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Update 5/27/2015

Summary: Secular bull market for stocks remain in effect with the realization that U.S. monetary policy is likely neutral at present but we have been locked into an extremely tight trading range for over six months. Based on our data there is no recession in sight. Eventually the Fed will begin to raise the Fed Funds Rate but the timing is unpredictable. Equity markets have proven be able to handle "slow" modest increases in interest rates but based on history the advantage of owning small cap stocks is likely over for this cycle.

Small Caps do extremely well when the monetary policy is expansive (either by QE or by lowering interest rates) but once the Fed goes to neutral they lose their edge and mid and large caps show superior relative strength. When the Fed is restrictive, small caps are particularly bad performers.

In the past month we have shifted away from micro and small caps and we are primarily in large cap stocks (Russell 1000).

The next generation of Alternative Energy / Solar Energy is upon us. Early stage solar utilities with dividends are now a viable option. We will have an extensive special report soon.

It's probably premature to call an end to the rally in Treasury bonds given that inflation is still very subdued.

The risks presented in our last client letter, namely the potential for the U.S. Treasury bond yield curve inverting thankfully did not come to fruition. We were able to quickly exit our holdings in US Treasuries for a small loss and return to being fully invested in equities. While no one ever likes being wrong, mistakes made in the course of investing are common and the best solution is almost always a quick resolution to the error. No sooner had the letter gone out to our clients that sentimentrader.com reported a very sharp spike in bullishness for Treasury bonds and at that point I knew a mistake had been made as we were no longer in the minority but amongst the majority. We always try to avoid becoming entrenched with the insistence that "I'm right and the markets are wrong." Losses are always better taken when they're emotionless and small.

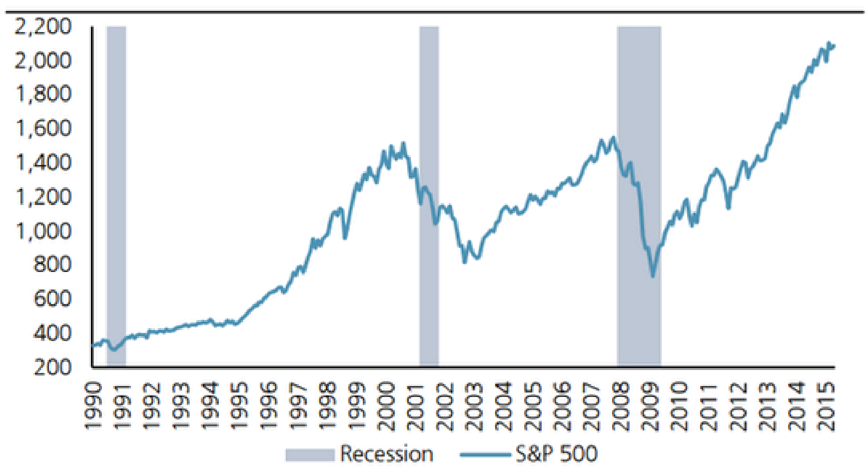
Since my realization in January that I was wrong about Treasuries, bond prices have continued to drop significantly lower and I view this as typical and positive late economic cycle behavior. While the decline is welcome in my opinion, what makes the current investment situation very different is there has never been a time in the past 100 years where both stocks and bonds have been so positively correlated. This tight correlation could present a problem when the next recession is upon us as it may be too much to ask for bonds to rally once again.

This presents a potential danger should the economy show signs of impending recession. In the past monetary and fiscal policy makers have used expanding economies to shore up their reserves to fight the next recession. In previous expansions Treasury yields would have risen significantly and budget deficits would have shrunk.

In other words could we really expect bonds to provide a decent hedge to stocks in a recession if bonds remain as overvalued as they are today?   I doubt it and a different tactical strategy should be used which I'll delve into at the end of this letter.

Will the impending rate hikes by the Fed kill the Bull Market in U.S. stocks?

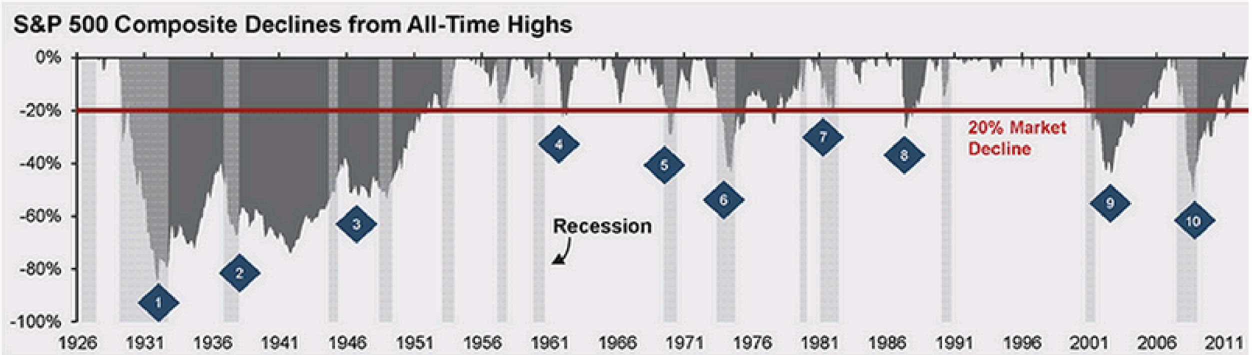
The quick answer to this question is no.   Bull markets don't end just because the Federal Reserve starts raising interest rates, they end when they've risen to the point of choking the economy. For example, the Fed began to raise rates in 1994 to 1995, then held steady till another wave of hikes in 1999. The recession commenced in 2001. The last rate hike cycle started in 2004 and the economic cycle peak didn't occur till 2007. Had you gone to cash in 1994 or 2004 you'd have left a great deal of money on the table.



Source: Bloomberg, UBS

Recessions, not the commencement of a rate hike cycle represent the greatest threat to investor's long term success. In my opinion, there is no such thing as "minor recession" they're all various shades of nasty and to be avoided for the equity investor.

I love the chart below as it really cuts to the chase. A bear market is defined as a 20% decline from a market high and since 1929, 8 out of the last 10 bear markets occurred during a recession.   1962 Cuban Missile Crisis and the Crash of 1987 were the two exceptions.   This lends to my viewpoint that unless we face extraordinary circumstances (for example, 1962's Cuban Missile Crisis) the major goal of our macro research is learning how to identify potential recessions with enough advanced warning to prevent significant losses.

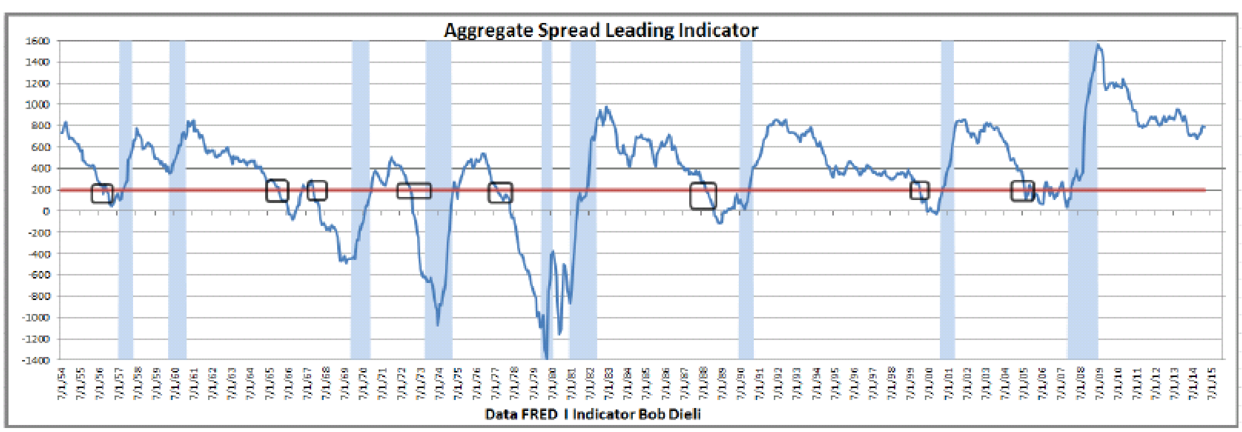


Characteristics of Past Bear Markets

◆	Market Corrections	Cycle Peak	Bull Market Duration (Months)	Decline from All-time High	Recession	Commodity Shock	Fed Tightening	Extreme Valuations	Commentary
1	Crash of 1929	Aug 1929	37	-84%	◆			◆	Excessive leverage, irrational exuberance
2	1937 Fed Tightening	Feb 1937	22	-74%	◆		◆		Premature monetary tightening
3	Post WWII Crash	May 1946	48	-54%	◆			◆	Post-war demobilization, recession fears
4	Flash Crash of 1962	Dec 1961	14	-22%				◆	Flash crash, Cuban Missile Crisis
5	Tech Crash of 1970	Dec 1968	73	-29%	◆	◆	◆		Economic overheating, civil unrest
6	Stagflation	Dec 1972	29	-43%	◆	◆			OPEC oil embargo
7	Volcker Tightening	Nov 1980	31	-19%	◆	◆	◆		Extremely high rates to reign in inflation
8	1987 Crash	Aug 1987	59	-27%					Program trading, overheated market
9	Tech Bubble	Aug 2000	118	-42%	◆			◆	Extreme valuations, mostly in tech stocks
10	Global Financial Crisis	Oct 2007	55	-51%	◆	◆	◆		Leverage, housing, Lehman collapse

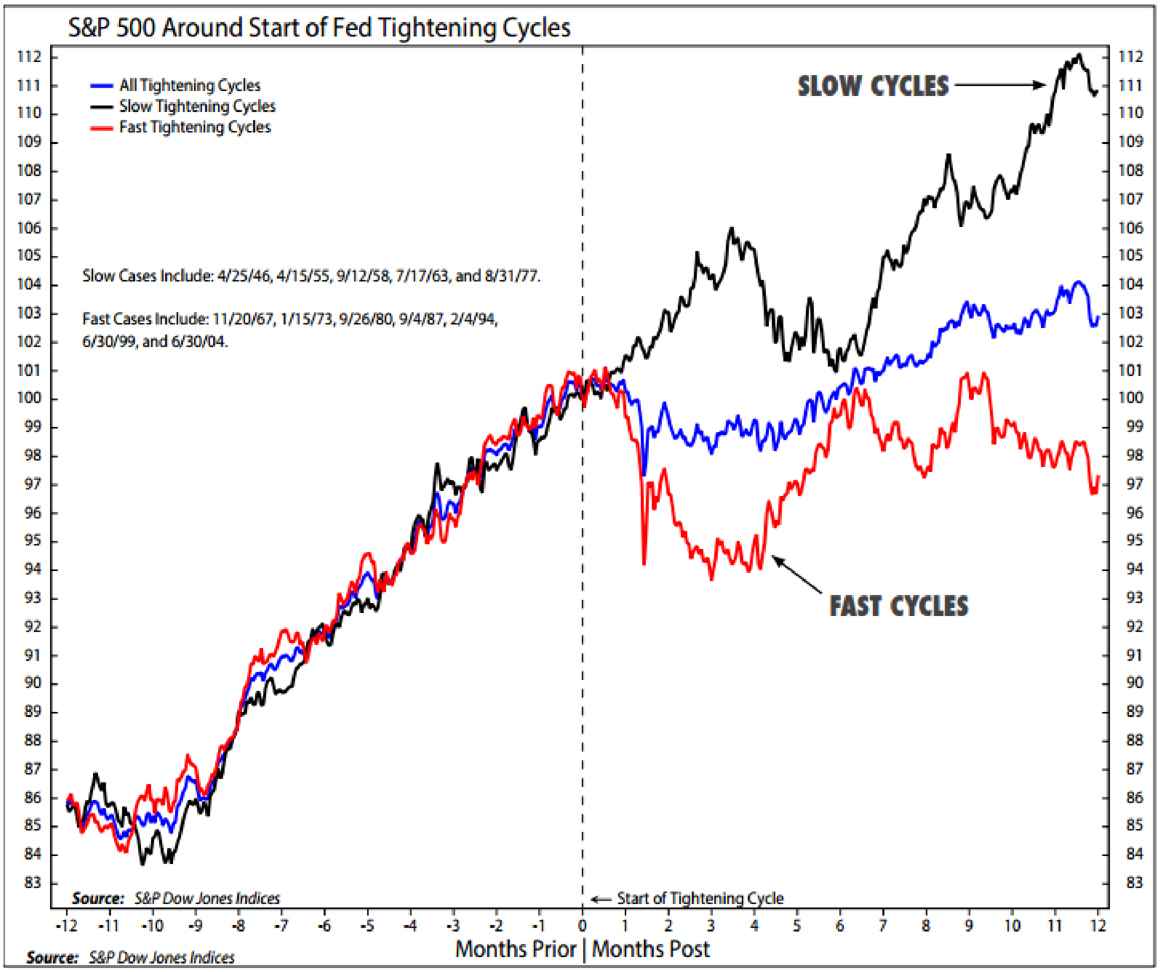
Source: Standard & Poor's, NBER, FactSet, Robert Shiller, J.P. Morgan Asset Management.
*A bear market represents a 20% or more decline from the previous market high.
Data are as of March 31, 2015.

One of my favorite recession predictors is Bob Dieli at nospinforecast.com. Over 30 years ago he developed what he calls the Aggregate Spread Leading Indicator. The track record has been very good and while we don't rely on just one forecaster, the simplicity and accuracy of the Aggregate Spread makes it very attractive. The Aggregate Spread combines two different spreads. Take the yield of the 30-year Treasury minus the Fed Funds rate and the CPI minus the unemployment rate. Then, subtract the yield spread from the economic spread. When the sum dips below 200 it's forecasting a recession in the next 9 months.



In a conversation I had with Bob Dieli last week I asked him to speculate as to when the first signs of a recession would occur and his answer was "at least not until 2017 unless the Fed gets too aggressive in raising rates."

Assuming we can trust the Chairman Janet Yellen and Vice Chairman Stanley Fischer: "If foreign growth is weaker than anticipated, the consequences for the US economy could lead the Fed to remove accommodation more slowly than otherwise". In non-Fed speak this means that if the World economies falter we'll be raising rates even slower than our slow expectations. It could take many years for the Fed to reach their goal.



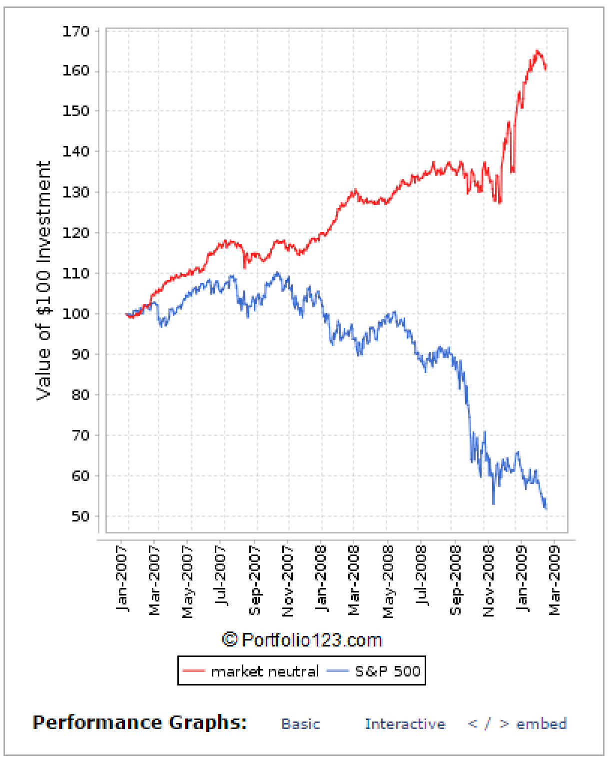
Conclusion: So the Federal Reserve is likely to raise rates sometime this year but has repeatedly tempered the potential reaction by inserting "Slow" into the phraseology. This is important since not all rate hike cycles are the same as the chart above reveals.

While I wouldn't be hasty in saying the bond market has topped (there is a very long trail of pundits who've incorrectly called tops). Another surge in the US dollar based on higher short term interest rates could propel long term Treasury prices higher when most of the world has zero % interest rates.

Eventually, the economy will reach its blow off stage or boom cycle but it's not on the near horizon. The "boom" will mark the end game to the cycle and we'll move significantly out of equities. One valid alternative to using bonds as a hedge could be: symbol "SH" or Proshares Short/Inverse S&P 500 Exchange traded fund. Since the SH is 100% inverse without leverage to the SP500 we know that it can be used to reduce risk and volatility in portfolios using the Russell 1000 as a universe.

For this example we used a 50/50 weight between the SH and our new "Foundation" portfolio system which every account now has. The "Foundation" system now in place (hat tip to Steve Auger of stockmarketstudent.com) has demonstrated significant Alpha in 15 years of back testing. Time will tell if the system continues its outstanding performance going forward but it does look good after 8 months live.

This is only a simulation as this illustration was not possible in 2007-2009. This equal weighting is what is called "Market Neutral". The Foundation portfolio delivered a significant amount of Alpha (return above the SP 500 index) even during the 2007-2009 period.



General Info

Inception Date	12/29/06
Last Rebalance Date	05/27/15
Days Since Last Rebalance	0
Rebalance Frequency	2 Weeks
Benchmark	S&P 500

Quick Stats as of 2/27/2009

Total Market Value (inc. Cash)	$ 161,579.89
Cash	$ -13.24
Number of Assets	9
Total Return	61.58%
Benchmark Return	-48.17%
Active Return	109.75%
Annualized Return	24.80%
Max Drawdown	-8.49%
Benchmark Max Drawdown	-53.03%
Sharpe Ratio	1.52
Correlation with S&P 500	0.19

The Foundation system has the largest weighting in client and in The Vegan Growth Portfolio. Only time will tell but should it maintain its superior performance we may choose to go Market Neutral when the next recession is anticipated.

Warmest regards,

Brad Pappas