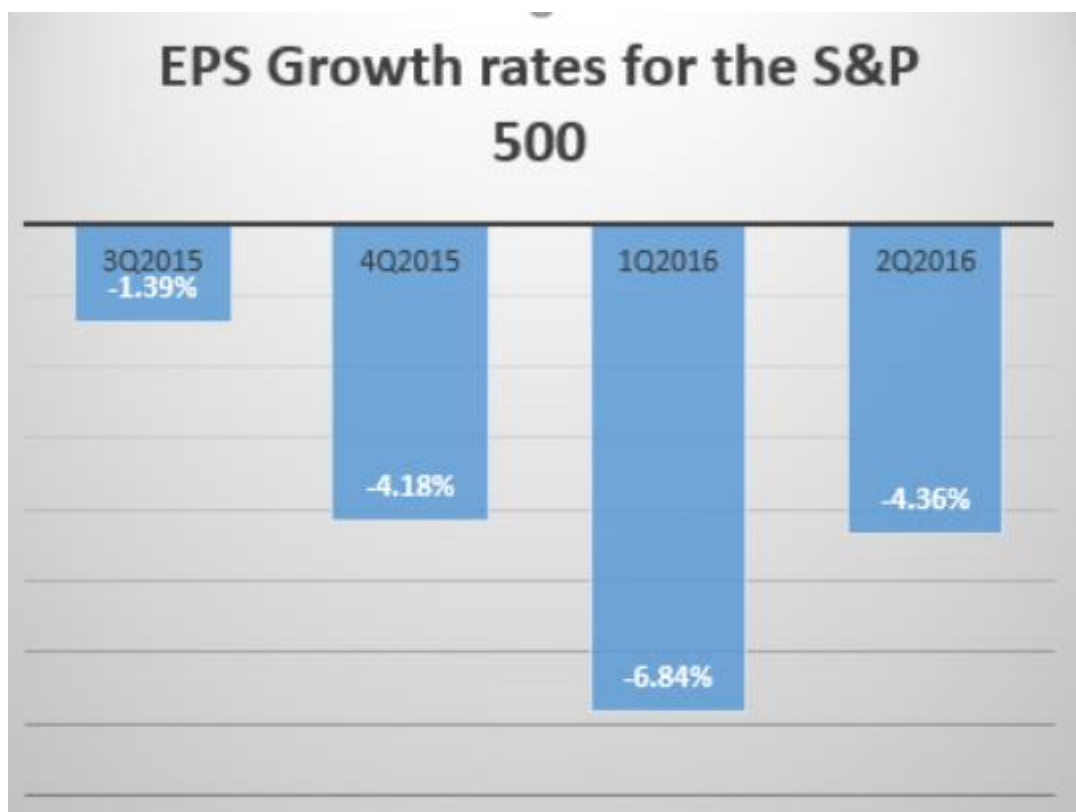
**Monthly Market Returns**

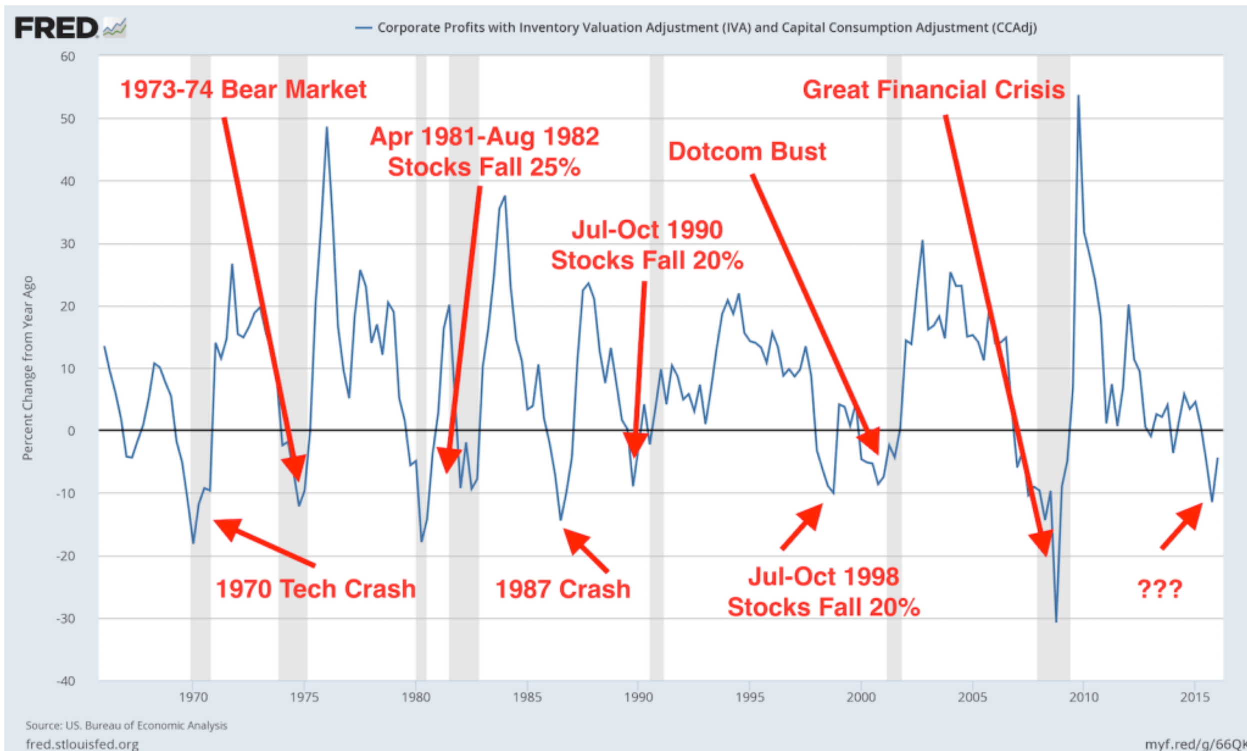
| Index | 1 – Month Return | Year to Date Return | 1 Year Return |
|---|---|---|---|
| S&P 500 | 3.68% | 7.55% | 5.40% |
| Russell 2000 | 5.97% | 8.37% | 0.10% |
| MSCI EAFE | 5.05% | 0.48% | -7.54% |
| Barclays Aggregate Bond | 0.61% | 5.94% | 5.83% |
| Brent Crude | -17.00% | 24.34% | -14.26% |
| Gold Spot Price | 2.32% | 14.65% | 23.20% |
| MSCI Emerging Markets | 4.95% | 11.37% | -1.07% |

## US Corporate Earnings

Thus far 97% of S&P 500 companies have reported earnings which have declined 4.36% on an annualized basis. This is the 5th straight quarter of earnings decline for the S&P 500. We are in the midst of a full-blown earnings recession in the United States as the tail wind of cost-cutting and unsustainably high energy prices have faded. To be clear, this doesn't mean that US companies aren't making money, it simply means that the amount of money they are making is shrinking and has been shrinking for over a year.



Since WWII there has never a period of time in which 5 consecutive quarters of earnings contraction was not followed by a recession. The contraction in earnings does not create a recession, rather it is a symptom of the underlying slowing of economic activity. The chart below provided by the Federal Reserve illustrates the link between a drop in corporate profits and the recessions that have followed.




In order to be buying stocks at all-time highs you have to believe one of two narratives:

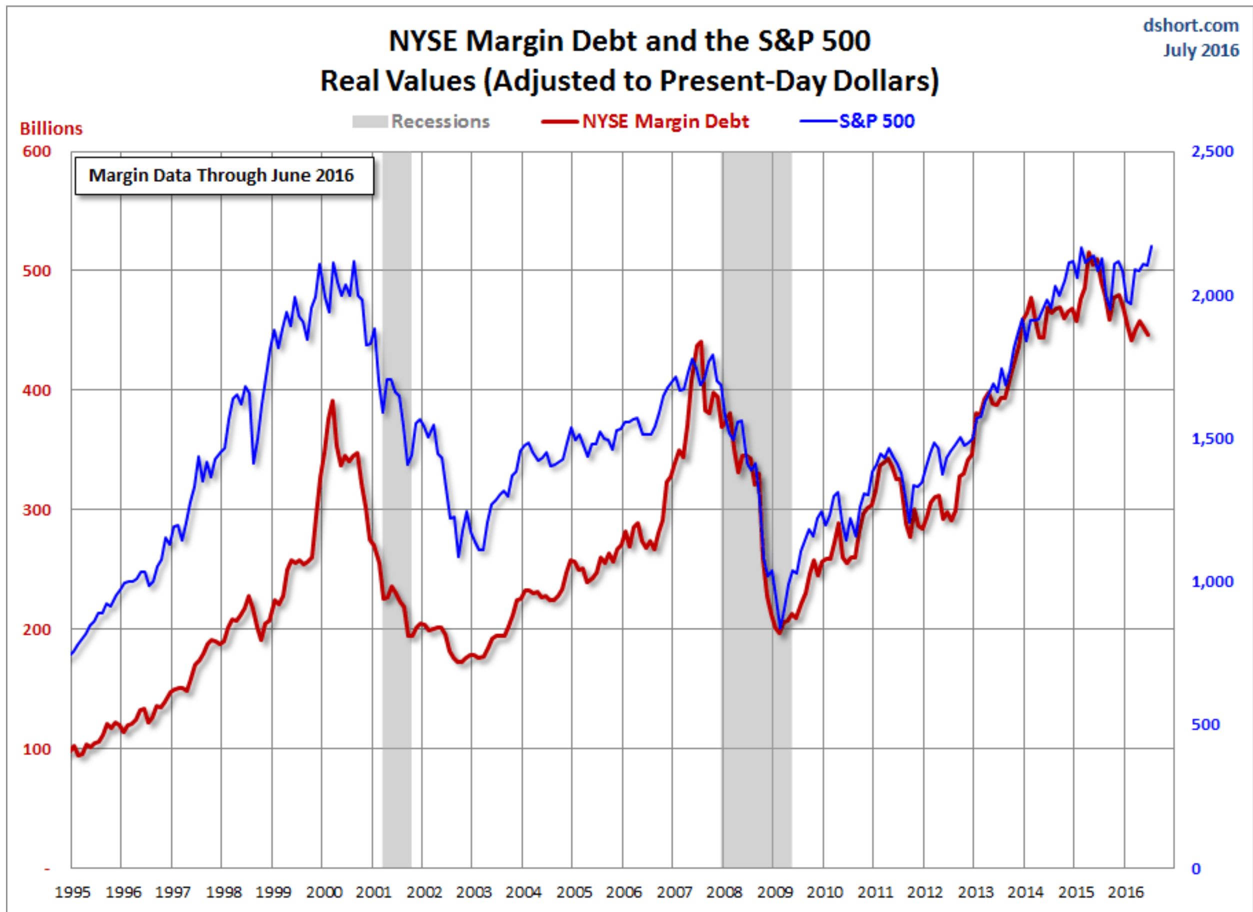
- This time is different
- The market is overvalued and there are still “greater fools” prepared to buy

One or both of those narratives may be true, only time will tell. Our contention is simply that the earnings picture in the US continues to communicate that caution is warranted in the near term given the valuations presently baked-in to the market.

## Market Structure

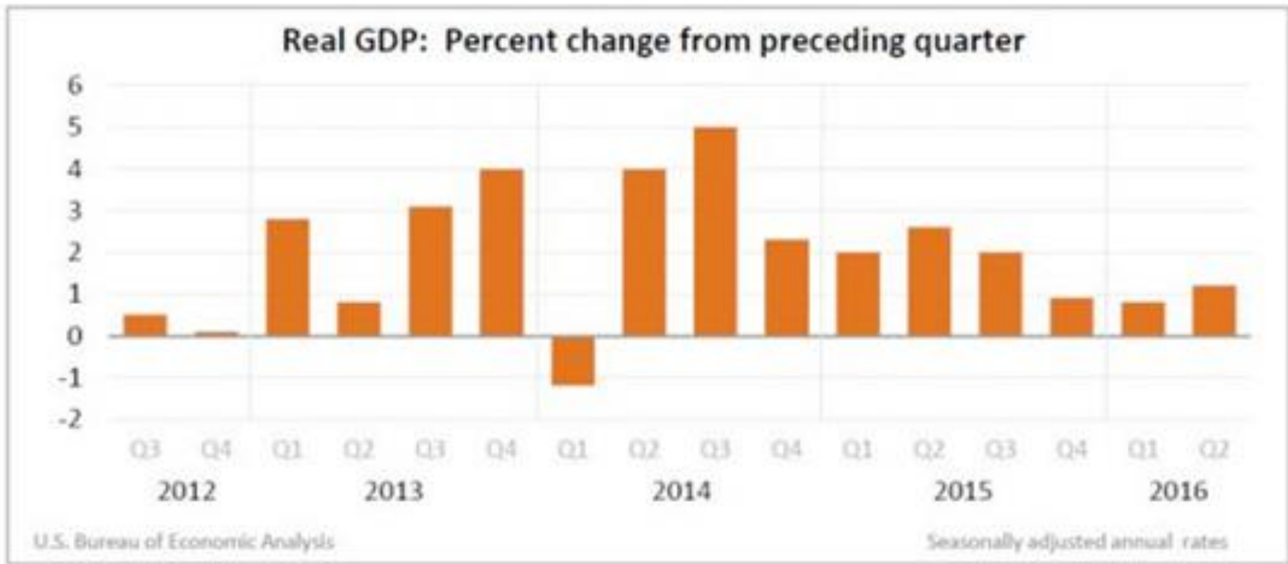
The term market structure is one of those vague, Wall Street-ish phrases that makes one sound intelligent but betrays little of substance. When we refer to "market structure" we're going a bit deeper than simply the price of something and looking at the number and attributes of buyers and sellers. Sometimes we can learn a great deal about the underlying health or disease in a market that has not yet been reflected in the price. For instance, in 2005, one could look at the housing market in say, Las Vegas and see prices climbing continuously and conclude that the market is healthy and demand is solid and growing. The market structure of Las Vegas and many cities in the US showed something different. It showed increasingly cash-strapped borrowers taking on inordinate amounts of debt at unfavorable terms with often no verification of their ability to repay. The structure of the housing market was lousy at best and that fragile structure indicated a potential correction before the correction took place. In a similar fashion but with different metrics, we look at the nature and number of buyers for stocks and what that can tell us about potential future moves in prices.

Below is a chart that tracks the value of the S&P on the right compared to the amount of margin debt on the left. Margin is another Wall Street word for borrowed money used to buy stocks. When one buys stocks on margin, they borrow more money than they have and, if they're right, make more money than if they just used their own cash. The more conviction the market has about stocks going up, the more likely folks are to borrow money to enhance their returns. When sentiment turns negative, the amount of margin debt declines. Margin debt is often a leading indicator for stocks on the downside and you can see that we have a notable divergence of margin debt going down and stocks climbing modestly in 2016. What this indicates to us is that "smart money" is pulling back while "dumb money" continues to buy. The amount of margin debt is at all-time highs and dropping neither of which are positive for stocks in the near term




## US GDP

US GDP numbers are anemic at best. First quarter data was revised down to .8% annualized and Q2 came in at 1.2% annualized. The Q2 figure will almost certainly be revised lower 3 months from now as has been the pattern as of late. What this tells us that the US economy, as measured by GDP is barely maintaining stall speed and this is now the 3rd quarter in a row that the economy has averaged less than 2% annual growth. All of this after massive amounts of stimulus which have accomplished little other than rewarding the owners of assets while penalizing savers and workers. This among other data points makes it very unlikely that we'll see a US interest rate hike in 2016 even though the Fed will continue to talk tough. They want to convince the market that the economy is strong enough to hike but don't have the data to justify it. The GDP figures do not surprise us and we expect near-term deterioration in this metric.



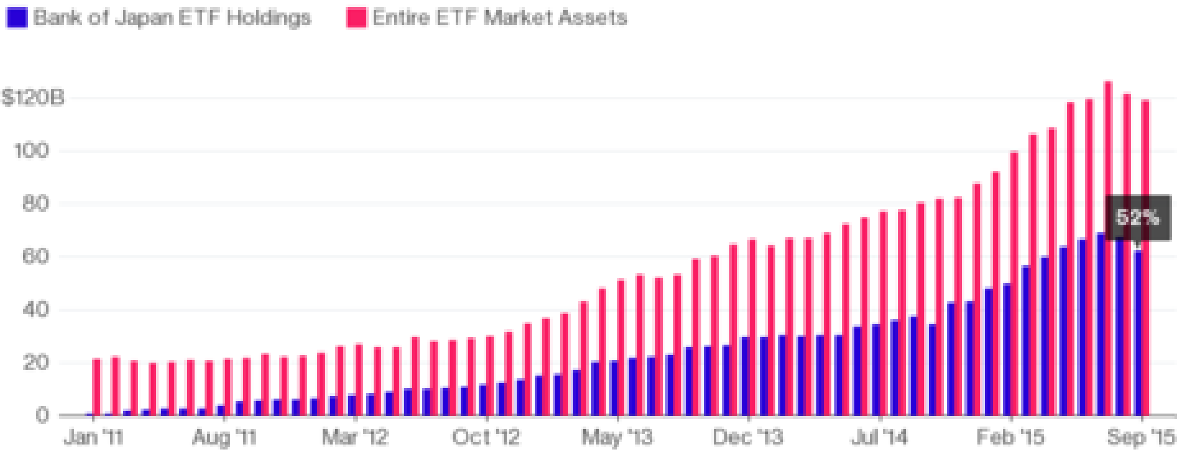

### Europe

European economic developments continue to be negative. Italian banks in particular are struggling to cope with soaring rates of non-performing loans and the EU yet again does not have the mechanism to effectively address the disparity between the debtor and creditor nations. Continued terrorist attacks in France and Germany along with a failed coup in Turkey the political instability of the region that will only serve to further divide the sentiments surrounding the EU as an effective governing construct.

### Japan

Japan is the leading or perhaps bleeding edge of desperate, experimental monetary policy on planet earth. Presently, the Bank of Japan (BOJ), which is their version of the Federal Reserve owns 52% of publicly traded stock ETFs. The BOJ simply creates new Yen on their reserves and then goes out and directly buys stock funds in Japan. Their holdings of stocks are indicated below:

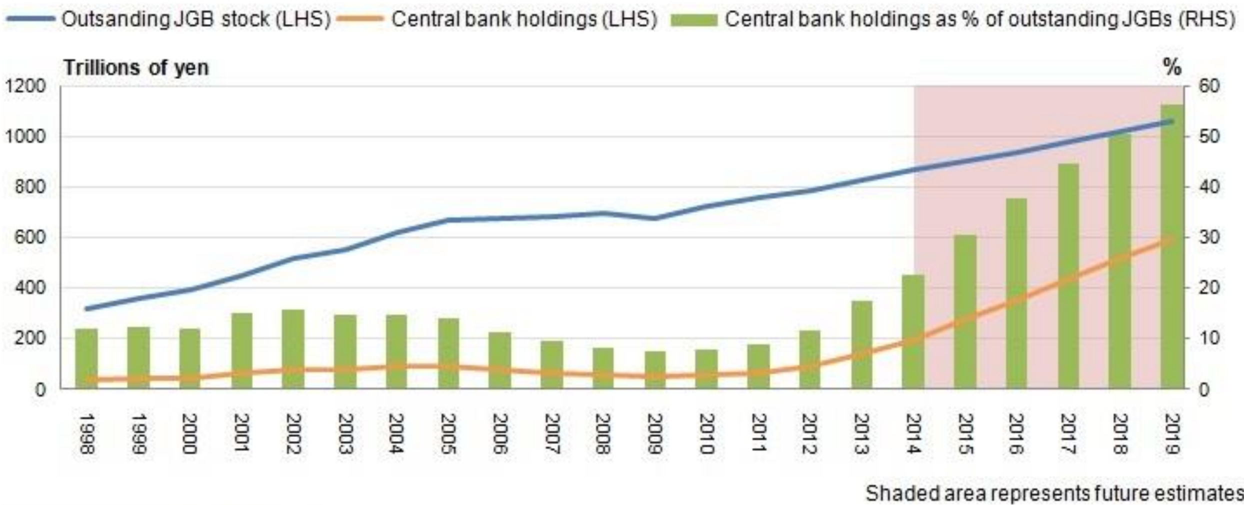
**Japan's ETF Whale**




Source: Tokyo Stock Exchange
Note: Converted to USD at 121.03 FX Rate

Japan hasn't stopped with the stock market however and also dominates the bond market. Presently, nearly 60% of Japanese government bonds are owned by the BOJ. In effect, the BOJ prints money and lends it directly to the government in hopes of creating some stimulus effect. The likelihood of this money ever actually being repaid to the BOJ is slim to none.

**BOJ's dominance of the bond market**




Source: Bank of Japan, Datastream

Reuters Breakingviews

Andy Mukherjee, Robyn Mak 05/11/2014

Japan, like the US and like Europe is approaching the problem of slowing economic growth as though it were purely a monetary phenomenon and failing to consider the idea that perhaps other factors such as aging populations and demographic shifts have an impact on demand. Instead, the idea is that if we produce enough money and thereby make it cheap, that in itself will create demand. This hasn't worked in Japan for years and the longer this experiment is pursued the more dangerous it becomes for the soundness of the currency. Japan is in unchartered territory as are we all. How and when this ends remains unclear, but it is unlikely to end well.

The points we've touched-on this month are by no means exhaustive but they do continue to paint a picture that should make investors cautious and aware as they consider their strategies and allocations. Problems are simply opportunities in disguise and we seek first to have an honest assessment of the environment, good or bad, and then clear strategies to benefit from that environment. Those opportunities abound, even in the world we live in and we seek to allocate capital accordingly.

In the weeks ahead, we'll be watching closely for any additional developments in the world's central banks that offer additional clues and would inform our allocations. Additionally, we'll be paying very close attention to data relating to the US consumer for signs of strength, which we hope for, but also for additional weakness for which we are prepared.

Until then,

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