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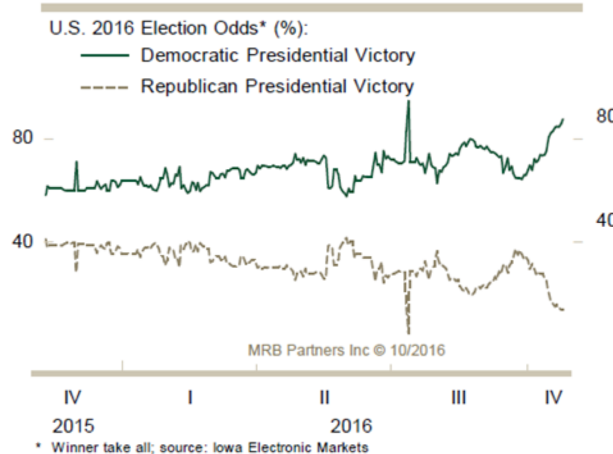
PEAK CAPITAL MANAGEMENT

A Landslide Defeat

PCM Report November 2016 Volume 7, Issue 11

Will there be a winner in November's Presidential election? The question is intended to be both rhetorical and philosophical as we are well aware that the next president will be elected in just over one week. This election cycle, however, feels very different than all previous elections in which I have participated in (I had the privilege of voting for Ronald Reagan in 1980 as a first time voter). This election has a sense of defeat attached to it, not just for the losing candidate but for the country as a whole.

What makes this election so different than past elections? It is almost always the case that only about 60% of eligible voters will participate in electing the next President. This means that approximately 30% of the voting age population will have voted for whomever prevails on November 8th. Typically, the remaining 70% either did not care one way or the other about the candidates, or their preferred person was defeated. In the past, only the rabid partisans seemed to be concerned with the outcomes but that is not the case this year. Whichever candidate prevails with around 30% support will be facing an extremely hostile 70% who believe their way of life will be forever and negatively impacted. A landslide defeat for the country.



While the polls remain tight, the odds that Clinton wins the election has risen 80% in the most recent models predicting a winner. It appears that a majority of voters make their decisions based on the personalities of the candidates but it is the anticipated policy changes that really determine how the markets are likely to respond. Determining who benefits from a Clinton or Trump presidency is not as difficult as it may seem given their public views and priorities.

Healthcare: Clinton is a solid supporter of Obamacare (Affordable Care Act) and believes the struggles are the result of the government not doing enough. She will push an increased enrollment through new and larger subsidies necessary to combat the average 25% increase in premiums that people are facing. Managed care companies, hospitals, and insurers should benefit from a Clinton presidency while biotech and pharmaceutical companies will face strong selling pressure as she has targeted them, accusing them of price gouging and threatening government price controls. Trump has vowed to repeal Obamacare and shift more responsibility (and funding) to the states. If Trump pulls off the upset, we expect insurance enrollees to decline hurting the earnings of care providers; however, he does not pose a threat to pharmaceutical companies. Overall, valuations on healthcare sector stocks are favorable and attractive and have room to rise once the political instability is complete.

Energy: As with healthcare, the candidates' energy policies are virtually opposite one another. Clinton will aggressively defend the Clean Power Plan (CPP) that is currently stayed by the U.S. Supreme Court. Environmental regulations on exploration would likely harm anything involving drilling (energy services) and coal -related energy while creating huge, high-risk opportunities with alternative energy companies in wind and solar. A Trump presidency would encourage more drilling and fracking in order to move towards energy independence as quickly as possible benefitting all aspects of oil and gas drilling and services.

Financial: There are surprisingly little differences between the candidates with respect to their views on banking, insurance and securities regulation. Clinton supports Dodd-Frank and would try to expand its reach to regulate the shadow banking operations in the U.S. Trump would likely try to shrink the reach of Dodd-Frank and be viewed as very friendly towards financial regulation in general. Big banks and broker-dealers would benefit under Trump and be forced to deal with higher capital requirements under Clinton. The biggest difference would be seen in forward Fed policy as Clinton will likely maintain the status quo of lower rates for longer and Trump would appoint a Fed Chair focused on normalization of rates at a much faster pace.

With near certainty the Congress and the White House will remain split and result in continued gridlock. While the rhetoric seems to get more vitriolic each year, the markets are comforted knowing neither party has the ability to take the country too far in any one direction. We expect the markets will be up low double-digits with a Clinton win as that poses less immediate uncertainty while a Trump surprise win would probably lead to a similar sized drop in stocks. More than anything, we will just be glad when this is over.

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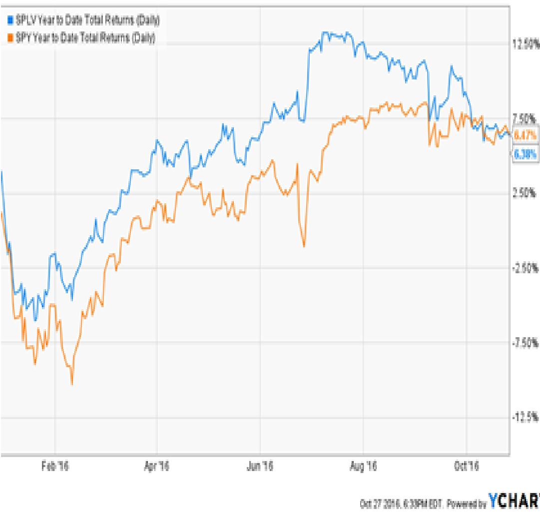
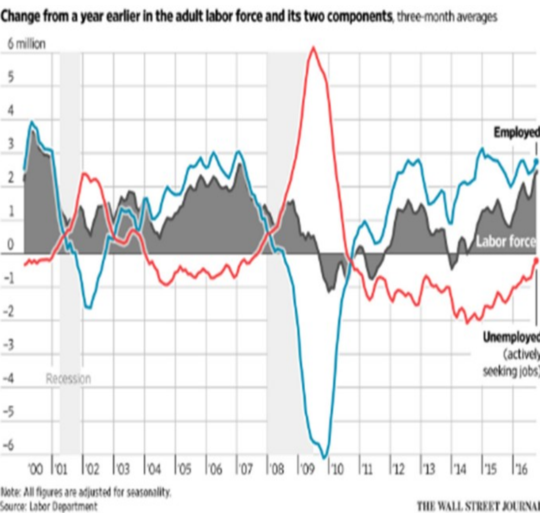
Low Volatility but High Risk



For much of 2016 low volatility stocks outperformed the broader cap-weighted S&P 500 index. In early July, the subset of the S&P with the lowest trailing volatility had gained over 12% compared to just 7% for the broad index. The last couple of months were quite difficult for the low vol strategy that now trails the index on a year-to-date basis. Looking at how the index is constituted suggests low volatility stocks tend to be more interest rate sensitive. When the yields began rising in expectation of a December rate hike these stocks have become . . . more volatile. It may take a couple of quarters of rebalancing before the strategy becomes less sensitive to changes in interest rate expectations.

- Slightly over 50% of the Low Volatility index is comprised of Utilities, Industrials, and Financials, sectors with high levels of debt and interest rate sensitivity.
- Low Volatility has outperformed the benchmark over the trailing 2 years 11% to 7% but has trailed in total return over the past 5 years by a margin of 60% to 70%.
- The index is reconstituted on a quarterly basis using the trailing 12-month volatility stats likely requiring an extended period of time to shift away from rate sensitive sectors.

Labor Market in Focus



Unemployment and job growth have served as a political pawn for both parties depending on what point the candidate sets out to make. As portfolio managers, the objective is to interpret the data points and draw appropriate conclusions. Unemployment ticked up slightly in September as a result of more people looking for jobs than jobs available. The labor market is viewed as stable given the sixth straight year of expansion. The labor force is defined as the employed plus those actively looking for work has been growing as depicted by the gray portion of the chart below. Clinton is pointing towards the growth while Trump is pointing to sluggish wages since the Great Recession. The more critical question is what does Janet Yellen think of labor participation and wages.

- In September, the labor market grew by 440,000 and 3 million over the past year, marking the largest 12 month gain since the tech boom in 2000 (Labor Department)
- The labor force participation rate grew by .5% in September (Labor Department)
- Employers added 156,000 jobs in September, primarily in healthcare, retail, and professional services (Labor Department)

Be Mindful of Correlations

Correlation Table (Select Asset Classes)	August 2016	October 2016
US Equity and Treasuries	-0.20	0.53
REITs and US Dividend Stocks	0.44	0.70
High Yield Bonds and Treasuries	-0.40	0.38
Mortgage and Corporate Bond	-0.13	0.55

In last month's PCM report, we highlighted the fact that correlations across asset classes – particularly between stocks and bonds – have increased in recent months. We've seen this trend continue in October and felt it noteworthy to further examine recent behavior across asset class returns. Given our focus on risk budgeting – which fundamentally relies on the volatility and correlations across asset classes to construct portfolios – it's critical to understand how asset class returns move together to gauge the degree to which our portfolios remain diversified. Specifically, we've observed that equity and Treasury returns remain more highly correlated than their ong-term averages. We've also observed a continued move higher in correlations across interest rate sensitive assets ahead of the December Federal Reserve meeting.

- We are again challenging the assumption that combining bonds with a stock portfolio will deliver a diversifying effect. In our view investors are going to have to consider other options, such as cash or short positions in broad asset classes, to maintain adequate levels of diversification
- We have seen this tendency in the past – correlations tend to rise as the market anticipates a change in Federal Reserve interest rate policy (see 1994 and 2004 for historical examples). An increase in rates from historically low levels can reprice all assets with great velocity.

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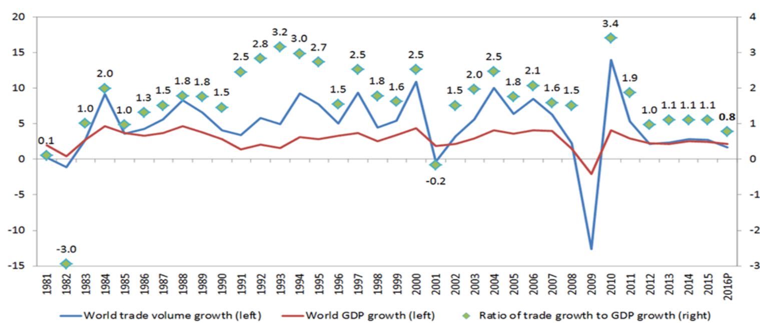
Macro View – Global Trade

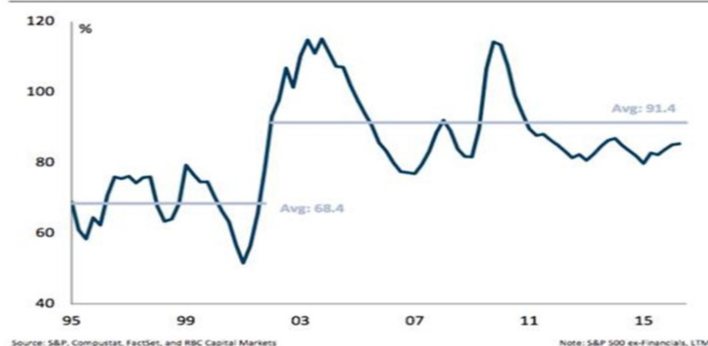
October brought together some of the sharpest economic minds for meetings among the IMF and World Bank. Front and center was concern over an increased focus on protectionism and a belief that growth is better served inside one's borders than more free trade. Christine Lagarde, Managing Director of the IMF, Jim Yong Kim, President of the World Bank, and Roberto Azevedo, Director General of the World Trade Organization, acknowledged slow global growth, but attributed the slow growth to a lack of global investment and tariff/non tariff factors (Wall Street Journal). They are quoted in the op-ed piece stating, "In an age when services comprise two-thirds of global economic activity, it is astonishing that barriers to services trade are often equivalent to tariffs of 30% to 50%." The chart below from the WTO shows global trade growth in blue reaching growth levels at their slowest pace since the financial crisis.



Sources: WTO Secretariat for trade, concensus estimates for GDP.

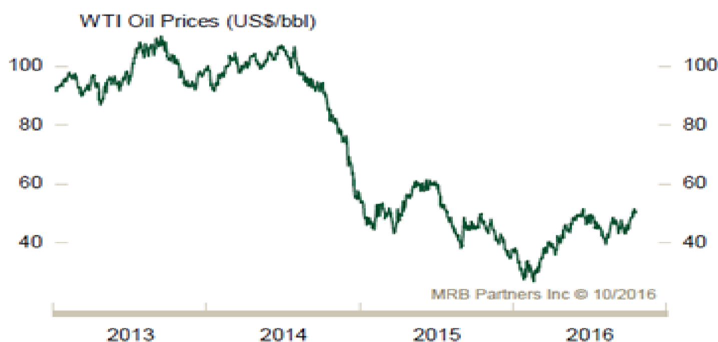
Taking Stock – Shareholder Yield

Buybacks and increasing dividends have been a focal point since the financial crisis. As of September 30th, the PowerShares Buyback Achievers ETF has a 5 year average return of over 17%, outpacing the S&P 500 over the same time period. Company's free cash flow is closely tracked given that if companies are able to generate more free cash flow from net income, a higher P/E multiple is justified because there are more funds available for dividends and buybacks. This is an increase in shareholder yield. The chart below from S&P demonstrates a spike in free cash flow heading in to 2011. Since that spike, free cash flow has trailed the average established since the tech bubble burst in 2002. Although, past buybacks, being corporate discretionary action, do not determine the likelihood of future buybacks. Increasing free cash flow, though can be an indication of increasing dividends and buybacks.



Fixed Income – The Energy Spread

The recent stabilization in oil prices have been a positive development for the high yield bond market as reflected in junk bond pricing. Bonds with BB or lower ratings have recovered from the losses earlier in the year and sit at the same levels as September 2015. Oil has benefitted recently from talks between Opec and the major non-Opec producing nations like Russia and China to curb production in order to lift prices. Whether an agreement can withstand increased production from the U.S. and the notorious cheating among Opec countries remains to be seen. The global economy is showing signs of slowing which typically translates into less demand for oil and downward pressure on pricing. The high yield market is strongly correlated to oil prices because of the amount of issuance for energy exploration companies.



Technical – Technically Correlated

Effective technical analysts are continually searching for relationships that have correlations strong enough to be useful in forecasting the direction of the markets. One of the broadest measures of how well the economy is performing is the Purchasing Managers Index published by the Institute for Supply Management (ISM). The chart shows the performance of the S&P 500 Index using year-over-year gains plotted against ISM data. Periods of weakness in the ISM reports have corresponded with weakness in stock prices, until very recently. The latest run towards a record closing price on stocks occurred when the ISM was turning sharply lower. We are confident one of the data series will reverse in the near future with the ISM moving higher or stocks moving lower. It is possible the next couple of months of ISM data is the best indicator of where stocks are headed after the election.

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Volatility Creep in Low Volatility Strategies

Clint Pekrul, CFA

The concept sounds intriguing – invest in stocks that exhibit lower return variability than the overall market and expect higher returns than the overall market in the long-run. Intuitively this should not be the case. If I assume less risk (i.e. lower expected volatility) from my investments, I should expect to give up some performance potential on the upside. This paradigm – commonly referred to as the risk-return-tradeoff – is the cornerstone of how our industry generally constructs investment portfolios.

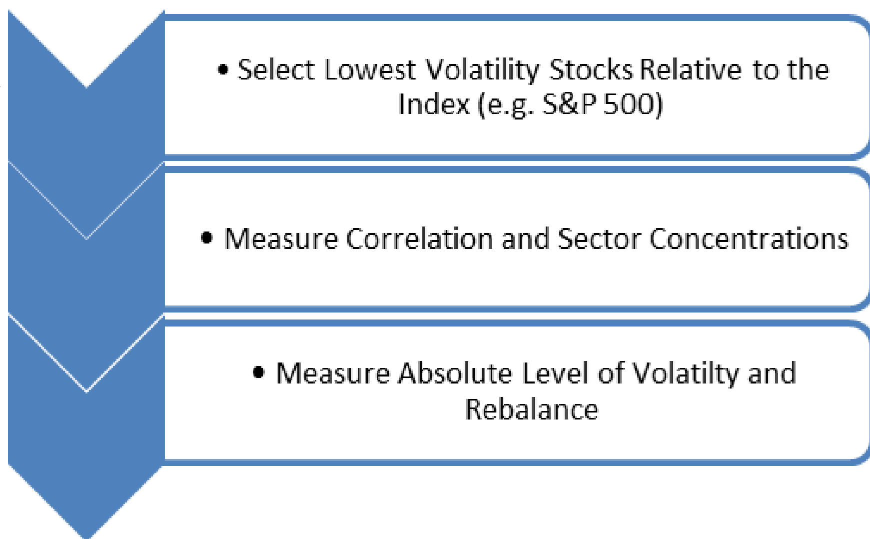
But a trend has emerged on the heels of the global financial crisis of 2008 – namely, low volatility investing. The idea is that by selecting stocks that exhibit the lowest volatility from a larger sample, such as the S&P 500, and periodically rebalancing, you can smooth out returns, increase the effects of compounding over time, and achieve better performance than the sample itself. It seems like a free lunch, and we don't deny the historical record of such an investment strategy. In fact, it's the back-tested results of low volatility strategies that have led to an exponential increase in the number of assets that follow the low volatility approach.

And therein lies a potential problem, at least in our view. To our knowledge, never before in the history of the capital markets have so many assets gravitated to a relatively small group of stocks. In our industry parlance, this means that low volatility investing could become a crowded trade, and generally, crowded trades don't end well. As assets pile in, prices are bid even higher and become more detached from fundamental valuations, and returns become more unstable. If your portfolio is not rebalanced in a timely and disciplined manner, downside risk can creep up very quickly.

Investors must be very mindful of exactly how a low volatility approach is implemented. First, if you decide to allocate assets to the lowest volatility stocks, it could result in a portfolio that is highly concentrated in a single sector or underlying industry. When this concentration happens, your portfolio might not be properly diversified. While you might hold stocks with the lowest volatility from the broader index, you might own a portfolio of highly correlated investments. Remember, simply evaluating each stock's return volatility tells you nothing about how stock returns move together in time. If investors run from a crowded low volatility trade, and every position is positively correlated, then downside risk could jump dramatically.

Second, if you implement a low volatility strategy, be mindful of how frequently the positions are reviewed for rebalance. What was a low volatility stock yesterday might not be a low volatility stock tomorrow. Much can happen over the course of a year, or even a quarter. In fact, in times of stress, market dynamics can change very quickly. Simply following a predetermined calendar rebalance (e.g. annual or semi-annual) might not be suitable for achieving a low volatility investment strategy.

A Comprehensive Low Volatility Strategy



And finally, and perhaps most importantly, investors should have a predetermined threshold for the absolute level of volatility they can with-stand. Looking at a stock's volatility relative to a broader index, such as the S&P 500, is only a part of the investment decision. It's little comfort for many to hold the least volatile stocks in the S&P 500 when the S&P 500 index volatility itself is 50%! In some cases, you have no other option than to look to other assets classes or even cash if you want a low volatility strategy to succeed.

We are not suggesting that low volatility investing does not have merit. In fact, we view low volatility investing as one of several factors present in the equity markets than can carry a risk premium over time. But in our view, simply slicing the capital markets based on volatility alone doesn't quite cut it if you are looking for a comprehensive investment solution. There are other factors to consider, such as the potential downside ramifications of a crowded trade, highly concentrated portfolios that are exposed to only a few sectors or industries, and portfolios consisting of highly correlated securities. Furthermore, a comprehensive low volatility strategy must have the discipline to "step aside" if the uncertainty of market returns becomes unbearable.

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Q: Do you anticipate a winner-take-all scenario with the election?

A winner-take-all scenario occurs when the party who wins the White House also takes control over both the House of Representatives and the Senate. Given where the polling is today and most likely scenarios, it seems unlikely a winner-take-all outcome will happen. Emotions are running at feverish levels during this campaign so I would not rule anything out. If Clinton wins in a landslide it is extremely likely the Democrats would take control of the Senate but it remains very unlikely they could threaten the Republicans hold in the House.

If I had to predict a winner take all scenario it would be on the Republican side. If the polls turn out to be less accurate than assumed and Trump wins the presidency, it is extremely likely the GOP would retain control over both the House and the Senate. The markets, and likely the country, prefer for government to be divided in terms of power so that one party does not have the ability to take the country too far in either direction.

Instances when the same party controls both branches of Congress and the Presidency tend to be short lived. This last happened when the Democrats controlled all 3 during President Obama's first 2 years in office and GOP controlled all 3 during the Bush Presidency for a short time.

Just to be clear, I don't believe it's likely that any single party will gain complete control of Washington. In general, a winner-takes-all scenario – whereby a single party takes control of both Congress and the White House – might not be viewed as a favorable outcome for the markets. I think the perceived risk could be that the country swings either too far to the left or too far to the right when it comes to economic policy and social agendas. There are also Supreme Court appointments at stake, which will have much longer-lasting ramifications.

Complete control of the Federal government by a single party would likely have far reaching ramifications when it comes to tax policy, international trade and bureaucratic regulations. In general, I think the markets like to see a bit of balance between the parties to provide some stability. The general view is that Republicans are more business friendly than Democrats, but historically, there are periods where markets have done well under both parties.

Q: Does this election represent the end of politics as we know it?

Based on the performance of the last 5 years the only thing that hedge funds have hedged are returns. It has been well documented that hedge funds have struggled I think many would agree that during this election cycle more people are dissatisfied with the choices they are given than in any other election in recent history. However, simply because there are two seemingly "unlikeable" candidates does not necessarily mean politics have really been altered.

I do see a more troubling trend shaping up that I think has the potential to end politics as we know it and that is the move towards populism. Donald Trump and Bernie Sanders are really two sides of the same coin with respect to how they appeal to voters. Both emphasize an "us against them" mentality to attract devoted followers to their worldview. There is little effort on consensus building because the opposing viewpoint must be demonized in order to succeed.

If not for some very questionable tactics including help from supposedly neutral party leaders, this election could have been between Sanders and Trump; an outright Socialist versus an Isolationist. This should make the vast majority of Americans who view themselves politically as being between the two extremes very nervous. It is far better for elections to be won between candidates who both lay out a vision for prosperity without playing the victim card or accusing others of ill intent. A populist tide would change politics in a concerning manner, let's hope we do not go down that path.

In the history of American politics, we've seen election cycles that were largely uneventful. But every now and again, the American people show a heightened interest in who will become their next Commander in Chief. When voters feel disenfranchised, or generally frustrated with their state of wellbeing, they look to their elected officials for answers. On the heels of the worst economic calamity in a generation, overseas wars with no end in sight and rising healthcare costs, it seems Americans are generally frustrated. And hence the rise of candidates outside the Beltway that circles Washington, D.C., such as Bernie Sanders and Donald Trump.

But the emergence of outsider candidates in the election process isn't new to American politics. What I think is interesting, however, is this notion of the "self-funded candidate" that doesn't really need a political party affiliation. Imagine a billionaire (follow Trump's lead) that uses social media to engage millennials to vote, with no respect to districts, party lines, etc. And they don't need grass roots efforts to fund their campaigns.

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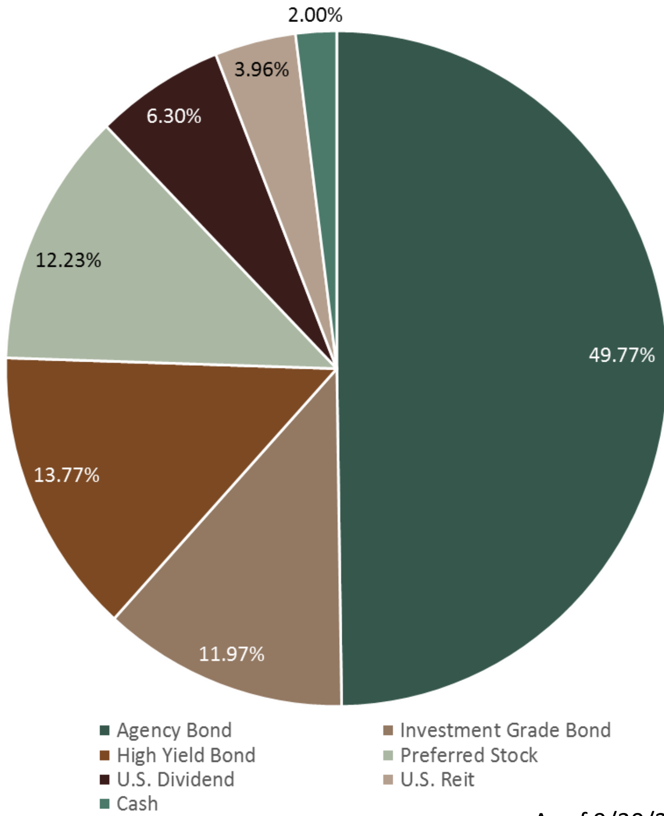

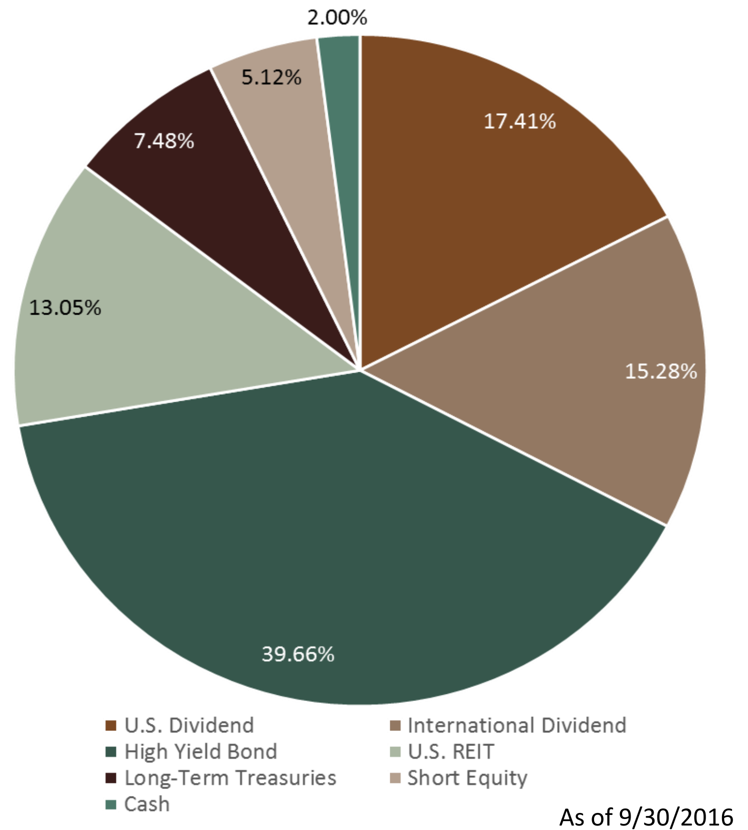

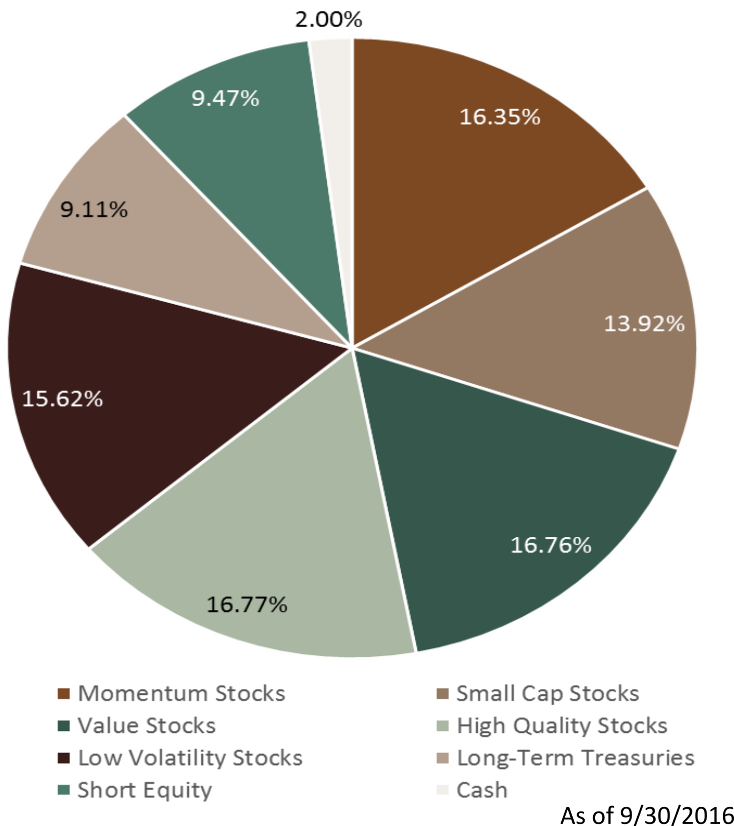

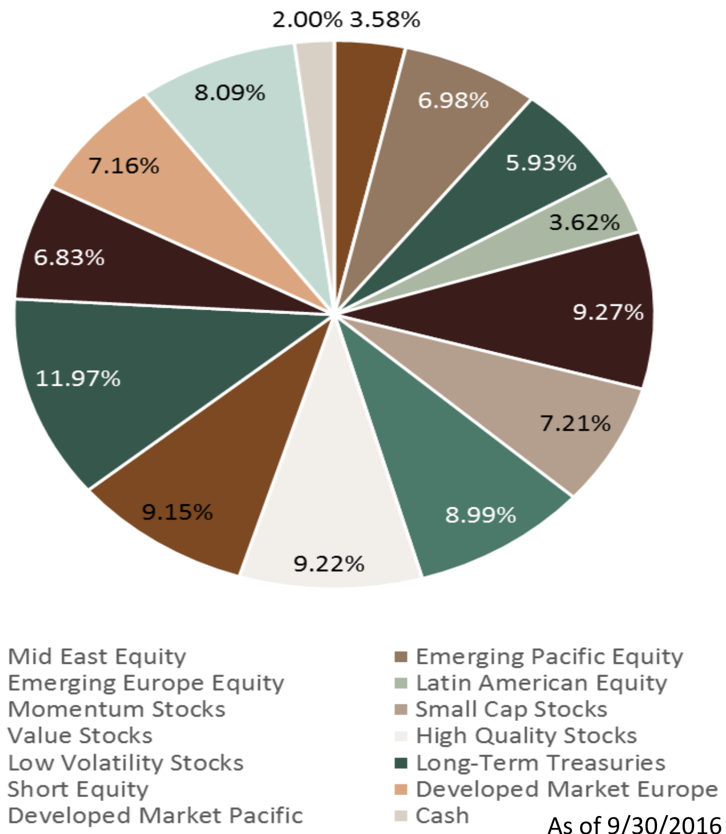

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PEAK CAPITAL MANAGEMENT

15455 Gleneagle Dr., Suite 100
Colorado Springs, CO 80921

Phone: 719.203.6926
Fax: 719.465.1386

Email: info@pcmstrategies.com
Website: www.pcmstrategies.com

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