

Market Outlook:

Time horizon

Much of investing is really about an investor's ability to absorb risk, and his/her timeline for expectations about returns. Even though the markets retreated last week on disturbing news about domestic and international corporate earnings and geopolitical volatility, investors with a longer time horizon have expressed becoming more comfortable with a greater exposure to stocks. The traditional underlying risks associated with owning stocks, they say, are mitigated in their decision to allocate more of their resources, comfortably, if the reward is there, ultimately.

By definition, however, as their gains accumulated during the recovery, so too did their risks. Last week's precipitous drops might prove to be a harbinger of a pullback long expected. Watching one's presumed gains erode on cyclical dips is a difficult leap of faith. *Does one really have a commitment to "long-term" horizons, or is the impulse to get out when the getting is good more compelling?*

Given that markets, like all things, are parabolic in nature, the answer is "a little of both." I know it might sound like equivocation, but striking an effective balance is a part of "active" (versus passive) portfolio management. The schemes that fit the paradigm for a perfect portfolio allocation don't exist unless an overlay of risk/reward assessment, time horizon, and macro factors is considered.

Because the markets were so adversely affected by the spending excesses and credit crises of the past decade, exceptional opportunities for capital gains became plentiful at the zenith of market performance in late 2008-2009. It was a unique, generational occurrence, which has paid off handsomely for the very bold. Despite its extraordinary returns, this bull run has several anomalies which I believe require a more stringent analysis than had been applied before the crash. A decade's worth of financial miscues (dot.com implosion, spending excesses, credit bubbles) eroded the confidence of a generation of unsuspecting investors. The slightest provocation elicits doubt about staying the course. Financial institutions brought the market to the precipice....and pushed it over.

The two factors which provided the greatest impetus for the equity market's swift recovery were the excessively low levels of global interest rates and the bargain basement valuations of stocks resulting from the 2008 "crash". Without these two elements, the recovery would have been a longer, more difficult climb back to financial solvency.

Because the timeline of recovery, and expectations, has become so compressed, I believe investors have become numb to cyclical fundamental factors that traditionally govern stock price performance, and which has emboldened them to assume greater risk in the process. That having been said, we are not going to "fight the tape" or recede from participating, even in the face of potential cyclical pullbacks. To the contrary, we are using our analytical tools to navigate more precisely through, what many had assumed was, a never-ending upward spiral.

Even the most prudent investor must realize however that markets don't "spiral upwards" indefinitely, nor do cycles and trends exist only on the "left side" of a parabola.

Stay focused

In spite of last week, our enthusiasm for equities has not diminished. In fact, we have steadily increased our asset allocation in stocks throughout the past half-decade, at the same time that rising prices (capital gains) have been occupying more space in our portfolios. What *has* changed is the sector blend and geography of our allocation. This quarter, for example, we see capital gains opportunity in foreign stocks despite a bit of shakiness, recently. **As the "Western" markets mature and make new highs, the laggards, and capital gains opportunities, are to be found in emerging markets and countries heretofore underexposed.**

My analytics presuppose that all things are cyclically parabolic, quantifiable, and tend to revert back to the mean over time. As such, we conclude that the bull market recovery is sustainable but unlikely to continue an unabated "spiral up" pattern. That fact surely must be obvious after last week's volatility.

The outcome of my quantitative processes are influenced by top-down, macro, and current events. The media has most notably focused on the fact that the public markets have recovered nicely from a series of unfortunate government-led and corporate mistakes. Unfortunately, the appetite for spending has not yet rejuvenated as swiftly in the "private capital" arena, the place where the engine of capitalism is supposed to reside. (Remember the "job creators"?) Therefore, we must watch carefully for signs that the real recovery will be migrating from the most visible landmarks (Dow Jones, S&P, etc) towards the more discreet, behind-the-scenes capital "underground". Keep your eye on money flow from banks, private equity, and corporations which will have a more significant meaning to those macro factors that govern the acceleration of economic growth in the *next* half decade and beyond.

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