks, has a quick decline and then rallies. Unfortunately, many of these rallies were just an early bear market rally. This happened in 1987, months before the crash. It happened in 2000 and again in 2008.

The charts below show 1987. It peaked in August and had a quick decline. But then rallied. Many thought this was a sign of strength. It wasn't. It was a fake-out rally, or a bear market rally.

The chart to the right show what happened after the rally. The market declined quickly going into the crash.

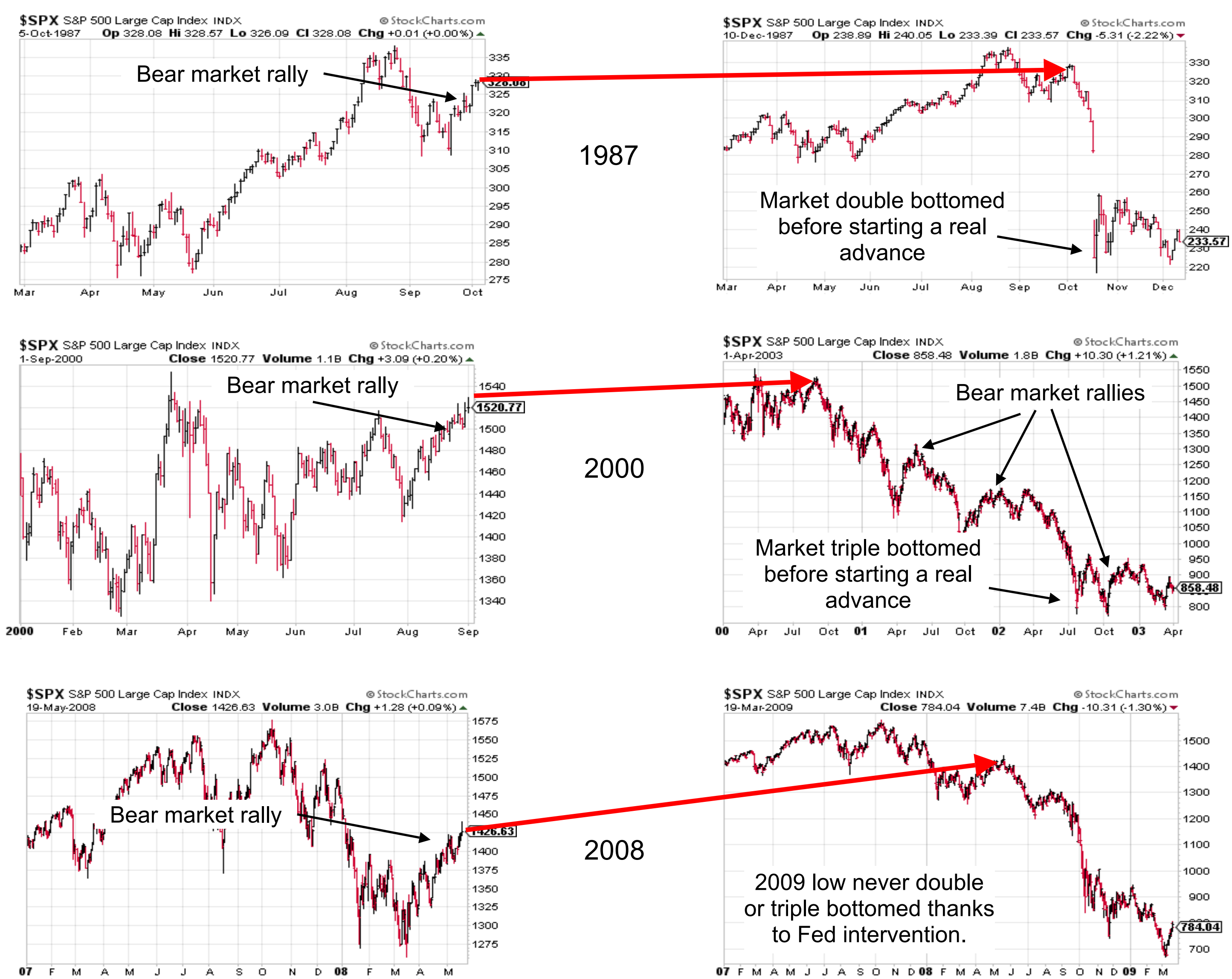
Even after the crash, the market wasn't a buy. It rallied a little, but then throughout November and half of December, it gave back the gains and re-tested the crash lows.

The peak in 2000 had a similar situation. After a springtime decline, it rallied for most of the summer and then had a quick decline, followed by a rally that many believed was as sign of market strength. What followed was a 2 year decline, with several bear market rallies.

Just like after the Crash in 1987, the first bottom wasn't THE bottom. The market went on to test the lows 2 more times before breaking out of the bear market.

2008's bear market had a similar decline and recovery as well. Many investors should still be able to remember the calls for calm early in 2008 by many in the administration and on Wall Street. They re-assured investors that everything was fine with the markets and that they had nothing to fear.

Boy were they wrong. The 2008/2009 decline was fast and furious. It came down faster than many expected. The charts show how quickly the market declined compared to the 2000 - 2002 decline.



The biggest difference with the bottom in 2009 was that it never re-tested the lows. In 1987, after the crash, the market re-tested the lows in December. In 2003, the market retested the lows over several months. In 2009, nothing. A "V" bottom. One of the rarest things in the stock market. Of course it was thanks to the Fed's manipulation.

This brings us back to today. The market is fragile, with PE multiples very high. The Market Cap/GDP ratio is abnormally high. Profit margins are at historic highs and Employee compensation is near an all-time low.

The market has suddenly gotten very volatile, similar to previous peaks. It has had a bit of a rally off the recent low, with many strategists and talking heads saying the bottom is behind us, just like previous peaks.

What does my crystal ball tell me? Use caution. Protect assets. We wouldn't be surprised to see the market rally if and when the Fed finally raises interest rates. How high? High enough to give smart investors a chance to sell into the rally.

Bear market rallies suck investors in, believing that the worst is over, when in reality, the bear is still in front of them. When all is said and done, the Market Cap/GDP ratio should come down to normal; profit margins should come down to normal; PE Ratios should come down to normal; and employee compensation should rise to normal levels.

The only way we can see any of this happening is with a substantial decline in the market. Will it be a crash like 2008 or a long bear like 2000 - 2002? We don't know. But we may have seen the top, and the recent action is similar to action after previous tops.

We believe that the Fed will want to act much faster than it did in 2008, but with rates already near zero, what can they do? Go to negative rates? Buy all bonds trading in the open markets? Outlaw selling stocks?

As HSBC's Chief Economist Stephen King recently wrote:

"*The world economy is like an ocean liner without lifeboats. If another recession hits, it could be a truly titanic struggle for policymakers... Whereas previous recoveries have enabled monetary and fiscal policymakers to replenish their ammunition, this recovery — both in the US and elsewhere — has been distinguished by a persistent munitions shortage. This is a major problem. In all recessions since the 1970s, the US Fed funds rate has fallen by a minimum of 5 percentage points. That kind of traditional stimulus is now completely ruled out."* - *Source: HSBC WARNS: The world economy faces a 'titanic problem - Business Insider - 5/13/2015*

So do we think NOW is a good time to be buying stocks?

For a buy and hold strategy - no; for a more nimble trading strategy - maybe. We are searching for stocks and investments that have already had their bear market decline. We are looking for good companies that pay a good dividend that are no where near their highs, and closer to their lows. This way, when the eventual bear market does happen, we should be in good shape, in a safe harbor of dividend payers that have already had most of their decline.

We are also holding a large amount of cash and monitoring a list of companies we would want to own at lower prices. **Certain companies that currently have a dividend yield of 4% might be a much better buy with a dividend yield of 8%. (As long as the dividend looks secure.)**

Our strategy is very clear and set in preparation for the potential bear market. **We have been here before.**

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