Smart Money Mid-Year *Update*

Special Report **May 27, 2016** **By: Jerry E. Tuma, MS, CFP®**

Jerry E. Tuma, MS, CFP®

Topics:

- Seasonality
- U.S. Economy
- Banking Weak Link
- China – Still in Trouble Despite Stimulus
- Where Else do You Want to Put Your Money?
- Emerging Markets Debt Bubble Too
- U.S. Market Topping Process Continues

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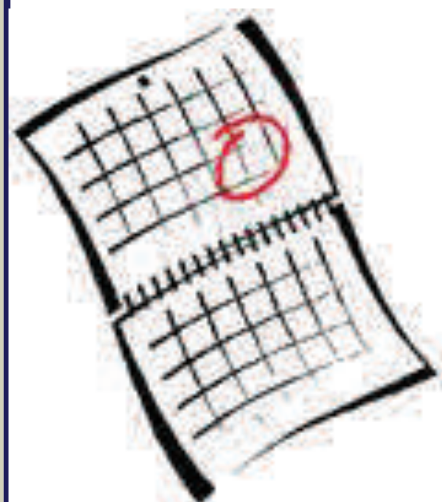
Just wanted to give everyone an update on our views as we approach mid-year. In my opinion, nothing meaningful has changed.

Seasonality



We experienced a big bounce in the U.S. market in March and April, which is typical market behavior. A recent study documented that March and April have actually been the ***two strongest months for the stock market over the past 20 years.*** I believe this is due in large part to the fact that most people file their tax return prior to April 15th and those that make IRA contributions will generally fund those just before their tax return is filed. (Source: *Springing to life? In last 20 years, stocks largest gains came in March, April*, 2/26/14, Market Watch).

So for tax reasons you tend to have a built in demand surge for stocks behind this seasonality, causing the market to rebound in the spring. In fact, multiple studies have demonstrated that the six strongest months for the stock market each year are usually the months from November to May.

Jim Stack of InvesTech has done a case study going back to 1960, where he calculated (in a hypothetical illustration) the difference one investor would experience if he invested only during the months from November 1st to April 30th versus a second investor who invests May 1st to October 31st.

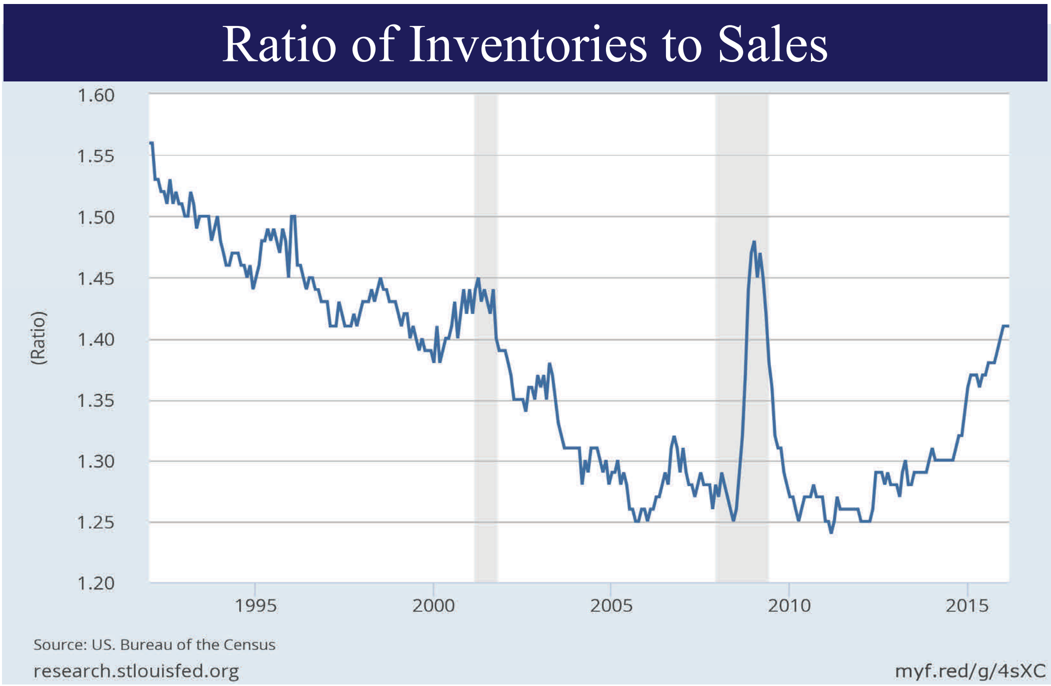
Starting with a base investment of $10,000 dollars in 1960, the investor who invests from November 1st to April 30th and then sits in money market for 6 months would have grown his investment to $644,961. The second investor who invested from May 31st to October 31st and sits in money market for 6 months, that investor's $10,000 would have grown only to $29,273 (Source: *Sell in May and Go Away...or maybe just remain defensive*, Jim Stack, 5/6/16, InvesTech).

	1960	2016
In Market May-Oct	$10,000	$29,273
In Market Nov-April	$10,000	$644,961

The case uses the S&P 500 as a proxy for the market with dividends reinvested. Note that you cannot invest directly in the S&P 500. Please note: this is not a strategy recommendation; simply an observation of past market behavior.

While no investing system is perfect, and this methodology certainly does not work every year, it just shows how strong the tendency for the market is to rise from November to May and then experience struggles between May through October. Hence the old Wall Street adage, "sell in May and go away."

U.S. Economy



The U.S. economy continues to struggle, as GDP grew at a mere .5% in the 1st quarter. Much of this slowdown, in my opinion, is due to reduced growth in China and globally, which we will discuss later.

In addition, the ratio of inventories to sales has risen dramatically over the past year or so, which typically occurs just before recessions.

One of our favorite analysts Stephanie Pomboy of Macro Mavens had this to say about inventories.

- Stephanie called it "...arguably THE biggest story—not just for retail—but for the market in general" After waving my arms like a crazy person about the monster inventory bearing down on the US economy, it's officially time to brace for impact...

- The last four inventory cycles—none of which involved an overhang this large saw profit growth flip from rising +18% y/y on average at the inventory peak, to contracting -5% y/y at its lows. After 4 consecutive quarterly declines (the weakest string since the Great Recession) everyone thinks that the worst is BEHIND us. But if inventories have anything to say about it, we are just getting warmed up.

Retailers have fallen on hard times almost across the board in the U.S. Some of this can be attributed to internet shopping but certainly not all of it. For example ***Macy's stock has fallen some 58% since early 2015***, in addition…

- (ETF Daily News): Kohl's missed analyst expectations on both revenue and earnings.

- Nordstrom's earnings fell 64% last quarter.

- (Baltimore Sun): Sports Authority will close all of its more than 450 stores across the United States after the bankrupt company was unable to secure a buyer, according to a new court filing... The Colorado-based retailer, once the largest sporting-goods chain in the country with stores in 41 states and Puerto Rico, filed for Chapter 11 bankruptcy in March with the intention to restructure. But the retailer was unable to reach an agreement with creditors and lenders and was instead sold at auction. The retailer reported $3.5 billion in revenue last year and employs 16,000 people

(Source: *Things That Make You Go Hmmm*, Grant Williams, 5/22/16).

Banking Weak Link

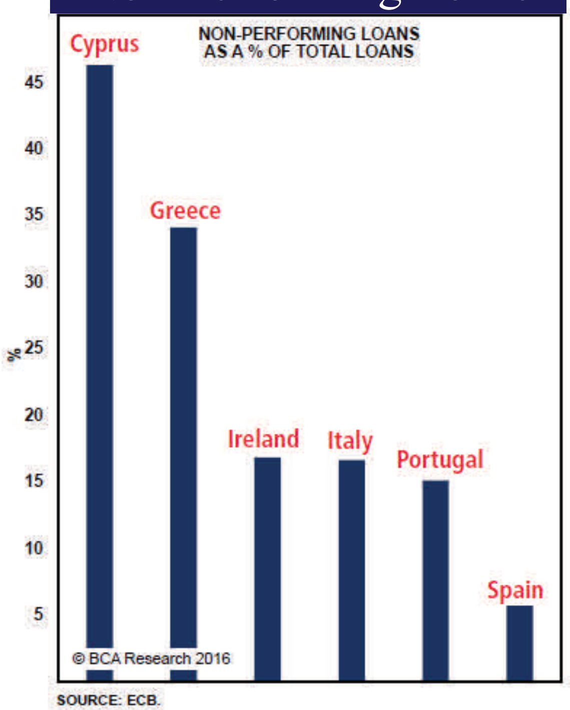
EU Bank Profits

This chart depicts the devastating decline in bank profits since 2007 in the Euro-zone, dropping to a 20 year low. Europe's banks need to be re-capitalized; they need a Euro wide FDIC type of institution which they currently do not have. And, to top it all European banks are primary lenders to the Emerging Markets which are another major weak link to the world economy. The NASDAQ European Bank Index dropped almost 50% in the last year and a half.

Banking remains the weak link of the world economically. In fact, the International Monetary Fund issued a new report estimating that approximately 15% of banks in advanced economies could have trouble sustaining profitability. The IMF report specifically singled out Euro-zone banks (due to non-performing loans) and China, where they estimate that approximately 16% of commercial loans are at risk (Source: The Bank Credit Analyst, May 2016).

Italy tops the list in Europe with almost 20% of loans in their banking system in non-performing status. While Greece and Cyprus have much larger NPL's as percentage of their loans. Their economies are much smaller than Italy which remains Europe's third largest economy. (source: *Thoughts from the Front Line*, John Mauldin, 3/21/16).

Non-Performing Loans



U.S. Banks Weak Too!

Where Else do You Want to Put Your Money?

One of the reasons that I think the U.S. stock market has been so resilient of is that there simply are not a lot of attractive investment options around the world right now. Compare charts of the S&P 500 (1995-2016) vs. several European markets.

As you can see, the U.S. experienced around a 50% increase above the old 2007 high. Germany, the Euro-zone's strongest economy, on the other hand is still well below the 2007 high, only experiencing a 40% bounce off the bottom. The U.K. had maybe a 30% bounce off the bottom (not shown). Spain and Italy are flirting with all-time lows.

If you were an international investor, where the heck would you put your money? The U.S. stock market has definitely led the way and even though we are likely to have some big issues in the coming years, if you're a global investor it has been almost the only game in town.

S & P 500 1995-2016

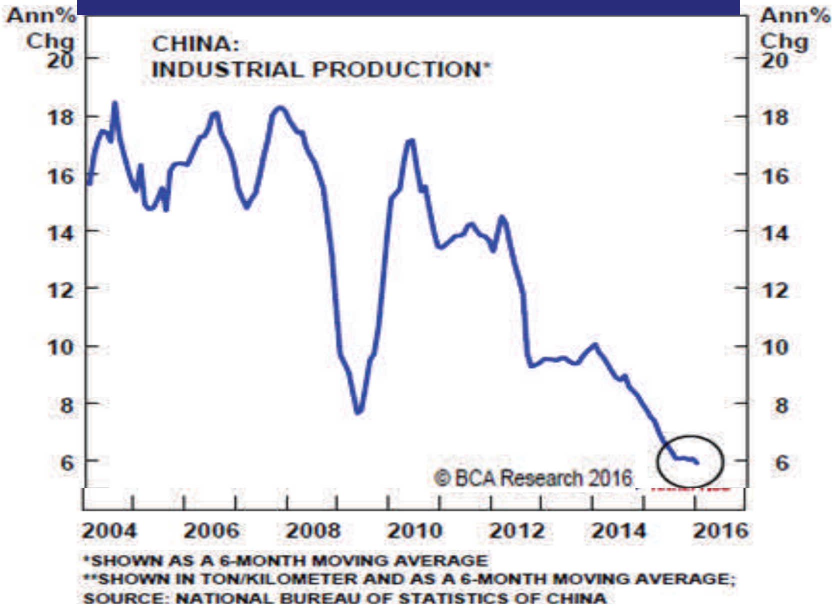
Germany Stocks

Spain Stocks

Italy Stocks

China – Still in Trouble Despite Stimulus

China – Growth??



China launched a new round of loans to stimulate their economy, which in the short run has paid off. However I have recently seen estimates as high as 40% of these new loans are being used to service debts on previous loans in the banking system.

China is somewhat unique in that their four largest banks (which are also the four largest banks in the world) are owned by the government and can be infused with cash anytime that the Central Planning Committee decides to do so. This quasi-public/private arrangement is unique in the world, at least in terms of its size, and it gives the Chinese government the ability to inject enormous amounts of stimulus into their economy almost overnight.

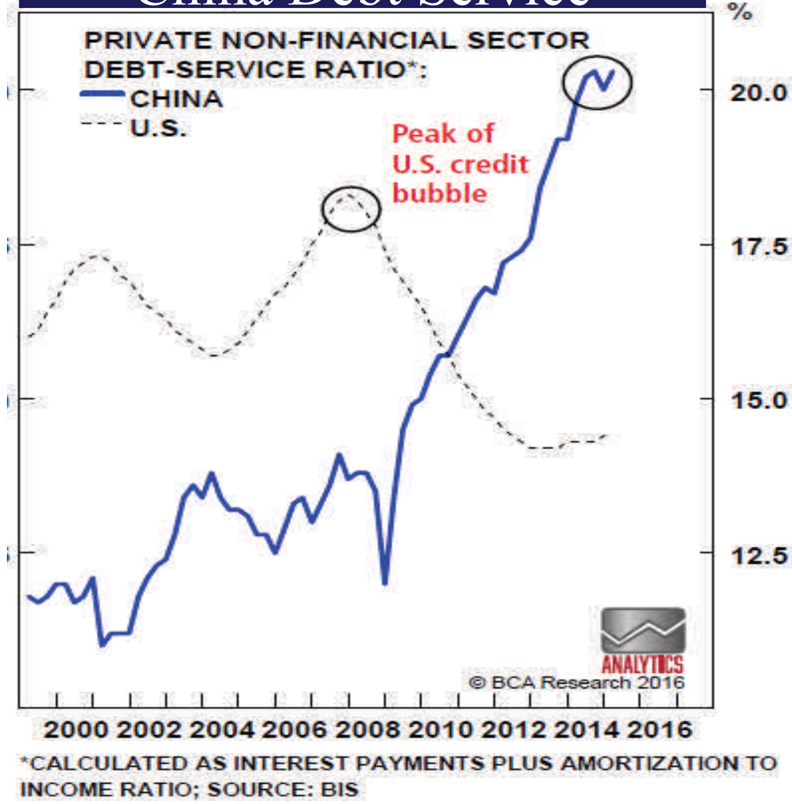
The problem is that there is oversupply virtually everywhere, as industry after industry in China has over-expanded. Chinese business leaders became accustomed to extremely high rates of economic growth in China, in the 10-12% a year range, and these industries borrowed enormous amounts of money to expand their operations, and now can produce way more of their product than even the monolithic Chinese economy can utilize.

In industry after industry, oversupply gluts and unsold inventories proliferate.

This has in turn resulted in plunging prices due to oversupplies in raw materials prices, which in turn jeopardizes the ability for these firms to pay their loans back as the value of their underlying assets in many cases have fallen by half. No one really knows the full extent of bad debts in the Chinese official banking and "shadow" banking systems (non-bank financial institutions) but, the problems are huge.

China Imports

China Debt Service



It will probably take 4 or 5 years to weed all of the bad debts out of the Chinese banking system. It's anyone's guess at the moment how many of these bad debts are going to be allowed to fail as the government does not want people to lose their confidence in the system, but at the same time they cannot allow people to believe they are always going to get bailed out by the government either, otherwise they will be increasingly reckless in their borrowing and investing behavior.

Market Jitters as Bonds Edge Toward Toxic

What may have been the first bond trading halt by a central government-run company has fanned investor fears and forced financial regulators to rethink their supervisory framework.

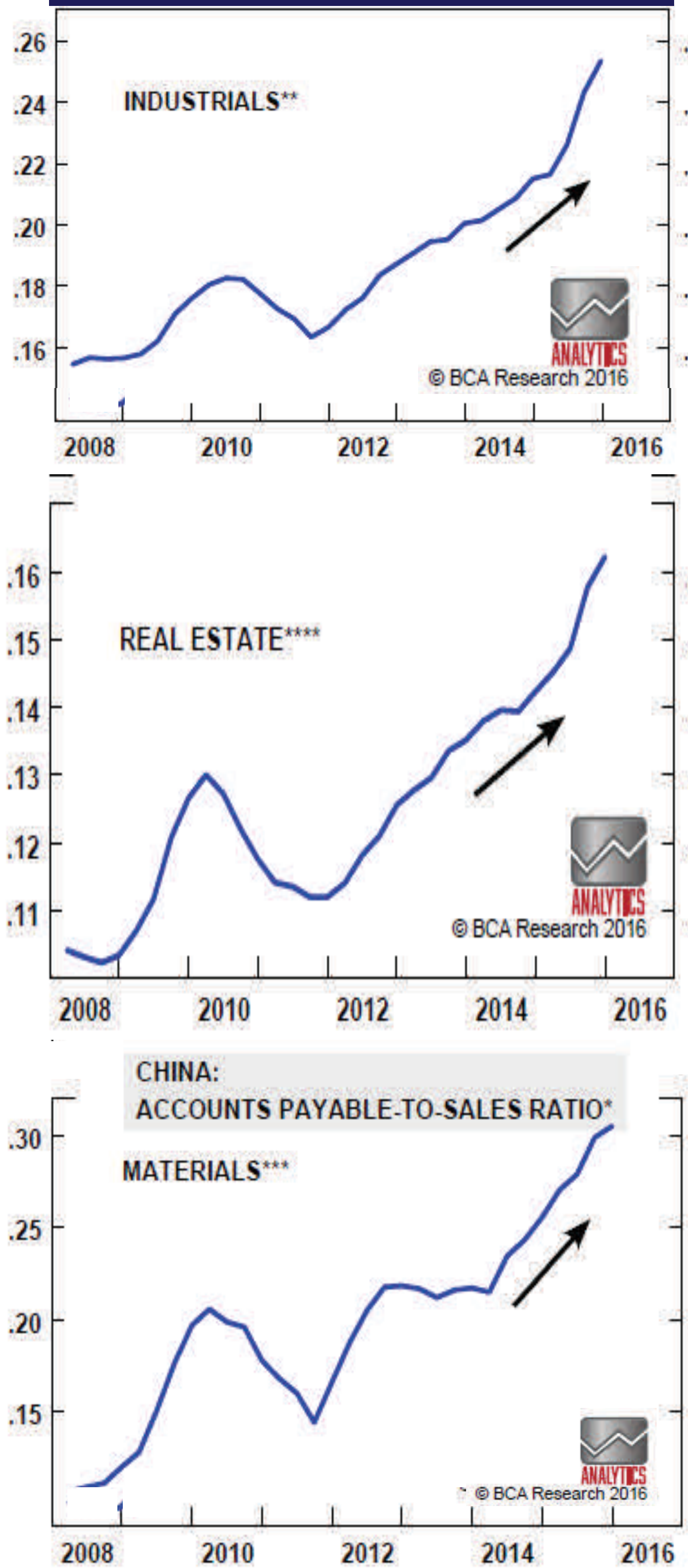
- China Railway Materials Co. (CRM), the nation's largest supplier of railroad construction wares such as iron rails, stunned the interbank bond market on April 10 by indefinitely suspending trades for all of its 16.8 billion yuan worth of bonds.

- Shanghai Yunfeng Group Co., a subsidiary of the country's third-largest property developer, Greenland Holdings Corp., defaulted on two batches of privately placed notes worth a combined 2 billion yuan from January to April, NAFMII said.

- Last October, Sinosteel Co., a steel products trader owned by the central government, missed payments on 2 billion yuan worth notes. In April 2015, a maker of electrical transformers named Baoding Tianwei Group Co., a subsidiary of central government-owned China South Industries Group Corp., became the first government backed firm to renege on domestic bonds. They were worth 4.5 billion yuan.

Toxic debt troubles have long been a fact of life among state and private companies that raise money on China's bond markets. But the problems have been papered over by government support. This means that rather than shoulder full risk, bond investors for the most part have enjoyed a sense of security based on government support for companies they target. Rather than let bond investors lose money when a firm cannot repay its debts, the government has usually stepped in with a rescue package, preventing default. The introduction of "new normal" policies to control a slowing economy two years ago marked the beginning of the end for automatic bailouts. Now, the central government has pledged to stop supporting inefficient companies and slash capacity in some industrial sectors.
(Source: *Market Jitters as Bonds Edge Toward Toxic,* Things that Make You go Hmmm, CAIXIN, 4/24/16)

Accounts Payable



*SHOWN AS A 4-QUARTER MOVING AVERAGE;
SOURCE: BLOOMBERG; BCA CALCULATION
**MEDIAN OF 241 FIRMS
***MEDIAN OF 174 FIRMS
****MEDIAN OF 76 FIRM

In industry after industry, oversupply, gluts and unsold inventories proliferate

This has in turn resulted in plunging prices for commodities, raw material prices, which in turn jeopardizes the ability for many of these firms to pay back their loans, as the value of their underlying assets in many cases have fallen by half.

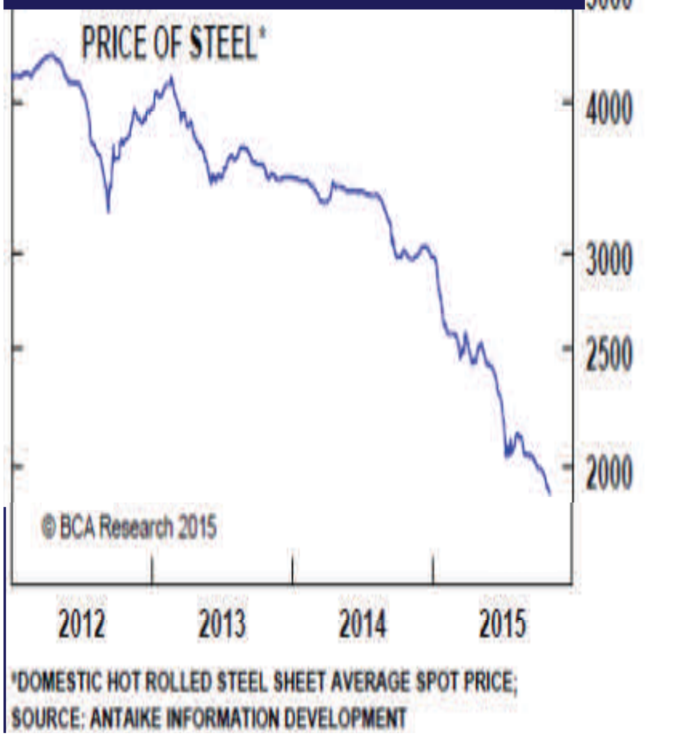
No one really knows the enormity of the bad debts in the Chinese official banking and "shadow" banking systems (non-bank financial institutions) but, the problems are huge.

On the next page you see the price of steel and iron ore as just two examples of how

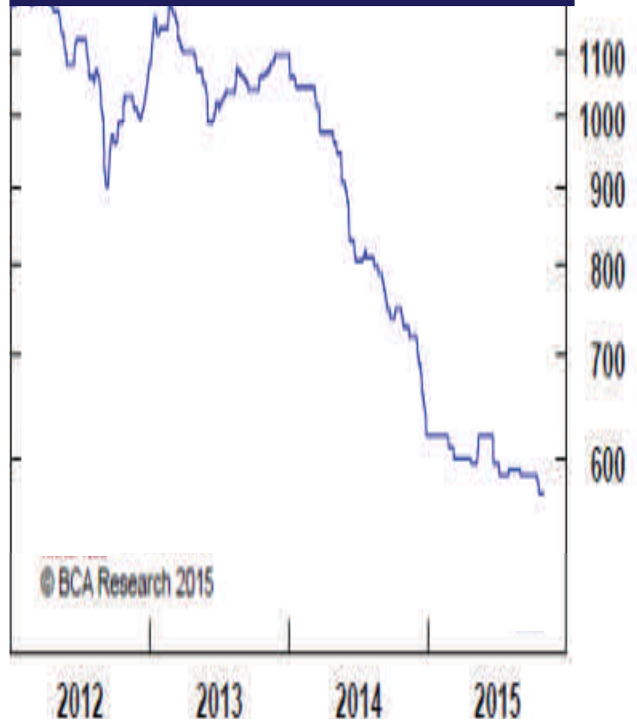
commodity prices have plunged due to a combination of the massive overproduction by Chinese companies, who had gotten used to the extremely high growth rates combined with the slowing Chinese economy.

In many of the Chinese banks and shadow banks they produced investment oriented products linked to the prices of the commodities. For example one investment I heard of was designed to pay investors 10% a year on their money and then give them their principle back in three years at maturity. No chance that these type investments will work for obvious reasons, as the underlying commodities have plunged in price.

China: Price of Steel



Iron Ore Spot Price



The March of the Zombies

China's surplus capacity in steelmaking, for example, is bigger than the entire steel production of Japan, America and Germany combined. Rhodium Group, a consulting firm, calculates that global steel production rose by 57% in the decade to 2014, ***with Chinese mills making up 91% of this increase*.**

In industry after industry, from paper to ships to glass, the picture is the same: China now has far too much supply in the face of shrinking internal demand. Yet still the expansion continues: China's aluminium-smelting capacity set to rise by another tenth this year. According to Ying Wang of Fitch, a credit-rating agency, around two billion tonnes of gross new capacity in coal mining will open in China in the next two years.

China's grotesque overinvestment in industrial goods is a far bigger problem. This binge has left many state-owned firms vulnerable to slowdown, turning them into profitless zombies. Deutsche Bank estimates that a third of the companies that are taking on more debt to cover existing loan repayments are in industries with overcapacity.

Anyone counting on a sustained upturn in the economy would do well to examine the pattern of the past few years. Since early 2012 Chinese growth has been trending downward, despite a rapid sequence of ups and downs. The force behind these fluctuations is on-again-off-again policy support from the government. Determined to keep the economy growing in line with its annual GDP targets, officials have turned to fiscal and monetary stimulus when growth has faltered. Wary of overdoing it, they have pulled back when the economy has picked up.

The current rebound follows a boom in lending as well as a series of policy incentives that have fueled a mammoth property rally in the biggest cities. Total new credit rose by 42% in the first quarter compared with a year earlier, the biggest increase in three years. New home prices in Shenzhen, a southern metropolis, soared by 62.5% year on year in March while those in Shanghai rose 30.5%.

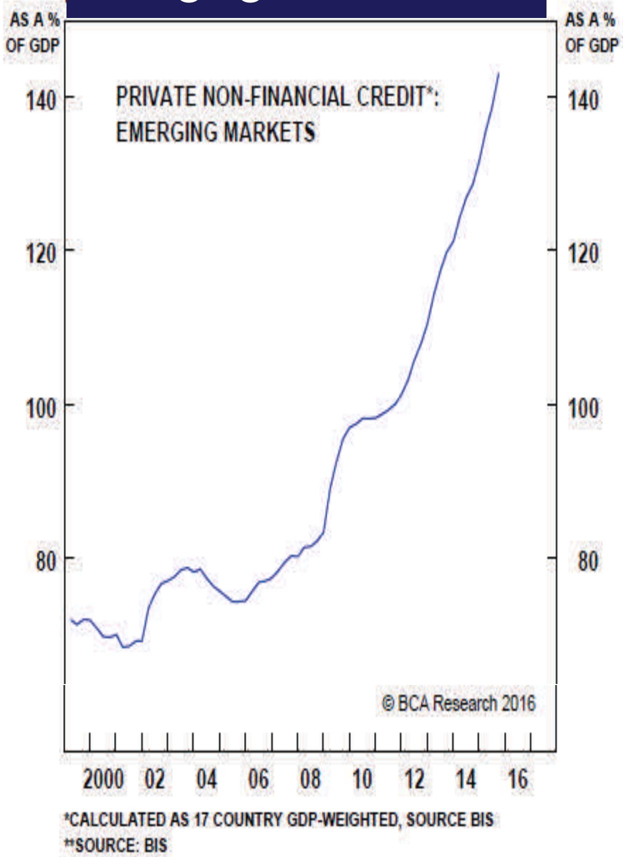
In January the government's broadest measure of credit grew at its fastest rate in nearly a year: Chinese banks extended $385 billion of new loans, a record. But borrowing more as profits dive will only worsen the eventual reckoning for zombie firms. (Source: *The March of the Zombies,* The Economist, 2/27/16)

Emerging Markets Debt Bubble Too

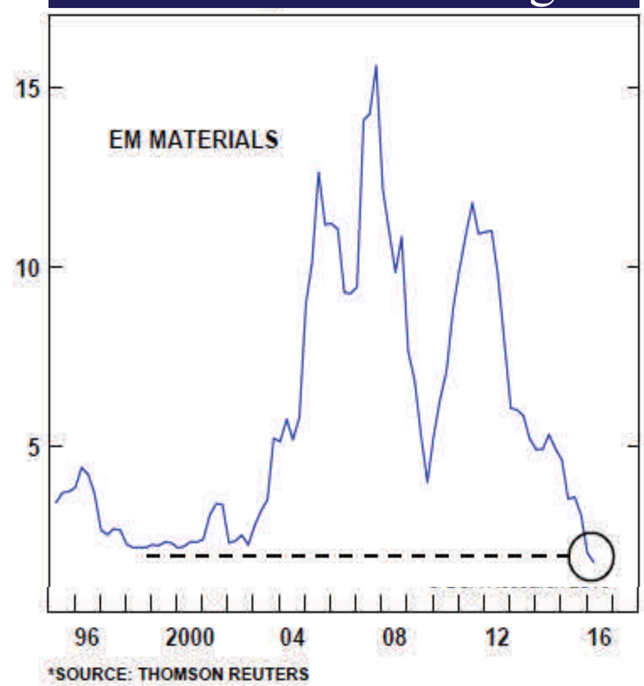
As you can see from the charts the other emerging markets which would include countries like Malaysia, Korea Taiwan, Brazil, Thailand, Mexico, Philippines and Indonesia, have also gone on a corporate borrowing spree in similar fashion to China— in many ways because of China—as many of these country's primary source of business has been supplying China with the raw materials needed to build out the Chinese infrastructure. And remember, the Chinese infrastructure build out has been the largest in world history. But no boom lasts forever, the bloom is definitely off the Chinese infrastructure boom.

The extent to which earnings surpass interest expense for Emerging Market loans has plunged.

Emerging Markets Debt



EM Interest Coverage



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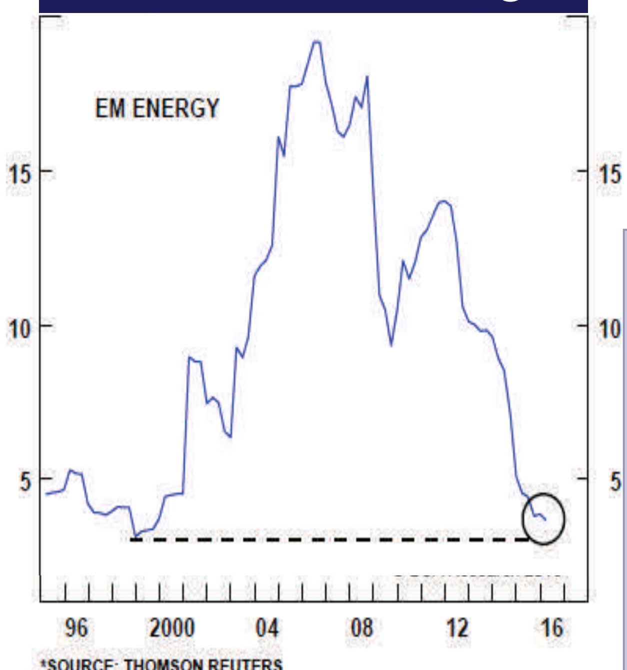


Dollar Surge Endangers Global Debt Edifice, Warns BIS

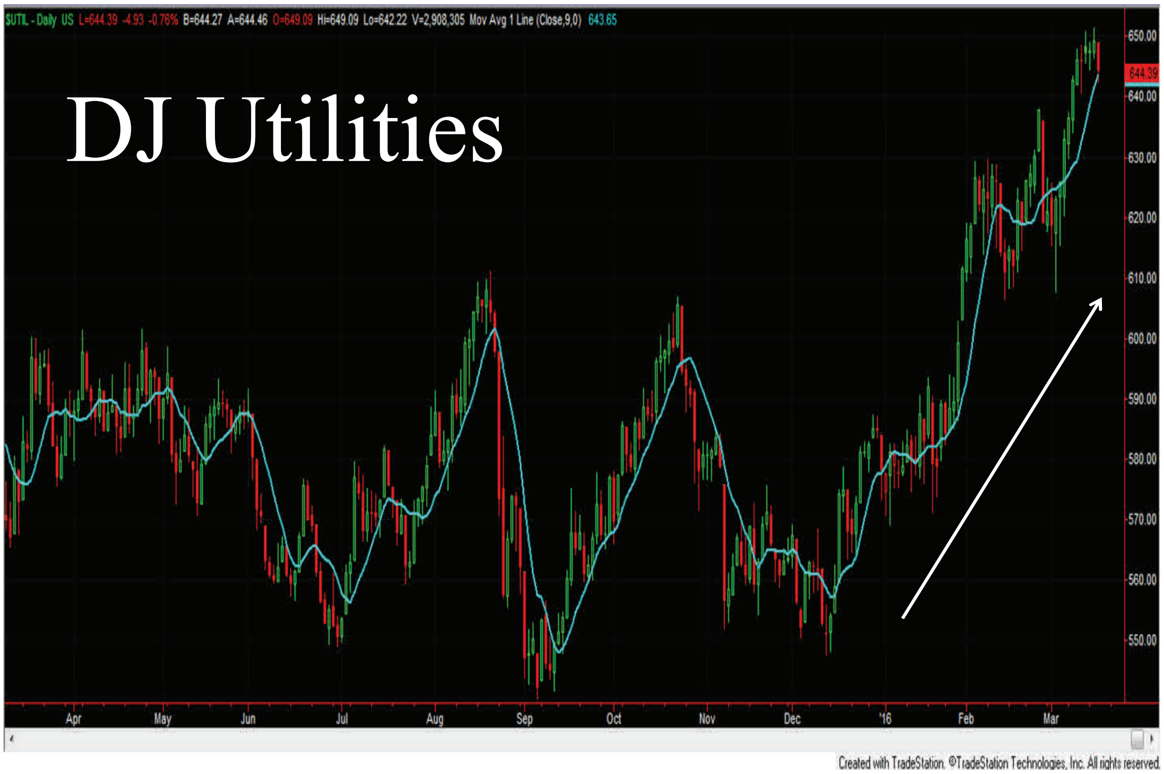
Dollar lending across borders has tripled to $9 trillion in a decade, some $7 trillion of this is entirely outside the purview of the American regulatory system.

The implication is no lender-of-last-resort standing behind trillions of off-shore dollar transactions, increasing the risks of a chain-reaction if something goes wrong. China has ample dollar reserves to bail out its entities should it decide to do so. The jury is still out on Brazil, Russia and other countries. (Source: *Dollar Surge Endangers Global Debt Edifice, Warns BIS*, Ambrose Evans-Pritchard, UK Telegraph, 12/14/14)

U.S. Market Topping Process Continues

I would have thought by now that the lengthy topping process would have concluded, but it obviously has not. However, there has definitely been a shift away from "risk-taking" assets and toward conservative assets, at least amongst the institutional investors. Note the difference in what has happened since last July for the bio-tech sector, which was one of the bellwethers of this last bull market vs. the utilities index, which is viewed as a very defensive sector of the stock market (people tend to continue paying their electric bills even in a recession).

Tale of Two Charts



While one market indicator that we watch (the advance/decline line) has improved significantly this spring, every other indicator that we watch for the market topping process has either stayed flat or declined. In other words six of the seven primary indicators that we watch still confirm a coming bear market.

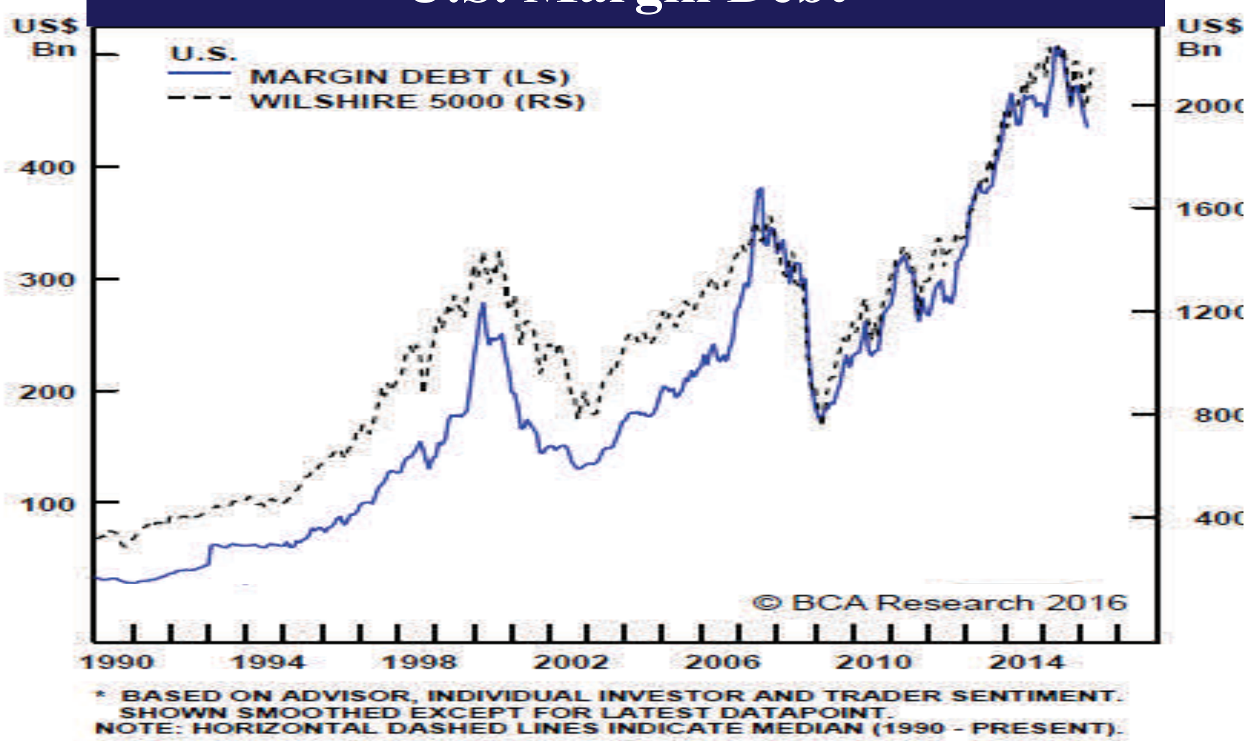
- Earnings – the U.S. market has now experience 4 consecutive quarters of negative earnings growth which is very rare unless we are about to enter a recession.

  Bank Credit Analyst noted that U.S. earnings per share growth has fallen -7.2% y/y. through March (source: *The Bank Credit Analyst*, May 2016)

- U.S. Margin Debt, which I would view as probably the single most important supply/demand indicator has continued to fall making it apparent that last July was likely indeed the top of the market cycle. As investors get more skittish and pare down their margin debt, this will likely put increasing selling pressure on the market.

- Seasonality – as we mentioned on page one we have now entered what historically has been the weakest 6 months for the market. Vacations by Wall Streeters produce lower trading volume in the summer, while September and October are typically when the bigger declines occur. September and October are not always negative, producing positive numbers many years, but if you look at the data the big crashes somehow always end up being in September and October.

U.S. Margin Debt



U.S. Market Topping Process Continues cont.

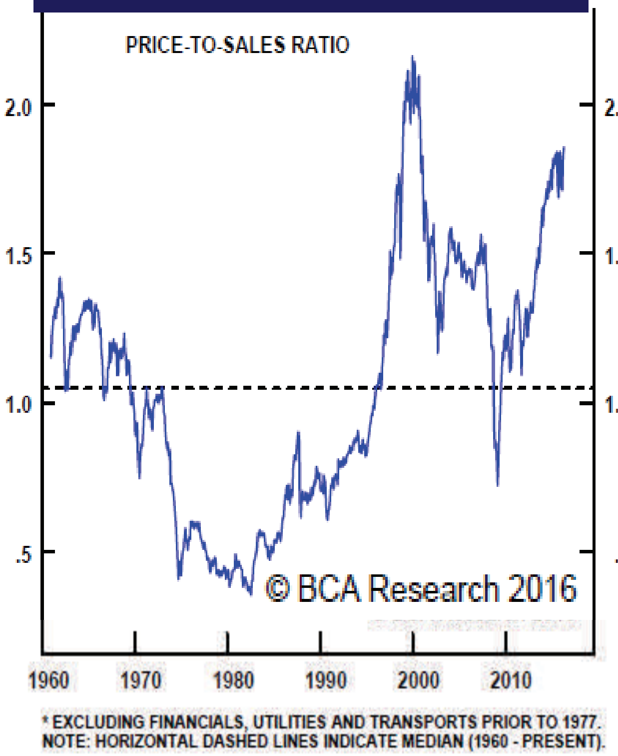
- Banks Weak – the U.S. banking sector has been hurt by the oil market, the strong dollar and other factors and has confirmed a “official” bear, by Wall Street’s rules, dropping 30% from the top last year until mid-February. While banks have experienced a bounce along with the rest of the market since February they remain in a confirmed down-trend. (See chart on pg. 3).

- Broker-Dealer Index—Stocks making up the Broker-Dealer Index which typically are firms that underwrite or sell securities also confirmed as a bear market in February, having fallen more than 30% from the top. The B/D Index has been bouncing this spring as well.

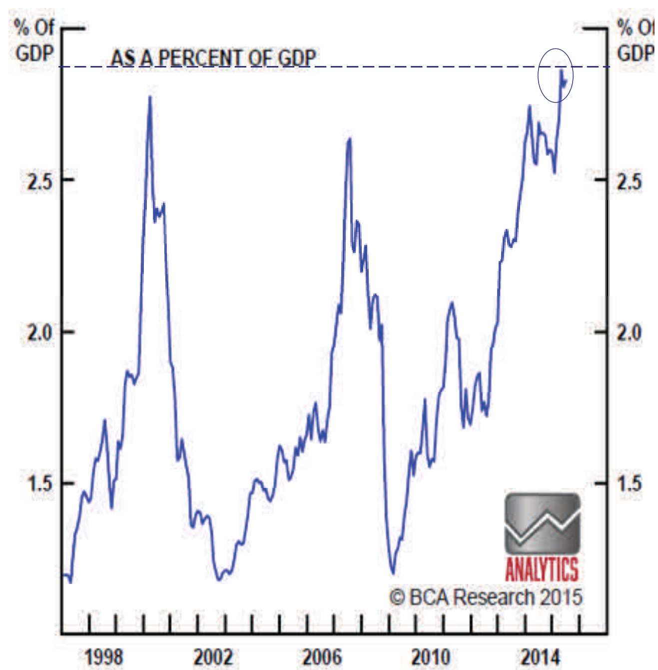
- Overvaluation – as we’ve mentioned many times previous the stock market has been as overvalued as almost any time in history with the exception of the Mt. Everest mega-top in 2000. The toxic combination of stocks being too expensive or over-valued combined with extreme leverage is what usually produces the largest bear markets.

ARCA B/D Index

Price to Sales Ratio



Margin Debt % of GDP



Conclusion

In conclusion, nothing has really changed since our recent newsletters published between December and February. We still remain (in my opinion) in a massive topping process, yet virtually all the things we watch for with one exception have topped or are falling. We still view this as a very risky market. As we've stated, the biggest bear markets tend to follow the highest levels of leverage (margin) when combined with over-valued stocks.

It's understandable why at least some people would continue to hold onto their U.S. stock positions, considering that the dollar has been rising. This means that overseas investors are seeing their investments go up in value even as the stock market has gone sideways for over a year, simply because the dollar has appreciated against most currencies.

However we are likely in the 9th inning of this rally and I believe that "really bad stuff" is about to happen internationally. The Euro-zone and Japan are exceptionally weak economically with markets that have abysmal looking charts. The primary engine of growth over the last decade plus, China, has enormous problems in their banking system and surplus capacity in all their major industries. Plus deflation.

The emerging markets which have followed China up in both their growth and their debt bubbles are having big issues just as China is, but generally do not have the financial resources to bail out their institutions and their problem debts as they go bad. And that's not even taking into consideration the potential for a major war in the Middle East with Saudi Arabia and Iran drawing lines in the sand against each other. I am planning a Special Report on the growing ***Holy War, Middle East and Oil***.

No bull market lasts forever, this one has been great while it lasted, but I believe it is in its last gasp. Institutions have shifted toward the defensive sectors of the market inside the U.S. And while nothing is exempt if the meltdown is bad enough, I personally believe that the U.S. economy will likely be the most sheltered in the next storm of any other major country, as we have purged most of the bad debts from our banking system and we are least vulnerable to shocks from China and the emerging markets, as we are not an export driven economy.

One potential benefactor of the coming shocks could be U.S. real estate. Remember that sequentially, the crises never seem to hit the same place twice in a row. Real estate got clobbered in 2008 but the vast majority of the problem loans in the system have been dealt with as real estate has risen since 2009. In addition foreign investors are sitting upon enormous amounts of U.S. dollar reserves. If the U.S. stock market begins to have trouble and U.S. bonds are paying almost nothing in these days of low interest rates, what is an investor to do?

In sum, I believe that the world economy is just about to enter another round of deflationary pressures. In the long run I still believe that inflation will be the big problem but it looks like not for at least a couple of years. In the short run, we think you should either be very conservative or use money management strategies that have the ability to make money in down markets.

As you can see in this newsletter, Jerry believes we have reached a market top. Today, many important indicators are flashing red. Perhaps last time your portfolio went down you promised yourself that you weren't going to ride it out next time. <u>This may prove to be the best time to take us up on our complimentary review of your finances.</u> Call 800-327-4285 and request Lesli, to schedule an appointment.

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All technical analysis and resulting conclusions and observations are based upon historical chart formations and patterns. Therefore, observations are a function of each analyst's interpretation of the charts—and also a function of mathematical probabilities. In effect, technical analysis is a study in probabilities. What happened x number of times in the past per a particular chart pattern does not mean it will always recur in the future. It logically follows that historical precedent does not guarantee future results.

**Global or international investing involves special risks, such as currency fluctuation, political instability, and different methods of accounting and different reporting requirements.*

**MACD is the difference between a security's 26-day and 12-day exponential moving averages.*

** The S&P 500 is an unmanaged index comprised of 500 widely-held securities considered to be representative of the stock market in general. You cannot directly invest in the S&P 500 index.*

** The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. You cannot directly invest in the NASDAQ Composite index.*

** The Russell 2000 is an unmanaged index comprised of 2000 smaller company stocks and is generally used as a measure of small cap stock performance*

** The Dow Jones Equity REIT Index is a capitalization-weighted index composed of 114 US listed Equity real Estate Investment Trusts (REITs) comprising 95% of the equity REIT investable universe*

** Small Cap stocks may be less liquid and subject to greater price volatility than large cap stocks.*

** Sector investing may involve a greater degree of risk than investments with broader diversification.*

** Investing in securities involves risk including the loss of principal invested. Past performance is no guarantee of future results.*

based on adverse economic and regulatory changes. As a result, the values of real estate may fluctuate resulting in the value at sale being more or less than the original price paid

** The price of commodities, such as gold, or oil is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility. In addition, investing in commodities often involve international investing in emerging markets, which involve significant risks. Please consider all of these risk factors before making a decision to invest in any product.*

** Investments in real estate have various risks including the possible lack of liquidity and devaluation*

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