BUTLER, LANZ & WAGLER

For the discerning, risk-conscious investor.

April Newsletter 2015

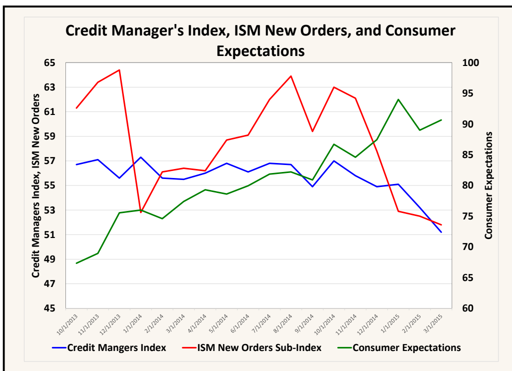
We've not had much of a rumbling of recession fears over the last five years, but a spate of terrible data this winter has led many to suggest that we may be closer to a recession than we've been since the Great Recession of 2007 to 2009. That's true, but it doesn't automatically indicate we're headed for a recession. To know that, we must look at the leading economic indicators.

There are three organizations that publish indices of leading economic indicators for the US – the Organization for Economic Cooperation and Development (OECD), the Conference Board, and Economic Cycle Research Institute (ECRI). Of these three, only the Conference Board has a completely transparent process of the metrics used and respective weights assigned to each in the construction of their index.

It will likely be informative if we look at each of the 10 components of the Conference Board's index to see if we can discern any kind of trend. The components of the Conference Board's Index of Leading Economic Indicators are:

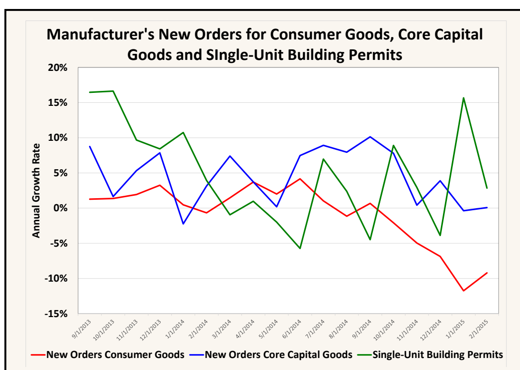
(1) Average weekly hours in the manufacturing sector, (2) Average weekly initial claims for unemployment insurance (4-week average), (3) Manufacturers' new orders for consumer goods and materials, (4) ISM Index of New Orders, (5) Manufacturers' new orders for nondefense capital goods excluding aircraft orders, (6) Building permits for new private housing units, (7) S&P 500 Stock Index price level, (8) Leading Credit Index, (9) Interest rate spread between the 10-year Treasury bond and the federal funds rate, and (10) Average consumer expectations for business conditions

Only the Leading Credit Index is not readily available. However, we will substitute the Credit Managers Index to get a read on credit conditions in the US financial system.



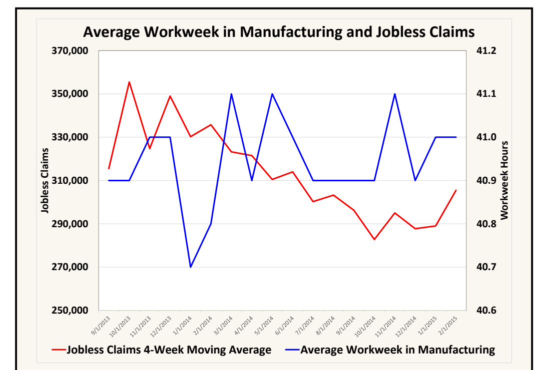
Our first chart shows the ISM Index for New Orders, the Credit Managers Index and consumer expectations for business conditions. Over the last 18 months, ISM New Orders have rallied and are now at an 18-month low. So is the Credit Managers Index. Consumers, oddly, are quite confident despite the fact that they have not really been spending.

Our second chart shows the growth rates of three different components: manufacturers' new orders for consumer goods and materials, manufacturers' new orders for non-defense capital goods excluding aircraft ("core capital goods") and building permits for single-family housing units. Building permits, although very volatile, are in an uptrend. Core capital goods are at an 18-month low and new orders for consumer goods are extremely weak, growing at a negative rate.



The third chart shows the average workweek in the manufacturing sector and the 4-week moving average of initial jobless claims.

The average workweek has gone nowhere in the last 18 months. Jobless claims are picking up, which is not good



Finally, we show the S&P 500 and what's known as the yield curve. The yield curve is the difference between the interest rate on two types of credit risk-free instruments – one short-term and one longer-term. The Federal Funds Effective Interest Rate is the short-term rate and the 10-year Treasury note yield is the longer-term rate. The yield curve shows the additional yield required from investors for taking on almost 10 more years of interest rate risk. This "yield curve" has been very successful at predicting recessions.

Stocks have lost momentum but are still in an uptrend. The yield curve's downtrend (called "flattening") is not good and a bit worrisome. It generally precedes recessions.

We're now in a position to make some generalizations. First, the S&P 500, building permits and consumer expectations look relatively strong. The yield curve, jobless claims, ISM New Orders, the Credit Mangers Index, and consumer goods new orders are weak. Average hours worked per week in manufacturing and new orders for core capital goods are neutral. That's three strengths, five weaknesses and two neutral metrics.

So what can we make of all this? The US economy is weak at the very front end of economic growth. We are not doing much today that leads to productive activity over the next 12 to 18 months. However, a recession is not imminent. We are quite a ways away from such a situation, in fact. But weakness in economic growth over the next 12 to 18 months does increase the risk of a recession due to an unexpected exogenous shock of some sort. Our economy is simply not likely to grow at a rate high enough to overcome such a shock.

Asset Class Overview

Asset Class	1-Month Return	Year-to-Date Return	12-Month Return	Cumulative 2-Year Return	Cumulative 5-Year Return
S&P 500 Index	-1.74%	0.44%	10.44%	31.78%	76.83%
Dow Jones Corporate Bond Index	0.37%	2.35%	7.36%	8.71%	39.23%
US Dollar Index	3.49%	8.87%	22.96%	18.66%	21.69%
Gold, per ounce	-2.51%	0.00%	-7.89%	-25.92%	6.16%
CRB Commodities Index	-5.45%	-7.87%	-30.46%	-28.52%	-22.49%
MSCI US REIT Index	1.26%	3.87%	19.48%	19.76%	73.02%
BONY Mellon Emerging Market Stock Index	-4.93%	-2.19%	-4.16%	-9.27%	-19.76%
Oil, West Texas Intermediate per barrel	-4.10%	-11.58%	-53.24%	-51.14%	-43.30%
10-Year US Treasury Note Price	0.45%	1.80%	4.52%	-2.28%	10.61%
10-Year US Treasury Note Yield, in basis points	-6.00	-23.00	-79.00	7.00	-190.00

Of the nine major asset classes we track, only four were up in March – corporate bonds, the US dollar, REITs and Treasury bonds. The S&P 500 was down almost 2% in March, but if you recall, it was up 5.5% in February, so it simply gave back half of what was gained in the prior month. Significantly though, through the end of the first quarter of 2015, the S&P 500 is up less than ½ of 1% and is one of the worst performing global equity markets year-to-date.

Corporate bonds, as measured by the Dow Jones Corporate Bond Index, and Treasury bonds, as measured by the price on the 10-year Treasury note, were up in March by 0.37% and 0.45%, respectively. That usually indicates interest rates fell, which they did in March by 6 basis points (a basis point is 1/100 of 1%). More importantly, interest rates have fallen 79 basis points over the last 12 months. The dollar was up a whopping 3.5% for the month, which is a little unexpected given the fall in interest rates. The dollar is now up 23% over the last 12 months and causing many financial and economic ripples.

One should not be surprised that given the strength in the US dollar over the last 12 months to see a corresponding 12-month weakness in things priced in dollars – the gold, commodities and oil. And that's been the case as those three asset classes have posted returns of -8%, -30%, and -53% respectively, over the same timeframe. They were down 2.5%, 5.5% and 4% respectively in the month of March. The commodity story for the last 12 months is really a story about the strength in the dollar. And commodities prices and the US dollar strength is also the story in emerging market stocks. They got crushed in March, down 5%, but in terms of value, there is more opportunity in this sector than the S&P 500. At some point, expect that to be exploited.

REITs were the fourth asset class to post gains in March, up 1.26%. That had a lot to do with markets coming to the realization that it would be unlikely, if not unwise, for the Federal Reserve to initiate and interest rate tightening cycle amidst a flurry of disappointing economic data. At the very least, there seems to have been a realization that the tightening cycle would begin later than originally expected. REITs are direct beneficiaries of stable interest rates. Interestingly, the return of REITs has been about the same as the S&P 500 going back 5 years, but REITs have almost doubled the return of stocks over the last 12 months.

Major Themes – Market Timing

Every month, we isolate one particular element of our portfolio management method and delve into what it means to the investor and why we employ that particular technique or hold that particular viewpoint. This month, we look at trend following.

Market-timing is the opposite of buy-and-hold investing. It involves trying to be in the market for the majority of uptrends and out of the market (or short it) for a majority of the downtrends. The biggest problem with buy-and-hold, and the reason people even try to time the market, is the large drawdowns the investor must endure, like the 55% drop in stocks from 2007 to 2009. Or the 45% drawdown in the S&P 500 during the dot-com bust. The Nasdaq was down over 70% in that bust. These significant drawdowns are difficult if not impossible to come back from in a timely fashion. Therefore, investors try to avoid the busts by timing the market.

Market-timing is simply putting the odds of success on the side of the investor. If stocks are overvalued, why have excessive exposure to them? If bonds hate inflation and the CPI is heating up, why not trim bond holdings? Market timing is not, as the mainstream would have you believe, trying to pick tops and bottoms. Trying to pick the exact point that a market will peak or the exact moment it will trough, is indeed a fool's errand. It's impossible to do with consistency. Market timing is not trying to pick tops and bottoms - it's reacting to changes in risk in the market, and risk is dynamic – it's always changing. So why have a static portfolio that ignores this very fundamental aspect of market behavior?

All of the successful money managers profiled in Michael Covel's book "Trend Following" and in Jack Schwager's classic "Market Wizards" are timing the market. Covel's book, as well as Schwager's series of books profiling the world's greatest investors and traders have one theme in common – successful market professionals time the market to manage their risk. All of the traders and investors profiled do it in different ways over different timeframe using different methods. But they all time the market because they know it's the only way to manage the downside risk in being exposed to financial markets. Their success shows that market timing can be done well.

Author Mark Boucher, in his book "The Hedge Fund Edge," profiles a European money manager who market-timed global stock markets for over 30 years. This money manager averaged about 19% per year versus a 20% maximum drawdown and had only one down year, where he was down only 5%. In our All-Weather Growth Portfolio, we time 6 different, disparately correlated asset classes in a way that most resembles the managers profiled in Covel's book. That is, we're trend-followers. We want to be long in uptrends, short in downtrends and in cash for trendless markets. We time each of these six asset classes independently of each other, and the non-correlated nature of the asset classes adds to our ability to manage risk.

All Weather Growth Portfolio

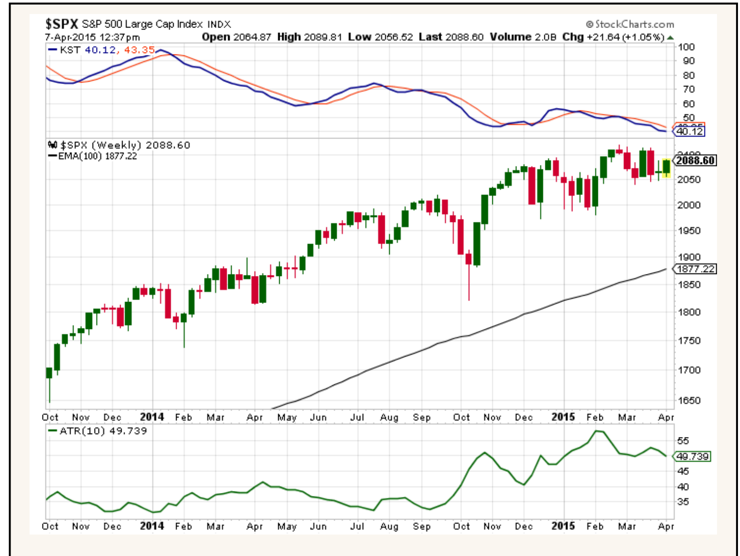
The All-Weather Growth Portfolio (AWGP) is the embodiment of BLW's core investment philosophy: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown to an acceptably low level, (3) timing each disparately correlated asset class independently, using a long-cash-short framework, allows the portfolio to earn consistent profits in every economic or financial environment. What follows is an overview of each of the six asset classes in which we employ a system in this portfolio. There are seven charts because two relate to US stocks – one which shows the leading sectors of the stock market as well as one which shows the broad stock market. We are trend followers, so each chart (with the exception of the stock sector chart) will show the intermediate-term trend in the middle. A measure of price momentum is in the top part of each chart and a measure of volatility is in the bottom.

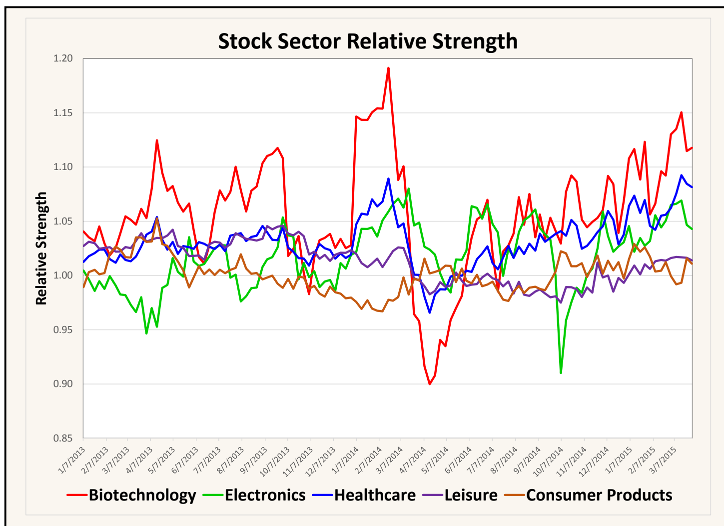
There were two changes in the intermediate trends of the six asset classes as of the end of March. Gold switched from "short" to "cash" and US stocks went from "long" to "cash." However, we are starting to see shorter term trends on many of these asset classes weaken or flip direction. Changes in shorter-term trends can eventually change the intermediate- and longer-term trends.

Asset Class	Long-Term Trend	Status as of Last Day of the Month
Stocks	Up	Cash
Treasury Bonds	Up	Long
Real Estate Investment Trusts	Up	Long
High Yield Bonds	Up	Long
Gold	Flat / Down	Cash
US Dollar	Up	Long

U.S. STOCK MARKET:

The US stock market lost its momentum (top chart) once more in mid-January and has yet to recover it. Volatility (bottom chart) is not yet indicating a bottom has been made. The longer term trend is still up, but stocks have not made any new net ground (and held it) since early December. Much of this volatility stems from the Fed trying to normalize interest rate policy. Clearly, stocks do not like the prospect of even a tiny uptick in interest rates. This is probably for good reason – the economy itself does not appear strong enough to handle the Fed's meager "normalization" goals at this point.





STOCK SECTORS:

The top five performing sectors have not changed much from last month. Consumer Products replaced Transportation. 8 of the 17 US stock sectors are underperforming the S&P 500 and 9 are outperforming it. For the most part, and perhaps a little quizzically, the sectors outperforming are mainly those sectors which typically lead the economy, with the exception of Healthcare, which is considered more of a defensive play.

REAL ESTATE INVESTMENT TRUSTS:

REITs had a great March after they struggled against a backdrop of a rising 10-year Treasury yield for six weeks ending the first week of March. REITs are still experiencing decelerating momentum, but the spike in volatility in mid-March may indicate an intermediate-term bottom.

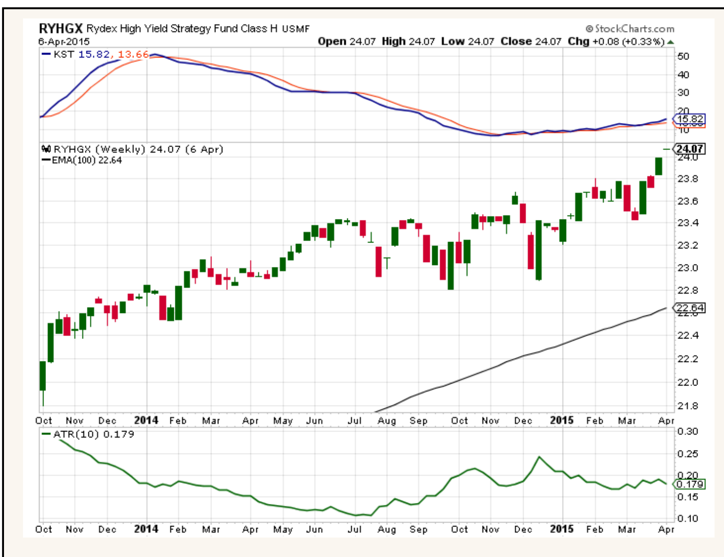
Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

GOLD: Gold had a fairly productive March, but the overall trend is quite clearly still down. A rising dollar and spiking interest rates have made for a dismal backdrop for gold. As those conditions eased somewhat, it made it possible for gold to stabilize. Momentum, although waning recently, is still far off its worst levels. And while volatility gives us no particular help in reading future direction, it does indicate that whichever direction gold does go from here, it will likely be a strong trend.

U.S. DOLLAR: As mentioned with the comments on gold, the dollar's uptrend has been strong with no real precedent. Momentum may be at critical juncture here though. At the very least, the March jobs report which was shocking in its weakness, will force consolidation. It's no longer a "no-brainer" that the US economy will outperform Europe and Japan.

HIGH YIELD BONDS: High yield, on a total return basis, is still in an uptrend. Momentum has slowly started ticking upward and volatility indicates the low in early December may hold for a while. Overall, high yield performed well in March and its volatile uptrend continues.

U.S. TREASURY BONDS: Treasury prices really took a beating in February as markets expected the Fed to hike rates even as the economy appeared to be struggling. Yields jumped and prices fell. But the worm turned in March as Treasuries regained about one-half of what was lost in February. March's weak jobs report may set the stage for renewed strength in April.



Alternative Income Portfolio

The Alternative Income Portfolio (AIP) is also based on BLW's core investment philosophy, but as you can see, there is one caveat: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown to an acceptably low level, (3) timing each disparately correlated asset class independently, using a long-cash framework, allows the portfolio to protect principal in every economic or financial environment. The only difference in philosophy, between the growth and income portfolios, is that we do not short any asset class in the AIP. When we are bearish on an asset class, we simply get out of it and place the proceeds in cash until a new uptrend is established. What follows is an overview of each of the 14 asset classes in which we employ a system in this portfolio. We are trend followers, so each chart will show the intermediate-term trend in the middle. A measure of price momentum is in the top part of each chart and a measure of volatility is in the bottom.

Asset Class	Long-Term Trend	Status as of Last Day of the Month
High Yield Bonds	Up	Long
Short-Term Bonds	Up / Flat	Long
International Corporate Bonds	Down	Cash
Short-Term Senior Secured Loans	Up/Flat	Long
Convertibles	Flat	Long
Ginnie Maes	Up	Long
Long-Term Bonds	Up	Long
REITs	Up	Long
Emerging Market Bonds	Up / Flat	Long
Agency-Backed Mortgages	Flat	Long
Dividend-Paying Stocks	Up	Long
Gold & Natural Resources	Down	Cash
Master Limited Partnerships	Flat	Long
Preferred Stocks	Up	Long

We are long 12 of the 14 income-producing asset classes because 12 of the 14 asset classes are either in uptrends or periods of no trend. Only Gold & Natural Resources, and International Corporate Bonds are in downtrends. Short-Term Senior Secured Loans flipped into an uptrend in March.

Investment	Symbol	Most Recent Dividend*	Payment Periods Per Year	Implied Annual Dividend Per Share	Last Month's Closing Price	Implied Annual Dividend Yield
SPDR Barclays High Yield Bond ETF	JNK	$0.189	12	$2.263	$39.22	5.77%
Vanguard Short-Term Bond ETF	BSV	$0.087	12	$1.045	$80.52	1.30%
PowerShares International Corp Bd ETF	PICB	$0.052	12	$0.624	$26.45	2.36%
Voya Prime Rate Trust	PPR	$0.029	12	$0.348	$5.54	6.28%
SPDR Barclays Convertible Secs ETF	CWB	$0.087	12	$1.040	$47.76	2.18%
Vanguard GNMA Inv	VFIIX	$0.021	12	$0.257	$10.81	2.38%
Vanguard Long-Term Bond ETF	BLV	$0.309	12	$3.708	$96.84	3.83%
Vanguard REIT ETF	VNQ	$0.745	4	$2.978	$84.13	3.54%
PowerShares Emerging Markets Sov Dbt ETF	PCY	$0.120	12	$1.440	$27.91	5.16%
Annaly Capital Management, Inc.	NLY	$0.300	4	$1.200	$10.40	11.54%
Vanguard Dividend Appreciation ETF	VIG	$0.459	4	$1.836	$81.71	2.25%
GAMCO Global Gold, Natural Resources & Income Trust	GGN	$0.070	12	$0.840	$6.95	12.09%
Alerian MLP ETF	AMLP	$0.293	4	$1.170	$16.57	7.06%
Market Vectors Pref Secs exFincls ETF	PFXF	$0.097	12	$1.168	$20.75	5.63%
					Average	**5.10%**

*Implied yields take the most recent dividend paid and assumes it gets paid for the next year's dividend payment periods, with the exception of the REIT and Preferred Securities ETFs, which have different distributin patterns. To calculate the implied dividend yield on these ETFs, we take the last year's dividends paid and divide by the number of expected annual dividend paymets. The average portfolio yield assumes equal weight allocations to all sectors.

LONG-TERM BONDS:

This chart should resemble TLT above because they hold the same thing – Treasury securities. Momentum is decelerating and volatility is starting to fall, as well. The intermediate-term trend is still up and the way forward will likely be volatile as Fed policy is no longer directly determined by economic health. It is instead being dictated by a need to "normalize" interest rate policy after the extraordinary policies set in place post-recession.

SHORT-TERM BONDS:

After the Fed's decision to hike rates in June appeared to be put on hold, short-term bonds started to regain strength. Momentum shows renewed price strength and volatility is showing that much of the selling in early February has turned into buying. The trend itself has never really been in jeopardy, despite the volatility.

EMERGING MARKET BONDS:

After going nowhere since July on a total return basis, March saw EM bonds test the upside of the range. Momentum is starting to turn around to the upside and the volatility spike in mid-December seems to have marked the bottom in dramatic fashion.

INTERNATIONAL CORPORATE BONDS:

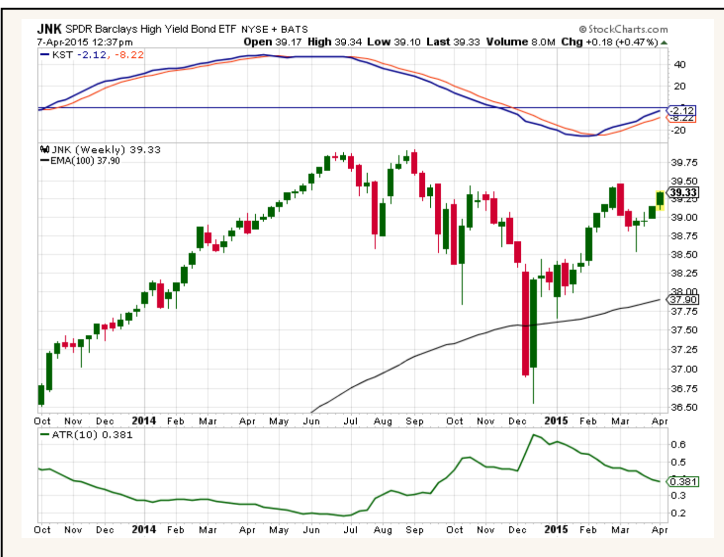
International corporate bonds are priced in local currencies, which have been getting hammered by the US dollar. Therefore this chart looks a lot like the US Dollar Index flipped over. Momentum is still tanking but volatility shows that a bottom may have been made in early March. Still, the trend is down and has been for eight months.

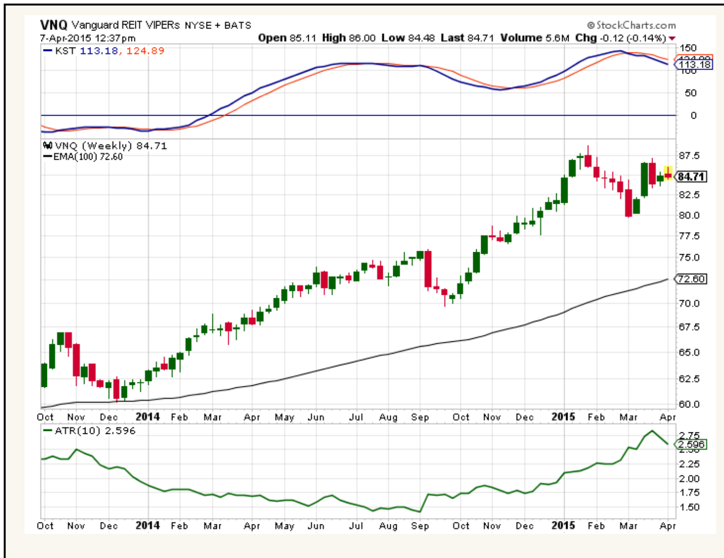
SHORT-TERM SENIOR SECURED LOANS: What a turn of events. Momentum has been in full-on acceleration mode since early December. Also, the trend appears to have gone positive again over the last several months. Having price go up as volatility cycles downward is probably a good thing for this type of security, which tells us that as confusion recedes, price goes up with newfound clarity.

CONVERTIBLES: Convertible securities are gaining some momentum recently and volatility has been elevated since October, indicating confusion over interest rate policy has bled into convertibles as well as other fixed-income securities. The trend is still up, however.

HIGH YIELD BONDS: As mentioned in the All-Weather Growth Portfolio section above, high yield is still in an uptrend. Momentum has slowly started ticking upward and volatility indicates the low in early December may hold for a while. Overall, high yield performed well in March and its volatile uptrend continues. One could argue a new uptrend was started with the low set in December.

GINNIE MAES: Ginnie Maes have been the very picture of consistency. Momentum is still high, but decelerating and volatility made an 18-month low recently as prices achieve new highs. That's a very good sign for this sector.





REITs:

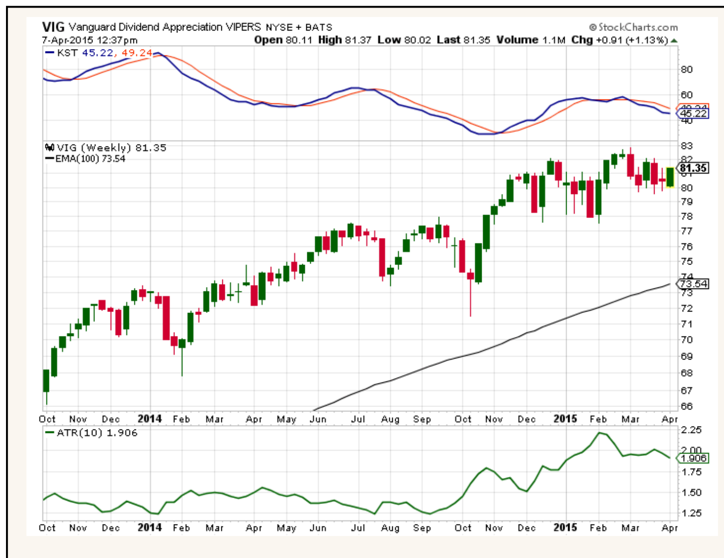
We talked about REITs in the AWGP section above. They had a nice March and the high in volatility mid-month may prove to mark the low for a while. As with most of the securities in the AIP, the February spike in interest rates did not help the price. REITs have yet to recover what was lost in February but the uptrend is still intact.

AGENCY-BACKED MORTAGES:

These types of securities are backed by the full faith and credit of the US federal government now that Freddie and Fannie have been taken over by the Federal government. Therefore, the risk is in interest rates – specifically the spread between long- and short-term interest rates. That spread is a proxy for the profitability of this mortgage REIT. As that spread has been flattening for several months, it's been difficult for this security to find renewed upside momentum.

DIVIDEND-PAYING STOICKS:

Dividend-paying stocks, like the stock market more broadly defined, are in an uptrend, but amidst waning momentum. Momentum is a leading indicator, which is why we watch it. For those seeking income, this is an important sector to consider because, although all stocks are indirectly impacted by interest rates, the correlation to stocks is not as high or as direct as with other income-paying securities. This gives the investor a diversification advantage.



MASTER LIMITED PARTNERSHIPS:

As one might have expected, the recent sell-off in oil has impacted all energy-related investments, and MLPs are certainly energy-related, even if not directly so. Most MLPs are involved in the middle chunk of the distribution channel – they don't explore, extract or sell to retail clients, but most of everything in between. Momentum, after tanking for seven months, is now flattening and volatility is receding amidst less confusion in this sector.

PREFERRED STOCKS: Preferred stocks are interest-rate sensitive, which is why they've been in an uptrend for the last 15 months – interest rates have come down in that timeframe. Like most securities highly correlated with bond prices, preferred stocks have not yet gained back what was lost in the February sell-off in bonds but the intermediate-term trend is still up.

GOLD & NATURAL RESOURCES: Volatility spiking in mid-December probably announced an intermediate-term bottom in gold-related stocks. From a contrarian standpoint, a lot is lining up favorably for gold right now. A rising dollar could kill the momentum, as could rising interest rates, but the gold market seems to be discounting those scenarios for now.

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