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Fundamental Tango

The economy and financial markets are forever sending out mixed, parallel, or confusing messages. Inflation or stagflation? Buy now, or take your profits? Proceed slowly, or go home? At this moment, the signals are hardly synchronized.

There are just as many observers who could make the case for a "bull run" as those who favor the opposite point of view, a "bear in hiding". Obviously, any disjointedness of the message being conveyed could perplex the financial system or those who participate in it.

Like most of us, you, the client, want concrete answers as to what to do *next*, or what to do *now*. In the absence of substantive answers to those queries, some (many) choose to do nothing at all.

Signs of that insecurity abound. Despite new highs in a few of the averages during the last quarter, the breadth of participation, (the total number of stocks and sectors), actually diminished slightly. Money flowed out of financial instruments during the quarter, either from profit-taking or "fear of the top". Consumer sentiment, a measure of likely future participation in equity and discretionary spending, also fell from its peak of last year. More stocks are in a cyclical bear than are in a cyclical bull.

Most investors hope to re-engage in the market... it's the only game in town. *When* is a different matter, altogether.

Market experts always say that it is impossible to "time" the market. Because so many of my measurements are actually undervalued relative to their nominal values, I would argue it's a great time to hold, buy on dips, or to "nibble" around the fringes.

Underlying those data, however, is a troubling statistic: the alarming diminution in earnings acceleration patterns. Whether it be downsizing or accounting alchemy, most businesses have wrung about as much profitability out of their balance sheet as possible. As a result, the rate of earnings expansion is actually shrinking for the first time in decades. With consumer demand lagging expectations, it is highly unlikely that the stock markets will offer you the returns you had last year. Get over it....and get used to it.

Markets

Because there are fewer compelling storylines to attract investment capital, clients are becoming skeptical about good fundamentals and are loathe to commit any new capital, even if on a short term basis.

But even more problematic is that so many more are looking for that golden goose, those returns of a halcyon period, which makes one prone to a "sucker punch", a foolhardy aggressiveness subject to whatever "cool story" might cause them to abandon logic and conservative biases in order to make up for perceived lost opportunity. These "faddists" didn't learn their lesson with dot.com, or gold, or leveraged mortgage securities. No, they seek profit above methodology, and, I believe, are doomed to fail yet again.

So, with "long-term" being too "*out there in the future, someplace*", and "short-term" construed as too "*choppy and risky*", what is one to do? The best thing is always to revert back to investment basics. Just like the golfer who must stretch his/her brittle bones first, and start the season with "short shots" (like most of us in the Northeast!!), it is always best to start with sound principles that enable the first step to be successful. **Shrinking the margin for error is always a good starting point when investing.**

My data definitely reveals a dichotomy between the way we perceive the economy and how those perceptions translate into real execution. Despite some remarkable government statistics suggesting improvements in the country's gross domestic product (GDP), the markets appear to me to be worried that we might barrel headfirst into another brick wall of unmitigated disastrous consequences. *To wit:*

...price increases in natural resources, particularly heating oil and energy, have cut into household and corporate budgets; Congressional studies recently reported that over 80% of our roads and bridges are in a state of disrepair; our population is aging, putting pressure on services and retirement benefits; a large percentage of the population is migrating to warmer climes, placing more pressure upon the housing market, transportation infrastructure, and healthcare services; interest rates have been historically too low, and, yet, fewer businesses are allocating precious resources back into R&D.

At the same time, Federal tax revenues are being squeezed by a smaller, less affluent workforce, while spending is being cut in areas like defense, education, agriculture, and healthcare research. The adrenaline that could have stimulated capital growth in the economy is now just a trickle.

While there is no way to document people's suffering on a "pain meter", we know that the after-effects of the recession have caused a huge shift in sentiment about how each of us manages expectations for the future. There might, indeed, be new jobs in the pipeline, but wages are at pre-recession levels and not sufficient in many cases to lift a family out of poverty. Here again, the dichotomy persists between commonly acknowledged good news and the perception by some that we are simply maintaining in order to get by. Economic parity is a fallacy for many. Optimism is an illusion to some.

Strategy

The foundation of my "parallel disconnect" theory is that these disaffections stem in part from systemic weaknesses in our institutions that have been masked by complacency and mostly forgotten because of the concerted efforts by us all to remediate the effects of the financial crisis. We know that cycles will forever come and go, patterns of inordinate joy followed by unflinching despair. When each cycle is done it becomes forgotten. But the obligation of government is to prevent the crises from ruining the most vulnerable amongst us. The wealthy benefit from the same rules that govern everybody else....we would hope. It's only right that we should all be mindful of which of our peers goes to bed hungry, impoverished, homeless, helpless, or in need.

In light of these societal imbalances, our portfolios favor defensive sector allocation, such as utilities, technology, and basic materials. We all expect and hope for an economic turnaround, but at the same time we recognize the reality that stock and bond investments are only moderately attractive right now after having experienced a five year recovery. It would be imprudent to jump on the train after it has already left the station. When the economy improves (and I believe the balance of the year should prove that to be the case), I also expect that interest rates might start to migrate up, reflective of an increase in business activity.

As noted above, the first principle of investing is to moderate downside risk through prudent allocation and diversification strategies. Trying to recover from catastrophic drawdown can be lengthy, painful, and fraught with volatility trying to catch up with the markets and friends. I believe that managing strategic probabilities is a function of good discipline and it always outperforms traditional benchmarks.

As an earnings driven investor, I always find it useful to look, first, at companies that manage their own cash flow well. That means that, year-over-year, they not only pay dividends but increase those payouts at a rate in excess of their competitors in the same space. Because of foresight and strategic planning, these businesses dominate their niche and deliver quality products to their consumers. While many investors like to dabble in the "new issue" markets for aggressive returns, I believe that risk is managed better, and portfolio returns generated more consistently, through a disciplined approach of selecting the "best of the best" in each category ranking. I also think that the market is focusing, slowly, upon those disciplines which grow the "P" along with the "E" consistently. At these valuation levels today, conservative investment objectives are outweighing people's need for greed and aggressiveness. Until, or unless, confidence levels improve, trying to hit "home runs" is probably a minority endeavor.

Conclusion

The simplicity of using one comprehensive methodology is to allow for monitoring factors on a consistent basis over a longer period of time. **Quantitative analysis, for example, enables those statistical redundancies to be calibrated and measured for probability of future performance, duration and magnitude both.** When these factors coalesce around certain "inflection points" the predictability of perpetuating that trend is optimized. The result is to eliminate subjective, or emotional, responses and to focus more acutely upon those factors which magnify trend and cycle duration. In effect, we not only manage the "upside" of portfolio analysis, we quantify and adapt to any "downside" modifiers which might impede cycle advances.

We know that there is always something which is worthy of investment today, and likely to be worth more twenty years from now. We also are always searching for the reasons why something happens...that's what it means to be human in a world of uncorrelated cosmic events. But, more importantly, it is crucial to avoid the *"what have you done for me lately"* syndrome, or to chase "hot tips" indiscriminately. As complex as we are, us humans, we are subject to immediate mood swings that mirror the trajectory of market benchmarks on a daily basis. Therefore, we should probably affix a more noble cause to our investing and build our asset allocation to reflect more than *"how did the Dow close last night?"*

Suggested balanced account asset allocation, Q2, 2014:

Equity:	55%
Fixed Income:	15%
Cash:	30%

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