Third Quarter 2014 Investment Commentary

Robber Baron Redux

* Rare Superman Comic Book Fetches a Record $3.2M

* $130 Million River House Residence Is Now NYC's Most Expensive Home For Sale

* Onement VI By Expressionist Barnett Newman Sells For $43.8 million

Visitors to Newport, Rhode Island who tour the mansions on Bellevue Avenue gain a perspective on the Robber Baron Era around the turn of the 20th century, when a few magnates controlled the oil, coal, steel, shipping, and railroad companies that dominated the economy. By the time Teddy Roosevelt put an end to their fun (the new PBS/Ken Burns series The Roosevelts has tons of fascinating info about Teddy), the Robber Barons had accumulated enormous wealth. The Robber Barons lived a life of luxury and largess compared to the general population. Over 100 years after these houses were built and are now all museums, the grandeur of these mansions even by today's wealth standards leaves quite an impression on how well the Robber Barons lived during that era.

We are in a new Robber Baron economy, where a privileged few are fantastically wealthy while the majority of the masses can only dream about living the dream. Some of today's Robber Barons control the social media and Internet businesses that nearly every person in the world uses every day. The lucky few that started these companies are rich beyond their wildest dreams and have accumulated their fortunes over a relatively short period of time. Firms such as Google (founded in 1998), Facebook (founded in 2004), and Alibaba (founded in 1999) come to mind. Founders Larry Page and Sergey Brin of Google (both worth $31 billion), Mark Zuckerberg of Facebook (worth $33 billion) and Jack Ma of Alibaba (worth $19 billion) have amassed fortunes that would impress even J.P.Morgan. Speaking of Alibaba, the Chinese company came public in mid-September in the most hyped IPO since Facebook two years ago. Alibaba is now the largest IPO in the history of capitalism, and the fact that it was a Chinese company that took the title and decided to list its shares on the New York Stock Exchange should not be lost on anyone.

During the 2012 election, the deteriorating socio-economic environment was defined as the 99% vs. 1% or the Have and Have Not economy. The anecdotal evidence, including the examples cited above, indicates that the spread today between the Haves and Have Nots has probably never been more extreme than since the original Robber Baron Era. As further proof, the newest show slated for primetime on

CNBC is called The Filthy Rich Guide, a show about the 1% of the 1%.

No true American should begrudge anyone that has created wealth by taking risks and working hard. Risk/reward is as American as baseball, hot dogs, apple pie, and Tesla. However, the U.S. economy at present is only working well for the newest Robber Baron types, the 1%, the Haves. At the stock market bottom in March 2009, the net worth of Americans was $55 trillion. Today, it is $70 trillion. Of the $25 trillion increase, $21 trillion has come from stocks and bonds. The Haves are disproportionately benefiting from aggressive central bank policies that have set interest rates at artificially low levels. The liquidity the Federal Reserve has pumped into the economy via its Quantitative Easing program has mostly ended up in financial assets (instead of the real economy) where the Haves own the vast majority of the assets. The extended length of time these extreme policies have been in place have created absurd valuations for other assets such as a rare Superman comic book, NY City real estate, or “art” like a canvas painted blue with a white line down the middle.

Despite the best intentions of the Federal Reserve, its policies since the 2008 financial collapse have been unsuccessful in accelerating real GDP and job growth but have been successful in exacerbating the spread between the Have and Have Nots. The disparity in the quality of life between the Haves and Have Nots has grown much wider and created a new Robber Baron Era. There is no easy solution to the present situation and it will be a long time before the current imbalances in our economy get resolved.

Third Quarter Market Commentary

Capital market returns during the third quarter of 2014 had a Have and Have Not quality to them. In the Have camp was the S&P 500 Index, which produced another positive, albeit modest, quarterly return and is up a solid +8.3% year to date. However, once you get past the top 200 largest stocks in the U.S. stock market, the return story was mostly Have Not. Small cap stocks as measured by the Russell 2000 Index took one on the chin and were down meaningfully for the quarter and are now negative for the year. The same is true for foreign markets, both developed and emerging markets, which also produced negative returns during the quarter. The broad U.S. bond market as measured by the Barclays Aggregate Index was essentially flat. High yield bonds were also negative for the quarter and commodities such as gold and oil got crushed, a reflection of slowing global growth and a strong US dollar trend. The U.S. dollar surged nearly 8% during the third quarter, its largest quarterly increase since 1992.

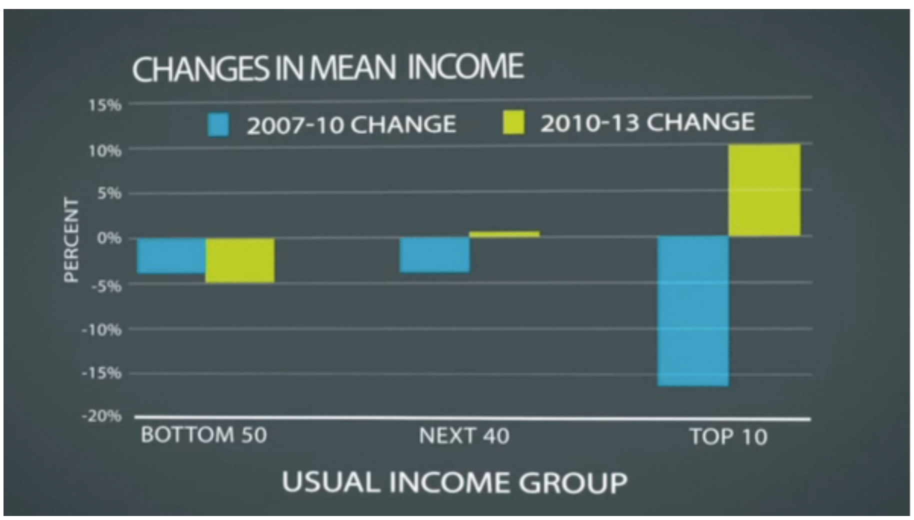
The following table includes the performance of major assets classes during the third quarter and year to date through 9/30/14.

	Third Quarter	Year to Date
S&P 500 Index (large cap US)	**+1.1%**	**+8.3%**
Russell 2000 Index (small cap US)	**-7.4%**	**-4.4%**
MSCI EAFE Index (large cap int’l)	**-5.9%**	**-1.4%**
MSCI EM Index (emerging mkts)	**-3.5%**	**+2.4%**
Barclays Aggregate (invt grade bonds	**+0.2%**	**+4.1%**
Barclays High Yield (non-invt grade)	**-1.9%**	**+3.5%**
Barclays Short-term Treasury bills (cash)	**0.0%**	**+0.1%**
Gold	**-9.0%**	**+0.7%**
Brent Crude Oil	**-15.0%**	**-11.8%**

The rest of this quarterly commentary will review some of the more interesting charts we stumbled upon during our various readings throughout the quarter that will help to provide some perspective on the current Robber Baron Redux world we find ourselves in today.

Income Trends

The chart below shows one of the sobering realities of the Robber Baron Redux. This chart from the Federal Reserve Board shows the change in average income for three income groups over two time periods. The income groups are the Top 10%, the Next 40%, and the Bottom 50%. The time periods shown are the years during the global financial collapse and its immediate aftermath and the "recovery" period in the years following. The Top 10% took the biggest hit to average income during the financial collapse, down over 15% during the 2007-2010 time period (but off of a higher base). The large income hit is not surprising since many individuals in the Top 10% were involved in areas of the economy that were the most negatively impacted by the financial collapse including banking, real estate, and financial markets. However, this group has experienced a meaningful rebound in average income in the post recession "recovery" period. The story for the Have Not groups or the other 90% of the U.S. population is much worse. The average change in income for the Next 40% has barely recovered any of the 2007-2010 declines while the poor souls in the Bottom 50% have continued to experience deteriorating average income gains.



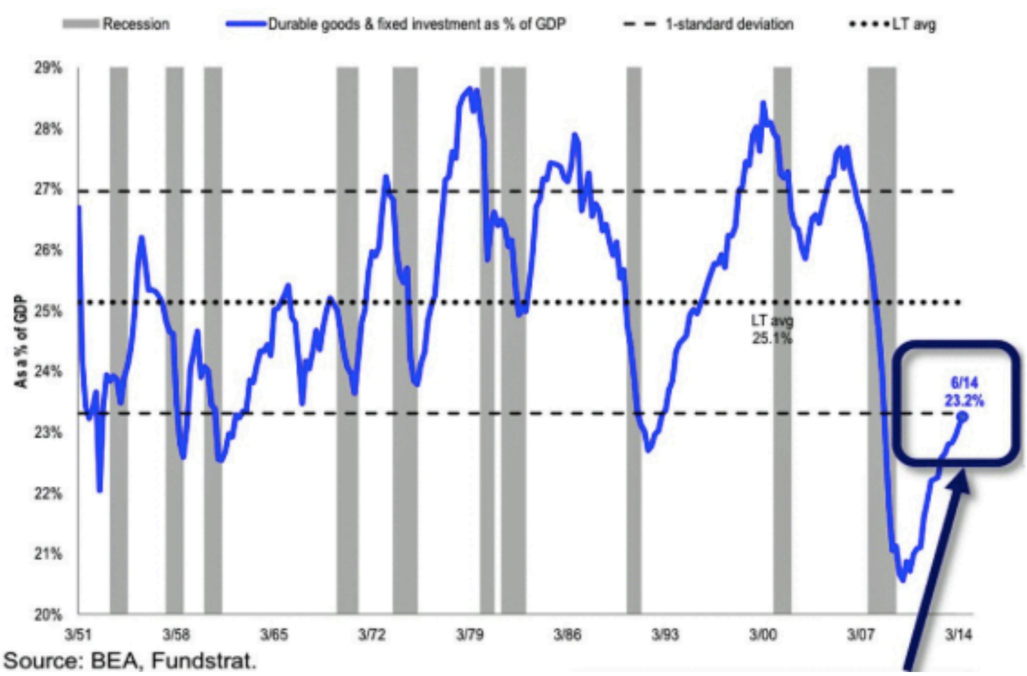
Source: Federal Reserve Board

Despite an extended period of aggressive monetary policies implemented by the Federal Reserve and designed to jump-start the economy and drive job growth, the policy effects are not flowing through to the average income profiles of the vast majority of Americans. While monthly U.S. job gains are now consistently in the low to mid 200,000 range, the quality and income profile of these jobs is still quite poor when compared to past recovery periods. Most of the job gains are part-time employees. The healthcare coverage mandates under Obamacare have had a large influence on the hiring bias towards part-time workers since the law was signed in 2010.

Corporate Profits

Labor costs and capital expenditures are the two largest cost components of a business operation. What happens when companies don't hire and they don't invest? Assuming revenues don't go down, corporate profits go higher. The next chart shows durable goods & investment spending as a percentage of GDP going back to 1950. The data shows the devastating impact the 2008 global financial collapse and ensuing recession had on corporate investment spending. U.S real GDP growth post the Great Recession has been anemic (2010-2014 average 2.25%), partially due to weak investment spending off of a depressed base. Considering the magnitude of the drop in investment spending during the Great Recession, companies have maintained a cautious stance on their capital expenditures since then.

Figure 7: Investment spend still 1-std dev below LT trend...

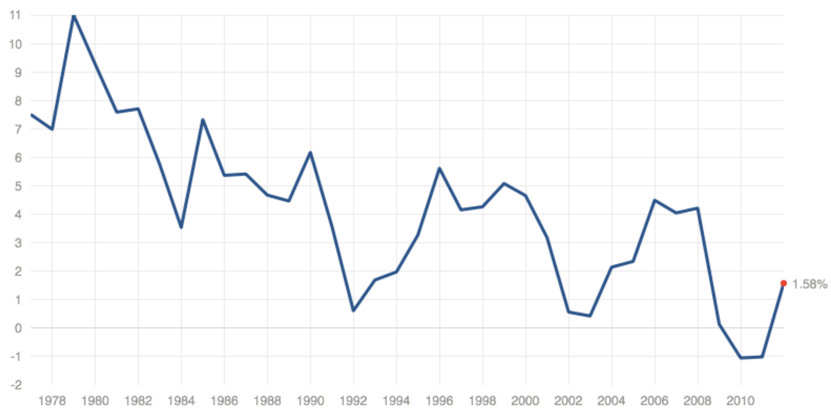


Source: BEA, Fundstrat.

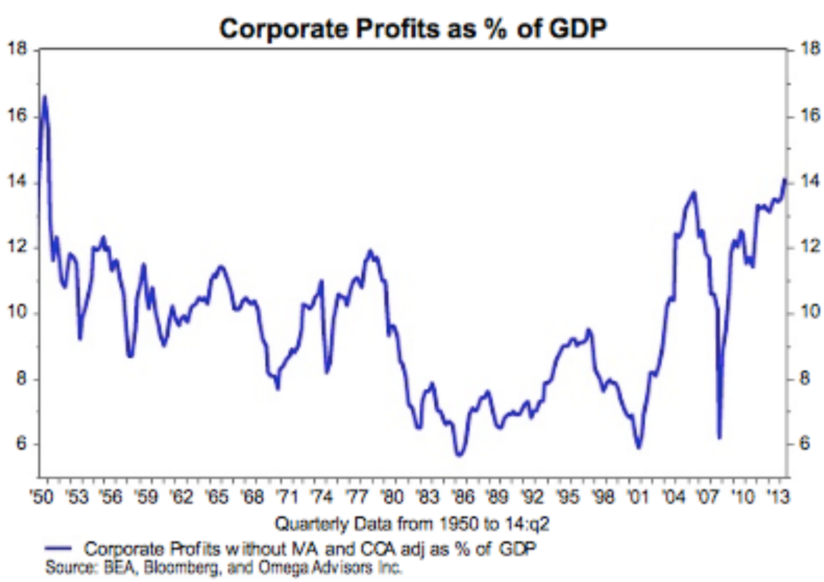
Continuing on with the cost side analysis, the first chart on the next page shows the median income growth rate in the U.S. from 1970 to 2013. The data in this chart corroborates the data shown previously in the Changes in Mean Income chart on page 3. Median income growth rates are weak overall and have not recovered much from the 2008 to 2010 decline. Given the weak trends in both average income growth and investment spending, corporate profits should be doing well even in a weak 2-3% real GDP growth world.

The second chart on page 5 shows that corporate profits as a percentage of GDP are at the highest level going back 60+ years. If you are a Have, you're loving life because the Haves are the shareholders in these companies and stock prices have risen in part due to companies delivering strong profit growth even in a tough economic environment. If you are a Have Not, life sucks. Most Have Nots own little if any stocks so they are not benefiting from the rise in stock markets brought on by profit growth and the knock-on effects of Fed policies. Have Nots are also getting whacked on the income side because employers are not giving out any meaningful pay increases to make up for the cuts in salary or benefits implemented during the 2008 financial crisis.

U.S. Median Income Growth Rate

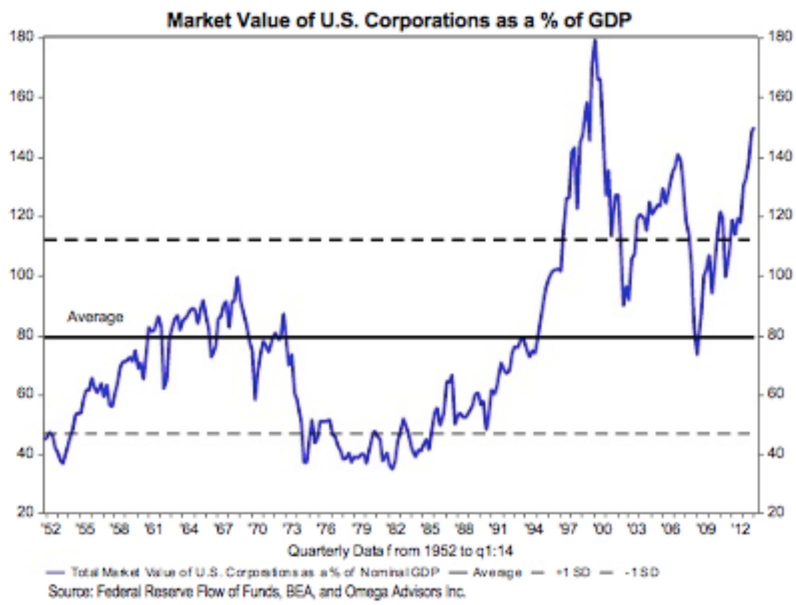


Source: U.S. Census Bureau

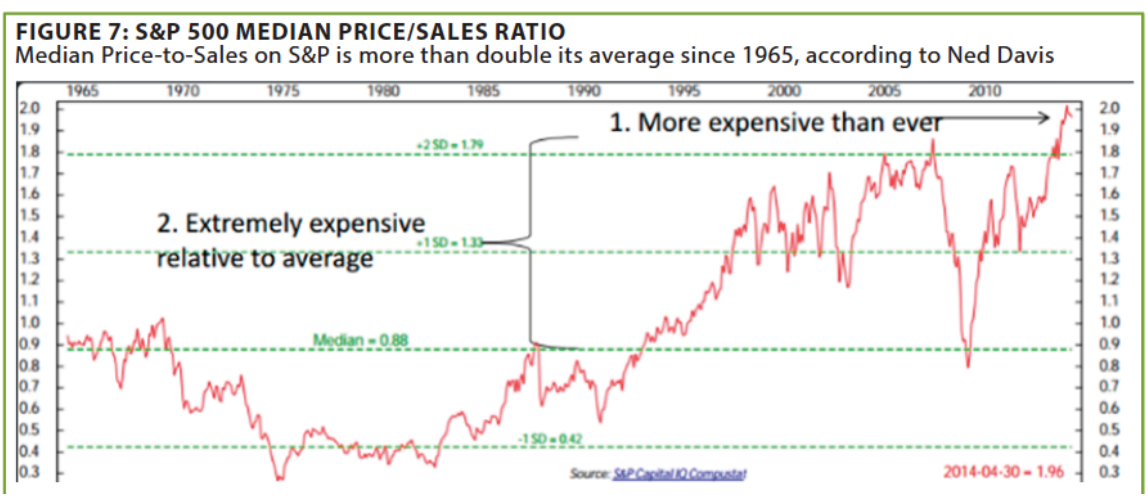


Valuations

Corporate profits have a direct influence on the valuations of U.S. corporations. The next chart shows that the market value of U.S. companies as a percentage of U.S. GDP are now at the second highest level since 1950, exceeded only by the Tech Bubble of 1999-2000 and right before the stock market experienced a significant decline. Valuations using this metric are now higher than before the stock market collapsed in 2008.

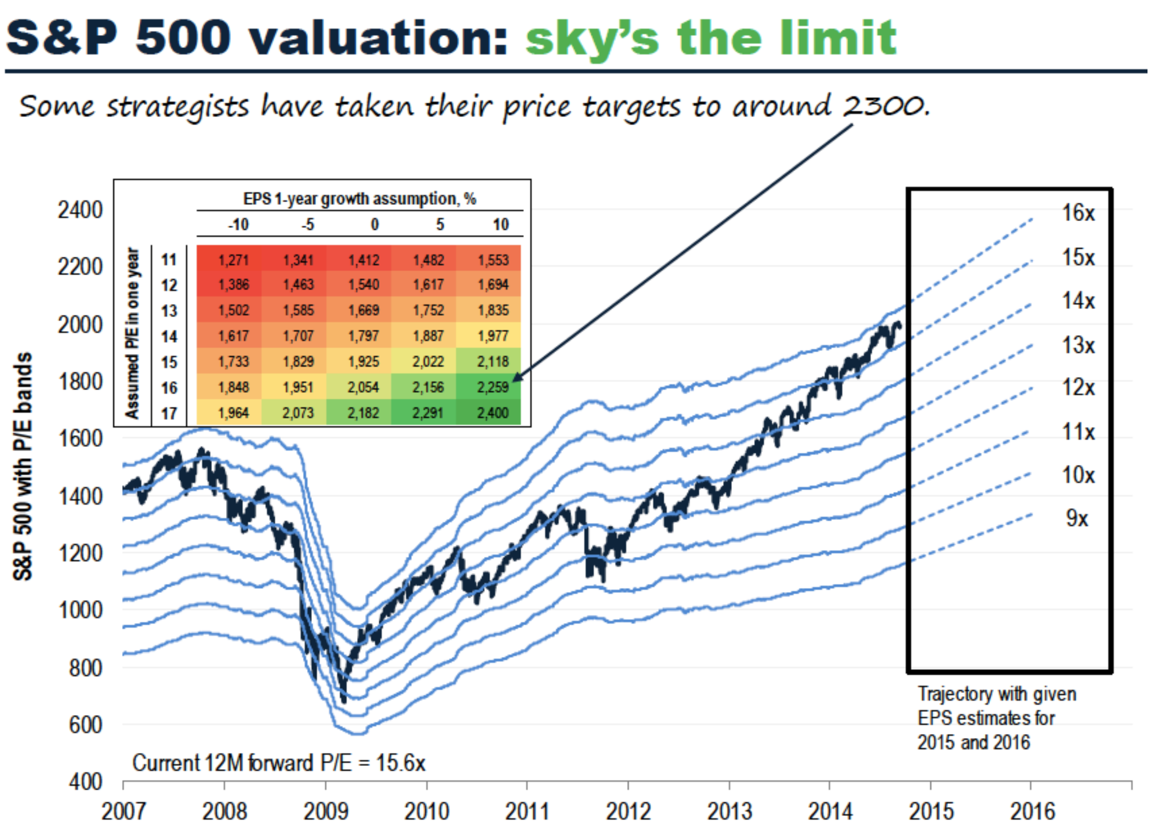


The next chart shows the median price/sales ratio of the S&P 500 Index going back to 1965. As shown on the right side of the chart, this ratio is at its highest level over the past 50 years.



Source: Ned Davis Research

The next chart shows the Price/Earnings multiple valuation range for the S&P 500 Index going back to 2007. It is another data point showing the market at the upper end of its seven-year valuation range.



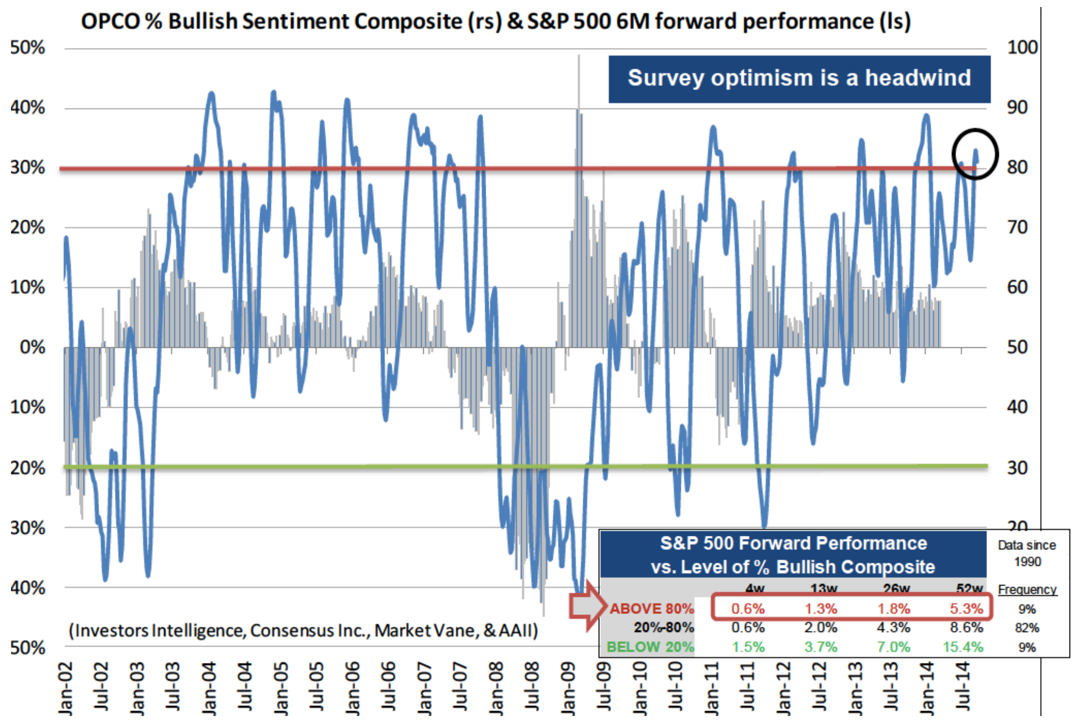
Source: IR&M, Bloomberg.
Chart shows S&P 500 Index with P/E bands based on consensus 12-month forward looking earnings estimates. Dotted lines show trajectory of P/E bands with given consensus estimates for 2014 and 2015.

Sentiment Indicators

It is human nature to become overly confident that a current trend will continue into the future. Investor sentiment readings are designed to gauge the level of investor optimism or pessimism. The chart on the next page shows the Oppenheimer Bullish Sentiment Index ("BSI") from 2002-2014. The BSI is a composite of various market sentiment indicators. Investor sentiment is a contrarian signal. That is, as investors get overly optimistic about investing and their expectations become too positive, then forward returns tend to be negative when extreme positive sentiment levels are reached. An example would be if your unemployed neighbor (for the Have Nots) or gardener (for the Haves) starts talking to you about hot stock tips, it probably is a good time to sell equities. The opposite is true in times of extreme negative sentiment readings.

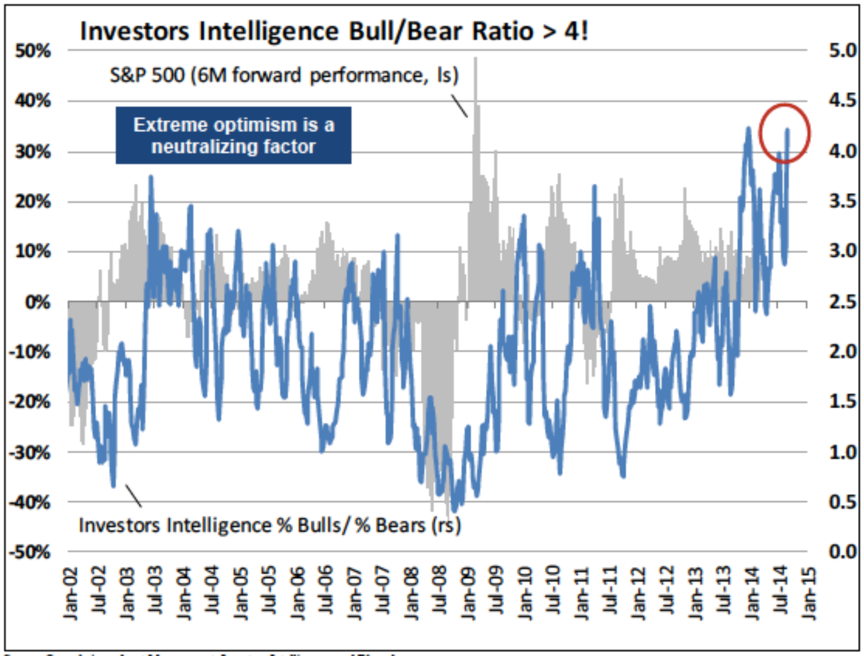
Let's review one of the more extreme time periods in this chart, which was in the Fall of 2008. You remember that bad dream, don't you? Global financial markets were in an Ebola epidemic like panic and investor sentiment readings reached extremely pessimistic levels. If you had the guts (or other small round objects) to buy stocks during that time period, within six months afterwards you would have earned over a 40% return on your money.

As shown in the following chart, the BSI reading in September 2014 was in the upper bounds and above an 80 reading. As shown in the table at the bottom right corner of the chart, when the Bullish indicator exceeds 80 (only 9% of the time), the performance of stocks on a 1, 3,6, and 12 month forward basis has a tendency to be negative. It is not a guarantee that it will happen, but this particular indicator suggests it is a good time to be a bit more cautious and less aggressive with an investment portfolio.



Source: Oppenheimer

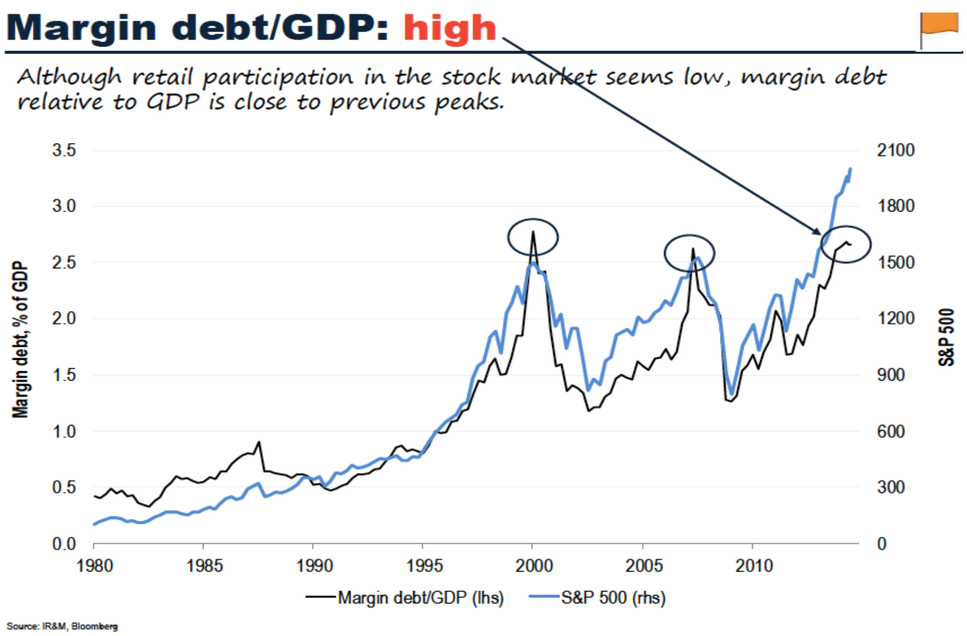
Another well-known sentiment indicator is the Investors Intelligence (an oxymoron akin to military intelligence) Bull/Bear Ratio. It measures the bullish and bearish readings of financial advisors and the investment recommendations of market newsletters. Similar to the Oppenheimer BSI, the II chart indicates that a state of extreme optimism exists and sentiment has never been higher going back to January 2002 or 12 years (they obviously don’t include this newsletter in their data collection). Again, it’s not a guarantee, but the data in this chart also indicates that a more cautious approach would be prudent as this juncture (hat tip to George H.W. Bush, the skydiving nonagenarian, for that line).



Source: Oppenheimer Asset Management, Investors Intelligence, and Bloomberg.

Margin Debt

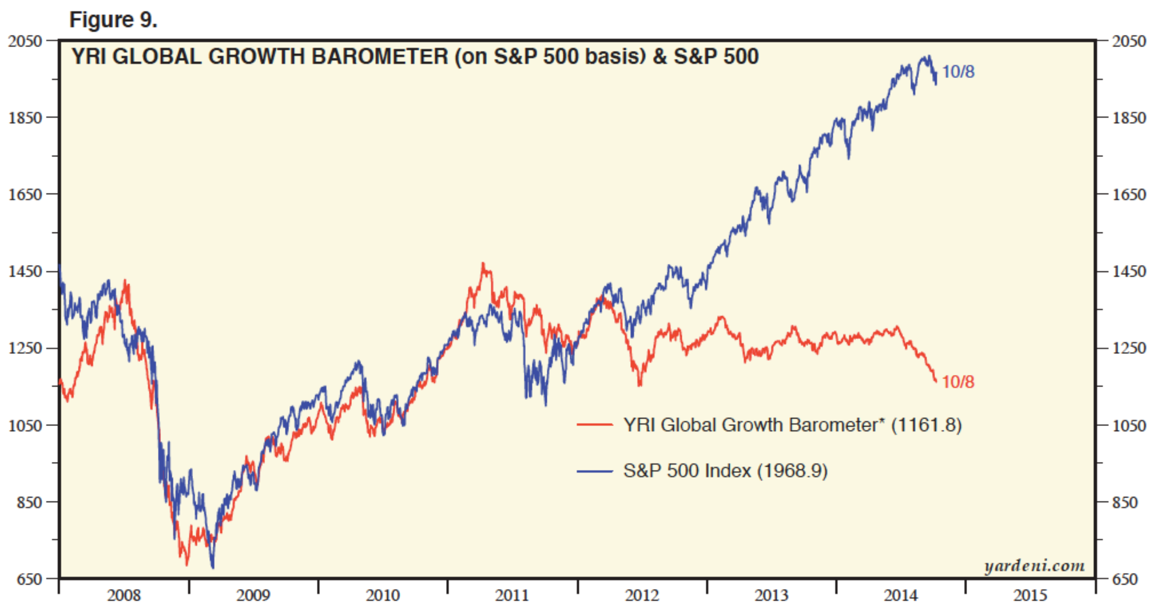
There is another major tailwind behind the steady drive higher in the S&P 500 Index since the March 2009 low. It's the cheap cost of debt brought on by extreme central bank policies, which have kept interest rates artificially suppressed well below normalized levels. The next chart shows the amount of margin debt (a loan from a broker/dealer where the cash is then invested in financial assets like stocks) as a percentage of GDP and compares it against the level of the S&P 500 Index. Historically, there has been a fairly tight correlation between these two. Note that the margin debt/GDP ratio peaked at about the same level during the Tech Bubble in 1999/2000 and again at the top of the Housing Bubble in 2007. At both points in time, the stock market also hit a peak. Margin debt/GDP is once again at the same level as the two previous stock market peaks. However, the S&P 500 Index has now advanced well ahead of the margin debt/GDP trend line.



Source: Ineichen Research & Management, Bloomberg

How long can this positive stock market trend go on? Only The Shadow knows. As shown in the next chart, the large cap portion of the U.S. stock market as measured by the S&P 500 Index is overextended relative to the YRI global growth barometer. Global investors have been drawn to the U.S. given the weakening economic outlook in Europe, Japan, and China and the geopolitical upheaval that is increasing outside of the U.S.

Global Growth Barometer



Source: Ed Yardeni Research

The next table provides some perspective on the duration of the present stock market rally compared to the other bullish time periods. The longest bullish run for the stock market occurred from 1990 to 2000 or 112 months in length. You remember those good times, right? Annual income gains were typically 3-4% throughout the decade, 401k balances were exploding, the U.S. Federal budget went into a surplus (national debt is now nearly $18 trillion), and U.S. real GDP growth rates were consistently 3-4% every year before it all ended badly in 2000. Yes, Fed policy in the mid 90's lead by then Chairman Alan Greenspan was way too loose for too long and created the good times (remember irrational exuberance?) and the eventual tech bubble collapse, which Greenspan staunchly refutes to this day. Hmmm, does this setup sound familiar?

The average duration of bull markets going back to the 1940's is 41 months and this includes the 112 month bull market of 1990-2000. The current bull market uptrend is currently at 65 months and the S&P 500 Index has advanced nearly 200% from the March 2009 low. When considering the extended maturity of this current bull market advance, along with some of the other valuation and sentiment indicators shown in the previous charts, it suggests a more cautious risk stance is warranted in the absence of a material pickup in global GDP growth.

Historical Bull Market Cycles -- S&P 500

Date of Trough	Date of Peak	Duration T to P	% Ch T to P
Apr 1942	May 1946	49 months	157.1%
Jun 1949	Dec 1952	42	96.2
Sep 1953	Aug 1956	35	119.0
Dec 1957	Jul 1959	19	53.8
Oct 1960	Dec 1961	14	38.9
Jun 1962	Jan 1966	43	79.8
Sep 1966	Nov 1968	25	48.0
Jun 1970	Jan 1973	31	73.5
Oct 1974	Dec 1976	26	72.5
Mar 1978	Nov 1980	32	61.7
Aug 1982	Aug 1987	60	228.8
Dec 1987	Jul 1990	31	64.8
Oct 1990	Mar 2000	112	417.0
Oct 2002	Oct 2007	60	101.5
Average		41.3	115%
Mar 2009	**August 2014 (a)**	**65 months**	**196%**

(a)As of August 27, 2014

Source: Standard & Poor's and Omega Advisors, Inc.

Summary

September marked the six-year anniversary of the global financial collapse. Despite the Fed's heavy-handed approach in trying to jumpstart the U.S. economy, job growth has been challenging, the quality of the jobs being added is poor, and wage growth for most Americans has been weak. Fed policies, despite the best of intentions, have exacerbated the spread between the Have and Have Nots and too many Americans are being left behind. Conviction levels at corporate HQs are muted so companies have held back on capital expenditures, held back on hiring, and been stingy on wage increases to workers. Instead of investing and hiring, companies have used excess cash to buy back stock. As a result, profit growth has sharply rebounded even though revenue growth has been modest in an economy struggling to produce real GDP growth consistently above 2.5%. The recent slowdown outside of the U.S. plus a strengthening U.S. dollar could make the 2015 profit growth forecast more difficult to achieve. The near term outlook is about to get more challenging, especially with the Fed ending QE this month and with the debate over when to end its current low interest rate policy heating up.

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IMPORTANT DISCLAIMER: