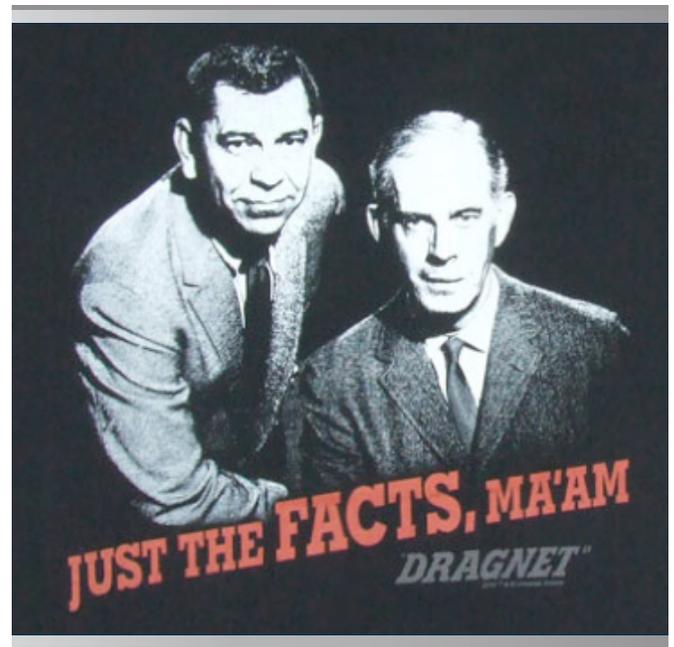


THE COMPASS



“JUST THE FACTS... MA’AM!”

One of the great detective shows of all-time was the series known as Dragnet starring Jack Webb and Harry Morgan (later known for his character of Colonel Potter in MASH.) The series actually had three different runs spanning several decades. Our favorite rendition was the four year period from 1967-1970 where Webb and Morgan played Sergeant Joe Friday and Detective Bill Gannon respectively. Character Joe Friday was a no-nonsense cop who was famous for his stoic integration of criminal suspects. If he felt the person was dodging the question or changing the subject he would respond by saying; “All we want are the facts, ma’am” or “All we know are the facts, ma’am.”



In honor of this great show and the famous catchphrase we thought we would name our latest edition of the Compass after Joe Friday’s famous saying; “**Just the Facts Ma’am.**” Our reason being as we travel the countryside speaking to investors and advisors we find most are blinded to economic truths and thus remain pessimistic and skeptical of this five-year stock market run because they simply don’t know the facts. In this paper we address six major skepticisms that investors have to the current bull market and refute them by stating; “Just the Facts Ma’am!”

Before we look at the six skepticisms we thought we would address the topic of skepticism in general and more specifically how it can bias us from seeing the actual truth. As the poster below states, skepticism can be stretched to the extreme where people come to believe that everything is a ruse and they have the ability to see through it all. But like the quote states, “Someone who sees through everything sees nothing because then everything is invisible.” We propose that many investors have come to believe that they can see through every positive aspect of this bull market run when in reality they can’t see the forest from the trees!

“Seeing through is not the same as seeing into. Someone who “sees through” everything sees nothing. Because then everything is invisible.”

As the above quote illustrates, skepticism runs especially deep for those that are educated and is supported by the famous quote made by early 20th-Century Philosopher George Santayana.

“Skepticism is the chastity of the intellect and it is shameful to surrender it too soon or to the first comer.”

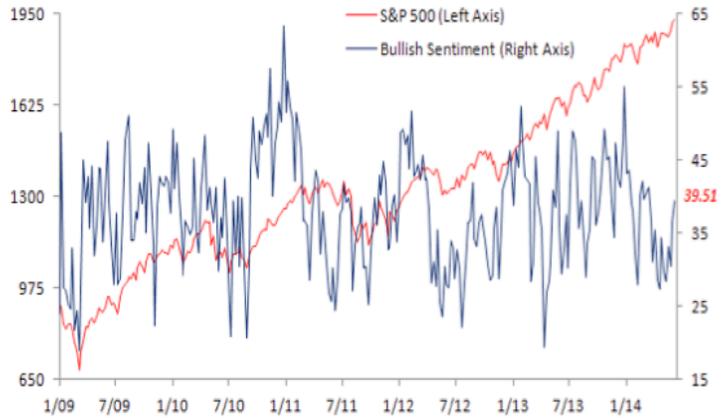


- George Santayana

Santayana’s uses the word “Chastity” not in its common form meaning purity but in its second form meaning, Personal Integrity. Thus the quote can be read as this; “Skepticism is the Personal Integrity of the Intellect and it is shameful to surrender it too soon or to the first comer.” Bottom-line it is very hard for intelligent individuals, usually those with wealth and means to give up their skeptical views readily. This is why Bull markets grow in skepticism because like a young child not getting their way, for the intellect to admit they are wrong and surrender their skepticism would be very shameful.

AII BULLISH SENTIMENT:

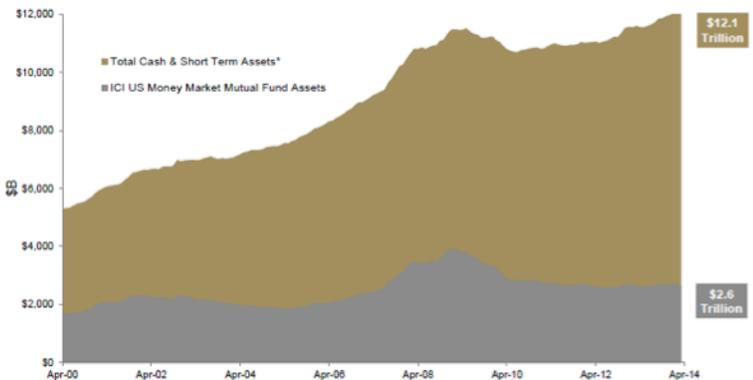
2009-2014



So how do we know that people are skeptical about the current bull market? In the chart above constructed by Bespoke Investment Group one can see as the S&P 500 has risen off of the 2009 low of 666.76 and has ascended to its all-time high of 1,985 on July 3, 2014 the AII Bullish Sentiment Indicator, a very robust and reliable metric of investor’s views on the market has remained at very benign levels. This phenomenon in our minds confirms Santayana’s quote as it pertains to people’s lack of faith in this bull market run.

CASH AND SHORT TERM ASSETS vs. MONEY MARKET ASSETS

(As of 4/30/14)



Another confirmation of investor’s disdain for this bull rally is the enormously high levels of cash being parked on the sidelines. Moreover, this record amount of cash totaling \$12 Trillion has grown by nearly 2.5x since March 2000 when total dollars equaled \$5.5 Trillion. Another point is that since April 2010 when the Fed instituted its 0% interest rate policy the amount parked in cash is up 20%. Bottom-line people remain skeptical about the economy and are parking their assets in record amounts of Cash earning virtually nothing as they perceive it to be safe from loss. *So what specifically are investors’ skeptical about?*



“JUST THE FACTS... MA’AM!”

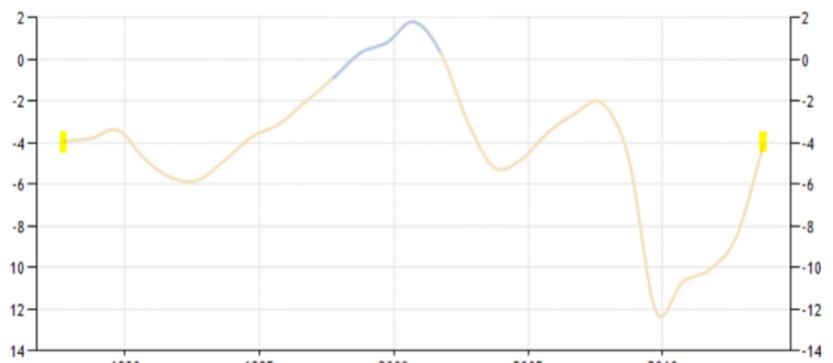
We have come to believe the **TOP SIX** concerns that have deterred people from investing are:

- 1 All of this US Government Debt is going to sink the Economy is it not?
- 2 Yes, the Stock Market is growing... but the Economy is not growing right?
- 3 The Dollar is about to crash and isn't it being replaced as the world's reserve currency?
- 4 This is only a Fed-induced rally... isn't it just another bubble that is going to burst?
- 5 We actually don't make things in the US anymore do we?
- 6 How can the stock market continue to grow when we are at all-time Highs?

1 All of this US Government Debt is going to sink the Economy is it not?

Yes, our nation's debt, at over \$17 Trillion, happens to be at a record high. But what many fail to realize is that our GDP (the best definition of the state of the Economy and equals the total output of all goods and services) at nearly \$17 Trillion is at an all-time high as well. The most accurate way to measure how a country's debt affects its economy is not measured by how much outstanding debt it has but by how much its annual budget deficit/surplus is as a percentage of the size of its overall economy (GDP). So where do we stand? Today at \$688 Billion our budget deficit is 4.1% of GDP which totals \$16.8 Trillion. As the chart above states, this is the same percentage level it was 25 years ago in 1989 when President Reagan left office and the budget deficit totaled \$188 Billion and GDP equaled \$4.6 Trillion. Lastly, the CBO just projected the Budget Deficit for fiscal yearend September 2014 will drop by \$100 billion to total \$583 or 3.5% of GDP.

UNITED STATES GOVERNMENT BUDGET (Percentage of the GDP)



Source: www.TradingEconomics.com | U.S. Treasury

How many Americans actually know this to be the case? We would suggest very little.



“JUST THE FACTS... MA’AM!”

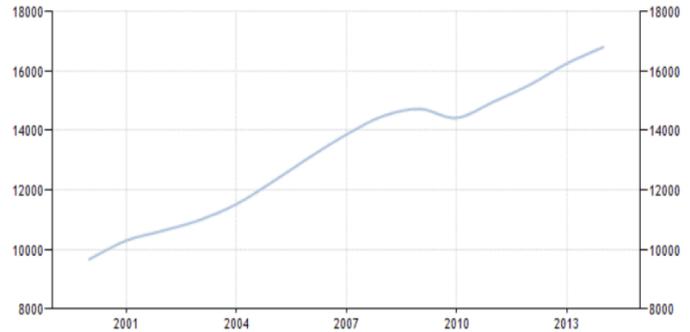
2 Yes, the Stock Market is growing, but the Economy is not growing all that much... right?

Another major skepticism is that the Stock Market has grown but the Economy has not. As we just stated above the current status of the Economy is best measured by Gross Domestic Product or the total output of all goods and services. What many people do not know is that GDP from January 2000 to January 2014 grew from \$9.8 Trillion to \$16.8 Trillion or by 71%. Meanwhile the Stock Market as measured by the S&P 500 has grown less than half of that or only 30% from the 1,525 level reached in March 2000 to its current level of 1,985. Bottom-line the Economy has grown by more than twice that of the stock market over the last 14 years.

How many know this fact?

UNITED STATES GDP (Billions of U.S. Dollars)

Source: www.TradingEconomics.com | U.S. Treasury

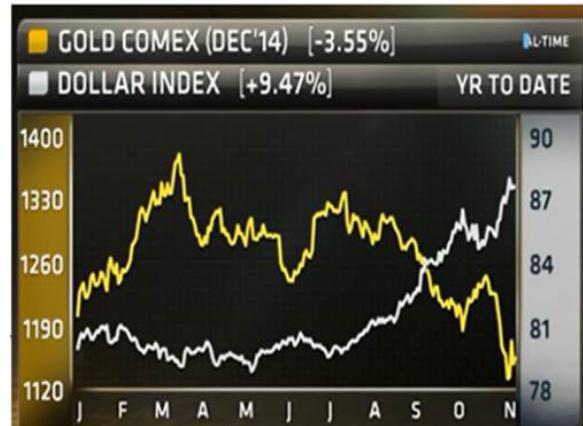


3 The Dollar is going to be replaced as the world’s reserve currency?

Yes, the US Dollar, as best represented by the Dollar Index (ticker DXY which is a basket of currencies including the Euro, Pound, Yen, Swiss Franc, Canadian Dollar and the Swedish Krona that are measured on a relative basis vs. the US Dollar) has taken its hits since the generational peak of 122 made in September 2001 when the world moved to its perceived safety following the 9-11 Attacks. From that September 2001 peak of 122 the Dollar fell 42% reaching a low of 71 in November 2011 when Standard & Poor’s downgraded the US Debt rating. Justifiably so, the Dollar has gotten its share of criticism. However, what has not been reported is that since reaching the all-time low of 71 the US Dollar has risen 15% and is currently setting a base at 81. We believe this appreciation will continue as the US Dollar is undervalued vs. other currencies in the DXY Index and should slowly rise over the next 3-5 years or so.

UNITED STATES DOLLAR INDEX VS GOLD COMEX (Dec '14)

Source: CNBC





“JUST THE FACTS... MA’AM!”

4 This is only a Fed-induced rally... isn't it just another bubble that is going to burst?

Many pundits have suggested that the current bull stock market rally is solely based on Fed money printing and is not justified based on company fundamentals. We would answer the pundits by mentioning that earnings eventually lead stock prices and if earnings are up (assuming forward P/E ratios are not stretched) then stock prices should be up as well. As the chart below shows, that is precisely the case as Corporate Profits measured by the US Bureau of Economic Analysis are up over 75% from \$1.23 Trillion in March 2009 (market bottom) to \$2.174 Trillion in January 2014. American Businesses are making money and at record amounts. *Skeptics are you aware of this?*

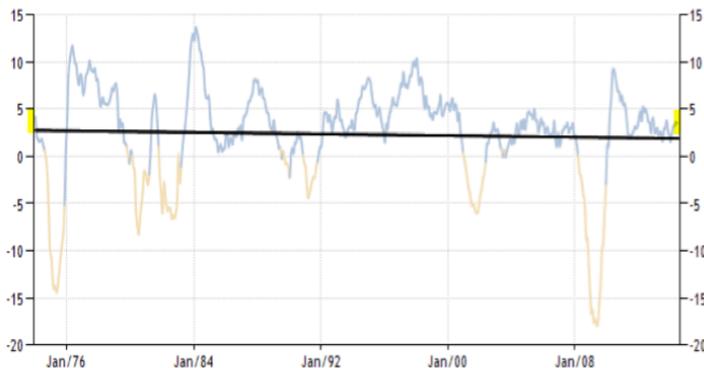
UNITED STATES CORPORATE PROFITS

Source: www.TradingEconomics.com | U.S. Bureau of Economic Analysis



UNITED STATES MANUFACTURING PRODUCTION

Source: www.TradingEconomics.com | Federal Reserve



5 We actually don't make things in the U.S. anymore do we?

Most people are unaware of the Manufacturing Renaissance that is occurring in the United States over the last five years. For the record, Manufacturing Production in the United States increased 3.50% in June of 2014 over the same month when compared to the previous year. On a comparative basis Manufacturing Production in the United States as measured by the Federal Reserve averaged a 3.26% annualized month-over-month increase from 1951 until 2014. That means that the current rate of manufacturing growth over the last year is higher than the average over the last 63 years. Moreover, as the chart below shows the rate of increase in the US as it pertains to manufactured goods produced domestically is at the same rate it was 40 years ago in 1974. Admittedly so the trend over the last 40 years is slightly downward sloping but when one views the last five years each of those monthly levels are above the 40-year trend. *Yes, we still manufacture things in the US and that rate of production is growing faster than the average over the last 60+ years.*



“JUST THE FACTS... MA’AM!”

6 How can the stock market continue to grow when we are at all-time highs?

Any financial advisor worth their salt realizes that when measuring the growth of any asset value over time the most prudent methodology is the real rate of return a.k.a. inflation-adjusted. Yes it is true that the S&P 500 (as measured by the July 3, 2014 record of 1,985) sits near an all-time high. However, according to Robert Shiller’s website www.multpl.com when measured in real terms or adjusted for inflation the actual record high is not 1,985 but the 1,525 level reached in the year 2000. According to the chart below, for the market to surpass that record on an inflation-adjusted basis it would have to close over 2,045. So when we are posed the question why should I put money in stocks when we are at all-time highs our answer quite simply is that when measured by the truest metric, the inflation-adjusted price we are not at all-time highs.



So how do we overcome our Skepticism? Our simple answer is to not only understand “Just the Facts” but to also not lose focus on the larger picture. As we explain by referencing the chart on the next page, we believe the larger picture suggests that we have entered a decade-long stock bull market and a decades-long bond bear market.

Hence, investors should not focus their efforts on being skeptical (trying to “see through”) of every individual economic statistic that is presented to them, but should view the market landscape from a much broader perspective.

By recognizing that the course of markets can be identified by longer-term patterns, investors can begin to free themselves from the emotional shackles of worry, fear, pessimism and skepticism that accompany investors’ psyche following deep recessions like the one that occurred five years ago.

“Seeing through is not the same as seeing into.

Someone who “sees through” everything sees nothing.

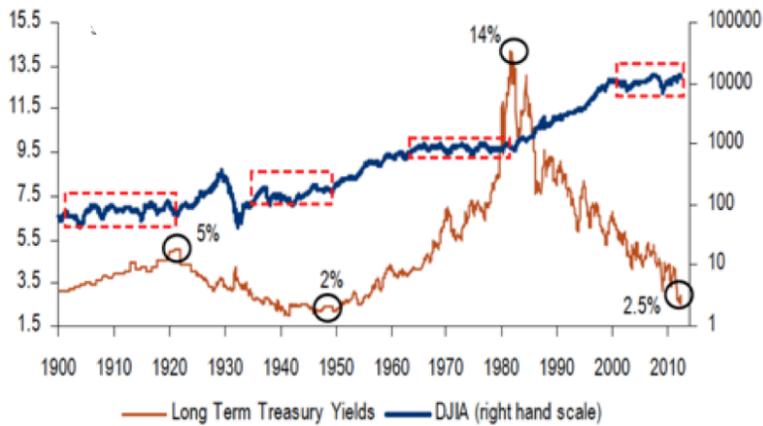
Because then everything is invisible.”



“JUST THE FACTS... MA’AM!”

In this chart developed by Merrill Lynch’s Equity Strategy Group in their report *The Longest Pictures: a Picture Guide to Financial Markets Since 1800*, they highlight that going back to 1900 that both the stock and bond markets move in patterns measured in decades and that are quite recognizable. As shown by the brown line over the last 114 years there have been two bond bear markets (1900-1920 and 1948-1981) and two bond bull markets (1920-1948 and 1981-2012) that on average total between 20-30 years in length. Bond bear markets occur when rates rise over time and bond bull markets occur when rates decline over time.

EQUITY PRICES & BOND YIELDS SINCE 1990
(The Longest Pictures: Picture Guide to Financial Markets Since 1800)
Source: Merrill Lynch Equity Strategy



The stock market follows a similar bull/bear pattern (blue line in the chart) but is defined by a shorter time frame ranging from 15-17 years. The four bear stock markets occurred in the periods 1902-1918, 1931-1948, 1966-1982 and 2000-2014. Each bear market in the chart is represented by a red dashed box and is defined by its sideways demarcation. The four stock bull markets are measured by the upwardly sloping blue line and occurred from 1918-1931, 1948-1966 and 1982-2000. Our feeling is that the Range-bound Market which began in 2000 has finally come to an end and has given way to a new Bull Market which if history has anything to say about it could last for the next decade or so. As it pertains to the bond market, with rates nearly doubling off of the historic July 25, 2012 low of 1.39% to the current rate of 2.56% one would expect that a long-term bond bear market has just begun. The prognosis of course no one can be sure of but would suggest that investors should focus their energy on overweighting equities and underweighting bonds for the at least the near future.

Summary – Almost in an odd way for the committed investor who knows what they own, why they own it and understands “just the facts” of the current status of the Economy, the mere notion that others are pessimistic and skeptical about the market rally is actually good for the prospects of future growth in equity prices. We base this premise on the assessment of the progress of markets over time by one of the investing masters, the late, great Sir John Templeton who once proclaimed, “Bull Markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” In our estimation we are nowhere near a point of euphoria, surely not are optimistic about the Economy and are probably between a state of pessimism and skepticism. If the Templeton quote is anywhere near being correct, this market is growing on the backs of those that are worried and fearful and based on the heightened levels of skepticism, has a lot more room to run.