Staring into the Abyss!

Table I: Global Equity Market Returns -%

Index	Apr 2016	YTD
Russell 1000	**.54**	**1.75**
Russell 2000	**1.57**	**0.03**
MSCI – EAFE	**2.9**	**(.20)**
MSCI – Emerging	**.54**	**6.29**
S&P 500	**0.39**	**1.74**

Source: Russell, MSCI and Standard & Poor's

The equity markets squeezed out positive gains for the month of April. The markets are still being supported by the Federal Reserve interest rate policy. Investors also were encouraged by 73% of the companies reporting Q1 2016 earnings beat estimates. Little weight was given to the fact that year over year earnings declined 6.3%. Higher than expected earnings also had a tailwind from continued buybacks from companies. Fundamentally, valuations are still leaning toward the pricey end of the spectrum. Sell in May and go away may be a prudent strategy.

Economics and Policy

Summer is rapidly approaching and the silly season of U.S. presidential elections will be in overdrive. The rhetoric is loud and toxic on both sided and tempers are likely to explode into violence. What is quite interesting is both the Republican and Democratic parties are angry at the government but with quite different expectations although both are quite disappointed in the weak economy.

Republicans are insisting that high taxes and government interference are killing the greatest economic engine ever seen. Despite record levels of tax collection, the budget deficit still exists and the debt is over $19 trillion. Regulations are coming fast and furious costing taxpayers $1.9 trillion. The 60 federal agencies have another 3360 regulations on the table. President Obama will be the first president to have 80,000 regulations in a year; this has happen three times during his presidency. The DOJ and the EPA in particular seem to find endless ways to tax; thwart or just outright cripple industries. Hillary Clinton was the recipient of voter wrath in West Virginia. It seems the voters (coal miners) have taken exception to President Obama and Hilary's view that the coal industry need not exist anymore. It appears Donald Trump is the presumptive nominee however Republicans remain divided as to who he really is and what can they expect in terms of real policy.

On the Democratic side Bernie Sanders has overstayed his welcome and continues to disrupt the coronation of Hillary Clinton as the nominee. What is driving the far left of the party is demand for free education, free health care, higher taxes on the "rich" and just more government overall. They deeply believe the world is rigged against them and anyone of wealth is so because of ill-gotten gains at their expense. Sanders, a socialist is drawing big crowds and racking up primary wins by proposing the U.S. become Europe.

What is really at the heart of this anger is an economy for nearly 8 years that has failed at nearly every level. The White House keeps referring to record number of months with new jobs and the millions of new jobs and oh yeah remember "the economy we were handed". Unfortunately, nearly every other economic indicator is sounding alarm bells that another recession may be upon us. The U.S. economy has been out of a recession since June 2009. During the past 7 years there has not been a year of GDP growth over 3%. Historically, the subsequent years to a recession is filled with solid job growth across all sector and growth well over 3%. Instead, we are still seeing near record numbers of folks on food stamps, 1 in 5 families where no one has a job, third lowest homeownership on record (63.6%), labor participation rate (62.8%) near all-time lows, and disposable income for the middle class that has fallen. This current economic environment is not a time where you would bring out the pom-poms. And all of this has occurred while the Federal Reserve has revved up liquidity and provided negative interest rates as a tool to reduce savings in an effort to increase consumption. That failed to stimulate the economy as well and may have introduced inflated asset prices in the stock markets.

The weakness is broad based. Industrial Production and Capacity Utilization have declined year/year 2.0% and 1.20%, respectively. Housing permits in March (Latest period reported as of this report) declined 8.8%. Second quarter GDP was up 2.6%. Historically 2Q is one the strongest in any year. The Unemployment rate held steady in April at 5.0% despite producing the lowest number of jobs, 160,000 in 7 months. Job creation in March and February were reduced by nearly 30,000 combined. Compounding this job weakness, the Challenger & Gray survey reported that there were 65,141 workforce reductions announced in April, an increase of 35% from March.

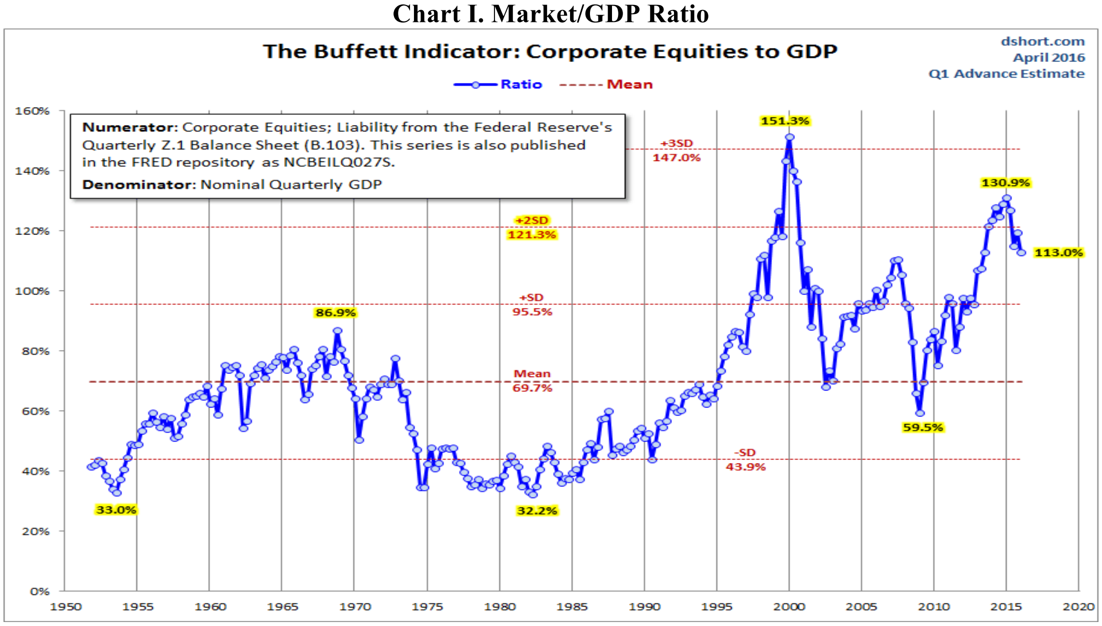
The economy is suffering from a failure of Keynesian economics and a culture of entitlement and dependence. And there are more cliffs in front of the economy. Tax revenues collected are at record levels and yet the budget deficit remains in a deficit while debt (And no they are not the same!) has doubled during the last 7 years. The rate of businesses opening is lower than number of businesses closing. The public pension shortfall is slowly but surely moving closer to the cliffs many states are approaching. The Treasury department just ruled that retiree's payouts could not be lowered by the Central States Pension Fund which is underfunded by over $6 billion. There are certain groups that believe taxpayers should bring the fund into balance. Taxpayers already pay more in taxes than they pay for housing food and clothing—combined! The "tax wealthy" chant is a fool's game if one has any familiarity with basic math. Currently, 45.3% pay no federal income taxes. The richest 20% pay 86.8% of taxes, top 1% pays 43.6% and the top 0.01% pays 20% of federal income taxes. Punishing success is not a rational route to wealth and further increases will compromise growth and build absolute dependence.

Globally, economies are on life support. A wave of immigration is adding to fiscal pressure in many countries. The threat of violence is growing, just as in the U.S. Compounding the fiscal tension is a growing clean water shortage. This will lead to food shortages in the near term. This is a global phenomenon, which is weighing heavily on economic growth.

Investment Strategy

The market sentiment is becoming more cautious. The threat of another recession, global tensions fanning the flames of fiscal discord and growing issues of water and food shortages is moderating investment market advances. Markets have lost confidence in Central Banks. This is leading to higher market volatility and currency debasement.

Chart I. Market/GDP Ratio



The stock market value to GDP ratio (Chart I.) has retraced a bit in April to 113.0% but remains alarmingly high. Money is slowly moving out of equities as valuation is high and economic health is failing. In addition to reducing allocations to equities it may be prudent to begin a hedging program to protect against increased volatility. External actions may force a re-valuation of equities and bonds. In the meantime, investors in addition to strategically allocating equity positions should consider additional allocations to private equity ventures. There has been a slowdown in middle market lending as banks are shying away due to capital restraints and over-regulation. PE exposure can be used to increase income cash flow while diminishing volatility although it may limit liquidity. Due to limited bank financing, a PE investor can negotiate very attractive terms. Additionally, there remain opportunities in real estate, particularly in farmland and timberland. There are concerns that farmland which has been a strong performer for over 10 years, may be peaking. Given the growing need for food globally, this caution may be misplaced. Farmland with irrigation abilities will be very much in demand, as droughts remain a very real problem.

Given the inflated values of traditional investments (Table I.), investors need to search in what many may call in all the wrong places for opportunities that have low correlation to traditional markets and offer attractive risk: return profiles. The low to negative interest rate environment and poor economies provide a backdrop where an investor is unlikely to obtain 6-8% returns in the traditional markets. In addition, to finding "out of the box" opportunities, a more defensive posture should be assumed.

Table I. World Valuations

Country	CAPE	PE	PC	PB	PS	DY
World	19.1	18.7	9.6	1.8	1.2	2.7%
Developed Markets	20.0	19.3	9.9	1.9	1.2	2.7%
Emerging Markets	13.7	15.2	8.0	1.6	1.2	3.2%
Developed Europe	14.8	23.8	9.2	1.7	1.0	3.5%
Emerging Europe	7.9	11.8	4.4	1.0	0.8	3.6%
Emerging America	13.8	28.9	9.5	1.8	1.2	2.8%
Emerging Asia-Pacific	14.8	13.9	8.6	1.7	1.3	2.9%
BRIC	11.3	13.3	6.2	1.3	1.0	3.1%

Source: StarCapital 3/31/2016

Many investors are raising cash as a defense method. Another would be to invest in gold. Yes, there are skeptics about gold however n times of global unrest history has shown that gold is a solid investment that is readily recognize across the globe. An allocation of 5-10% into gold might not be imprudent as some may think. During the recent financial crisis gold went from approximately $665 in June 2007 to around $1,720 in December 2012, over 150% returns. We are not predicting similar returns in the future however, cash helps in a bear market and gold is really just another form of cash.

Instead of staring in to the abyss, investors would be wise to re-structure portfolios while most are still under a belief that all is well and the disturbing atmosphere leading up the presidential will actually result in rational people electing rational politicians despite all of the evidence to the contrary.

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