

Power Shift

When 2014 began, few thought that the markets had the ability or the urgency to achieve yet another year of record high valuations. Overall, however, most investors would agree that their expectations have been more than fully realized. My research sees stronger fundamental underpinnings for market performance, even acknowledging any potential economic risks on the horizon. This generation's "Great Recession" has slowly become a financial rebound of historical proportions. Never mind that the "net return" on equities during the past six years has been less than five percent...peak to peak...clients are jumping in full bore, or so it seems.

So what could possibly be the problem?

Two things stand out immediately. First, the percentage of persons who actually own stocks has dropped precipitously over the past decade. Burned by crises in dot.com and the housing/credit markets, investors are loathe to play the game. In effect, the greed and recklessness of Wall Street has single-handedly managed to alienate a large percentage of its current and potential constituents, such that many would rather leave altogether than try to compete with computers, traders, or worse, crooks.

Secondly, geopolitical unrest and domestic political inertia have depressed investor's psyche and flow of capital sufficient to shut off a major source of innovation and ideas that once galvanized great societies to create scientific wonders, brick and mortar infrastructure, social institutions, and moral goodness.

All is not lost, however. We simply need to re-boot political and social willpower to create a fair and equitable playing field for commerce. A classic imbalance between "*what is*" and "*what it should be*" is tilting the landscape towards inertia, in spite of the fact that the stock market is making record highs. If we are to believe the widely held theory of "trickle down" economics, then those who benefit most from the market's largesse must step up their activities in and contributions towards education, energy, economics, ethics, and charity. One should not be surprised to hear that, for the disaffected, they feel the tail is wagging them!! Look, no one begrudges the markets doing well. But if we look back on the previous two years (post recession) and realize that all we did was to widen the gap between the affluent and the poor, and then the market's recovery might have been for naught. For too long, we have equated the success of the financial bourses and our own economic well-being with how many things we acquire, a limitless demand for disposable consumption.

Markets

The flight *away from* consumption might be this bull market's greatest legacy. Today, greater efficiency and cost savings punctuate the culture of a larger percentage of companies that trade on global exchanges. **One might correctly posit the notion that there is a direct correlation between the advent of computers and a steady decline in the cost of doing business.** The erosion in energy prices worldwide, for example, is not an inadvertent event, but rather amongst other factors a direct link between a shift from heavy machinery, exclusively, to computing power. In this regard, we observe that access to wealth and power within the citizenry is getting broader, not shallower. The migration of technological efficiency into business is this generation's hyperlink for social and economic change.

As processes and technology improve, not just in energy production but across a spectrum of businesses, so too will the probability of capital gains and profitability. Signs are already there that the recession has bottomed out. Our best economic, scientific, and political minds are now searching for creative alternatives to finding and building wealth. Changing demographics are altering the landscape in profound ways. The world's aging population is a factor in the creation of life saving medicines, and the growth in pharmaceutical and healthcare industries. Residential migration to the cities imposes a declining burden upon rural communities, while placing more emphasis upon urban matters such as efficient automobiles, modern transportation, newer schools, and energy efficient buildings. The "new economy" will need civil engineers and financial accountants. The cost of retraining and educating the workforce is an issue our political leaders must address and finance. Gridlock is no longer an option.

Anecdotal evidence suggests that the public and its leaders are starting to "get it". There is momentum in certain market sectors that is having a spillover effect upon other sectors. Beyond the statistics and data, the conversation is getting more positive.

For example, while we know that the current decline in energy prices is having a positive effect upon corporate profitability and trade data, its anecdotal impact also can be felt in households and boardrooms as spending in retail and other discretionary activities accelerates. Pricing, which has always had an influence upon gross domestic product (GDP), is moving in favor of consumers. Last year's retail sales and durable goods orders (inventory growth) slowly improved from the year prior. Thus, more aggressive market sectors are seeing a greater influx of investment capital.

Most of the market's attention is focused upon equities, but we also have a keen interest in the bond market and the future direction of interest rates. While it may be a "foregone conclusion" that austerity packages must unwind at some point, it is our particular concern the manner and rate of monetary tightening. The fundamentals are in place to support a 3% ten year Treasury bond yield, but it is the journey getting there that has my attention the most. Letting interest rates float is a delicate undertaking, and we must trust that the Federal Reserve has its finger on the pulse of the economy with great care. To reduce portfolio volatility, we have already begun to shorten portfolio bond maturities or to sell appreciated bond positions and to redeploy assets into other asset classes.

Strategy

One of the ways my proprietary tools are able to isolate economic changes is by quantifying money flow from source to target. We anticipate this quarter to be heavy with activity in Industrials, Basic Materials, and Technology. In addition, those sectors in which efficiencies are creating capital gains, like alternative energy and biotech, have a strong bias in our models. As funny as it may sound, an odd coupling between raw materials and computers now fit together like hand-in-glove!!

Volatility is part of the investment game. The VIX (volatility) index had been especially active at the end of last year. October's market swoon was a bit of a jolt to those who thought the bull market would never go down. But interestingly enough, the psychological transition that lower equity prices afforded them was a boon for stock performance at the end of the year and going into 2015. **We see enough of a combination of conservative and speculative money going into selected sectors to justify our expectation for a continuation of the current short cycle advance into the first quarter of the year.**

This is what markets and economies do. They go from up to down, and down to back up again, sometimes in a linear (straight line) fashion, more often parabolic. What we see is that declines tend to inspire new generations of solutions. Usually, during those declines, societies adapt by doing more with less, creating technology and inspiration in the process. Then, after a few decades of growth, markets fall back down again from the weight of the excesses, greed and neglect that have been created. When the headwinds are at their greatest, the pack separates into the haves and the have-nots.

It is at our most bountiful times that we need to pay attention to our social conscience. If not, when the bad times inevitably occur, we could wind up with a moral and financial deficit, a time of extreme recalibration...that curiously looks a lot like the precipice that is January, 2015.

Conclusion

Current trends, although slightly exaggerated, are confirming the likelihood for a continuation in the bull market, but certainly with a "duller edge" than in the previous two years. Earnings that derive from consumer demand are becoming more sustainable than those which are crafted from accounting alchemy. Consumers are emerging from their shell, but slowly and cautiously. This, while still reeling from the after-effects of a decade and a half of Wall Street's bad habits.

Our work focuses not so much on the day-to-day gyrations of market mania, but on a quantification of cycle movements within a longer macro demographic. **As a result, we feel safe in predicting that 2015 will see a steady migration from laggards to leaders and that sentiment will improve for the future.** Every asset class and sector has its individual merits, but the rest of the year should be a rebalancing of leadership from defensive equities to aggressive and innovative opportunities in Biotech, Energy, Food and Agriculture, Ecology, and Infrastructure.

The remaining questions to be answered for 2015 are whether higher stock prices place too great a burden upon historical earnings acceleration patterns (P/E) for markets to continue to perform, and whether higher interest rates might wreck the magnitude of the gains we already have achieved.

Suggested Balanced Account Asset Allocation Q1, 2015: Equity 65%/ Fixed Income 15%/ Cash 20%

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