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A Rocky Mountain Humane Investing, Corp. Company

All Roads Lead to Treasuries
8/18/2015

Summary: Erosion in world stock markets is accelerating as economic demand is close to coming to a standstill. While people may relish the prices you pay at the gas pump the decline in the price of oil and the opportunity for green power the devastation to the energy industry will have serious consequences for the US and world economies, especially Emerging Markets that use oil revenues to pay off dollar based debts.

Risk/reward for owning stocks has become unfavorable relative to the potential of long dated Treasury bonds. There's lots of talk of a "crash" but those are rare events and our view is that in the short term who knows what will happen but longer term risks are building for stocks.

We have sold the bulk of our equity holdings as we believe there is a significant possibility, make that "probability" that the US stock market is in a topping process. The S&P 500 and other US indices may be making a significant market top and that a 1 to 2 year bear market looms ahead. US growth is slowing to a virtual stall and the Fed has expended there arsenal of simulative policies.

If this is the case, then there should be significant move higher in long dated US Treasuries. At present the 30 year US Treasury bond yields 2.8% and based on past price moves coinciding with economic weakness the yield could drop below 2% and possibly to 1.5% in the next 18 months.

Last month I mentioned the internal deterioration in US and global equity markets, so far in the month of August the erosion is accelerating. US equity markets have been under the influence of extreme monetary measures and the effects of those policies are waning. The exhaustion of Fed stimulus is not without precedent as the same thing has occurred in Japan and in the US during the 1930's.

Despite the Fed pulling all the possible levers for growth, US economic growth could be slipping into a recession by 2016. At this point it's really just an academic argument as to whether or not a recession is possible by next year. The flight to safety from world stock markets to safety (US Treasury bonds) has already begun.

1930's Markets don't repeat but they frequently rhyme….
(Hat tip to Ray Dalio & Bridgewater Daily Observations 3/11/2015)

Since the 1950's bear markets in stocks have coincided with economic peaks or booms and that has been the standard thinking since then. I've frequently mentioned Bob Diehl's Aggregate Spread indicator which has been very accurate as a recession timer since the 1970's. The present economic environment is not conducive to accuracy in the Agg Spread since the present economic expansion has been anemic and the likelihood of a "boom" is in doubt. This go-around has been different and rhyming with the 1936-1937 economy and market behavior.

In 1931 interest rates hit 0% and by 1936 interest rate based monetary policy ceased to work.

By 1933 money printing starts since interest rates couldn't be lowered. The Fed begins printing money aka "QE". Since the great recession of 2008 the Fed has initiated 3 rounds of QE.

In 1937 the stock market peaks after a 300% rally off the lows. In 2015 we've had a 190% rally off the 2009 low.

In 1933-1936 and 2009-2014 the economy improves.

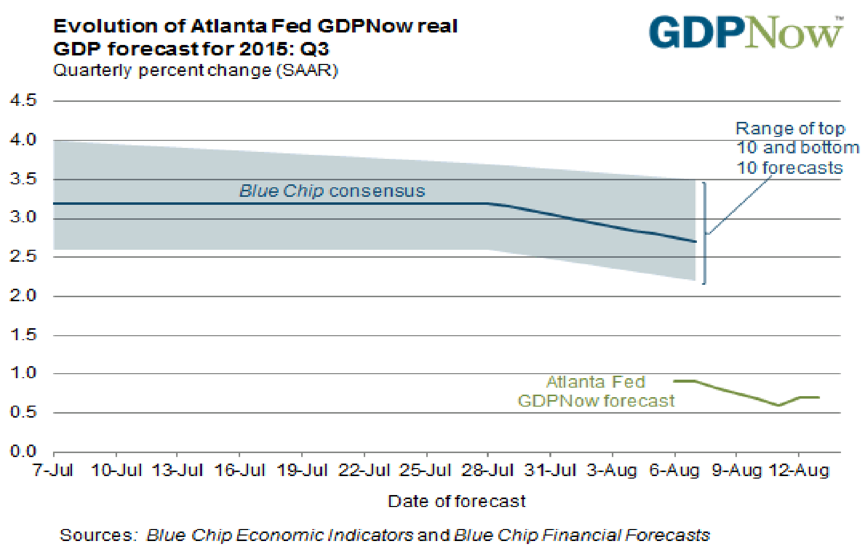
In 1937 the Federal Reserve begins to raise interest rates in rapid succession and raises bank reserve requirements due to worries of inflation and gold inflows which increased the monetary base. Even in 1937 a European war was a concern the fear was that European countries would sell their US assets and repatriate their gold.

Treasury bond yields spiked higher in the first quarter of 1937 based on inflationary fears but then began a significant rally in which yields dropped from approximately 2.9% to 2.5% by the end of 1938. Stocks dropped by 50% as they went into a prolonged bear market lasting for a year.

No doubt you have seen the shifts in your portfolios from stocks to the various Treasury dominated securities, symbols TLT TLH EDV and TMF.

In my opinion the best strategy right now is to remain in long dated Treasuries as the coming months may be very ugly for world stock markets, especially since we're in the historically roughest months of the year.

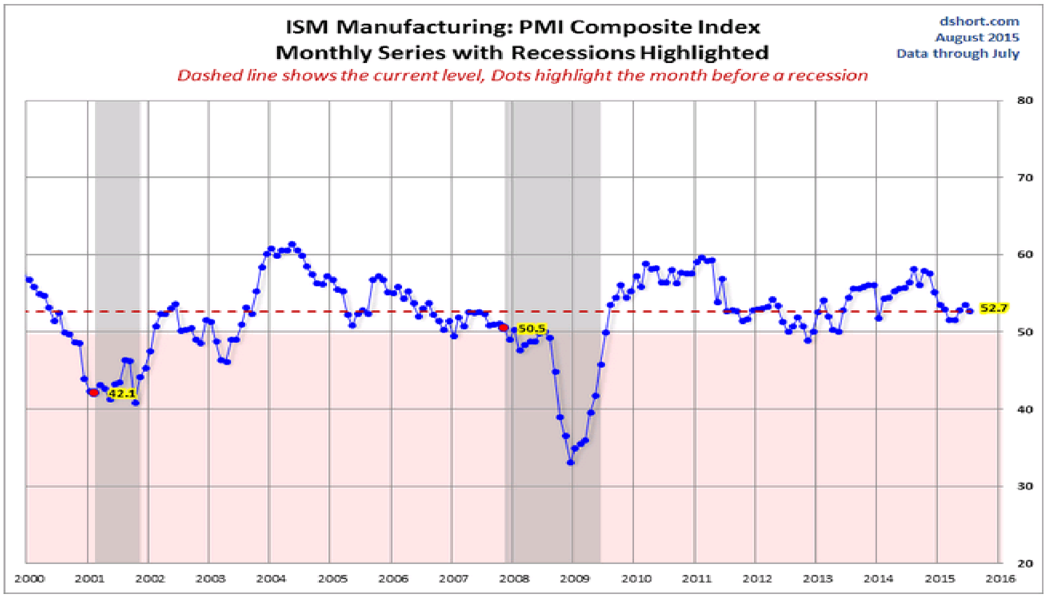
The underlying problem is that first half 2015 economic growth in the US is 1.45%, plus the Atlanta Federal Reserve is forecasting even slower growth of just 0.7% for Q3 2015. What makes me worry about US stocks at this juncture is that the consensus of "Blue Chip" forecasts is between 2.2% and 3.5%. How the US stock market can continue to resist a steep drop in the face of declining growth is befuddling.



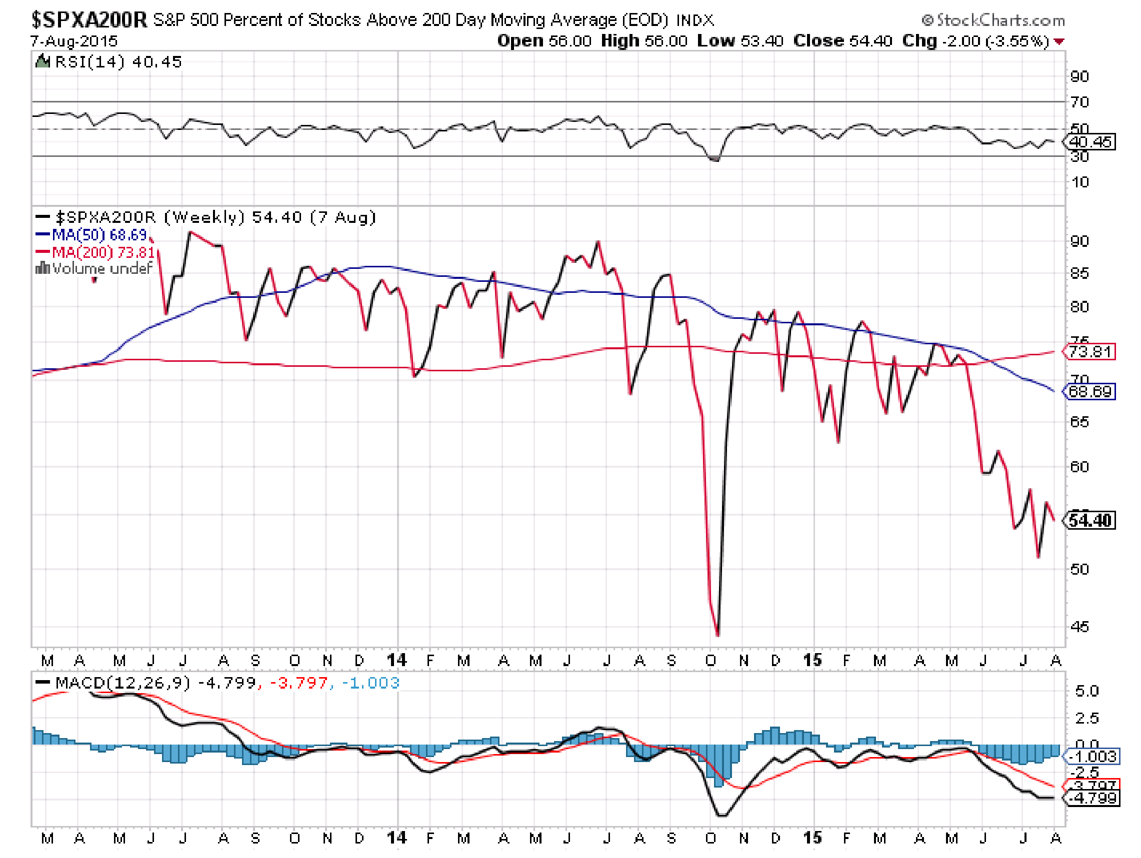
There have been two times in the past 10 years that first half US growth fell to 1.45%, 2011 and 2008 and both were rough years to say the least.

One of the best single indicators of where the economy stands is the ISM Manufacturing Index. When the index dips below 50, under normal circumstances can be a dangerous proposition. We've flirted with 50 in 2011, 2012 and 2014 and only massive injections of capital by the Fed under the title of Quantitative

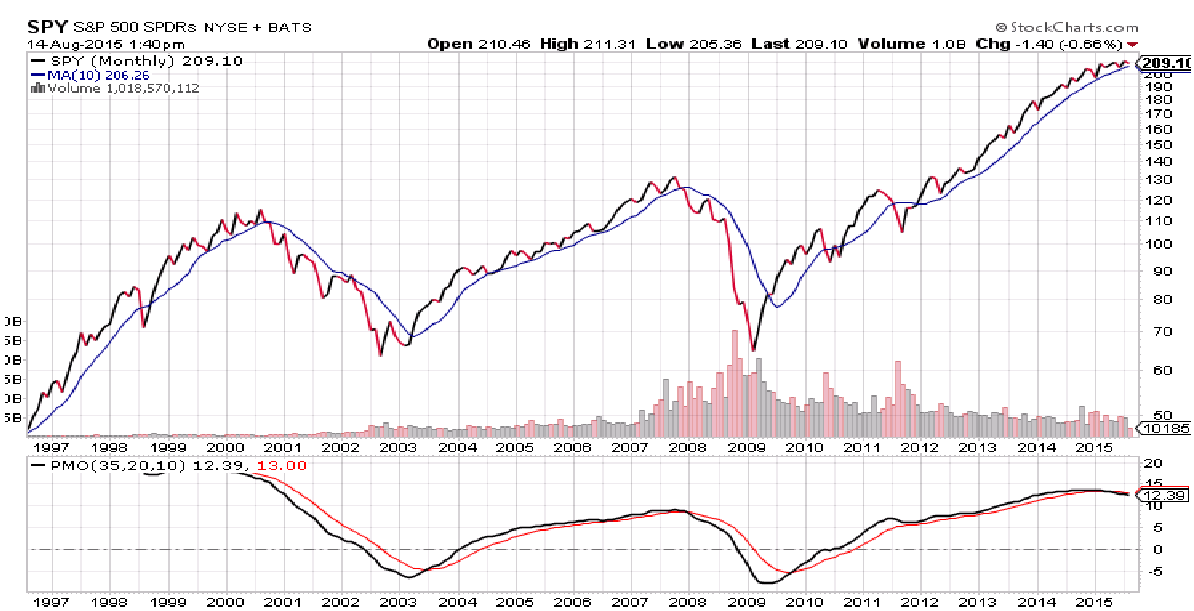
Easing helped to assure we didn't recede further.   In 2015 it's different as the Fed has stopped providing QE and would even like to raise short term interest rates, so we can't look for help from the Fed anymore.



The slowing growth is reflected in the percentage of stocks above their 200 day moving average.   The percentage has been declining slowly since 2013 the rate of decent increased after July 2014 and again in March 2015. Right now just 54.4% of stocks are above their 200 dma and this compares to 90%+ in 2013. Simply put, it's much harder for your investments to be productive when the rate of participation is declining.

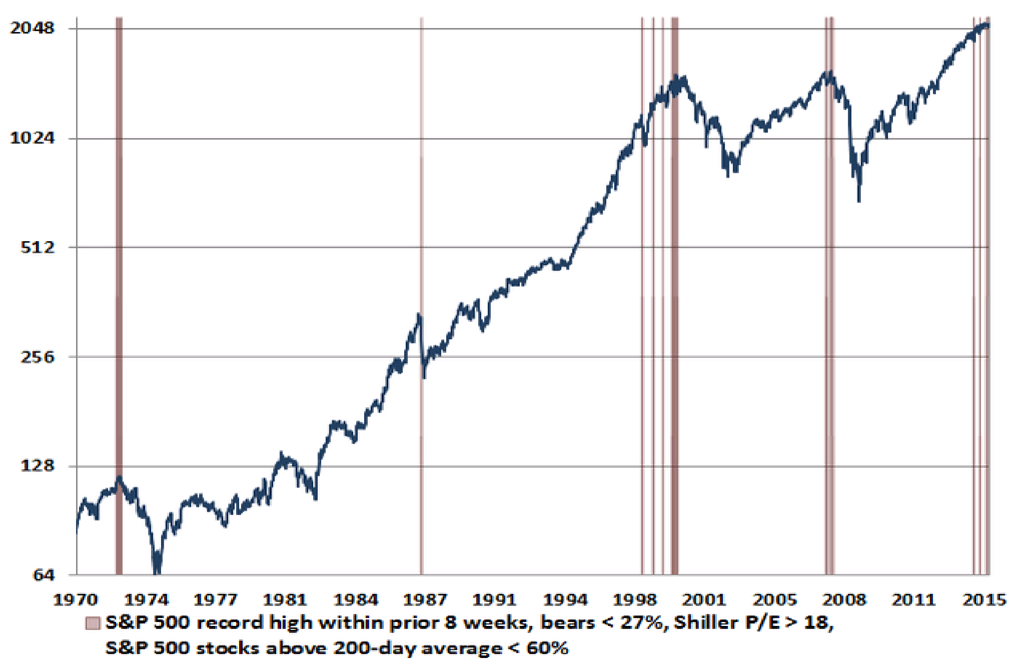


The case for owning stocks gets worse when we look at the technical picture. Below is a chart of the SPY or S&P 500 since 1997 with its 10 month moving average. This is a good simple and accurate timing mechanism and as we can see the SPY appears to be in the process of rolling over and wouldn't take much for the SPY to go below the 10 ma. The graph below is the Price Momentum Oscillator which has already rolled over.



Finally, there is this chart from John Hussman: It's a simple chart using just 4 factors which are all present today. Will the US markets decline based on the precedents show by the chart below? Only time will tell but the odds are in favor of a decline which would solve the issues of the declining number of stocks participating and allow the markets to reset.

In the meantime is best to play it safe until the potential topping process resolves itself one way or another.



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8/18/2015