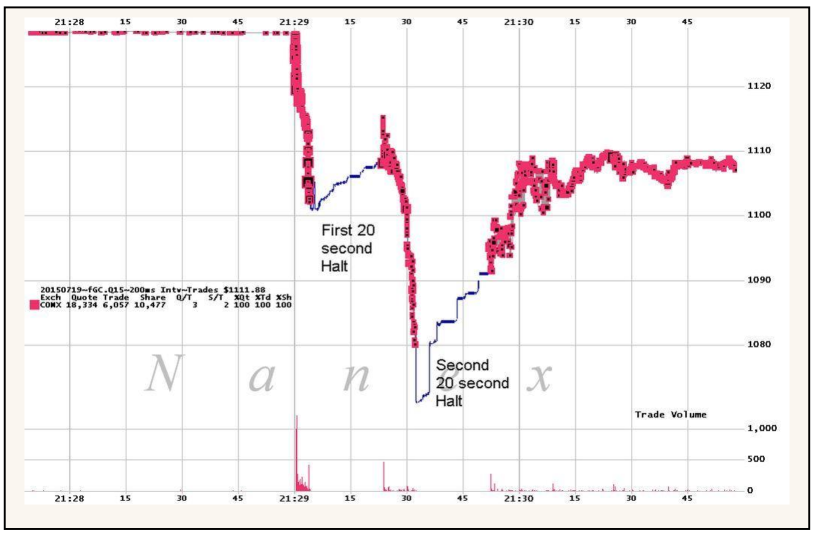
BUTLER, LANZ & WAGLER

August Newsletter 2015

Gold Fails to Glitter in July

July was a bad month for gold. It was down almost 7% for the month and down almost 8% on the year. What's interesting (and instructive) is the most recent gold slam-down on July 19. $2.7 billion worth of gold futures contracts were dumped on the market minutes before even the Chinese markets opened, let alone the very liquid US futures markets.



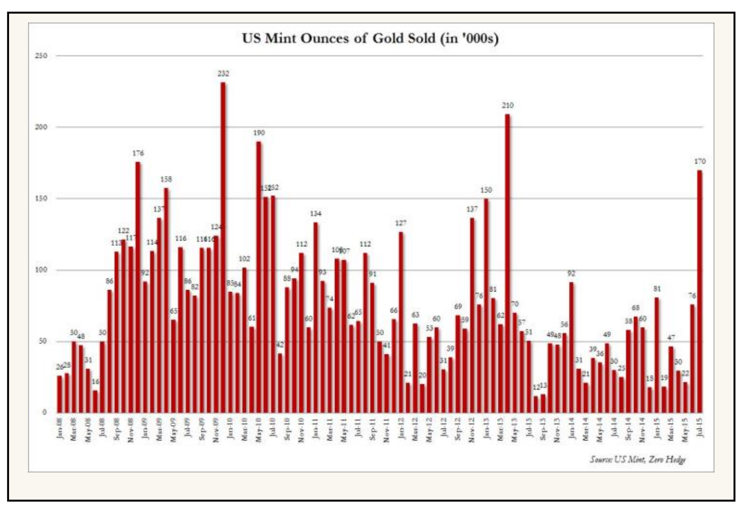
The order was so huge that it necessitated a halt in trading for two brief periods of time. Clearly, the person selling $2.7 billion worth of gold is a speculator who does not have $2.7 billion of gold in a cave somewhere. If that were the case, you would sell in tiny chunks in the more liquid US markets so as not to drive the selling price down on yourself. No, it appears the very intention was to shock the market downward in an attempt to induce even more selling which would create a very easy profit. That move pushed gold from $1,130 per ounce to a low of $1,080 in 40 seconds before it found its sea legs.

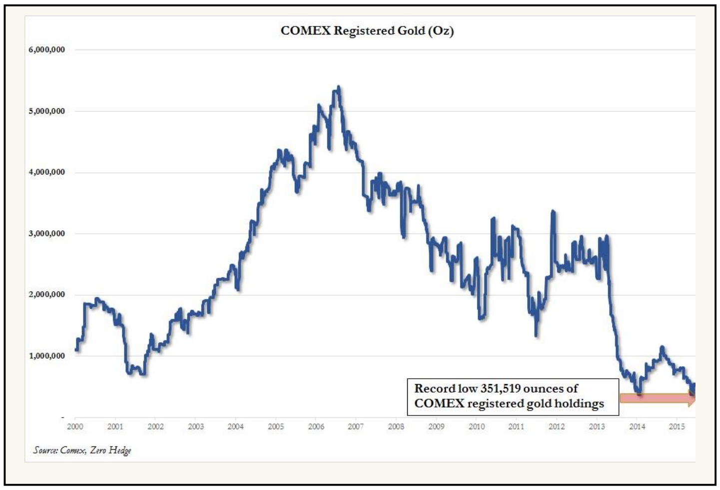
Meanwhile, the demand for physical gold at these futures-induced low prices started to skyrocket. July saw more Gold Eagle one-ounce coins sold by the US mint than at any point over the last two years.

The Wall St. Journal reported that, "Gold's plunge to 5-year lows this week has prompted a swift rise in demand form jewelry retailers in China and India…leading to a doubling of the premiums paid on physical gold."

In late July, the Royal Canadian Mint began to ration its precious metals coins due to strong demand. A similar situation occurred at the Perth, Australia Mint.

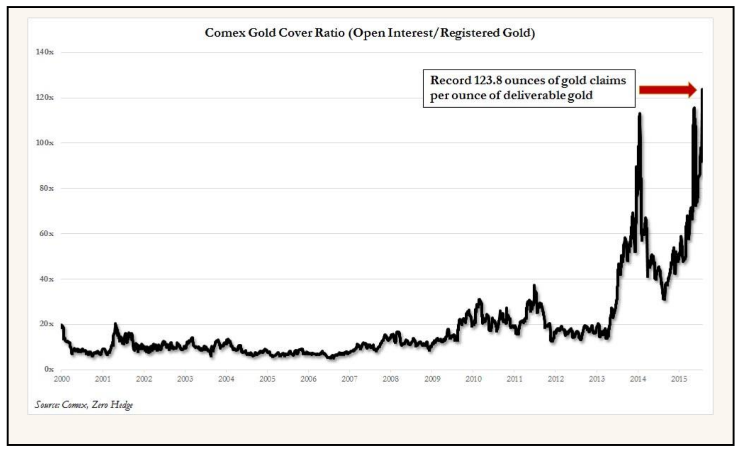
At the Shanghai Gold Exchange, demand by mid-month July was enough to equal full-year 2015 global mining supply. There are other indications of increased demand and perhaps the biggest fly in the ointment in the whole "gold-is-getting-spanked-and-could-go-to-$350" meme is that more people are demanding gold be delivered to them at expiration of futures contracts. Because of that, we can see that gold bullion banks are losing their stockpiles of gold.





A bullion bank is an investment bank that functions as wholesale supplier dealing in large quantities of gold. All bullion banks are members of the London Bullion Market Association and all banks providing commodities futures firms with gold for delivery in the settlement of futures contracts are bullion banks. They are routinely obligated to report to the COMEX (the commodities exchange where gold futures are traded in the US) the level of their gold inventory. That inventory is split between "registered" gold and "eligible" gold. Eligible gold could be gold that belongs to a private party who is simply storing his gold with a bullion bank. We are not concerned with this type of gold. We're more interested in registered gold, which is approved by the exchange as being in the correct form for delivery to satisfy gold futures buyers who are taking delivery of gold.

Note from the chart that registered gold – that which is approved for delivery at settlement - in COMEX vaults is now at an all-time low. While it may be the case that previously registered gold has simply been moved to an eligible vault, it's more likely that people are demanding more physical gold now than previously. This means that with so many futures contracts trading with so little actual gold backing them all up, you get this:



This chart shows that there are currently 124 claims to an ounce of Gold stored at COMEX for every actual ounce of gold at the COMEX! We've never seen this kind of lop-sidedness. The actual math works like this: while the gold coverage ratio is 123.8 ounces in potential paper claims to every ounce of physical gold, a more accurate way to look at this is that there are 217,500 long futures contracts open and the same number of short futures contracts because there are two parties to each contract – a buyer and a seller. Since each "long" futures contract (buyers) is a claim on 100 ounces of gold, if just 3,516 of these "longs" actually wanted gold delivered to them, the COMEX would be insolvent because they would fail to deliver the last 100 ounces of gold. And those 3,516 contracts are a mere 1.6% of the open long contracts.

Since things have never gotten this out of whack, it's hard to tell what will happen, but it's likely that the exchange would never be in real jeopardy. COMEX would simply have to entice the eligible vault holders to convert their gold to registered status. But the very fact that a shortage of vaulted gold forced this situation would be bullish for gold prices.

But one last point before we conclude. For many years now it has been suspected that the Chinese have been stockpiling gold. And while nobody believes China's official gold holdings data, it is known that historically the Chinese prefer to buy a certain type of gold bar called a "gold kilo." On the last day of July, a little over 222,000 gold kilo bars were removed from the COMEX vaults. It is presumed these bars are being demanded by China.

COMMODITY EXCHANGE, INC.

METAL DEPOSITORY STATISTICS

GOLD KILO
Troy Ounce

Report Date: 7/31/2015
Activity Date: 7/30/2015

DEPOSITORY	PREV TOTAL	RECEIVED	WITHDRAWN	NET CHANGE	ADJUSTMENT	TOTAL TODAY
BRINK'S, INC.						
Registered	0.000	0.000	0.000	0.000	0.000	0.000
Eligible	958,131.951	44,014.719	267,335.565	-223,320.846	0.000	734,811.105
Total	958,131.951	44,014.719	267,335.565	-223,320.846	0.000	734,811.105
LOOMIS INTERNATIONAL (HK) LTD						
Registered	0.000	0.000	0.000	0.000	0.000	0.000
Eligible	17,779.503	739.473	0.000	739.473	0.000	18,518.976
Total	17,779.503	739.473	0.000	739.473	0.000	18,518.976
MALCA-AMIT FAR EAST LTD						
Registered	0.000	0.000	0.000	0.000	0.000	0.000
Eligible	36,909.348	0.000	0.000	0.000	0.000	36,909.348
Total	36,909.348	0.000	0.000	0.000	0.000	36,909.348
TOTAL REGISTERED	0.000	0.000	0.000	0.000	0.000	0.000
TOTAL ELIGIBLE	1,012,820.802	44,754.192	267,335.565	-222,581.373	0.000	790,239.429
COMBINED TOTAL	1,012,820.802	44,754.192	267,335.565	-222,581.373	0.000	790,239.429

Here's the conclusion. The physical gold market is about as strong as it has been since the last gold smack-down in 2013. When prices in the futures market drive spot prices down, just as simple economic analysis would suggest, people demand more of it. Contrary to simple economic analysis, as demand for spot gold increases with a very stable supply, prices have actually gone down in the futures market. The reasons for this disconnect are many, but suffice it to say that at some point, the divergence between the furious selling of gold futures and the equally furious buying of physical gold will have to be resolved. Unfortunately for gold owners, it will probably take an economic or financial shock to change the negative sentiment in the paper gold markets – futures and ETFs. And they're the ones that set the price in the markets for gold bullion and coins.

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	1.97%	2.18%	8.97%	24.80%	90.98%
Dow Jones Corporate Bond Index	0.61%	-0.47%	2.02%	8.52%	28.23%
US Dollar Index	1.86%	7.53%	19.50%	19.21%	19.50%
Gold, per ounce	-6.58%	-7.45%	-14.66%	-17.24%	-7.51%
CRB Commodities Index	-10.83%	-11.91%	-31.20%	-28.66%	-26.16%
MSCI US REIT Index	5.48%	-2.80%	5.57%	14.15%	55.45%
BONY Mellon Emerging Market Stock Index	-7.04%	-9.02%	-19.59%	-7.14%	-22.41%
Oil, West Texas Intermediate per barrel	-20.85%	-12.92%	-52.10%	-55.58%	-40.76%
10-Year US Treasury Note Price	1.20%	0.58%	2.49%	1.04%	2.61%
10-Year US Treasury Note Yield, in basis points	-15.00	3.00	-38.00	-40.00	-74.00

It's always best to start an analysis of markets with the currency. Even though the US Dollar Index was up, it matters more that it was up primarily due to US strength (potential rate hikes) than weakness in Europe or Japan. A rising dollar generally drives the values of things priced in dollars downward – commodities and gold.

The CRB Index – the benchmark for commodities prices – absolutely tanked in July, down almost 11%. Oil's 21% drop weighed heavily on the overall index. Commodities, particularly industrial commodities like oil, lumber and copper, reflected what's becoming a more obvious global economic slump. Gold was down almost 7% for the month, but more than half of that carnage occurred over two consecutive days in mid-July amidst a high-frequency-trading route. Even though that pain in gold prices could be tied to a suspicious $2.7 billion dump of gold futures at a very illiquid time of day, the fundamentals have not been positive for gold – higher interest rates, less Fed accommodation and a strong dollar.

Low commodity prices lead to low interest rates and the yield on the 10-year Treasury dropped 15 basis points, allowing Treasury prices to rise over 1% and corporate bonds to rise a little less than that. All else held constant, falling interest rates will be favorable for stocks – which were up almost 2% - and REITs – up 5.5%. Emerging market stocks tanked in July as they are generally tied to commodities prices and they tend to move inversely to the US Dollar Index. It should be noted that the entire gain for July in US stocks was given up in the first week of August.

All Weather Growth Portfolio

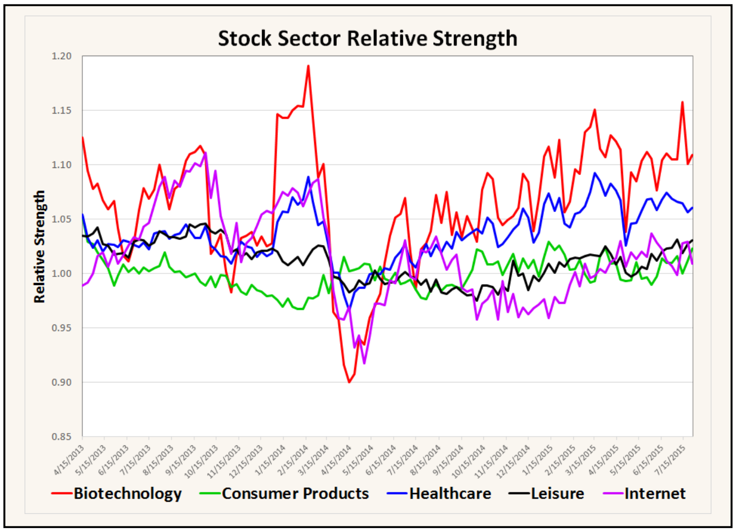
The All-Weather Growth Portfolio (AWGP) is the embodiment of BLW's core investment philosophy: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown to an acceptably low level, (3) timing 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 panel of each chart and a measure of volatility is in the bottom panel.

There were several changes made to the AWGP in the month of July. We sold the Technology, Healthcare, and Internet stock sectors and replaced those with the Leisure, Consumer Products, and Banking stock sectors. We also closed out our short position in Gold in July. That money was in cash as of the end of the month.

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

U.S. STOCK MARKET:

While stocks are clearly mired in a trading range, it's the internals that are starting to concern analysts. Each thrust upward is made on fewer and fewer stocks participating in the thrust. Unless and until that trend can be reversed, the stock market is suspect, to say nothing of the waning momentum that's now been in effect for almost two years. Still, there are some sectors that are outperforming. The broad market, however, is starting to look tired.



STOCK SECTORS:

As of the end of July, the top five sectors in the stock market are Biotech, Healthcare, Leisure, Consumer Products and Internet. With the exception of Leisure and Internet, these sectors are defensive. No, Biotech is not generally considered to be defensive, but it does not have a high degree of correlation with the broad market. Relative to the broad market, Biotech is quite volatile, as can be seen in the chart the left. The Growth Portfolio was long Consumer Products and Leisure in July, along with Banks (not shown).

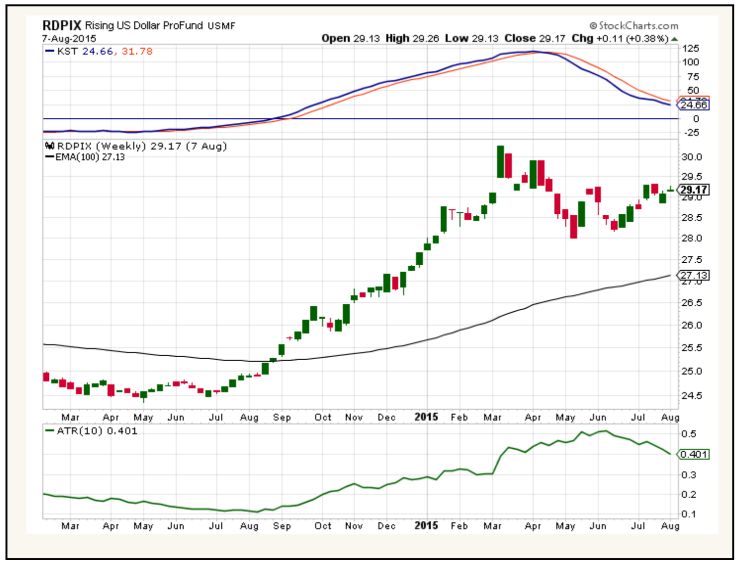
REAL ESTATE INVESTMENT TRUSTS:

REITs are sensitive to interest rates and as long as yields at the long end (10-year and 30-year maturities) rise, REITs will suffer. That's been the case for most of 2015 but REITs did pop in July by about 5.5%. Our growth portfolio has been in cash for our REIT allocation for some time. If rates have hit an inflection point – that is, they have stopped spiking upward – perhaps this sector will find stability.

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.

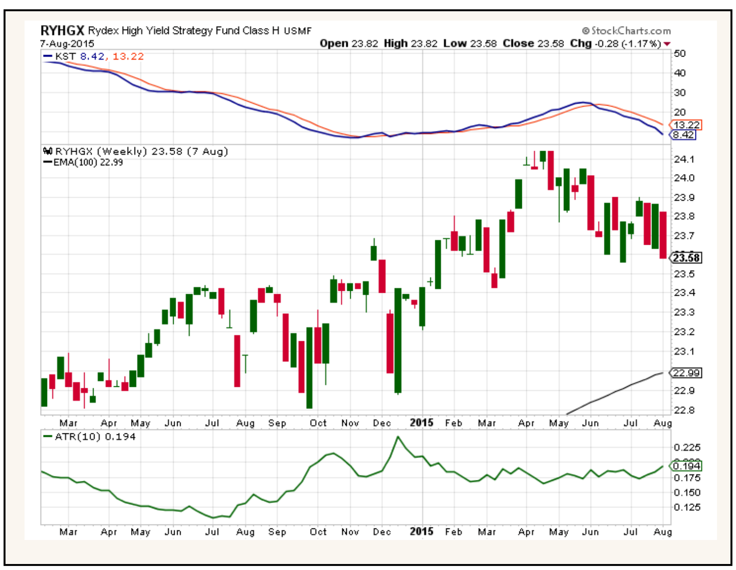
GOLD: We've covered gold *ad nauseum* in the first section. However, we should probably point out here that we are now in cash after closing a profitable short trade in gold in July.

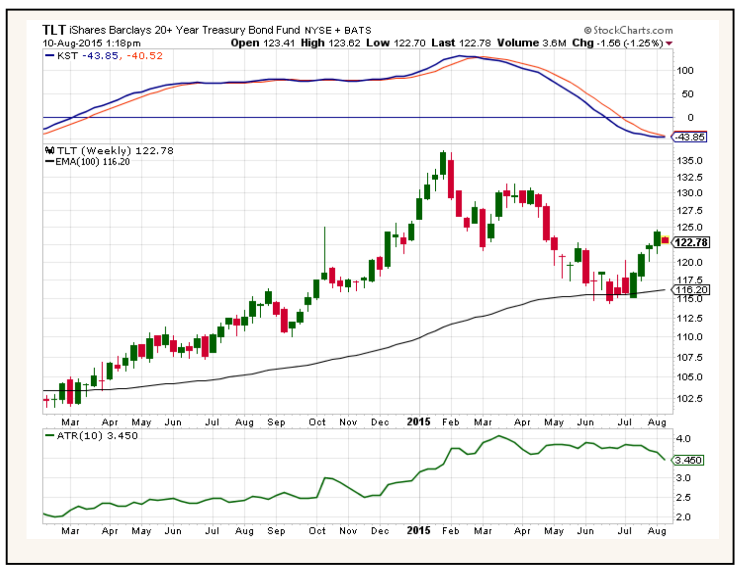
U.S. DOLLAR: We are long the US dollar and have been long, on and off, for the better part of the 14-month uptrend. Much of the up-trend is predicated on the US economy being strong enough to warrant the intended interest rate hikes by the Federal Reserve. And, of course, even if that weren't the case, weakness in Europe and Japan would support the value of the US Dollar Index.



HIGH YIELD BONDS: These bonds should be performing better in the current economic environment. The problem is that there is more risk in the energy sector today than has been the case historically. Many newer shale oil companies have been financed by high-yield debt and oil prices tanking have made these issues more suspect, bogging the sector down. We are still long here.

U.S. TREASURY BONDS: Treasuries are one of our longer-term systems. As such, although we've gotten close to having been taken out of this, we are still long. Even though bonds were up in July, there is still a huge disconnect between bonds/yields and the health of the economy. In July, it seems that's become more apparent, but China is still a massive seller of US debt.





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	Flat	Long
Short-Term Bonds	Up	Long
International Corporate Bonds	Down	Cash
Short-Term Senior Secured Loans	Up/Flat	Long
Convertibles	Up	Long
Ginnie Maes	Up	Long
Long-Term Bonds	Flat/Down	Cash
REITs	Up/Flat	Long
Emerging Market Bonds	Up/Flat	Long
Agency-Backed Mortgages	Down	Cash
Dividend-Paying Stocks	Up/Flat	Long
Gold & Natural Resources	Down	Cash
Master Limited Partnerships	Down	Cash
Preferred Stocks	Up/Flat	Long

We are long 9 of the 14 income-producing asset classes as of the end of July because only 9 of the 14 asset classes we track for this portfolio are not in downtrends.

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	$0.183	12	$2.198	$37.60	5.85%
Vanguard Short-Term Bond ETF	BSV	$0.089	12	$1.069	$80.03	1.34%
PowerShares International Corp Bd ETF	PICB	$0.051	12	$0.611	$26.20	2.33%
Voya Prime Rate Trust	PPR	$0.028	12	$0.336	$5.31	6.33%
SPDR Barclays Convertible Secs ETF	CWB	$0.084	12	$1.012	$47.19	2.14%
Vanguard GNMA Inv	VFIIX	$0.020	12	$0.235	$10.71	2.20%
Vanguard Long-Term Bond ETF	BLV	$0.319	12	$3.824	$90.22	4.24%
Vanguard REIT ETF	VNQ	$0.761	4	$3.045	$78.79	3.86%
PowerShares Emerging Markets Sov Dbt ETF	PCY	$0.130	12	$1.560	$27.58	5.66%
Annaly Capital Management, Inc.	NLY	$0.300	4	$1.200	$10.08	11.90%
Vanguard Dividend Appreciation ETF	VIG	$0.442	4	$1.768	$79.66	2.22%
GAMCO Global Gold, Natural Resources & Income Trust	GGN	$0.070	12	$0.840	$5.26	15.97%
Alerian MLP ETF	AMLP	$0.296	4	$1.182	$14.43	8.19%
Market Vectors Pref Secs exFincls ETF	PFXF	$0.093	12	$1.120	$20.19	5.55%
					Average	5.56%

*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:

We covered this above in the Growth Portfolio review. July saw a bounce back in longer-term bond prices. And the price action in this sector is a perfect opportunity to differentiate the Alternative Income Portfolio from the All-Weather Growth Portfolio. We will either be long or in cash each of these sectors and it takes an outright downtrend for us to be in cash because we are trying to generate income with this portfolio. We were in cash in July.

SHORT-TERM BONDS:

Shorter-term bonds have gone nowhere, really. They will react more to proposed rate hikes than longer-term bonds, usually, and that's been the case in July. We were long this sector in July.

EMERGING MARKET BONDS:

Emerging market bonds are not what they once were. They are now more susceptible to commodity market sell-offs and US dollar strength. Given that, this sector has been remarkably resilient. We were long in July.

INTERNATIONAL CORPORATE BONDS:

This chart will look like the inverse of the chart of the US Dollar Index. The sector needs a falling US dollar to make gains and that has not been the case for 14 months. We were, therefore, in cash in July.

SHORT-TERM SENIOR SECURED LOANS: This sector looks a little like a chart of yields – and it should. As rates rise, this type of fund should do reasonably better than a portfolio of fixed-rate debt. The problem is that it will probably require significantly higher rates to do exceptionally well. We were long in July.

CONVERTIBLES: Since convertible bonds are a hybrid between stocks and bonds, it's easy to see how it may have hit a snag since June. In the last two months, both stocks and bonds have had trouble making headway. So, this hybrid will do the same. We were long in July.

HIGH YIELD BONDS: We covered high-yield above in the Growth Portfolio section. The sector is getting hurt by its exposure to energy companies, which have, for the most part, been poorly capitalized since the advent of the "shale oil miracle." We were still long in July, but clearly, even though the sector has remained almost unchanged for two years, that may not hold for too much longer.

GINNIE MAES: After poor results in May and June, July saw a bounce from this sector. Of course, Ginnie Maes are an interest rate-sensitive sector so they will ebb and flow along with bond prices (and inversely to yields). We were long in July.

REITs:

We covered REITs above, but real estate is interest rate sensitive. As rate pressure at the long end has subsided in July, REITs have found their sea legs. We were long in July.

AGENCY-BACKED MORTAGES:

Agency-backed mortgages are as sensitive to rates as any mortgage – that is, they will rise on falling yields and fall on rising yields. We were in cash in July.

DIVIDEND-PAYING STOCKS:

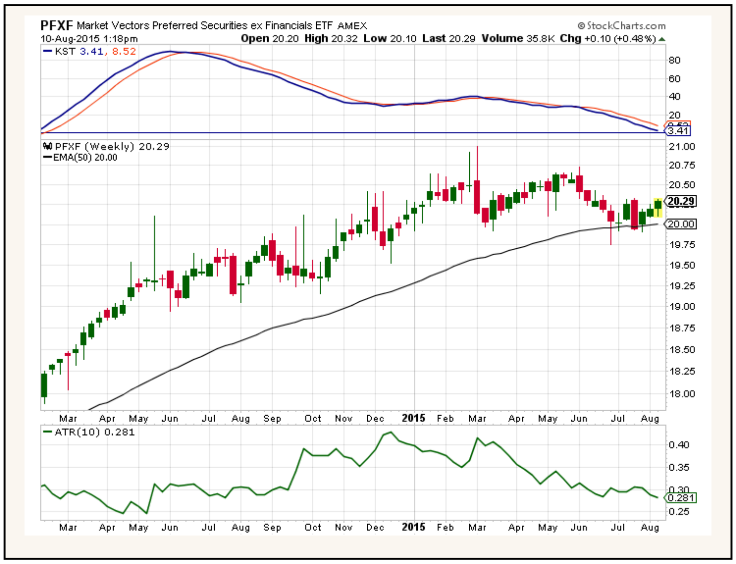
This chart will look almost exactly like a chart of the S&P 500. This sector is comprised of stocks, but those that pay dividends. Therefore, there's generally a little bit of a floor on this sector relative to non-dividend-paying stocks. It was up in July, like all stocks, but not by as much. But they also held their value better in the first week of August than the broad market. We were long in July.

MASTER LIMITED PARTNERSHIPS:

MLPs look like oil prices because the two are connected at the hip. But MLPs have lost only 1/3 of what oil has. These things are still in a downtrend, but it will make for quite an opportunity at some point. The question is when. Certainly, the fact that it pays about 3 times what you can get in a Treasury will garner some attention soon by value investors. We were in cash in July.

PREFERRED STOCKS: Although preferreds were weak in May and June, its chart is one of the few in our Alternative Income universe with a clean chart. The uptrend has certainly waned, but the sector has found a little life with a more mild interest rate environment. We were long in July.

GOLD & NATURAL RESOURCES: Gold has been getting crushed. Therefore, gold miners have been getting crushed and they are at the heart of this sector. At some point, energy and miners will make for an excellent contrarian play. But that will probably necessitate a weaker dollar and that is not the case so far. We were in cash in July.



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