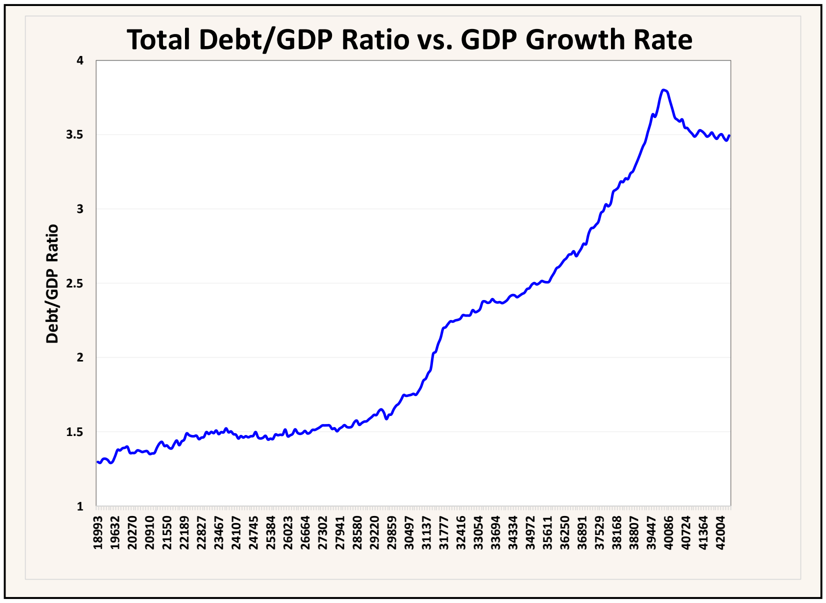
June Newsletter 2016

The purpose of this month's newsletter is to highlight the reasons that Saudi Arabia may have come to the end of a 40-year-old secretive system of agreements between Saudi Arabia and the United States. Many of these problems stem from the dramatic fall in the price of oil – Saudi Arabia's chief export.

At the outset, we probably need to define "petrodollars." The word "petrodollar" would actually be better described as "petrodollar recycling." It's the exchange of US dollars for oil. The dollars that end up in the bank accounts of oil producing nations then get "recycled" back into US securities, especially US government debt – Treasury bonds. This has allowed the US to be able to run budget deficits and issue debt with much less problem than would otherwise be the case. Unfortunately, the benefit of having the reserve currency, and the petrodollar system specifically, has proven to be an enabler of bad habits at the fiscal level. In other words, the petrodollar system has enabled the US to avoid having to address the biggest systemic problem that it has – it cannot afford its entitlement system, its debt or its future liabilities.



The chart shows that since 1976, the ratio of total debt-to-GDP in the US went from a state of stability with an upward bias, to a ludicrous uptrend that culminated with the debt binge of the Great Recession in 2007-2009. The petrodollar system has been a major enabler of US profligate spending in all three sectors – household, government and corporate.

Bretton Woods

The dollar-advantageous petrodollar system replaced the old dollar-advantageous Bretton Woods system that was put in place at the end of World War II. It was a gold-exchange standard that fixed the exchange rate of every nation's currency to the US dollar and allowed the central banks of foreign nations to convert US dollars into gold on demand. Bretton Woods made the US dollar the official reserve currency. But because the US ran up its expenses through welfare and warfare in the 1960s, Nixon felt compelled to end Bretton Woods in 1971 as it was becoming apparent that it had printed way too much money to be covered by a shrinking stockpile of gold.

Petrodollar System

By July 1974, the US was dealing with an OPEC-imposed embargo on oil sales to the US as retribution for the country's support of Israel in the Yom Kippur War. As Bloomberg wrote recently, then new Treasury Secretary William Simon and his deputy, Gerry Parsky, were told to meet with the Saudis in secret to effect a plan that would accomplish a few things: (1) the US government would protect the House of Saud, (2) the Saudis would make sure that OPEC agreed to the exclusive use of US dollars in all international oil trading, (3) the Saudis would plow their US dollar oil revenues back into US assets (mainly Treasuries), and (4) the Saudis would use their position within OPEC to avoid another oil embargo.

As one might expect, amidst a very low opinion of America by the Arab OPEC members, the Saudis asked for, and were granted, anonymity in their purchase of US financial assets (particularly Treasuries). The system created was known as the "petrodollar system." The fact that international oil trades had to be executed using US dollars whether the US or Saudi Arabia was or was not a party in that trade proved to be huge. Again, a market supporting the use of US dollars was created which gave "advantages" to the US that would not have existed otherwise.

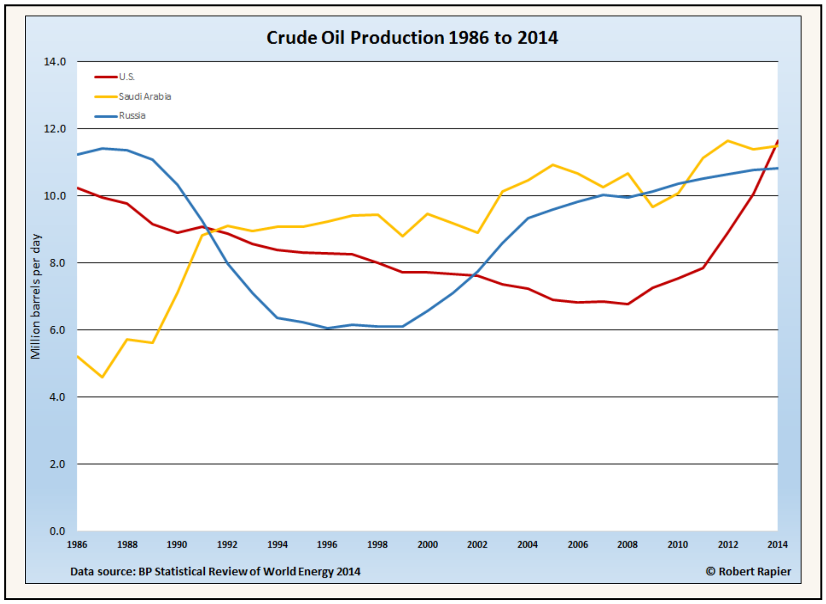
Implications

It would be difficult to overemphasize the importance of the petrodollar in the way the US has conducted its fiscal affairs for the past 40 years. The US dollar is still the reserve currency today due in no small way to the petrodollar system. And, while our purpose here is not to detail the myriad ways the US dollar's status as reserve currency has impacted the US economy in the years post-WWII, it does bear mentioning that many believe the impact has been more negative than positive. For one thing, it's allowed more money-printing than would have been the case otherwise because "reserve currency" status reduces the domestic inflation money printing normally instigates.

A second but related effect is that it gave the US much more room to take on debt because so many different countries would accumulate dollars, that they would routinely invest a portion in interest-bearing Treasury securities. This has kept interest rates in the US lower than what they would have been absent its status as reserve currency. The bottom line is that the US has enjoyed the "benefits" of having the reserve currency, but few realize that these benefits have actually been negatives.

But here's the thing. Saudi Arabia is not beholden to the agreements made with the US in the early 1970s. There is literally no good reason left for the Saudis to "play ball" with the US. Nor is there much of a reason for the US to placate the Saudis as the US is much less reliant on them, or OPEC, for its oil needs.

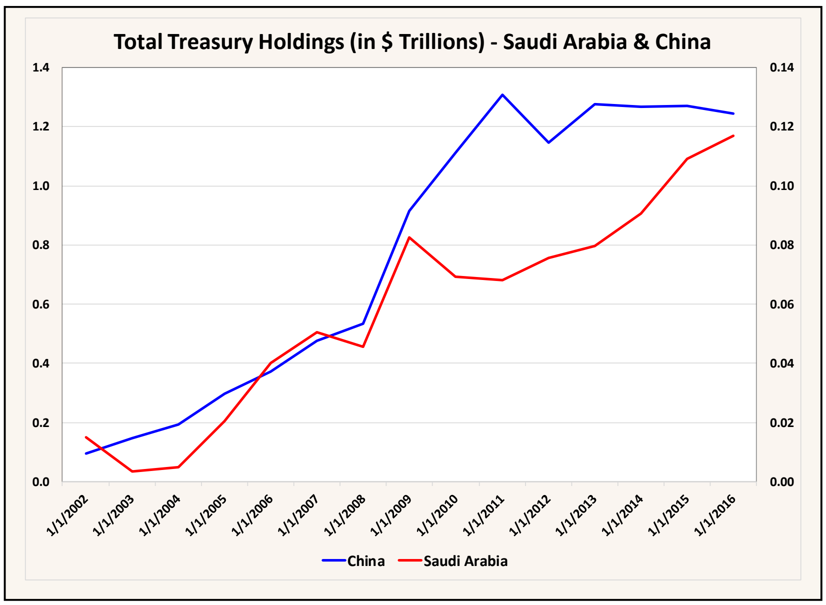
In fact, as the chart to the right shows, the US was producing as much as Saudi Arabia as of the end of 2014, thanks in large part to the "shale oil and gas miracle" that started about 2008.



So we can now address why the end of the petrodollar era might prove to be a huge market-mover.

First, there is the impact of less demand for dollars. A lesser demand for US dollars, all else held constant, would lead to a falling "price" of dollars, which leads to rising prices of goods priced in dollars, i.e., inflation.

Second, there is the flagging demand for US Treasury securities. Both China and now Saudi Arabia have threatened to sell their Treasury holdings in retaliation for various reasons. Massive selling of Treasuries lowers the price of the securities, thereby increasing the yield, or interest rate. As part of the bundle of secret deals made with the Saudis in the early 1970s, the Treasury holdings of all Middle East countries, including Saudi Arabia were obscured by lumping all "oil exporters" together in one line-item (Andrea Wong's Bloomberg article details these secret deals: see May 30, 2016 "The Untold Story Behind Saudi Arabia's 41-Year U.S. Debt Secret"). But as a result of a successful Freedom of Information request, the Treasury Department started disaggregating this category last month.



Although the Treasury did release data going back to 1974, it is only sporadic for Saudi Arabia until 2002, which is when this chart begins. Note that the chart has two different axes for the two data sets. Data from the most recent reporting shows that Saudi Arabia holds $116 billion in Treasury securities. That's not as much as the $1.8 trillion that China holds, but it is not a trivial amount. And since most central banks hold about 66% in US dollar-denominated assets, and $116 billion is only 20% of the Saudi's total reserves, it's likely they hold another $200 billion or so in accounts whose owner is not clear. $300 billion is certainly not trivial and even at $116 billion, it makes the kingdom one of the US's largest creditors.

In conclusion, then, Saudi Arabia more than at any point since 1974, has the incentive to end the petrodollar system, as it's no longer evident that they benefit from it. If they do end that 40-year old system, there could be any number of effects: inflation, rising interest rates, and a broader role for the Chinese Yuan in international transactions. The degree to which the US would see higher rates of inflation and rising interest rates depend on the specific actions taken by the kingdom. This is a story well worth following.

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	1.53%	2.59%	-0.49%	9.01%	55.88%
Dow Jones Corporate Bond Index	-0.23%	5.86%	5.03%	8.16%	29.99%
US Dollar Index	3.06%	-2.91%	-1.14%	19.20%	28.46%
Gold, per ounce	-5.98%	14.80%	2.27%	-2.64%	-20.78%
CRB Commodities Index	0.83%	5.61%	-16.59%	-39.06%	-46.82%
MSCI US REIT Index	2.11%	4.75%	6.23%	12.71%	34.64%
BONY Mellon Emerging Market Stock Index	-3.61%	4.08%	-14.62%	-18.22%	-33.89%
Oil, West Texas Intermediate per barrel	6.18%	31.72%	-18.93%	-52.54%	-52.45%
10-Year US Treasury Note Price	-0.17%	3.19%	1.40%	3.10%	5.26%
10-Year US Treasury Note Yield, in basis points	1.00	-43.00	-28.00	-64.00	-121.00

So much of May's market action can be tied to the strength in the US dollar, which was up over 3%. The strength was due almost entirely to the Fed's very vocal desire to raise interest rates. That seemed to be verified by economic data that was stronger than the first quarter of the year. A rising dollar kept interest rates from rising too much – up only a blip. Both corporate and government bond prices were down only slightly. One would expect that such a surge in the dollar would result in a drop in gold and oil prices. Gold did drop by almost 6% but oil was able to rally 6% on improving fundamentals. Gold, though, finally has a positive 12-month return. The CRB commodity index, due to its heavy weighting in energy, was also seemingly immune to the upward trajectory of the US dollar.

Believe it or not, REITs, or Real Estate Investment Trusts, are the only asset with positive returns over every timeframe covered above, and over the past 5 years, only the S&P 500 has had a higher return. REITs have been benefiting from a near-0% interest rate environment for a long time now and any time the Fed's conversation turns to hiking rates, REITs suffer. When the Fed backs off such hawkish talk, REITs surge. Emerging markets appeared ready for a breakout as the dollar weakened, but these equities could not further the momentum they found in April. For many asset classes, the first half of May was completely different than the last half, and emerging market stocks were a case in point. That index was down 6.5% to May 19, but up 3% to the end of the month. The S&P 500 performed in a similar way, but was only down 1.5% by May 19th but up about the same 3% from the 19th to the end of the month.

All Weather Growth Portfolio

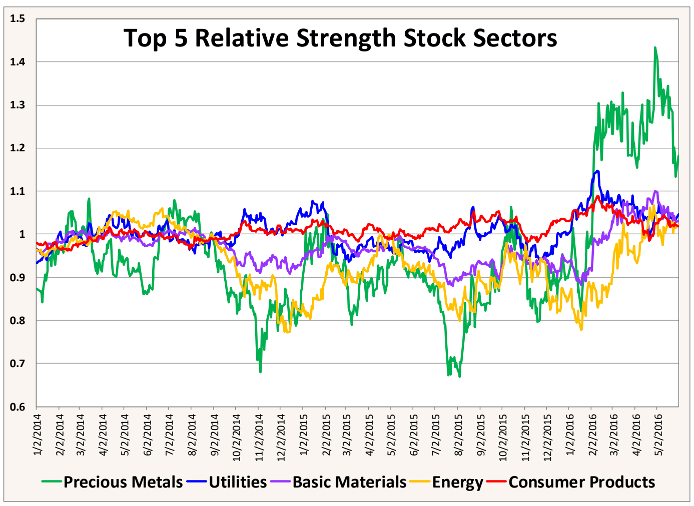
The All-Weather Growth Portfolio (AWGP) is the embodiment of our core investment philosophy: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown to an acceptably low level, (3) timing each disparately correlated asset class independently, using a long-cash-short framework, allows the portfolio the potential 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 panel of each chart and a measure of volatility is in the bottom panel.

In the month of May, only two changes were made. First, we closed out our short position in stocks early in the month, and went to cash. However, things were setting up for a long entry in stocks at the end of the month of May. Second, we initiated a long position in gold. No changes were made to any of the other four asset classes.

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

U.S. STOCK MARKET:

As per the chart to the right, the market for stocks rebounded in mid-May and has surged forward, despite the renewed chatter from Fed-heads that a summer interest rate hike was in the cards. The move up in stocks was either due to the market's collective disbelief in a rate hike, or the fact that the Fed's hawkishness was taken as a vote of confidence in the economy's health. Given that a belief in the latter requires a belief that the Fed has access to a special wisdom not available to market participants, it seems less likely the case. Interestingly, the index of leading economic indicators has surged in lockstep with stocks going back to the bottom in mid-February. We were in cash as of the end of May.

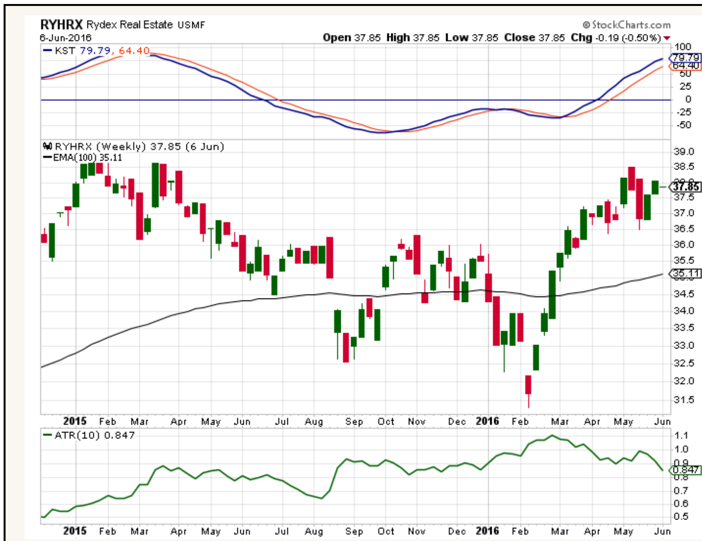


STOCK SECTORS:

As mentioned prior, we were in cash at the end of May. Still, going into May, the top five performing stock sectors were Basic Materials, Consumer Products, Energy, Precious Metals, and Utilities and that reflects the mood of markets at that time. Each of these five is a defensive sector with the possible exception of Energy. That sector may not be classified as defensive in the traditional sense, at present, it does represent deep value, and value is defensive. As per the chart, Precious Metals has absolutely trounced performance of the S&P 500 since late January.

REAL ESTATE INVESTMENT TRUSTS:

REITs have bounced back rather dramatically since mid-February, after spending most of 2015 in a downtrend. But since that time, accelerating momentum and volatility receding from elevated levels has set the stage for a big move up. Rising rents and near-0% interest rates have made the REIT space a good one to be in for much of the recovery. But 2015 shows that in an environment of slowing economic growth coupled with hawkish interest rate talk from the Federal Reserve make for a bad cocktail. We were long REITs as of the end of May.



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 afternoon at 5:35 on Greg Knapp's radio show, *The Greg Knapp Experience* on the same stations.

GOLD: Gold has enjoyed a comeback of sorts due primarily to two factors. First, the environment for interest rates has changed. All of 2015, gold was beaten down due to the Fed's intent to hike rates, which gold is not particularly fond of. Second, many countries outside the US were thought to be recovering and higher rates were expected. Toward the beginning of 2016, however, both of these memes changed. It became clear that the Fed was not likely to hike rates four times in 2016, as was originally thought, and many countries have since moved to a committed stance of negative interest rates, which benefits gold, which we were long as of the end of May.

U.S. DOLLAR: Not mentioned above as a factor in the resurgence of gold was the down-move in the dollar. The dollar has been down for the better part of 2016 as it appeared less likely that the Fed would hike interest rates. That helped gold, oil, and other commodities priced in dollars. Note the fleeting 4-week period of green before the most recent red bar on news that we created only 38,000 jobs in May, as the odds of a rate hike in June plummeted. We were in cash at the end of May.

HIGH YIELD BONDS: Obviously, the total return chart of high yield bonds below is impressive. Among other factors, the price of oil (a sector heavily represented in most high-yield bond indices) starting to recover and the perception of a lower probability of recession has helped this asset class. But what's really helped this sector is a less aggressive Federal Reserve. We were long high-yield as of the end of May.

U.S. TREASURY BONDS: After a terrible first half of 2015, Treasury bonds have been in an uptrend and hit 2-year highs in early June. Momentum is flat and volatility is extremely low, which would normally imply a breakout to either direction is close. That move may have been to the upside after a dismal May jobs report, but it's too early to tell. We were long as of the end of May.

Alternative Income Portfolio

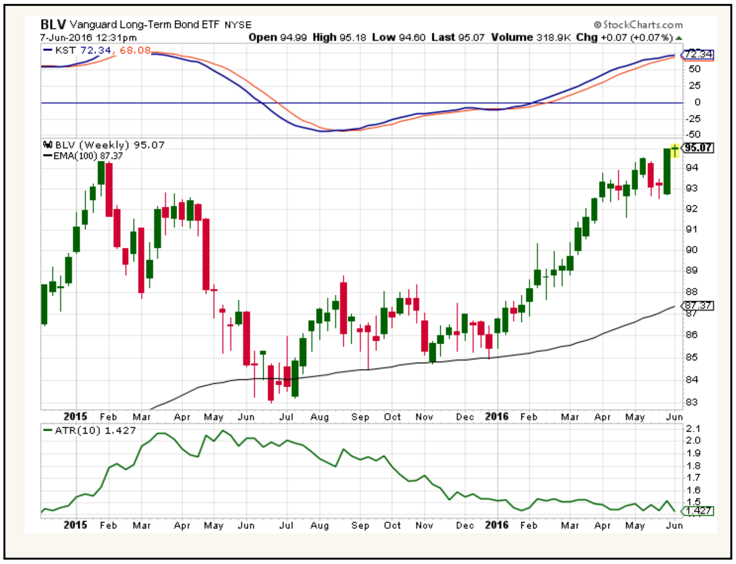
The Alternative Income Portfolio (AIP) is also based on our core investment philosophy, but as you can see, there is one caveat: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown 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	Trend	Status as of Last Day of the Month
High Yield Bonds	Flat/Up	Long
Short-Term Bonds	Up	Long
International Corporate Bonds	Flat	Long
Short-Term Senior Secured Loans	Flat/Up	Long
Convertibles	Flat	Long
Ginnie Maes	Up	Long
Long-Term Bonds	Up	Long
REITs	Up	Long
Emerging Market Bonds	Up	Long
Agency-Backed Mortgages	Up	Long
Dividend-Paying Stocks	Up	Long
Gold & Natural Resources	Up	Long
Master Limited Partnerships	Up	Long
Preferred Stocks	Flat/Up	Long

As of the last trading day of May, we were long 14 of the 14 income-producing asset classes. We were long 13 of 14 going into May. We added the last of the 14 – Master Limited Partnerships (MLPs) in the latter half of May.

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	$0.187	12	$2.244	$35.23	6.37%
Vanguard Short-Term Bond ETF	BSV	$0.098	12	$1.170	$80.35	1.46%
PowerShares International Corp Bd ETF	PICB	$0.049	12	$0.589	$26.16	2.25%
Voya Prime Rate Trust	PPR	$0.027	12	$0.318	$5.10	6.24%
SPDR Barclays Convertible Secs ETF	CWB	$0.125	12	$1.505	$43.73	3.44%
Vanguard GNMA Inv	VFIIX	$0.021	12	$0.251	$10.79	2.32%
Vanguard Long-Term Bond ETF	BLV	$0.292	12	$3.504	$93.55	3.75%
Vanguard REIT ETF	VNQ	$0.883	4	$3.531	$83.67	4.22%
PowerShares Emerging Markets Sov Dbt ETF	PCY	$0.124	12	$1.483	$28.39	5.22%
Annaly Capital Management, Inc.	NLY	$0.300	4	$1.200	$10.58	11.34%
Vanguard Dividend Appreciation ETF	VIG	$0.410	4	$1.640	$81.75	2.01%
GAMCO Global Gold, Natural Resources & Income Trust	GGN	$0.070	12	$0.840	$6.27	13.40%
Alerian MLP ETF	AMLP	$0.240	4	$0.960	$12.21	7.86%
Market Vectors Pref Secs exFincls ETF	PFXF	$0.096	12	$1.150	$20.51	5.61%
					Average	**5.39%**

*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 ETF and the Preferred Securities ETF, which have different payout policies. To calculate the implied dividend yield on these securities, we take the dividends paid over the prior year to get a more accurate view of what to expect over the course of the coming year. The "Average" number on the final line, highlighted in green, is a simple average of the yields shown. It is not a current yield on the portfolio as the average yield assumes we are invested in all 14 securities and that equal weight allocations were given to all. That may, or may not, be the case at any given time.

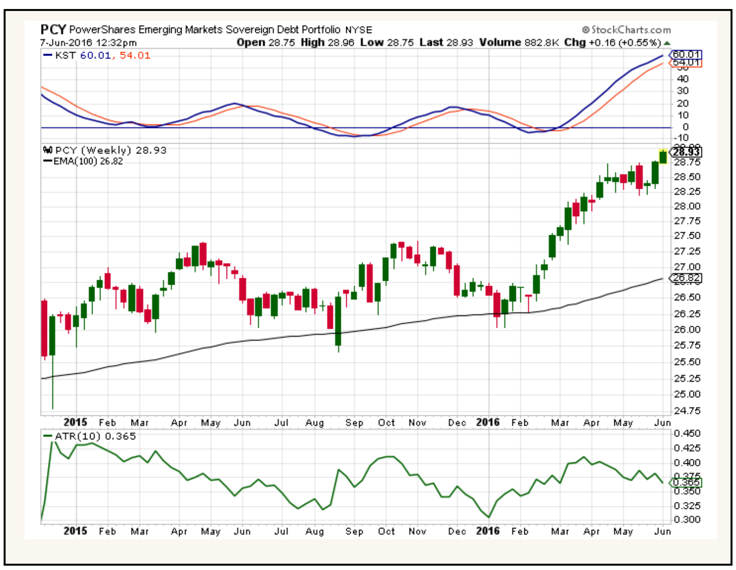


LONG-TERM BONDS:

As explained above, long-term Treasury securities have been in quite the up-trend. That's because yields have collapsed and the outlook for higher interest rates seems uncertain at best. In addition, there is a certain amount of asset class rotation favoring high-quality bonds at the moment, benefiting this asset class. We were long as of the end of May.

SHORT-TERM BONDS:

These bonds – short-term – do not pay much interest but they tend to behave in a very non-volatile way. The chart to the right appears to be the perfect up-trend, and it is, but the entire move on this chart – from low to high - is less than 3%, but still proves useful for investors. One might expect the trend to be down with the threat of rising interest rates but it is not, and we were long as of the end of May.



EMERGING MARKET BONDS:

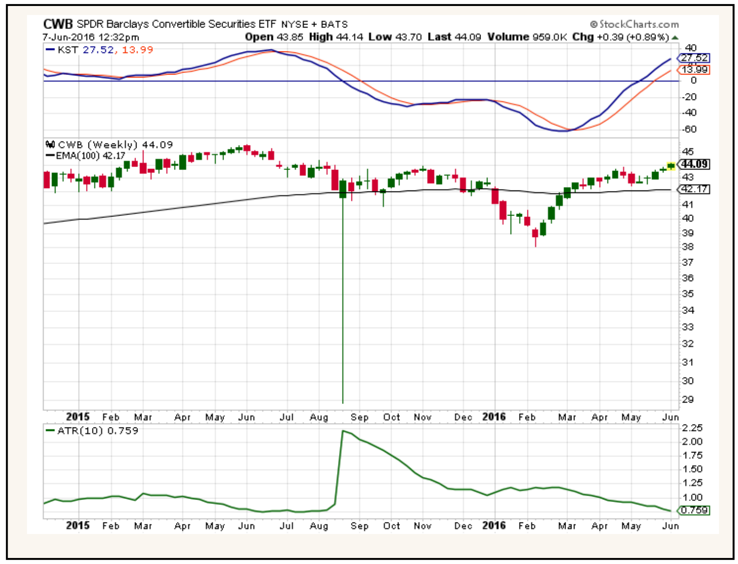
Emerging market *bonds* have never been in as much trouble as emerging market *stocks*. In fact, this asset class made a new high on a total return basis in late February. For a bunch of government bonds, its dividend is relatively attractive, as well. We were long as of the end of May.

INTERNATIONAL CORPORATE BONDS:

Since these bonds are issued in local currencies, they will trend in the opposite direction of the dollar. Since the greenback has had a rough 2016, we could have assumed international corporate bonds to have had a very good 2016, which is the case. Like many of the asset classes covered in this newsletter, momentum has accelerated to the upside while volatility has achieved significant lows. That could be a sign that these things have gone up too far too fast. We were long as of the end of May.

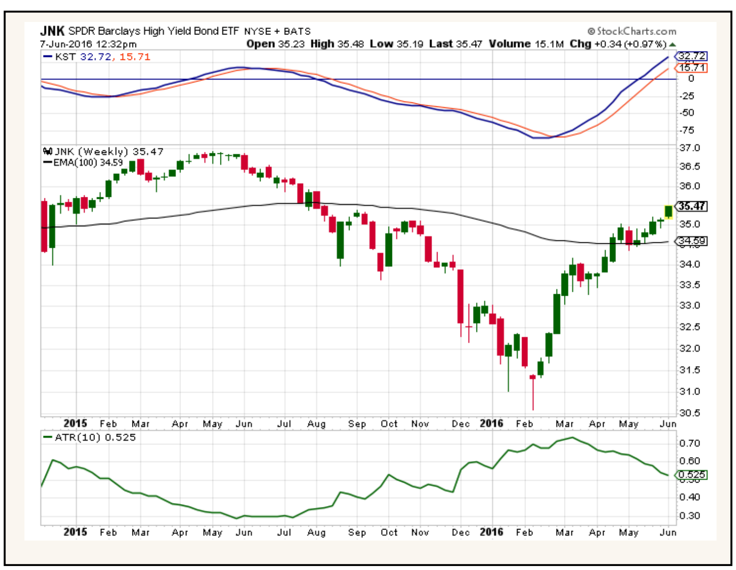
SHORT-TERM SENIOR SECURED LOANS: More than any other factor, these loans have been influenced by the health of the economy. For most of 2015, there was a feeling that a recession may be imminent. That feeling reached critical mass in late 2015 and early 2016, and then almost over the course of 24 hours, that meme was universally discredited, much to the benefit of this asset class which rallied 15% off the lows. We were long as of the end of May.

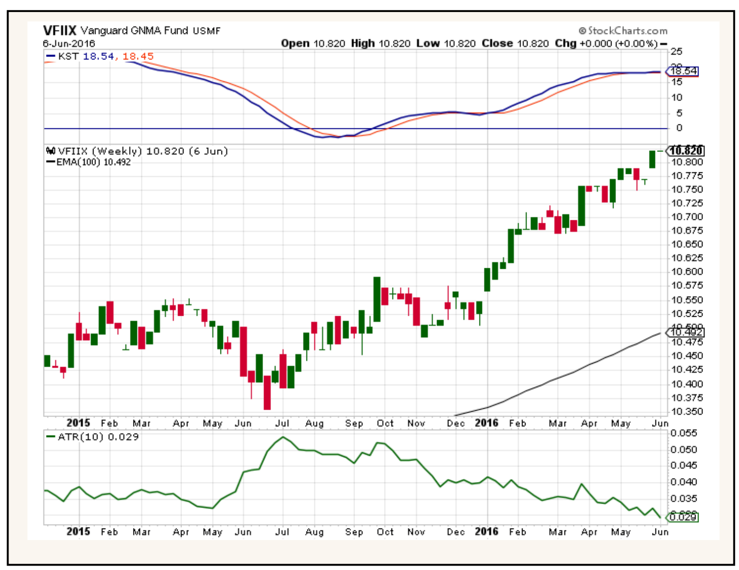
CONVERTIBLES: Convertibles are up 15% from the lows, have accelerating momentum and significantly low volatility, much like the stock market. Which makes sense because these are bonds and preferred securities convertible into the common stocks of the issuing corporation. We were long as of the end of May.



HIGH YIELD BONDS: High yield bonds have been a big story on the way down (because of the perceived insolvency of junk oil companies) and a big story on the way up as its recouped much of 2015's downtrend. The perception of a healthier economy and a lower probability of aggressive rate-hiking in 2016 has pushed high yield higher. We were long as of the end of May.

GINNIE MAES: Good ol' GInnie Maes. Much like the short-term bonds above, this is a very non-volatile asset class. From the low on this chart to the high made very recently, this asset class has only appreciated less than 5%. Ginnie Maes pay more than short-term bonds, but it's still not much. On the other hand, it's in an uptrend dating back to mid-2015. The move is partly due to the feeling that refi risk is minimal as the Fed seems more likely today to raise rates, or leave them alone, than to cut them. We were long as of the end of May.





REITs:

REITs have bounced back rather dramatically since mid-February, after spending most of 2015 in a downtrend. But since that time, accelerating momentum and volatility receding from elevated levels has set the stage for a big move up. We were long as of the end of May, as we were in the growth portfolio.

AGENCY-BACKED MORTAGES:

Mortgage REITs, especially those backed by US government agencies, have seen one of the biggest moves off of the mid-February lows. Annaly, one such REIT, is up almost 40% in that time, after never really having had a significant sell-off in 2015. We've probably been long this asset class over the last 18 months more than or the same as any other in the portfolio. We were long as of the end of May.

DIVIDEND-PAYING STOCKS:

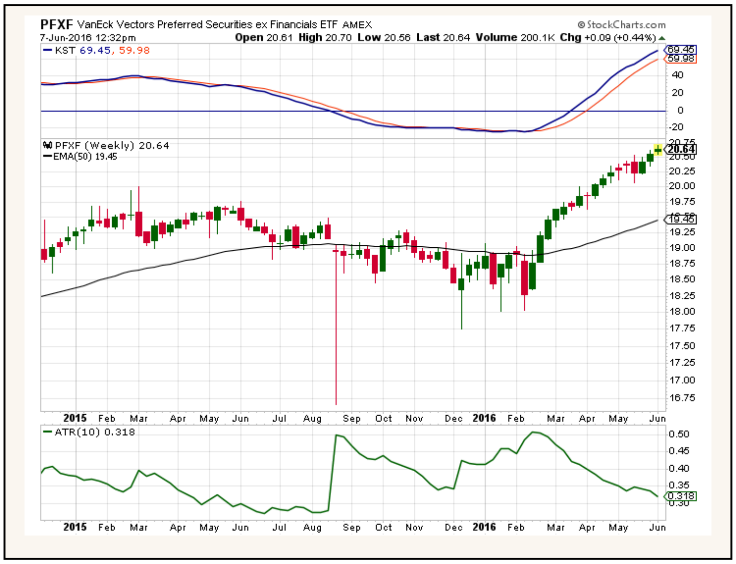
This subset of the S&P 500 is up a little bit more than the S&P 500 itself from the lows of 2016, and that makes sense because there is still a little risk-aversion left in the market and the thought is that the dividends paid by some stocks will help protect their price in bear markets, while growth stocks paying no dividend will be punished relatively more in such an environment. Whether that's true or not is less important than the belief in that old market axiom, so demand for these stocks has been relatively high. We were long as of the end of May.

MASTER LIMITED PARTNERSHIPS:

There has finally been enough evidence of an uptrend here to warrant going long, which is what our position was as of the end of May. This asset class pays a relatively high distribution, making it attractive even in downtrends. Like almost everything that has risk, MLPs had been in a downtrend for most of 2015, and then in mid-February 2016, found a bottom. Since then, this asset class is up over 60% on a total return basis as it has recovered in lockstep with oil. Again, we were long as of the end of May.

PREFERRED STOCKS: Preferred stocks behave more like bonds than stocks. Due to the combined fears of a looming recessions and a Federal reserve stubbornly tied to tighter monetary policy, including a very aggressive rate-hiking plan, preferreds had a terrible 2015. But since mid-February, this asset class is up around 12%. We were long as of the end of May.

GOLD & NATURAL RESOURCES: Since gold peaked in September of 2011, this asset class lost 80% of its value and has had rare opportunities to be long. But from the middle of January to late April, this fund was up almost 95%. But then the Fed started talking about how they were going to hike rates this summer and gold, and this asset class based on it, quickly gave back a little bit of that. The news that we only created 38,000 jobs in May has taken a June interest rate hike, and maybe even July, off the table, or that's what a plurality of pundits believe. Gold has since recovered. We were long as of the end of May.



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