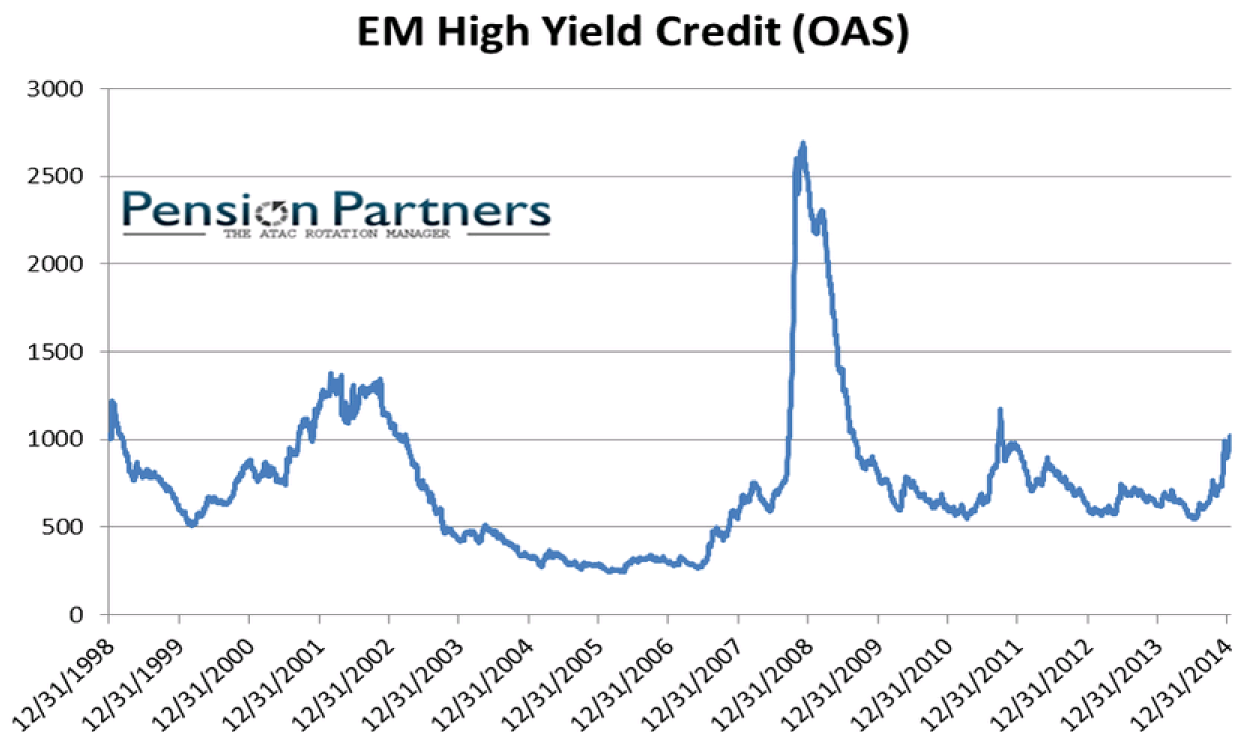
A Rocky Mountain Humane Investing, Corp. Company
OptimizedPartners
Investing in Everyone's Future.
www.optimizedpartners.com | brad@greeninvestment.com
303-747-0500

The Great Deflate 1/27/15
(Non-Super Bowl Edition)

This letter is going to take on a multi-dimensional tone which is a significant shift away from being stock market centric to an explanation of our diversification U.S. Treasuries, closed end bond funds and other inverse correlated holdings.

In the 3rd quarter of 2014 we began to see troubling divergences like the spread between the yields of Treasury bonds, Emerging Market and Junk bonds. This widening disparity is a reflection of money moving from lower quality bonds to the safety of Treasuries, as investors are lowering their risk profile. Moves over 1000 basis points were seen in 1998, 2001-02, 2008-09 and 2011. None of these periods were good years for equities although in the case of '98 and '11 the weakness was not prolonged but the damage to equities was substantial.

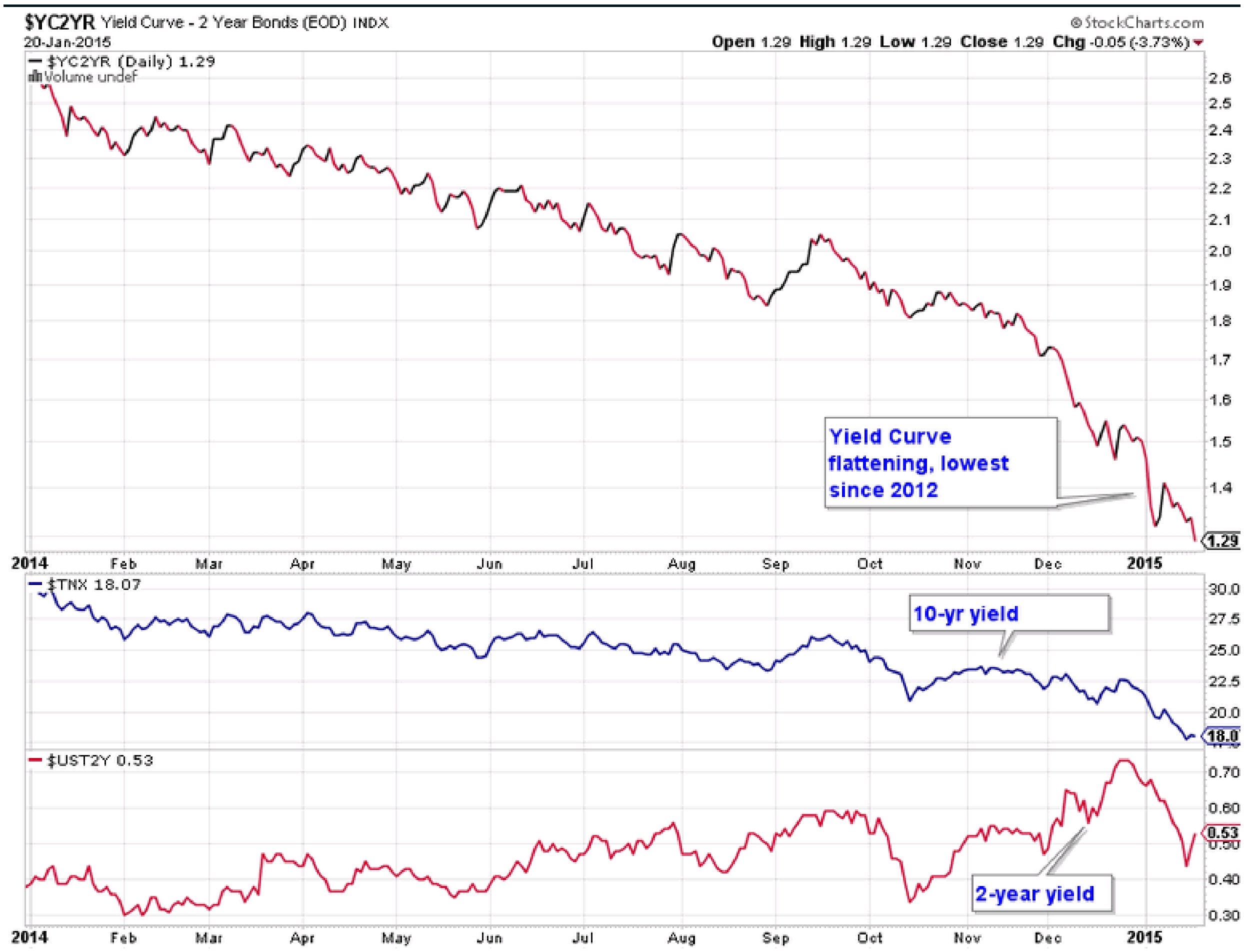


Large disparities in yields can represent a difficult hurdle for smaller companies that need the credit markets open and functioning properly. In other words, let's say a Solar utility company that relies heavily on financing may now have to pay a premium of 8% or 9% on credit rather than 5% or 6%. But that's assuming the credit markets don't lock up the way they did in 2008 and 2009 where credit was almost impossible to acquire. This is why we are waiting to see how badly credit markets devolve in 2015 to see how this eventually ends for the new breed of green utilities.

Part of the disparity was due to the decline in oil prices, which at present levels of mid $40's a barrel creates real risk for oil producing countries like Russia, Venezuela plus small to mid-sized heavily leveraged drillers for debt repayments. But the real issue is that in the 4th quarter global deflation began to assert itself in debt, currency and commodity markets.

When countries begin to offer negative interest rates we really should be asking ourselves what's gone wrong? We can easily envision an investor who swaps out of the Swiss Franc and opts for gold because the yield on gold (o%) is still better than -1%, but to talk of this sounds ludicrous.

In addition to diverging interest rates between Treasuries and Junk, we're seeing a classic move to yield inversion which has a very accurate record of being negative for stocks and raises the risk of recession. The problem this time around is that with interest rates at 0% it's impossible for long term rates to fall below short term rates, but the yields are converging nonetheless on the two year Treasury note.



Our goal as investment managers is to avoid the dogma of only being invested in one asset class and to diversify in such a way that our accounts will have a good chance of maintaining their upward ascent regardless of economic and market conditions.

The investment world is changing rapidly at present and equity and bond markets are being supported by the trillions in cash being dispensed (otherwise known as QE) by the central banks of the U.S. and as of yesterday, the European Union (EU).

There will be winners and losers in this gambit to generate some sort of inflation and economic growth but largely the success has been minimal. No doubt QE generates a significant amount of economic inequality as it appears the primary winners are not really the economies but investors. The goal of the EU is to lower of the value of the Euro relative to the dollar USD to invigorate buyers of their goods and services. QE is the alternative when standard monetary policy has lost its effectiveness.

The EU will continue to push down yields through open market purchases to help individual countries. Greece tends to get most of the headlines and the recent elections which supported the anti-austerity movement will only add to the potential chaos. The countries behind Greece that pose a much greater level of risk are Italy and Spain which qualify as “too big to fail”.

But if you’re an investor or just a hard working person who’s worked hard their entire life and has all their money in the bank in Euros, you’ll be a loser. This is why there is a rush to convert out of the Euro and into the USD, US Treasuries and eventually gold.

For these reasons and others we’re in this very odd place where the US has strong growth with no sign of impending recession, yet Treasury bond prices are flying higher and giving equity like rates of return. A trend we don’t envision ending until the rates of the 10 and 30 year Treasury notes and bonds are on par with Euro counterparts. Hence….the “Chart Of The Year” below.

In the U.S. all is not necessarily better. While there are no emerging signs of impending recession it does appear that growth is slowing. How can it not when the oil industry is at a standstill and oil, like it or not did account for most of the job growth in the U.S. since 2009. There will be layoffs and probably a pause in the growth of alternative energy.

DoubleLine Funds s “Chart Of The Year”

Strategy: Own long dated U.S. Treasuries

We have moved away from a 100% invested in equities strategies to a balanced 50-50 weighting of stocks to bonds. Should signs of a recession become visible we’ll move to 30% stocks / 70% bonds.

I anticipate that both weakening of the U.S. economy and the devaluation of the Euro will continue to have a pronounced positive effect on the value of Treasuries. We are avoiding mid length Treasuries such as the 10-year Note and opting for the long duration 30-year where the maximum effect of treasury migration will occur.

To add salt to the issue of reducing equity exposure is the likelihood that the Federal Reserve will probably begin to raise the Federal Funds level sometime in mid to late 2015. Any serious stock market weakness would probably push this back into 2016 but this is a serious headwind. To raise interest raise in a weakening economy will bring back images of 1937 when Republicans willed the Fed to raise rates prematurely and forcing the economy back into recession.

While it’s been opined that the Fed wants to raise rates “just to show it can” their goal is to raise rates to such a degree that they will have the option in the future to use standard monetary policy than QE in the event of a future recession.

The Race to Negative Yields: Global 10-Year Yields (%)

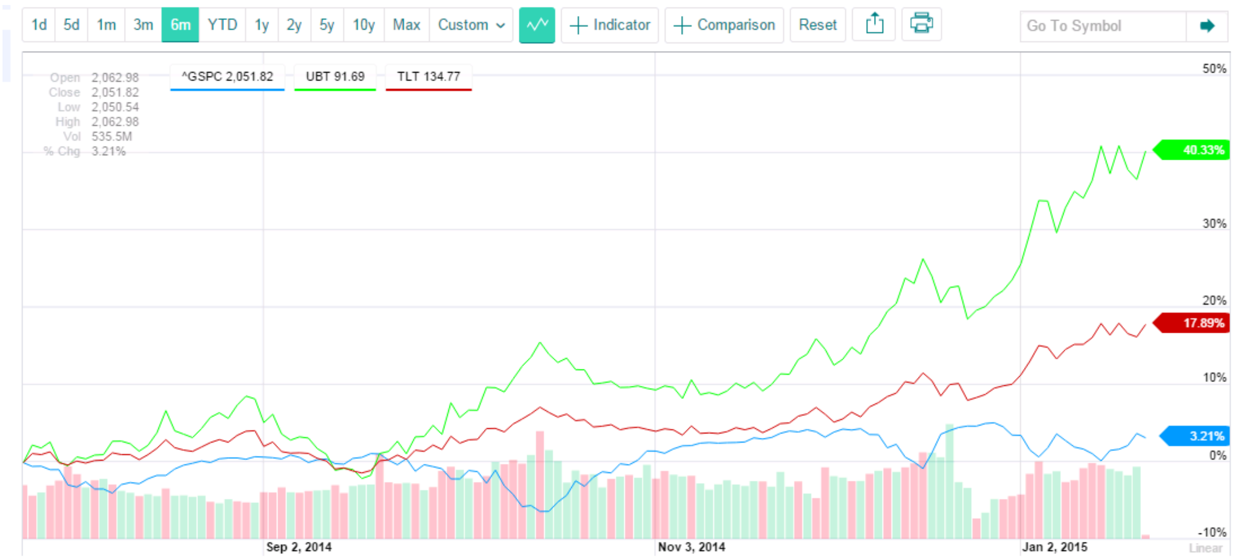
Country	10-year Yield (Jan 1 2014)	10-year Yield (Today)	Difference	52-Week Low in Jan 2015	All-Time Low in 2015?
SWITZERLAND	1.07	-0.17	-1.25	Yes	Yes
JAPAN	0.74	0.23	-0.51	Yes	Yes
GERMANY	1.93	0.40	-1.53	Yes	Yes
FINLAND	2.13	0.41	-1.72	Yes	Yes
NETHERLANDS	2.23	0.44	-1.80	Yes	Yes
AUSTRIA	2.27	0.45	-1.83	Yes	Yes
DENMARK	1.98	0.47	-1.51	Yes	Yes
FRANCE	2.56	0.58	-1.98	Yes	Yes
BELGIUM	2.56	0.67	-1.89	Yes	Yes
SWEDEN	2.50	0.72	-1.79	Yes	Yes
IRELAND	3.51	1.09	-2.43	Yes	Yes
NORWAY	3.00	1.26	-1.74	Yes	Yes
SPAIN	4.15	1.38	-2.77	Yes	Yes
HONG KONG	2.31	1.42	-0.89	Yes	No
CANADA	2.76	1.47	-1.29	Yes	Yes
ITALY	4.13	1.50	-2.63	Yes	Yes
UNITED KINGDOM	3.02	1.51	-1.51	Yes	No
UNITED STATES	3.03	1.82	-1.20	Yes	No
SINGAPORE	2.56	1.86	-0.70	Yes	No
POLAND	4.35	2.09	-2.26	Yes	Yes
SOUTH KOREA	3.59	2.30	-1.29	Yes	Yes
PORTUGAL	6.13	2.37	-3.76	Yes	Yes
AUSTRALIA	4.24	2.58	-1.66	Yes	Yes
NEW ZEALAND	4.72	3.34	-1.38	Yes	No
CHINA	4.78	3.47	-1.31	Yes	No
PHILLIPPINES	4.12	3.96	-0.16	No	No
MEXICO	6.45	5.31	-1.14	Yes	No
SOUTH AFRICA	7.91	7.20	-0.71	Yes	No
INDONESIA	8.45	7.30	-1.15	No	No
INDIA	8.83	7.70	-1.12	Yes	No
GREECE	8.42	9.09	0.67	No	No
BRAZIL	13.26	11.72	-1.54	No	No
RUSSIA	7.88	13.79	5.90	No	No

Pension Partners
THE ATAC ROTATION MANAGER

One of the best ways to play this rush into Treasuries is via “UBT” or the ProShares Ultra 20+ Year Treasury 2X ETF and the “TMF” Direxion Daily 20+ Treasury 3x ETF. In the chart below the six month return on the UBT is 40.3% compared to 3.21% for the S&P 500.

The trade is not without risk of course. Investor sentiment to Treasuries is very positive at present which is not good, we would prefer more skepticism.

As the chart below shows the return of the 30-year Treasury (TLT) and the leveraged 30-year Treasury (UBT) has really excelled relative to the stock market.

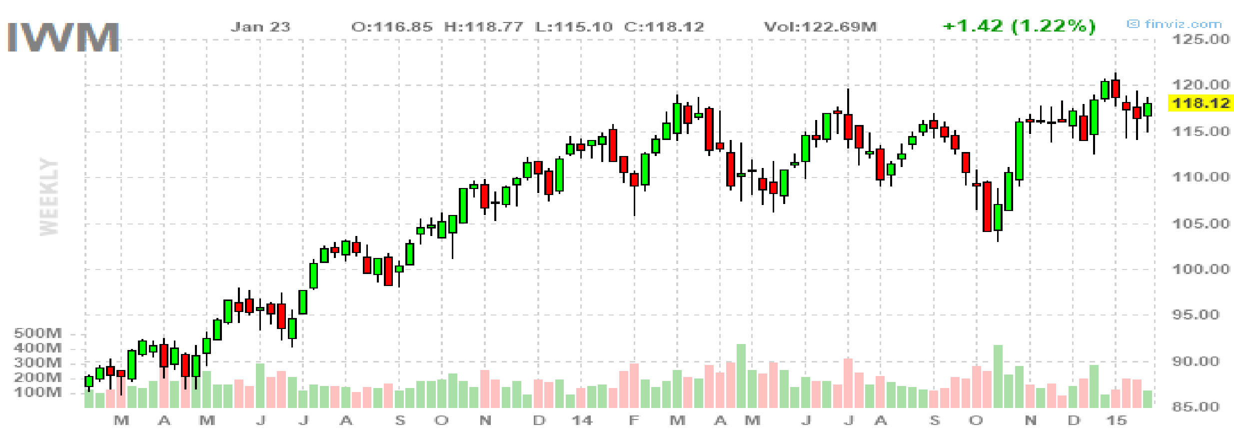


U.S. Equities: It remains the most amazing period of levitation I've experienced in 30 years. We haven't had a lasting pullback since November 2012 which has trashed almost every sort of risk control or hedging.

2014 was actually the worst year since 2000 for active managers as small and mid-cap stocks were flat to negative while the sole area of strength was in the large cap S&P 500. This is an important factor since micro, small and mid-cap stocks are the way to deliver Alpha (rate of return in excess of the S&P 500).

The current rapid deflation of the Euro versus the USD could be the fundamental platform for a return to micro, small mid cap dominance but it's too early to tell. These smaller companies generate revenues primarily in the US and thus avoid the currency wars dominating the World at present. So I think there is hope for small cap stocks on an absolute and relative basis. Our systems delivered very strong returns in December in what was a rather anemic December rally.

Should the Russell 2000 Index (IWM) push past and stay above 120 I would expect to see some follow through as money moves away from the trendy large cap stocks. If this move happens I would expect to see some real strength in our systems.



Strategy 2: Closed end bond funds taxable and tax-free selling below NAV (net asset value)

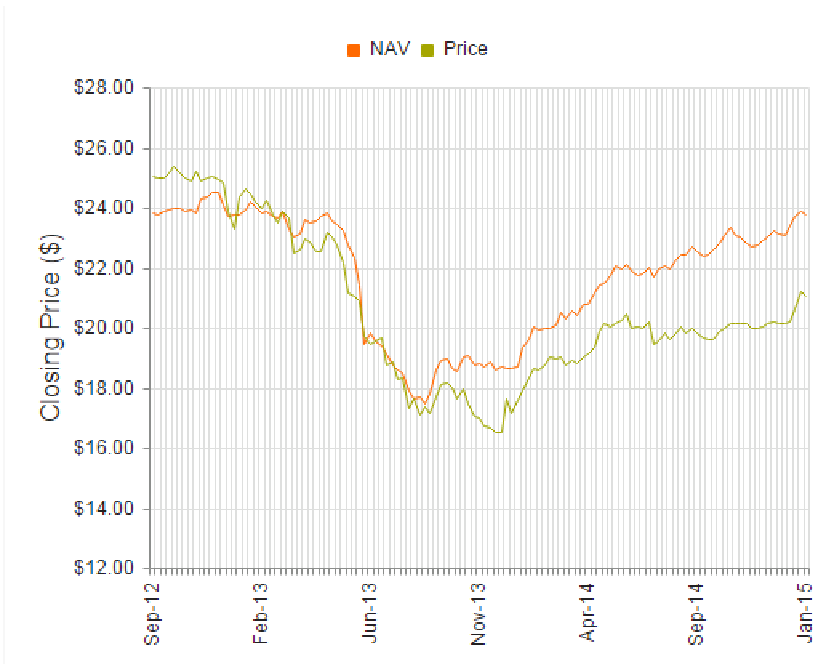
This is an excellent option for conservative clients. It won't have the same capital gains returns that Treasuries could have but they are safe with low volatility. We own an assortment of these closed end funds, for example:

BlackRock Muni Target Term Trust: stock exchange symbol "BTT"

Share price as of 1/27/14 $21.09

Net Asset Value (total assets divided by number of shares) is $23.81

Discount to NAV -11.42% with a current distribution rate of 4.55% federally tax free



The hope with BTT is that eventually the share price will rise to the point of matching the net assets of the fund. If that were to happen (perhaps in a panic when investors realize rates will be 0% for a very long time) the BTT would provide a very nice compound return with an 11% capital gain along with the 4.5% annual yield.

That's it for now everyone.

Brad Pappas

Long all positions mentioned: TMF, UBT, EDV