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Altitudinal Indigestion

As the US markets made multiple consecutive new highs last quarter, less overhead resistance meant greater unlimited upside potential, even as the "air supply" became less plentiful. But untapped potential also raises concerns about whether economic fundamentals are really strong enough to keep stock rallies going. To do so, there needs to be a clearer picture about what default options are available to investors if equities' prices continue to rise, or if events on the ground dictate a contraction. Despite staggering to a jittery ending in the past few weeks, benchmarks are indicating that the markets have a bias to continue rising.

Depending upon one's tolerance for volatility, financial indices are either *recovering their true potential*, or *leaning towards excessive valuation*. Thus far, the relationship between corporate profits, consumer spending, lower interest rates and GDP has shown a remarkable equilibrium, even in the face of variables which have the capacity to destabilize them.

While being held psychological hostage to exogenous current events (terrorism, Mid East tension, airstrikes in Syria and Iraq), investor's commitment to financial instruments is actually picking up steam. The classic pull between speculators and fundamentalists is tilting towards staccato trading, which helps further the debate about whether the current sequence of new highs is reality-based or merely a fiction of grandiose proportion. Nevertheless, one cannot argue that this year's portfolio appreciation has been good for the psyche.

The only difficulty I see with these patterns is that the sector weightings of today's portfolio bull are narrowly defined, and that the breadth of participation is likely to stay quite shallow in the next few quarters. In fact, if economic recovery were to become more inclusive, those most likely to do well would be cost-push sensitive companies (commodities, non-cyclicals) and harbingers of inflation, the one stealth tax we all wish to avoid.

Ultimately, we surmise one of two things will happen, neither of which is promising for the high-wire gamblers out there. Either the market accepts that *"fundamentals matter less"* and continues to push forward, or the economy actually *does* improve beyond current constraints so much so that interest rates start to rise leading to the onset of higher prices for goods and services.

At present, my models favor the "improving economy" scenario, and a likelihood of higher interest rates, higher economic output, and (modestly) higher equity prices. One shouldn't find it strange, though, that this "good news" overlay might be negative for stock performance in the short term as we grow accustomed to a new normal in pocket-book economics: a strengthening in employment, wages, and, of course, prices. Additionally, I would expect sector allocation in portfolios to migrate towards tangible assets and industrials in that scenario. We might also be mindful that a rise in interest rates sets up an alternative investment scenario away from stocks and into bonds, a balance which I think investors would welcome.

The one thing we must be careful about in this "good news" panorama is how rising prices might impact upon corporate profitability. Those businesses which rely upon customer foot traffic could be vulnerable to a slowdown in discretionary spending if consumers decide to "bank" their new-found largesse. The ability to pass-along core costs to the end-user is vital if corporations are to maintain profitability and sustainability. **When the demand pipeline contracts, business loses its most valuable means of generating profits and share price appreciation.**

One reason why I might expect investment banking activity to increase in the next few quarters is that it is cheaper to acquire profits than to build them from scratch.

Markets

Equity prices are trading at P/E levels well above historical norms as a result of the five year run we've been on. Thus, most benchmarks look too expensive to this observer. Fair market value would look more balanced at 13-15 times forward earnings projections. In light of current earnings and price acceleration rates during 2014, it is dangerous to project too far out with so many variables as yet unanswered. Do we consider double-digit equity returns to be logical for 2015? Might earnings actually catch up to share price expansion? And what if equities recede in the face of slower consumer demand, profit taking, higher interest rates, or some unknown global conflagration? My work is indicating not more than historical rates of equity price appreciation for next year (6%), as the fourth quarter of this year becomes a staging area for necessary changes and rebalancing of portfolios.

We also have to consider the impact of psychological reticence even to bother with the stock market on the part of some investors, having been burned at least twice already in the last 15 years (dot.com, credit crisis). The impact of having a "dual" emotional connection to the financial markets (in or out) cannot be overstated. Out of fear, confusion, or desperation, some have even expressed that they now prefer a return *of* their assets, more than they are seeking a return *on* their assets!!

There is no doubt in my mind that the Fed will eventually abandon its bias to keep the cost of money low. Global macro factors are too strong for the markets to be manipulated into an artificial condition of euphoria, even as we hold on to cash with a vice grip. The influence of austerity programs and governors of money supply is beginning to wane. In fact, I would argue that the policy combination of austerity and lowering interest rates has created a schizophrenic confusion within the financial markets at a time when absolute clarity was needed. I have written repeatedly (and sarcastically) that "**you can lead a horse to water, but you can't make him *spend***". The Fed has diminished the capacity for recovery in the short term, I believe, by creating a population bifurcation as it relates to the allocation of spending and savings: those who have the resources *are* spending, those who do not *cannot*.

Additionally, corporate expenditures have been subdued during the market's recovery. Unless business can see a scenario in which they are rewarded for taking on new costs, they will be hesitant to do so. As with all market barometers, these things are variable, cyclical, and unpredictable. The one constant amongst all principles of business endeavors, however, is that **demand drives revenue growth, which in turn drives asset expansion potential.**

The financial markets are not entirely to blame for the volatility they sometimes exhibit. Investors, themselves, manifest certain characteristics that lead to their emotional ambiguity. Without having a strict discipline, most people succumb to greed and emotionalism when it comes to portfolio structuring. Just like "*keeping up with the Jones'*", many follow the herd, jumping in too late and too enthusiastically. Rather than subscribing to a prudent methodology, some buy in when the market *confirms* momentum, and sell out when the indices *retreat*. Greed guides them in, fear takes them out. This is exactly the opposite of how opportunity should be uncovered. We cannot forecast precisely when risk will occur. We know only that risk is always a part of the investment equation. Therefore when things are at their worst, opportunity for upside performance is usually at its greatest. Conversely, with the averages trading at these levels today, it is incumbent upon us to play the trend but to prepare also for a potential reckoning. That's just the nature of the beast, and what we saw in the past few days of trading activity.

Conclusions

The strongest performers for the first three quarters of the year are not likely to be the strongest performers into the balance of the year. As mentioned, valuations and momentum are simply too high to be able to count on a continuation of price performance without some kind of pause or profit taking such as occurred at the end of last quarter. However, the obvious place to look for performance and balance within one's sector allocation going forward is in those sectors, regions, and capitalizations which have not yet manifested full pricing potential, such as Basic Materials, Biotech, Energy (alternative sources, in particular), and Financials. The cyclicals should lag, until the consumer jumps in convincingly.

The secular demographic themes that I believe will lead to near and long-term portfolio opportunity are in **infrastructure development, agriculture, healthcare and life sciences, military/defense, ecology, and energy.** For example, my quantitative work confirms an increase in industrial activity globally, with commensurate demand for commodities and currency. The valuation potential of these sectors when measured against current levels is compelling. Ancillary businesses which could benefit from these demand shifts include internet, transportation, and real estate. Earnings acceleration always drives valuation expansion. We simply need consumers to step up to the plate with their money and spend convincingly, as we need business to demonstrate a commitment to capital expenditures without hesitation.

It would be foolish to say that we are at a critical inflection point in the markets right now, because in the world of parabolic sciences there really are no *points*, just *periods* of accumulation or distribution. Indeed, we are at levels sufficient to suggest it is appropriate for a distribution (downtrend) in equity valuations to occur, but given no empirical evidence to the contrary, I would prefer simply to abide the uptrend, and to be smart about balancing risk and current allocations. In other words, the fourth quarter should be a parallel to what has already occurred this year.

Suggested balanced account asset allocation, Q4, 2014:

Equity:	65%
Fixed Income:	10%
Cash:	25%

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