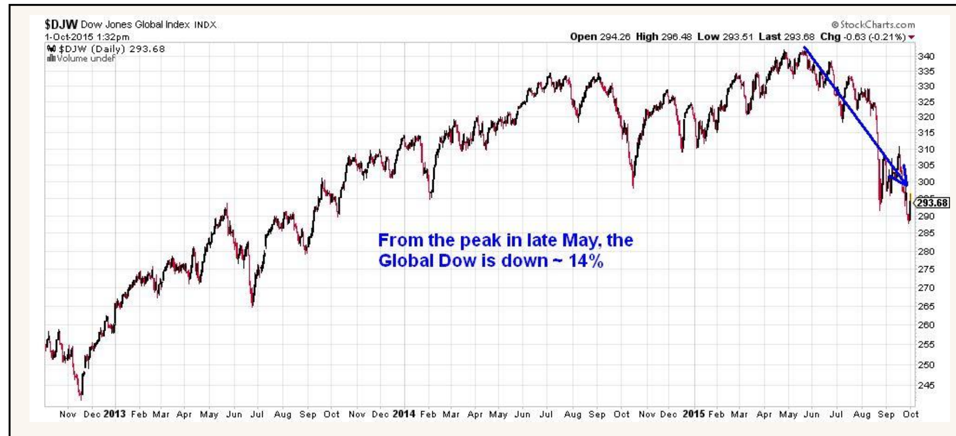
BUTLER, LANZ & WAGLER

For the discerning, risk-conscious investor.

October Newsletter 2015

Stock markets, as well as most other global markets, responded in September to a growing concern that the global economy is either slowing, or worse, recessing. Much of that concern can be traced to the Fed's decision not to raise interest rates. The primary concern in the US is the impact global economic slowing could have on US corporate profits. Less profit means less value these stocks have. The Dow Jones Global Stock Index is a useful proxy of global stock markets and it's down 14% from the peak in late May.

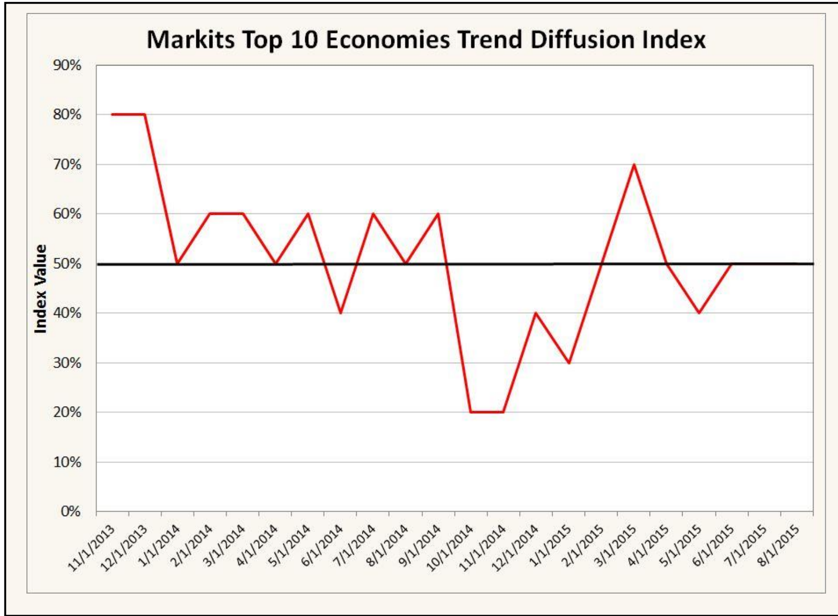


While there are concerns regarding every country's economy, even here in the US, most of the anxiety stems from the seemingly non-ending string of bad news coming out of China. In this month's newsletter, we will examine the health of the largest global economies, and China certainly belongs to that group.

Our first step in analyzing the global economies is to understand which global economies are included in the top 10. We rank each country by GDP in US dollars, and we get the following, ranked from highest to lowest, to get our top 10: US, China, Japan, Germany, France, UK, Brazil, Russia, Italy and India. A company called Markit releases a country-specific diffusion index (which means the index can only have values from 0 to 100) for every country, every month. More specifically, they release a manufacturing index, a services index and a composite index for each country. From that data, we can see which, if any, of the top 10 economies are in a recession. We can also see if these economies are accelerating or decelerating.

Only three of the top 10 economies are in a recession if we use a value below 50 on Markit's Composite PMI Indices as our definition of "recession". Those three are Brazil, China and Russia. Since China is the second largest economy on earth, that does give us reason for concern. However, it's not strange at all to see two or three, or even four of the world's largest economies in a recession as per Markit's indices. In June of 2013, four of these countries had sub-50 readings and several more were close. But we did not hear about a "global recession" back then; we simply heard that Europe was probably in a recession. That may have been true, but Germany was relatively strong, so we didn't get much of that story affecting our markets in the US.

What investors are more concerned with, though, is the trend these economies are experiencing – are they accelerating or decelerating? As it turns out, this is a little more distressing. Five of the ten largest economies have Markit Composite Indices below their 12-month trend.

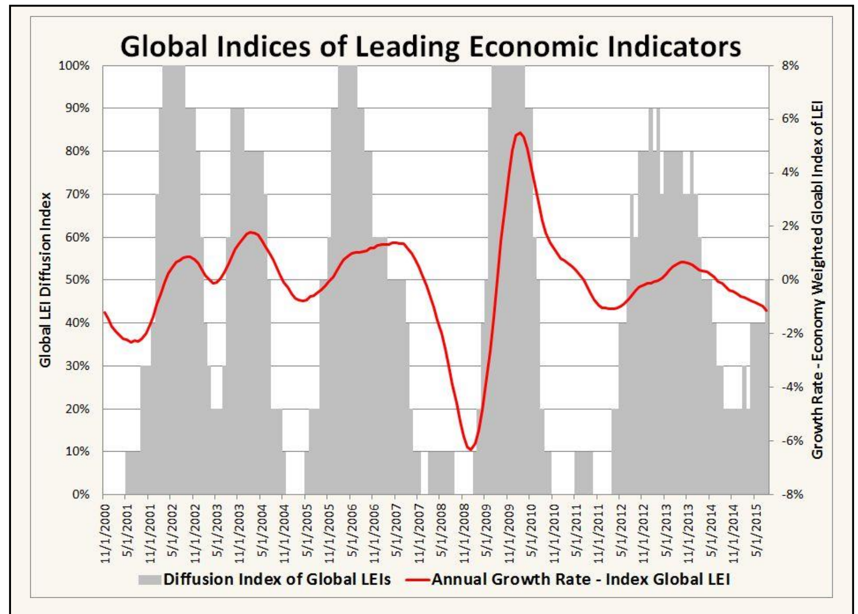


This is a volatile indicator, but since October 2014, only one month was above 50%. That means that since last October, there was only one month were more than 5 of the top 10 global economies were growing above trend, or accelerating. And the countries not accelerating were decelerating.

But these types of diffusion indices, like the ones Markit and the Institute for Supply Management (ISM) produce ever month, are *coincident* indicators. That is, they are coincident to the economy. They tell you what is going on now. Of more importance to investors are the *leading* indicators. Leading indicators tell you what to expect over the next 12 months. They are not infallible, but they almost always get the direction right within a reasonable period of time.

We can use OECD (Organization for Economic Cooperation and Development) data on country-specific indices of leading economic indicators to construct a "master index" of the top 10 global economies' leading indices, and weight them according to their contribution to the global economy. We can also construct a diffusion index that will tell us how many of the ten largest economies have leading indicators growing faster than average – i.e., accelerating. The chart below shows both.

Currently, the master index is "growing" at a negative rate, roughly -1% annually. That's a 72-month low and that's not good. Worse, perhaps, is the fact that it's now been negative for 11 consecutive months. On the bright side, the growth rate is not deeply negative, at least not yet. The last time our master index was growing at a similarly negative rate (but slightly better) was three years ago, and we did not have a global recession – just weak growth. Also, the fact that the diffusion index is at 50% and moving in the right direction is somewhat encouraging. This means that five of the top ten economies are seeing their leading economic indicators growing faster than average. Those countries, by the way, are France, Germany, India, Japan and Italy. Unfortunately, not shown on the chart, six countries have leading indicator growth rates that are negative and two of those belong to the US and China – the two largest global economies. Russia and China look the worst, however.



Janet Yellen and the Fed did not raise rates in September as many expected. That's because the global economy, and the US economy specifically, probably could not have handled it. They are just too weak. Over the long run, investment asset classes reflect real economic value – not central bank monetary policy. Therefore, it's very important to know the position of the global economy in its cycle. And judging from global leading indicators, we should be aware of the chances of a global recession. While that does not seem imminent currently, it certainly warrants our attention because economies weaken first before recessing and the global economy is weakening.

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	-2.64%	-6.74%	-2.65%	14.18%	68.25%
Dow Jones Corporate Bond Index	0.71%	-0.01%	2.40%	9.15%	25.74%
US Dollar Index	0.66%	6.47%	12.13%	20.11%	22.56%
Gold, per ounce	-1.71%	-5.81%	-7.82%	-16.08%	-14.90%
CRB Commodities Index	-4.12%	-15.74%	-30.44%	-32.14%	-32.45%
MSCI US REIT Index	2.45%	-6.88%	5.30%	14.56%	45.43%
BONY Mellon Emerging Market Stock Index	-4.88%	-21.37%	-27.99%	-23.67%	-37.00%
Oil, West Texas Intermediate per barrel	-5.86%	-15.58%	-50.35%	-55.68%	-43.30%
10-Year US Treasury Note Price	0.98%	1.64%	3.39%	2.10%	1.85%
10-Year US Treasury Note Yield, in basis points	-15.00	-11.00	-46.00	-58.00	-47.00

It all starts with money and its value. In September, the US Dollar Index increased by 2/3 of 1% in large part on the back of euro weakness, even as the Fed's decision to do nothing at its September 17 meeting should have been bearish for the dollar relative to the euro. That same decision rippled throughout every asset class. Interest rates fell on the 10-year Treasury from 2.21% to 2.06% therefore catapulting Treasury note prices higher by almost 1% and corporate bonds higher by almost ¾ of 1%. Interestingly, only the dollar, both types of bonds (Treasury and corporate) and REITs are higher this month of the nine asset classes we track. Both types of bonds and the US dollar are also the best performers year-to-date.

When the dollar is up, we expect things priced in dollars to move down. Gold, oil and the broader commodities index were lower in September by 1.7%, 5.9% and 4.1% respectively. These three asset classes are lower over every timeframe included in the chart.

REITs were up almost 2.5% in September and are only one of four asset classes up over the last 12 months (the other three being government and corporate bonds and the US dollar). The S&P 500 was down about 2.6% and is now down year-to-date and over the last 12 months. We haven't seen that in a while. Emerging market stocks are one of the worst performing assets over just about any timeframe. Only oil and commodities have performed worse over the last 12 months. Much of the pain coming from emerging markets has been tied to a strong US dollar.

All Weather Growth Portfolio

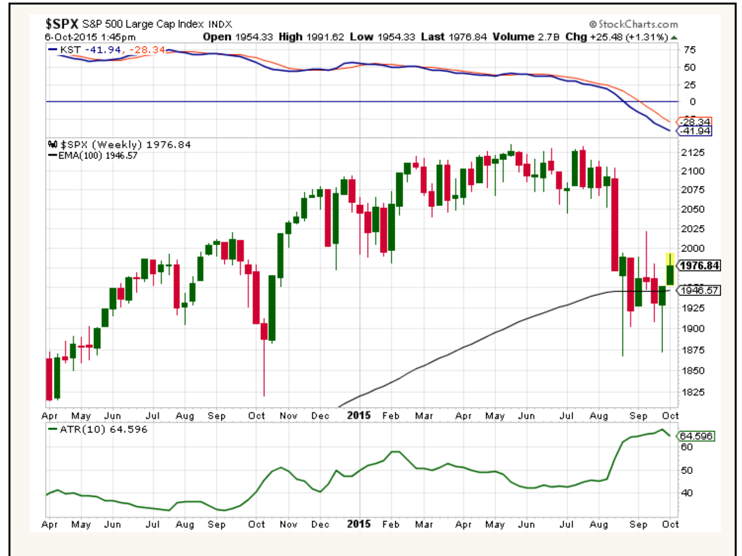
The All-Weather Growth Portfolio (AWGP) is the embodiment of BLW's core investment philosophy: (1) A portfolio of active, dynamic systems controls portfolio risk more effectively than buy-and-hold, (2) extreme diversification is necessary to reduce portfolio drawdown to an acceptably low level, (3) timing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

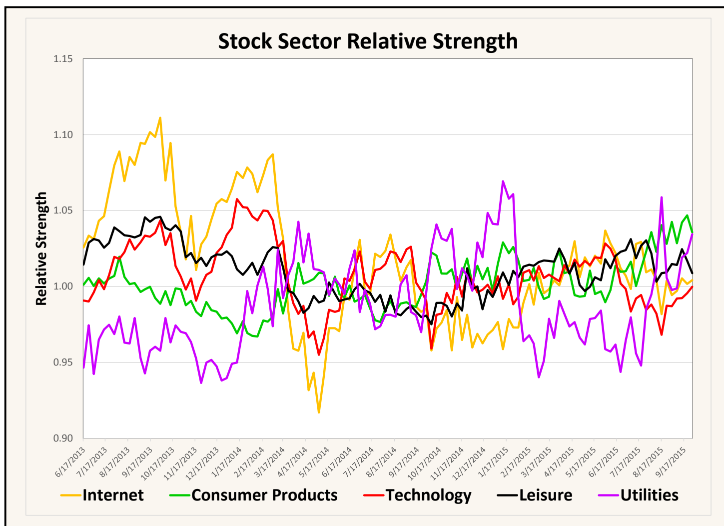
There were several changes made to the AWGP in the month of September. At the beginning of the month, we sold the equity exposure we had to the banking and consumer products sectors and replaced them with healthcare and internet. We also exited our long high yield position and went short. We covered our short in real estate and we initiated a short position in gold. Our positions as of the end of September are shown in the following chart.

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

U.S. STOCK MARKET:

Look at the last bar on the chart to the right. That's the stock market jumping on news that September jobs data was horrific across the board. The feeling is that the economy is so bad that the Fed dare not raise interest rates any time soon. And while that may force many speculators to cover their short positions, adding to what appears to be buying, we're also moving into Q3 earnings season. Current expectations are so low that it should be easy for most companies to meet or beat expectations. If they do not, we may see weakness again.





STOCK SECTORS:

There are only four sectors with greater relative strength than the broader market: Consumer Products, Utilities, Leisure, and Internet. Utilities, because they have a decent inverse relationship with interest rates, spent most of the year to date under pressure. Many expected the fed to raise rates, and when they did not, the sector has regained the love it lost in late 2014 and early 2015. It's been a while since it's been one of the better performing sectors.

REAL ESTATE INVESTMENT TRUSTS:

Like most interest rate-sensitive sectors, REITs have spent the majority of the year selling off. And while the portfolio currently has this position allocated to cash, we closed a short position on it last month. It may very well turn into a long candidate again shortly, but there may have to be more evidence that the US economy is growing weakly for that to occur. That would ensure a low rate environment coupled with enough economic growth to keep REIT-held space fully rented up, at rising lease rates.

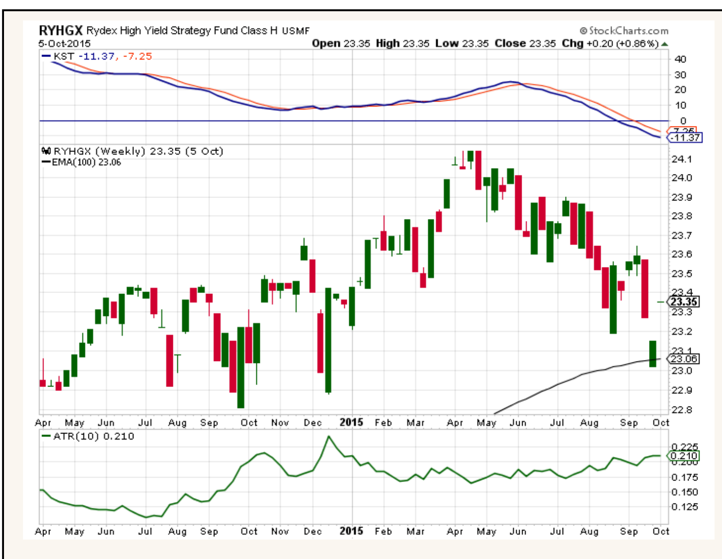
Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday afternoon at 5:35 on Greg Knapp's radio show, *The Greg Knapp Experience* on the same stations.

GOLD: Gold is in a pronounced down-trend courtesy of a strong dollar and fears of rising interest rates. Neither conditions is very conducive to gold price appreciation. However, now that the Fed seems to be off its rate-hiking schedule, gold may find a bid. Unfortunately, as long as the economy keeps its head above water, stocks will also catch a bid - normally bearish for gold.

U.S. DOLLAR: The big move in the dollar is behind it. Markets have been discounting the Fed's inability to raise rates for the better part of 2015. So when the news hit that the one thing that's made the dollar look so much better than other currencies – higher interest rates – would not be coming to fruition in September, there was a knee-jerk reaction lower, which was soon recovered. The fact is that the US economy is still stronger than both Europe and Japan, the two highest weighted currencies in the US Dollar Index. Those economic realities seem to have set in.

HIGH YIELD BONDS: High yield bonds are under pressure right now mainly because the shale oil space, which issued a ton of low-grade bonds, is under duress. Low oil prices are hurting that sector's ability to make interest and principal payments in a timely fashion. The threat of higher interest rates also hurt these bond prices. But now that higher rates seem to be on hold, it seems like much depends on the solvency of the shale oil industry.

U.S. TREASURY BONDS: Longer-term Treasury bonds should enjoy our current environment – low economic growth and deflationary winds blowing. Still, China is an active seller of Treasuries. This sector could see a certain amount of inflow as the Fed's decision to hold off on rate hikes takes hold.



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

We were now long only 4 of the 14 income-producing asset classes as of the end of September because only 4 of the 14 asset classes we track for this portfolio were not in downtrends going into October.

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	$2.238	$35.66	6.28%
Vanguard Short-Term Bond ETF	BSV	$0.088	12	$1.050	$80.39	1.31%
PowerShares International Corp Bd ETF	PICB	$0.047	12	$0.569	$25.64	2.22%
Voya Prime Rate Trust	PPR	$0.028	12	$0.336	$5.06	6.64%
SPDR Barclays Convertible Secs ETF	CWB	$0.144	12	$1.724	$44.72	3.86%
Vanguard GNMA Inv	VFIIX	$0.021	12	$0.256	$10.77	2.37%
Vanguard Long-Term Bond ETF	BLV	$0.286	12	$3.426	$89.34	3.83%
Vanguard REIT ETF	VNQ	$0.761	4	$3.045	$75.54	4.03%
PowerShares Emerging Markets Sov Dbt ETF	PCY	$0.130	12	$1.560	$27.43	5.69%
Annaly Capital Management, Inc.	NLY	$0.300	4	$1.200	$9.87	12.16%
Vanguard Dividend Appreciation ETF	VIG	$0.442	4	$1.768	$73.74	2.40%
GAMCO Global Gold, Natural Resources & Income Trust	GGN	$0.070	12	$0.840	$4.99	16.83%
Alerian MLP ETF	AMLP	$0.299	4	$1.196	$12.48	9.58%
Market Vectors Pref Secs exFincls ETF	PFXF	$0.097	12	$1.158	$19.59	5.91%
					Average	**5.94%**

*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:

Long-term bonds have probably seen their bottom for a while, but we employ a trend-following system – with an emphasis on "following." That means the trend always changes before we act. We need to get past the price damage which occurred from February through June before the trend is likely to have changed enough for us to re-enter.

SHORT-TERM BONDS:

Here's one asset class we are still long – short-term bonds. No, they don't pay much, and when they trend up, it's usually not going to set the world on fire. But it is one sector that has a positive return year-to-date, and once higher rates were taken off the table for the foreseeable future, we see that momentum has picked up.

EMERGING MARKET BONDS:

Here's another asset class we were still invested in going into October. It may be in a slightly upward tilting range, but it is paying a pretty good dividend. Right now, anyway, it makes sense to hold this asset class, which also jumped on the news that the Fed was holding off on its rate hikes.

INTERNATIONAL CORPORATE BONDS:

This sector will look like the US Dollar Index upside down because it's priced in local currencies. If the dollar resumes its uptrend and breaks out of its range, this security will likely fall further. However, if the dollar recedes, we may have an opportunity to go long here. It's been in a bit of a range (with the US Dollar Index) since early 2015, so it will not take much to shift into an investable trend.

SHORT-TERM SENIOR SECURED LOANS: Here's an asset class that we exited recently. This asset would have probably benefited from higher short-term rates, but starting in about May, as economic data in the US began to disappoint with regularity, investors started discounting the possibility that the Fed could do nothing. Ultimately, the Fed did nothing so the trend is down.

CONVERTIBLES: Admittedly, as downtrends go, this does not appear to be one with much negativity behind it. But the chart is misleading due to the big tail on the bar that reflects the mini-crash of August 24. It was actually down about 9% from its peak in June. Still, this may be one of the first asset classes to turn around as it's been in a range for about 18 months that should be relatively easy to recover from if rates stay muted.

HIGH YIELD BONDS: Junk has become an unmitigated disaster thanks to weakness in the US oil production industry. We talk about this asset class more in the AWGP section above.

GINNIE MAES: As is easy to see from the accompanying chart, GNMAs have been an area that has not sold off with the rest of fixed income securities. In fact, its total return is positive on the year as we go to press. We are invested in GNMAs currently, but unfortunately, it's only paying a little more than 10-year Treasury notes. Still, this has been a low-volatility winner for the portfolio.

REITs:

We're in cash here as one might expect looking at the chart. The only thing it has going for it technically is the spike in volatility at the bottom in August. Fundamentally, the fact that the Fed appears handcuffed in its desire to hike rates has helped recently. The "sweet spot" for this sector is a low-growth economy and a handcuffed Fed so we may see an uptrend develop here.

AGENCY-BACKED MORTAGES:

This is a sector that will benefit with lower short-term rates. It's seen its momentum turn up since it bottomed in late July. We've been long this asset class for only a couple of months but it is one of the few not in an outright downtrend. On a total return basis, it's up over 20% year to date, most of that from its fairly high dividend.

DIVIDEND-PAYING STOCKS:

The stock market has been worried about an interest rate hike for months now. But since it appears the Fed will have difficulty raising rates, given the absolutely terrible jobs report released October 2, this asset class may get a little relief with the rest of the stock market – as long as earnings reports don't disappoint. Still, this asset class has a lot of work to do to turn around its downtrend.

MASTER LIMITED PARTNERSHIPS:

Ugly. Unfairly so, perhaps, but still ugly. If we were value hunters, we'd probably be long this asset as its trading near all-time lows set in the Great Recession. And although these businesses are tangentially related to the price of oil, they are primarily involved in the piping, shipping and transport of oil, which is not a direct tie to oil prices. Only recently has production come down in the US and not even by that much. But it is in a pronounced downtrend and as trend-followers, we've not been invested here for a while.

PREFERRED STOCKS: It's a little surprising that the preferred stock space has not performed better. Yes, fears of rising rates started to grip this asset class in May and drug it into a downtrend and those fears were legitimate based on Fed-speak. But most of these securities have extremely long maturities and should therefore react more to long-term rates than short-term. We think that the weakness is due to credit (rather than interest rate) risk, but lower rates would still help this asset class.

GOLD & NATURAL RESOURCES: Gold has been in a downtrend and therefore so have the miners that produce that metal. But that sector is also one of the most beat up and disliked. Continued economic weakness may actually help this sector.

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