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Ice Cube

Because the markets continue to make new highs, and have seemingly stabilized around a new normal, investors find themselves with the unenviable dilemma of trying to decide whether the market is about to *"melt up",* as some have called it, or melt down. Obviously, the answers are critical not only to your net-worth, but also to your emotional well being, as well.

Granted, there are credentialed scholars and pundits on either side of these issues....that's what makes markets, after all. But one's intent, on both sides, should be to develop and master a set of rules, a discipline, by which one can improve the probabilities of portfolio success under all market conditions.

No doubt the range of possible scenarios for this market, at this time, is vast. My approach is to combine traditional fundamental analytics along with proprietary quantitative statistics to arrive at a set of variables which narrow the possibilities, and probabilities, of these factors negatively influencing my outcomes.

Since all investing involves risk, let's start with the thesis that *current market valuations are already at magnitudes which defy traditional cyclical gravity.* That is not to suggest that it can't go higher, or that there is something "wrong", or not quite right, with the equity market's recovery. Instead, we need to apply a wisdom that comes from experience, along with empirical metrics, to identify what signals are being given by the markets, and what restrictions the secular/macro overlay might impose upon them.

It seems that, this time around, some analysts are only focusing upon the "improvements" they see in areas such as housing starts, unemployment, corporate earnings, etc. to justify their scenario that the economy, and therefore the stock market, is, and should be, accelerating. While I have no specific quarrel with those who espouse that point of view, I would point out that the improvements they cite represent either a return from the depths of the recent recession to levels previously achieved, or an alchemic corporate accounting which creates and encourages large hordes of cash in corporate treasuries, even as the average investor struggles to gain any foothold in his savings levels.

We should also acknowledge that without those average citizens and their discretionary savings/dollars, economic acceleration would come to a screeching halt. How could it be possible to sustain the stock market's earnings gains without a vibrant and stable consumer base?

My proprietary analytics draw the following macro conclusions:

***Inflation and higher interest rates are definitional components of any economic renaissance, even if temporarily (artificially) suppressed.**
***The depletion of natural resources is an ongoing global crisis.**
***Earnings and productivity are shifting from West to East, changing the balance of economic and political influence.**
***The globe's population, infrastructure, and climate is getting "older".**
***Austerity, as a response to previous excesses, is causing economic contraction and hardship for the less affluent**.

Markets

With the massive amount of deleveraging that has been taking place globally, I can envision several scenarios which might carry enormous risk for future equity performance. Bear in mind, though, that absent a suitable alternative, stocks are still the best game in town. While global central banks try their best to keep interest rates down, the influences of their monetary policy are confirming the theory for those who subscribe to the "melt up" philosophy of market inevitability. *"Why not go up?",* they ask. *"There are no other options for investing, at present".*

These theories, however, are not effectively looking at probabilities, science, or recent history. They calibrate only one side of the equation: the current "improvement" in economic statistics. While it is possible for the markets to continue making new highs, advancing in an almost linear fashion, satisfying our obsession with stock performance, it is also highly improbable for it to do so. **Whenever a bull market surges, investors forget that each upcycle also implies a regressive downcycle response. There are two sides to a parabola**. I will acknowledge that we are in a remarkable secular turnaround, a new bull phase emerging from economic collapse, but those resounding rhythms have become excessive and overvalued in the short-term according to my analysis.

There's nothing wrong with being defensive, awaiting the "next shoe to drop". As the old parable tells it, better to be prepared with a brick house than to be blown away by a capricious, unexpected wind. Asset allocation is our brick house.

Economic and demographic realities demand that we focus upon and overweight in **emerging markets, telecom, infrastructure, banking, utilities, alternative energy, healthcare/pharmaceuticals, technology, and agriculture.** Demand in these categories is certain to increase in underdeveloped regions and investors need to stay ahead of the curve, not rejoicing for too long in their current success at the risk of being run over by the next cyclical undertow. The global economy is not yet under such intense pressure that inflation has taken hold, but it is a likely cyclical/secular possibility. Nor do these data exist in a vacuum. The moral, societal, and lifestyle needs of the unfortunate amongst us are inexorably interconnected to the aspirations of those who are well-off and in need for very little more.

It's also important not to conflate *the market* with *the economy.* While many fortunes are being multiplied, or created for the first time, by the market's five-year recovery, many more people are not quite as fortunate. Whereas the technology and desire to address many of our social inequities might exist, we have yet to capture completely the attention of the financial and political gurus who wield the power and control the economic resources to do so. **Government and Wall Street might not be the answer to all that ails us, but they certainly shouldn't be part of exacerbating the problems, either.**

<u>Strategy</u>
During the halcyon age of consumerism in the 1980's-90's, our collective cultural psyche evolved from our parent's Depression Era mentality to a "Gordon Gekko-like" aggressiveness. That kind of thinking was sustained, and even encouraged, as long as people had good jobs, the world was not at war, and asset valuations were rising. Unfortunately, the recent recession wiped out a generation's worth of net worth, as well as the all-consuming enthusiasm we might have had for playing the casino game of "capital appreciation". The market's collapse took all the wind out of our sails, even as it may have recalibrated the opportunity for wealth building and starting over. I have seen firsthand that some just prefer not to play in the markets any longer, believing the game is rigged or unfair, serving as a playground only for those who can already afford to take the financial risks.

We are rapidly moving into a bifurcated structure in which some pontificate about, and dabble in, the economy and financial markets, and others whose reality is far from the canyons of Wall Street. We need to develop a sense of empathy for both points of view, but not to be so consumed by the 24 hour ups and downs of equity trading that we lose a sense of compassion and perspective. The run-up to the last market crash was gradual, but fueled by excessive speculation. Leverage, in the form of bigger houses, more margin on securities transactions, increased fees on bank products, indiscriminate consumer borrowing, might have increased valuations, but it also increased the sheer number of "things" that saturated our landscape.

It all seemed so good as long as the pile of "things" continued to appreciate in value. Once it all started to unwind, the creditors had to be paid. Resale values fell, collateral fell, enthusiasm fell. In short, the whole thing collapsed upon itself.

Leverage is good if used wisely. My fear is that those who espouse the never-ending bull theory of this current recovery are only looking at valuation expansion, again, as the barometer of perpetual success. The public is skeptical that there might not be a second or third economic collapse in the offing within their brief lifetime. By compromising its integrity to create the bubble, Wall Street is contributing to that sense of uneasiness. "Melt up" or "melt down" is not the issue; cooking the golden goose and forever ruining opportunity for everyone else is the issue.

New highs? Old news.

New paradigm? Try *"old paradigm redux".*

Suggested Balanced Asset Allocation, Q3 2014:
Equity 55%/ Fixed Income 25%/ Cash 20%

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