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Welcoming the Dark Side

December 20, 1015

Summary: I believe after a few false starts that we're now in a major Bear Market for stocks. A "Bear Market" is a market that can fall in excess of 20% or more. Since 2013 making money in stocks has been a very difficult and frustrating experience. We couldn't have known at the time but the US stock market in 2014 began a two year process of topping. This topping phase may have ended last week. For investors who are correctly positioned for a Bear (and you, my client are well positioned) it's an exciting time.

The values of Treasury Bonds can be expected to rise sharply and Inverse Exchanged Traded funds can rise very sharply as the stock market declines. The inverse exchanged traded funds we'll be using provide an accurate inverse correlation to the stock market. Hence if the markets fall the value of the Inverse ETF's rise.

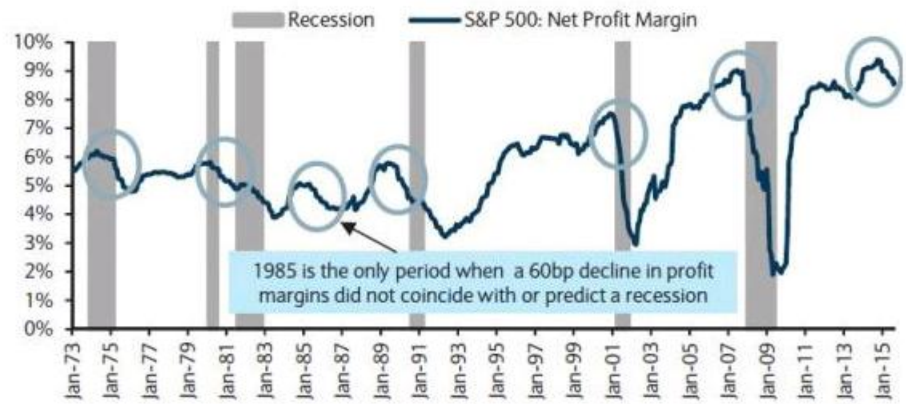
I've been looking for a major market turn to the downside for well over a year. I've been wrong a couple of times as the "buy the dip" mentality provided a solid floor for any declines. But market behavior in the last two weeks i.e. the failure of the S&P 500 to make a new all- time high has left an ominous double top formation. It looks like 2015 will join 2000 and 2007 as years of major market tops. And, I expect with high probability that 2016 to be the year where the US and World stock markets significantly break to the downside.

If we exclude the US markets we can see that the rest of the world markets have rolled over as well. It's a myth in this cycle that diversification amongst countries offers safety in diversification, the correlations are much too tight.

Most of the classic signs of a major market top and the early onset of a recession in either 2016 or 2017 are present.

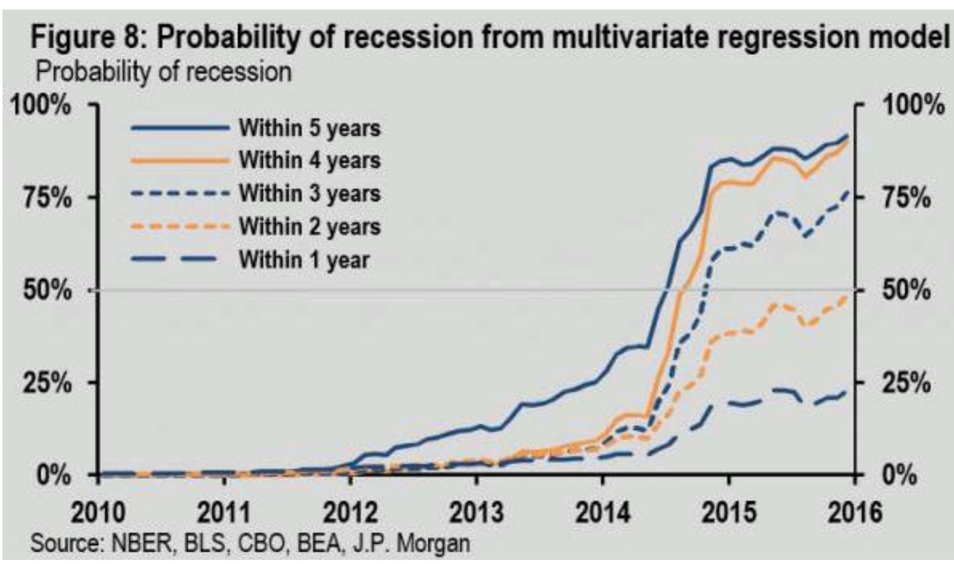
- Credit spreads which reflect the difference in interest rates between high quality Treasuries and Low Quality/High Yield Junk bonds are at levels normally associated with recessions and major market declines.
- Declining profit margins: Declining profit margins are a fairly accurate predictor of future recessions with only one false signal in 1985.

A large decline in profit margins usually leads to or coincides with a recession



Source: Thomson Reuters, Barclays Research

- Last week Janet Yellen and the Fed decided to finally raise interest rates and the timing could not be worse. US manufacturing is already at recession levels and US service related industries are approaching early recession levels. Yet, the Fed chose to raise interest rates (and will continue to do so in 2016) in an effort to normalize interest rates so they'll have some sort of effective tools to fight the next recession with. By raising rates in a slowing economy rather raising them in the traditional sense of a booming economy might well insure a recession does occur. Just think about that for a moment……..



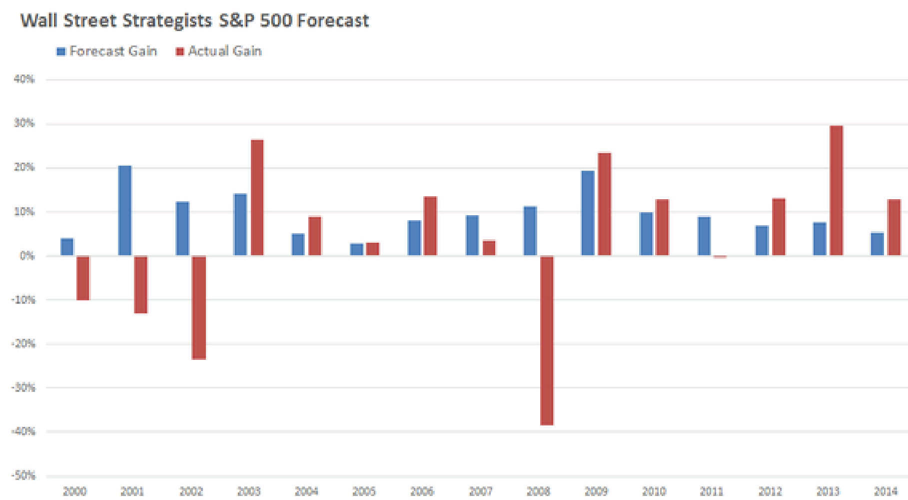
Lastly, and to me this is stunning and devastating most retail investors: A week ago Barron’s polled 10 top market strategists from major firms *including Citi and JP Morgan where the two charts above are from.* All ten strategists are **BULLISH!**

This is what Barron’s had to say:

> *Based on their mean forecast, the Standard & Poor’s 500 index will end next year at 2220, an increase of 10% from Friday’s close of 2012. An advance of that magnitude is more reflective of the market’s rout last week, however, than undue exuberance among our prognosticators. To the contrary, the strategists were more cautious in their comments than in recent years past.*

Forecasts such as provided by these brokers is worthless and reflects (at least in my opinion) calming words to soothe the “buy and hold” crowd.

You might ask yourself exactly how bad is the advice of the leading strategists at major banks and brokers?



SOURCE: BIRINYI ASSOCIATES, S&P CAPITAL IQ.

They are always positive year in and year out and the magnitude of their misses as astonishing. Not once in 15 years did they ever predict a down year.

What should we expect to see in 2016:

As mentioned earlier 2015 will be the year of the market top and in 2016 we can expect a very bad year if you own stocks.   Many of you were clients in 2013, the last good year to own stocks. 2013 was a mid-cycle year. It was a year where there was never a chance to “buy the dip” as there were no dips to buy, just an unrelenting rally through the year.

2016 will likely be a mid-cycle year as well but to the downside. In my experience and studies of bear markets once the fear of recession takes hold the downward pressure to sell and drive prices lower is fairly unrelenting.   When rallies do occur, they’re squashed quickly as they’re viewed as opportunities to sell and reduce risk.

"Market crashes" are rare events but you can tell the bear market will be in its final phases with the rout accelerates into a major plunge.   Consider it the "grand finale" when the media has declared we're in full blown recession and the stock market "crashes".

The life cycle for the Bear Market can be time stamped as of May 2015 and most bear markets last in the range of 18 months.

<u>How will we invest in a Bear Market?</u>

1. Own minimal or no stocks at all.   At present all OP accounts are either at bare minimum holdings or have no stocks at all.   In a matter of days my guess is that whatever stocks are left will be sold.

2. The bulk of client account assets will be in Treasury Bonds.   We can expect a massive "flight to safety" as money comes out of the world stock markets and currencies and into safe US assets, Treasury bonds in particular.

   The effect of our Fed raising short term rise will have a positive effect on the US dollar relative to most currencies because most of the world – especially the EU are at 0% short term.

3. ***The Dark Side*** At present we own three Inverse exchange traded funds. It's my plan to keep the value of these ETFs in aggregate under 25% of the account value for most accounts. This percentage can be exceeded if the stock market really takes a major hit since the value of the Inverse ETF's will spike higher.

   3 favorite inverse ETFs

   "SDS" is inverse to the S&P 500 index. For social screening purposes owning the SDS or any other Inverse ETF does NOT represent ownership in an objectionable company.   In reality it's classified as a "short" position.

SDS [NYSE]

ProShares UltraShort S&P500

Financial | Exchange Traded Fund | USA

The higher they climb, the mightier they fall?

SQQQ: The NASDAQ 100 has been the strongest index for the past year and it's filled my many outrageously valued names like Amazon, Netflix or Google.

SQQQ [NASD]

ProShares UltraPro Short QQQ

Financial | Exchange Traded Fund | USA

"TWM" an inverse proxy for the Russell 2000. In Bear markets small cap stocks typically sustain crushing losses due to lack of market liquidity.

TWM [NYSE]

ProShares UltraShort Russell2000

Financial | Exchange Traded Fund | USA

Lastly, I'd like to thank everyone for your trust and support over the past year and wish you all a very happy, safe and profitable 2016! Brad Pappas

Disclosures

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