

Roundtable Special Edition

This month, Peak Capital offers a unique perspective by providing answers to some pressing questions based on the conversations we have with the readers of the PCM Report.

We are fortunate to be joined by a luminary in the financial industry, Adam Schenck of Milliman in addition to PCM's Chief Investment Officer and Head of Research. All three will weigh in on where the markets and economy are headed including growth, inflation, and mid-term elections. Highlighted are some great calls from this year and a sense of where they are positioning for the future.

Roundtable Contributor Biographies

Brian Lockhart, CFP

PMC Founder &
Chief Investment Officer



Brian is the founder and Chief Investment Officer of Peak Capital Management, LLC (PCM). With over 20 years of portfolio management experience, he serves as the co-portfolio manager of PCM's suite of strategies. Brian directs the company's tactical allocation of PCM's unique investment models and has been crafting ETF strategies for nearly a decade, making PCM an early adopter of ETFs.

Brian has been featured in multiple media outlets including Barron's, Forbes, Fortune and Business Week. An active conference speaker, Brian communicates on topics ranging from portfolio and risk management to alternative investments.

A graduate of Polytechnic State University in California, Brian received his Bachelor of Science degree in Business Administration with a concentration in Financial Management. He and his wife, Cindy, have been married for over 25 years and love living in Colorado where they raised their two children, Caleb and Jennifer.

Brett Lapierre, CFA

PCM Director of Research &
Chief Equity Strategist



Brett Lapierre serves as the Director of Research and Chief Equity Strategist at PCM. He specializes in rules-based, fundamentally-driven investment model development, research and portfolio analysis.

For several years, Brett worked exclusively with VPM Partners, helping advisors develop, analyze and implement disciplined, rules-based stock screening processes. His recent institutional experience includes Janus Capital Group and Charles Schwab where he worked closely with portfolio managers, analysts and chief investment strategists in a number of capacities including macroeconomic research, tactical asset allocation decisions, portfolio and risk analysis, market commentary and thought leadership.

Brett has a Master of Science in Finance degree from the University of Denver and a Bachelor of Science degree in Business Management from Spring Hill College in Mobile, Alabama. He holds the Chartered Financial Analyst designation and has 18 years of financial industry experience.

Adam Schenck, CFA, FRM

Milliman Principal, Lead Portfolio
Manager



Adam is a managing director in the Portfolio Management Group within Milliman's Financial Risk Management Practice in Chicago. He serves as the portfolio manager for funds in the market that utilize the Milliman Managed Risk Strategy™. He leads a team that analyzes and implements risk management strategies on baskets of assets and performs research on volatility and stock return distributions. The team also produces tools that include volatility forecasting models used to create the Milliman Guarantee Index™, which is published monthly for use by life insurers.

Adam has a Master of Science in Financial Mathematics from the University of Chicago and a Bachelor of Science in Mathematics/Computer Science from Eckerd College.

Q: Oil is stealing a lot of headlines recently. There are both positive and negative aspects of the collapse in oil prices. How do you expect oil to trade in 2015 and what impact will that have on U.S. growth?



Oil is important to the global economy and we are fortunate to have history to call upon during times of extreme volatility. Oil fell from \$140 to \$40 over six months in 2008 and dropped 57% in 1986 when Saudi Arabia was also protecting market share from the N. Sea producers.

The current price drop results from a marginal imbalance in supply and demand that will get worse in 2015 if OPEC doesn't cut production (no indication at this time). I think oil could find a bottom near \$40 and trade between there and \$65 this year if supply is not interrupted geopolitically.

The impact on growth is equally debated today. The comparable drop nearly 30 years ago did not derail the economy although it brought a devastating recession in energy dependent states like Texas and Alaska. Low gas prices are a massive tax cut for consumers that should boost spending and GDP growth in 2015 and could lead to higher PE multiples for the markets. One risk to the economy is capex

losses are likely to be concentrated in the oil patch and supporting industries and be offset by growth in the broad economy. Not all energy investments are alike as can be seen from 2nd half of 2014 that saw drillers fall 46% while refiners actually gained 2%. Most concerning is the \$5 trillion in debt for drilling and infrastructure. As Jim Rickards points out, it was only \$1 trillion in sub-prime debt that led to the Great Recession.



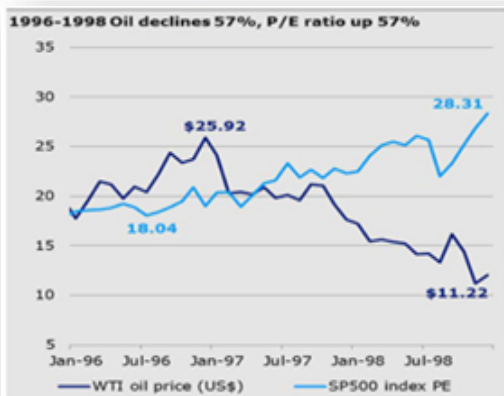
With the collapse of oil prices in the second half of 2014 we think the short-term pain will be a longer-term gain for the global markets, as consumers will have more disposable income to spend. Our view is that lower oil prices will likely bring consolidation within the U.S. shale gas industry, as producers may struggle to keep operations going at current levels. One risk that has emerged from the fall in oil prices is the sensitivity that oil prices have on the US high yield bond market. Many shale gas

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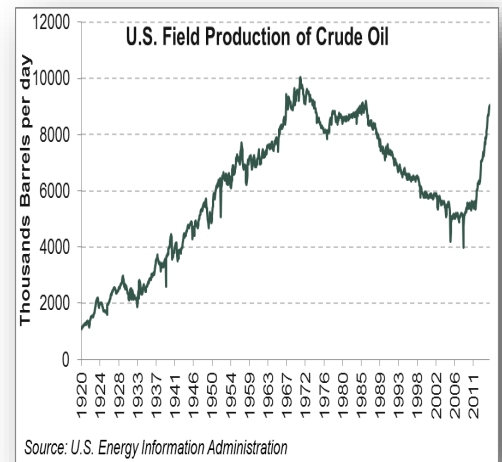
producers have issued below-investment-grade debt to fund their operations. Because of this, the longer oil prices remain below the breakeven point for many producers (e.g., \$50), the more likely these companies are to default on the outstanding debt. There are banks based in the western part of the U.S. that have significant exposures to the shale gas industry. These institutions could potentially be hit hard if the shale gas industry sees large scale defaults. While these risks are something to be on the lookout for, we feel that lower oil prices will be a net benefit to the global economy.



I expect oil prices to find a bottom some time during the first half of 2015 as U.S. shale production tapers off. Offshore rig counts in the lower 48 states have declined since the end of October, down 16% according to a report put out by Baker-Hughes. The U.S. energy Information Administration (EIA) is forecasting a further decline of 24% by October of this year. This does not necessarily mean a decline in overall production, but it does suggest to me a potential slowing of the supply buildup and thus less downward pressure on crude oil prices. EIA projects total U.S. production to hit an average of 9.3 million barrels per day (bbl/d) in 2015. That is up from 8.6 million bbl/d average in 2014 and very close to an all-time high for U.S. oil production of 10 million bbl/d. The demand side of the equation has to remain steady and I see that unfolding.



spending given the dramatic slowdown in exploration. The energy sector represented 20% of capex growth the last five years and 12% of total capex spending. Job



Much of the growth in the U.S. economy over the last several quarters has been driven by the U.S. shale revolution. This is largely true for job creation. I expect the rest of the economy to pick up the slack related to any slowdown in shale oil production. The net impact of low or falling oil prices is positive for the U.S. economy, particularly the consumer.

Q: That is a good springboard to discuss your macro view for 2015 for the economy and markets.



I see continued uneven growth for the U.S. economy in 2015. A slowdown in U.S. energy exploration, weak trading partners and a strong dollar pose a challenge to growth in my view. But as I said earlier, low energy prices are a net positive for economic growth in 2015. I would be surprised if we saw a repeat of the fourth quarter's 5% real GDP growth during 2015. I would expect a more modest 2-3% annualized quarterly growth rate on average. And I would not be surprised to see below 2% later in the year. I'm just not convinced that the U.S. economy is on the verge of accelerating given falling commodity prices, anemic growth in Europe and the over-indebtedness that remains. A continued surge in the dollar could hurt U.S. growth prospects and make imports more attractive to U.S. consumers. Currency wars could also serve to disrupt activity throughout the world. To me, this translates into the same type of uneven growth we've seen since coming out of the 2008-2009 recession.

I think the likelihood for uneven economic readings in the U.S., equity market valuations that are on the high side, economic challenges in Europe and China and diverging central bank policies, with the Federal Reserve moving towards a more normal monetary policy stance, will help keep investors on edge and translate into greater volatility for financial markets in general. Investors have been lulled to sleep with the relatively low U.S. equity-market volatility in 2013 and 2014. I think we will see more normal levels of volatility in 2015. Despite the growing headwinds, I think equity prices will finish the year higher amid continued earnings

growth and low inflation, which is generally supportive of equity-market valuations.



As we enter 2015, our view for the global markets is that investors will continue to see an increase in market volatility across most major asset classes. We have already seen volatility increase in global equities, commodities and in the foreign exchange markets throughout 2014, and into 2015. What we do expect to see is volatility in the fixed income markets rise in 2015 as well. Even with continued heightened levels of equity market volatility, the US market appears to be growing at a sensible pace and path. However, the question is; "how strong and for how long can the global economy sustain a strong US dollar without disrupting the current path of the US market?" Investors who are looking overseas at investment opportunities are being met with much larger headwinds than in the US. Many foreign countries are facing depreciating currencies, changes to the regulatory environment, slowing global growth and an economic climate in Europe that is beginning to look deflationary. In Europe, problem areas of the past (i.e., Greece) have re-emerged as problem areas once again. We believe participants are beginning to realize that issues of yesteryear were not corrected. The market seems to be waiting to see how Greece's new Prime Minister, Alexis Tsipras, will handle these challenges in the coming year. We thin commodity-producing countries such as Chile can expect to have an uphill battle in 2015, if we continue to see slowing global demand; especially if demand from China continues to fall. Overall, we are positive on equity growth in 2015, but investors may want to recalibrate their investment expectations in anticipation for a more challenging year than the last.



While risks remain, I still expect economic growth to surprise on the upside and the data seems to support that. Consumer sentiment is at an 11-year high, including future expectations that rose sharply in January. Small Business Optimism measured by NFIB is back above pre-recession levels with hiring accelerating. Lastly, Leading Economic Indicators are at 2006 levels and remain above the critical 18-month average.

This bull market is aged and about to become the 3rd longest since 1930. Valuations concern me given the nearly 200% appreciation since March 2009 and recent gains during periods of uneven economic growth. While the cap-weighted S&P 500 sports a reasonable PE of 17, the median valuation of the index is closer to 21 meaning the average stock is definitely extended.



The average family is likely to save nearly \$1,200 in energy costs this year giving a significant boost to consumer spending. Given that the consumer represents 68% of GDP, I expect growth to remain strong if not derailed by the U.S. dollar moving too high. I expect the Fed to remain very accommodative and history shows that the market performs well when the Fed begins a tightening cycle, only struggling after the 3rd rate hike. I expect modest PE expansion and 5% EPS growth that would leave the S&P 500 6% to 8% higher than current levels.

Q: What is your outlook for fixed income? Is this the year that rates finally raise and what are your expectations for the Fed?



It's hard to believe that we are still asking this question in 2015. But we do think 2015 is the year that the Federal Reserve begins raising rates. Our expectation is that the Federal Reserve will increase rates in a very prudent, deliberate, and minimal manner. One thing we expect is for the Fed to clearly communicate their plans with the public. Since the inception of quantitative easing in 2008, equity investors have benefited from the Fed "shielding" their portfolios from market declines, placing put like instruments on the market. Previously, if the market took a small step back, the Fed would step in and announce another round of quantitative easing, thus lifting the stock market back up to previous levels. We think the end of this "Fed Put" is in sight, which will put equity investors at risk. We strongly believe the end of this program will force investors to find other methods of risk management in their portfolios, as the Fed will no longer be there to do it for them. Traditionally, investors have viewed fixed income as a tool for diversification and risk management. With the impending realization of rising interest rates, fixed income securities may become a challenge for investors looking to manage portfolio risk, as rising rates places downward pressures on bond prices. We believe one method for managing portfolio risk through these challenging periods of rising rates is to use risk managed equities to manage volatility and shielding investor assets against significant sustained market declines.



Fixed income results should again be dominated by growth and inflation expectations and Fed policy. In their December meeting, the Fed chose to remove the phrase "considerable time" instead choosing to say they will be data dependent. Given that 2 of the Fed's preferred indicators, Personal Consumption Expenditures and forward inflation expectations, both show weakness, any tightening this year is likely to be very measured.

I expect the yield curve to flatten with short-term rates rising by mid-year but long rates remaining mostly unchanged on continued low inflation expectations. I would not be surprised to see the 10-year Treasury yield fall to 1.50% and the 30-year yield to 2.50%.

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Investors who have chased returns in high yield are likely to be disappointed this year. I expect negative returns on low quality bonds as energy defaults (16% of high yield market) and sub-prime education and car loans create a rush for the exits. This should be a year where credit quality trumps duration in terms of importance.

Muni bonds continue to look attractive to me and should benefit from a rotation out of high yield bonds. This year will likely see a slight contraction in new issuance along with strong demand driving yields lower and providing strong returns.

All pressure should be off the Fed as the combination of a rising U.S. dollar and low energy costs will keep inflation closer to 1% than the Fed's target of 2%. I expect the Fed will hike rates at their June or July meetings as it will not jeopardize

growth. Considering that Schlumberger recently announced 9,000 in layoffs and other energy companies are following suit, the cut back in capex spending might lead to weaker employment meaning both of the Fed mandates suggests caution on their part.



I may be somewhat of a contrarian here. First of all, I see short-term rates rising with the Fed likely beginning its move towards normalizing monetary policy mid-year or later. This will have an immediate impact on the short-end of the curve. In fact, we have already seen the market anticipating this move with the general uptrend in 2-year Treasury Yields for much of 2014. I expect this to continue despite the sharp drop in 2-year yields in January.

For the long end of the yield curve, I could see interest rates actually finishing the year lower. The likelihood for uneven economic growth, an environment of low inflation and perhaps growing deflationary pressures, not to mention continued strength in the U.S. dollar, all suggest to me there is little upward pressure on long-term interest rates. In fact, we could see further downward pressure on U.S. 10-year Treasury yields in my view as foreign investors unwind positions in emerging market currencies and elsewhere. It is quite amazing to me that the U.S. has one of the highest 10-year yields of all developed economies. Are we a bigger credit risk than Italy or is there something else going on? Central bank manipulation of interest rates and currencies is making it hard for investors to make sense of yields and spreads worldwide. They do not necessarily reflect the growth or inflationary prospects of their respective countries. With that said, we should be cautious when interpreting the meaning behind the level of interest rates, at least for now. Forecasting them may be a fool's errand as well, but there is mine.

Q: Stable currencies are generally good for economic activity and asset returns. Are we entering an era of greater currency volatility or instability with diverging central bank policies?



I do expect greater volatility in the currency markets this year as central banks become more desperate to stave off deflationary forces. The ECB fired the first shot across the bow in 2015 when they recently announced they would implement their own quantitative easing (QE) program by buying €60 billion of bonds each month until at least September 2016.

The Bank of Japan is equally committed to devaluing the yen in order to gain a competitive advantage on their manufacturing competitors. A wildcard that could dramatically change the global currency markets would be the Bank of China moving to devalue the yuan. China's growth could slip below 5% this year as their housing bubble deflates and banks write down bad loans tilting policy makers to take an unexpected step.

We do benefit from the high degree of transparency among central bankers. Policy statements used to be filled with lots of words without saying anything and commentators spent hours trying to interpret absurd clues like the "briefcase indicator." While it can be difficult to determine the efficacy of different policy actions, bankers today signal their intentions.

With the U.S. economy poised to continue its growth trajectory, the dollar should continue to appreciate against the euro and yen. Where volatility concerns me is in the emerging markets where companies issue bonds payable in USD but earn profits in their local currency. As the USD appreciates, the cost of debt service goes up and profits fall leading to capital flight that compounds the problem.

As long as the currency moves are

measured and don't move too far too fast I think the markets will be able to digest this year's volatility without creating crisis.



The global investment environment is likely to offer a number of challenges for investors in the coming year. Unprecedented central bank interventions continue to distort what is really happening in many regions of the world. This is impacting the flow of capital and the assessment of risk in my view. Over-indebtedness, slow growth and large imbalances have a way of doing that to an economy, but I digress. As a result, I see a more hostile environment ahead, which will likely show up in currency markets.

To say we are in the early stages of a currency war may not be too far from the truth. It seems the prevailing mentality worldwide is "every-central-banker-for-themselves." This suggests to me greater volatility and uncertainty across exchange rates, which represents a potential headwind for U.S. economic growth. I am not optimistic that we will see any improvement in the large global imbalances that still exist today.

Many of these imbalances stem from various structural issues that remain throughout Europe and China. No one is really moving to enact structural reforms or rein in spending in my view. They have little incentive to do so and there is little political will as well, particularly across Europe. Syriza's victory on an anti-austerity platform in Greece's recent elections says a lot about overall feelings in Europe. Germans may be the exception, but they know they would be on the hook for what happens in the periphery. Concerns that Syriza's apparent momentum could spark similar success in other European countries, like Spain and Italy, have grown. This will likely heighten volatility in financial and currency markets. Let's hope central banks can buy enough time and growth for governments to get their fiscal houses in order. I wouldn't hold my breath though.



The start of 2015 has been interesting to say the least, in regards to the foreign exchange markets and central bank policies. U.S.-based investors allocating assets to international markets have seen dramatic swings in the foreign currency rates during January 2015, notably due to the Swiss National Bank's decision to abandon the cap on the Swiss franc against the euro. Additionally, the European Central Bank announced plans to buy more than €1 trillion of bonds by the end of September 2016. Shortly after the President of the European Central Bank, Mario Draghi, announced the latest round of its bond-buying program, the euro fell relative to the U.S. dollar, and the European equity markets quickly rallied. When you couple that with the action of central bank policies in other large economies, we think it's hard to see how the U.S. dollar could not continue to remain strong relative to major world currencies in 2015. Similar to equity volatility, investors have experienced historically low foreign exchange volatility in recent years. But as we entered 2015, investors have experienced an increase in foreign currency volatility, which equates to currency risk. Currency risk is the risk of potential loss due to having to convert an investment denominated in a foreign currency back into U.S. dollars; investors can benefit or be harmed from taking on currency risk just as with equity risk. In 2014 and early 2015, U.S.-based investors have been largely hurt by the strong dollar when investing overseas. The increase in foreign exchange rate volatility does not only affect U.S. investors allocating assets to foreign-based companies but also investors who invest in U.S.-based multinationals. In recent news, Procter & Gamble announced that the company expects currency volatility to reduce profit by 12% and sales by 5% in 2015. We expect to see more companies make similar announcements as we make our way through earnings season.

Q: Is there one particular risk for investors you think most analysts are over looking?



I would have to agree with Doug Kass of Seabreeze Partners who usually puts together an annual list of surprises before each year begins. In his piece titled "15 Surprises for 2015," which is worth the read, he mentions a loss of faith in central banks as his top surprise. I have been thinking about this for some time and see it as a potentially large risk that is not really being priced in by the markets. A loss of faith in the Fed would be highly disruptive to the global economy and financial markets worldwide and lead to much greater uncertainty in my view. It remains extremely crucial that the Fed maintains its credibility around its mandate of stable prices and full employment.

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The largest monetary experiment in history has been underway since the "Great Recession" and it is far from over. The ECB has now joined Japan and the U.S. by going down the QE road. I do not have a lot of faith in QE-Europe being successful by itself. Structural reforms are greatly needed and they have to deal with diverging interests and no real legal union. But the ECB is taking the immediate and easier route it seems in order to give governments time to get their act together. In terms of the Fed, it may have damaged its credibility already. I recently heard James Bullard, President and CEO of Federal Reserve Bank of St. Louis, give the opinion that the FOMC's credibility around its inflation target

is in jeopardy with the fed funds rate at zero. Inflation is too high to justify the low fed funds rate in his view. The market does not seem to think so, as inflation expectations five years out are quite low. I see central bank credibility as something to pay very close attention to.



I see multiple risks that are mostly ignored by the analyst community. The first, and most likely risk to occur, is excessive appreciation of the USD. The dollar moving too far can cause a profit recession in the U.S. if not an outright economic contraction. As mentioned above, an ultra-strong USD can create an emerging market debt crisis causing a financial collapse similar to the 2008/2009 crash.

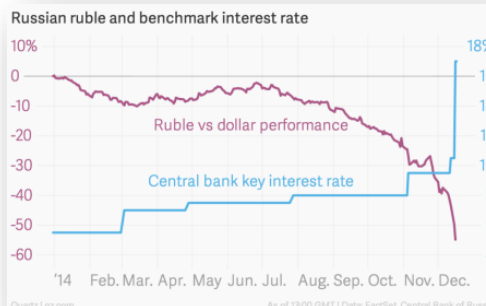
The next most likely risk I am concerned with is the ECB's QE failing and the Euro region slips further into deflation. There is no policy unity in Europe, illustrated by the just completed vote in Greece where the anti-austerity candidate prevailed. A Greek debt default would likely lead them to exit the euro and initiate a chain reaction of dominos tipping that eventually leads to a breaking up of the euro.

The last risk I will touch on feels more like a black swan event than the first two I mentioned. Russia, more than any other country, is

50% of total government revenues. Analysts predict the Russian economy could contract as much as 5% this year creating public calls for change. Putin cannot influence global oil demand but could use military actions to try and either threaten supply or drive oil higher through geopolitical turmoil. Invading Kiev seems to be the most plausible step but I would not rule out targeting Middle East oil fields through mercenaries or even staging troops in Syria.



The one risk that we believe most analysts have overlooked is the ability of central banks to act in a way that deviates largely from the consensus market views. The question on a lot of analysts' minds is; did the Swiss National Bank spark a global review of central banks' current foreign exchange policies? This is a market risk that few can foresee but the market impact can be detrimental to investment returns. Two additional questions on the horizon are, "Could Greece leave the European Union? Could Denmark de-peg from the euro?" There are many unknowns; especially in Europe. We believe U.S.-based investors not only face equity risk, but also currency risk, and sovereign risk when investing abroad.



suffering from oil below \$50. With the threat that oil could go even lower and remain at depressed levels for an extended time, Putin's leadership could easily be in jeopardy. Energy represents 80% of Russia's exports and more than

We implement the "managed risk equities" approach via our Milliman Managed Risk Strategy. This seeks to stabilize portfolio volatility and reduce downside exposure during severe sustained market declines. Our risk management techniques were originally developed to help some of the world's largest financial institutions stabilize portfolio volatility and weather market crisis. Today, the Milliman Managed Risk Strategy is on of the more widely used risk management techniques in the marketplace and can be accessed at both the institutional and retail level.

Q: Looking at opportunities in the market, any investment picks or asset classes you are particularly bullish on?



Not surprisingly, the opportunities I see are predominately large cap domestic companies. I expect stock picking to re-emerge in 2015 with broader indices volatile and upside limited. A common theme is also identifying companies poised to benefit from higher levels of discretionary income.

1. Harley Davidson (HOG) - The company has excellent management that transformed it into one of the most efficient manufacturers in the U.S. They have been consistently growing their market share in the U.S. and overseas through the introduction of the The Street models with low entry points. Motorcycle aficionados have endorsed the Live Wire project, an electric bike set to be released in 2017. HOG is trading at 16.8x 2014 earnings with 17% EPS growth, selling for 14 times this year's earnings. Lastly, how many companies can boast customers so loyal as to tattoo their brand on their biceps?
2. Apple (AAPL) - Could be the company that benefits the most from low energy prices. Consumers' savings at the pump over a few months can pay for a new smartphone or wearable. AAPL is the strongest brand in the world with tremendous upside potential domestically and abroad. I love AAPL's valuations, trading at a 20% discount to the S&P 500's PE ratio with over 25% EPS growth in our forecasts (5% EPS growth on S&P 500). AAPL is a bargain at 14x 2015 earnings.
3. Southwest Energy (SWN) - Given the weakness in energy, this may surprise some. This is a natural gas play with an enterprise value more

than double the current stock price and one of the most attractive debt-to-EBITDA ratios in the industry. With 6 new liquid natural gas (LNG) plants approved for construction, demand for natural gas should increase as the U.S. increases exports to Europe to help them reduce dependence on Russian gas. SWM trades at 10x our 2015 estimate making their valuation compelling.



I think U.S. equities remain relatively attractive to me amid better prospects for the U.S. economy relative to Europe and Japan. Earnings growth could slow and valuations on U.S. stocks are already above long-term averages, so I think investors will have to be selective in playing the next leg of the bull market. Technology sticks out to me as an attractive area as productivity growth has been stagnant, not to mention the benefit of low gas prices likely accruing to consumer electronic companies. I would expect capital spending in technology to improve as companies seek to make their employees more productive.

I like long-term U.S. Treasuries and investment-grade corporate debt as well. I've already mentioned global yields are at historically low levels and that the U.S. remains one of the more attractive areas for yield seekers. I think this will help put downward pressure on long-term U.S. Treasury yields. I'm not that bullish on high yield debt amid its high exposure to energy prices. I think the rally in the U.S. dollar has more to run. Europe is likely to remain mired in economic stagnation, as is Japan. This does not mean stocks in those regions will perform poorly. Valuations in Europe and emerging markets are more reasonable when compared to U.S. stocks, but there is the strengthening dollar to contend with. If you are interested in those areas, I would suggest hedging

some of the currency exposure. I see stock picking to be at a premium in what will continue to be an uneven world. Unlike 2014, stock pickers as a whole could finally see better relative performance this year.

Conclusion:



I want to sincerely thank Adam Schenk, lead portfolio manager for Milliman Financial Risk

Management, for participating in this round table discussion. His responses were both insightful and well articulated.

The list of concerns that can keep portfolio managers up at night is quite long today. At the top of the list might be the overwhelming consensus for what is "supposed" to occur. I get very nervous when the entire investment community appears to be on the same side of the trade. Regardless of how likely that outcome is, rarely is everyone right.

Where consensus is almost certain to be right is that volatility will be higher in 2015 than in 2014. Volatility spiked in the first month of 2015 causing some to wonder if the TOGIT market remains (the only game in town). January finished down 3.1% giving hope to bears according to the so-called January effect. Their memories, however, must be as short as a QB's after an interception as January 2014 saw a 3% decline and still finished the year with double-digit gains.

Stay tuned

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