

Market Perspective

July 18, 2014

Is the Emperor wearing clothes? Similar to the moral of the Hans Christian Anderson story, that is the question many investors have been asking about the current stock market. Is the market really as wonderful as we are told or will the Emperor (the market) be exposed? Fueled by historically low interest rates around the globe and supported by government cash infusions, the S&P 500 has managed to rally to all-time highs despite mediocre performance from both the U.S. economy and corporate earnings. The concern is how long this can last, and what happens when all of the support is removed? To date, the Fed has proved adept at keeping things afloat. With 2014 just passing the half-way point, we wanted to illustrate what our fundamental, technical, and sentiment indicators are telling us in an environment where our tactical portfolios are “cautiously Bullish”.

When we say “cautiously Bullish” we mean that at present our indicators are not signaling that a Bear Market is at hand. As such, we have established a solid core position in the market. However, we have kept a portion of the portfolios in cash equivalents as the market has shown periodic episodes of rapidly rotating leadership so far this year.

While the press has been trumpeting an S&P 500 that is hitting new highs, the journey has not been without some turmoil along the way. After a great run in 2013, many of

the leading stock groups from last year experienced a fairly sharp correction back in March / April of this year. For example, the Biotech group corrected 24.7% in eight weeks before bouncing back and recovering most of its decline. Money was flowing from the leadership to what are perceived as the more stable stocks, keeping the indices afloat. Performing especially well were yield stocks, as we have seen in our Dividend Stock portfolios.

The current Bull Market began on March 10, 2009. The rally is now five years and four months old. That makes it the fourth longest Bull Market in the modern era since 1921 (the longest being eight years from August 1921 through September 1929). There have been 16 Bull and Bear Market Cycles over the last 93 years. These Bull Markets all began after a bottoming process, were followed with a buy-zone and then underwent a topping-process that ultimately led to a Bear Market. Given that we are well past the “buy zone” off the bottom, at this stage we are examining our indicators for signs of a top, or when it will be time to protect.

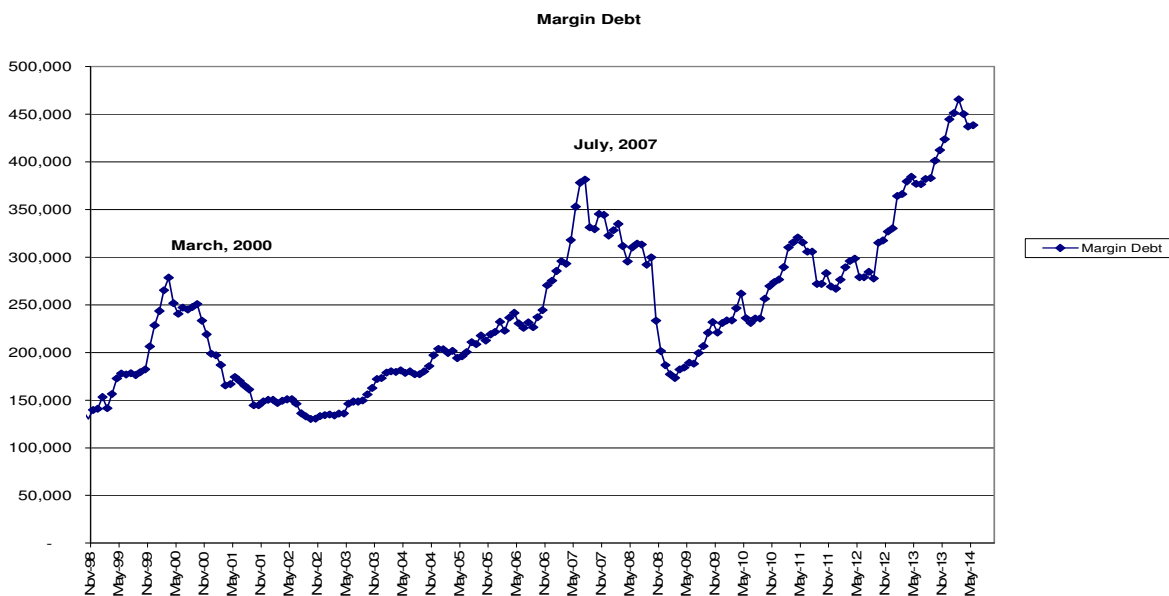
Fundamentally, the story has changed very little. The key driver has been the historically low interest rates causing a lift in asset values. No matter how bad U.S. economic fundamentals come in, the Fed’s ability to keep interest rates low works as the trump card that keeps investors in the stock market and prices moving higher. In simple terms, many investors are frustrated by the low returns on other investment alternatives, such as bonds, and feel forced into the stock market in hopes of increasing total returns. The laws of supply and demand then take hold, and with the increased demand for stocks, prices go up.

How the low interest rate support unwinds is likely the key item in answering our “is the Emperor wearing clothes” question. Removing the massive amounts of stimulus and support provided by the world’s Central Bankers without shocking equity markets is truly going to require special skill. The big concern is how violently markets may react to an actual interest rate increase, especially given how poorly it has handled even hints of them

coming. The interest rate increases could be a traumatic event in the modern world of communication. The good news for now is that all indications are for the low interest rate environment to remain for a while longer. These indications are supported by the recently released Federal Open Market Committee (FOMC) minutes illustrating that the Fed is very mindful of the effects its actions could have on markets and the economy and indicating that the Fed will look to move as tactfully as possible.

Technically, our indicators remain mostly bullish. Breadth on the NYSE has confirmed the rally and remains in an uptrend. Stocks making new 52 week lows have not picked up, and the major indices are moving away from levels of support with rising moving averages. On the flip side, volume has been light, but it has been this way for much of the rally since 2009.

On the sentiment side, one indicator that is potentially bearish is the use of Margin Debt. It has reached an extreme level. With interest rates at an historic low for so long, and with the Fed acting to support markets at any sign of trouble, speculators have felt emboldened and have pushed the use of Margin to record highs. These highs in themselves



do not necessarily mean trouble is looming, but the use of Margin Debt is high octane fuel that helps propel markets up when being added, and down when being removed. In addition, having a sentiment indicator alone reach a Bearish height would not be enough to turn us Bearish, we would want the Fundamental and Technical indicators to line up as well.

The good news, for now, is that the market is generally positive. The summer trading volume has been seasonably light, and the March/April volatility has calmed down, albeit temporarily. After taking some steps to protect during that spring volatility, we have recently added additional exposure in our tactical portfolios but are treating this market with some healthy caution. Our goals in the tactical portfolios remain the same as they have always been – *make it and keep it*. We want to err on the side of caution this late in the Bull Cycle, keeping in mind that markets move in spurts and great opportunities will come.

We indeed may be in the topping phase, but that phase can last for a long time and good money can be made along the way. Until we get the confirmed signs that a top has been reached, we continue with a cautiously bullish stance in our tactical portfolios. The Emperor has yet to be exposed, but we will keep a sharp eye on our indicators. We hope you enjoy your summer and we will update you should the environment change.

WE WILL KEEP YOU INFORMED.

CHURCHILL MANAGEMENT GROUP

** This report is meant to inform the reader of our current market opinion, which we, as professional money managers, use in our decision-making. It should be noted that stock market and bond market data are subject to varying interpretations and any one interpretation will not necessarily guarantee investment success. The information obtained from the sources specified herein and used as basis for our current market opinion is believed reliable, but we do not guarantee the accuracy of such information.

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