

On the surface, 2015 looks to have been a relatively quiet year for investors. The S&P 500 began the year at 2060 and looks to end around 2070. The benchmark 10-year U.S. Treasury bond opened at 2.17% and will end the year around 2.25% even though it began December trading at 2.15%. The greatest volatility was seen in the commodity world where gold began at \$1,135/oz. and will close the year around \$1,015 and the price of crude oil will be roughly cut in half from its 2014 closing price.

The year has been anything but boring, however, unless you enjoyed a Rip Van Winkle-like sleep in 2015. This year has been filled with warnings, corrections, panics, and rallies. There were periods where Central Banks took center stage, where concerns about China drove sentiment, and where energy stole the spotlight. Perhaps the most important factor for investors was the emergence of FANG stocks.

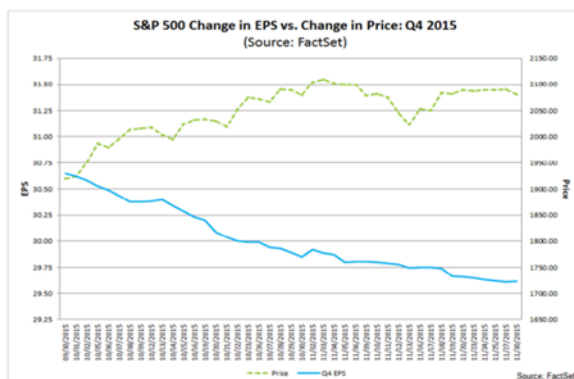
Facebook, Amazon, Netflix, and Google provided more than 100% of the market's returns in 2015. It was most pronounced on the Nasdaq where the index is currently up 5% year-to-date but would be -6% if you took out the returns from the FANG stocks. Likewise, the S&P 500's negative return in 2015 would have been worse sans the mega-stocks. These stocks may be the most popular but they are anything but a value at current prices. Amazon trades at a price-to-earnings ratio near 1,000 and Netflix at nearly 400, almost making Facebook at 88 times and Google at 36 times earnings seem like value stocks. The last time four stocks so dominated market performance was in 1999, a period investors would do well to remember.

This month's PCM Report will outline some of the key factors we are watching as we enter 2016 and include our forecast for earnings, GDP, fixed income, and stock market returns. Next month we will take time to defend our forecasts in our annual Roundtable Forum.

As the above title suggests, we believe seatbelts, if not HANS devices (head and neck support), will be needed in the coming year. When multiples expand near market peaks it leads to high levels of volatility. The S&P is trading around 22 times trailing earnings making it more than 30% above its long-term average. The median P/E of 19.5 is equally pricey, also 30% higher than average.

The chart shows the level of disconnect between earnings and stock prices in the 4th quarter, a trend that is unsustainable in our view.

In January 2015 we accurately forecasted an earnings recession that continues to put pressure on equities. All the pieces are in place for a continuation of lower earnings with now more than a 50% likelihood we will see an outright recession in 2016. The combination of a strong US dollar, contracting industrial and manufacturing activity, and plunging commodity prices will make it difficult for companies to increase earnings in 2016. This environment favors stock picking over index investing.



While the benchmark U.S. Treasury bond has traded in a narrow range, the rest of the fixed income world has seen high levels of volatility that we expect to rise even more in the new year. High yield bonds, with high levels of energy exposure, have seen a double-digit decline this year. Emerging market debt, while only modestly lower in 2015, still appears to be powder keg ready to explode. We have shifted portfolios to minimize credit risk and embrace duration risk entering 2016 with muni bonds still our largest allocation. Credit cycles generally lead the business cycle so as defaults rise and credit conditions tighten, this points to slower economic activity and heightened recession risk.

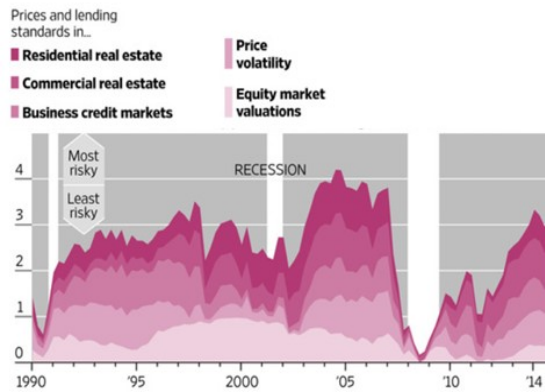
The greatest tail risks going into 2016 are also in fixed income. Emerging market debt has surged to nearly \$30T and represents more than 200% of cumulative emerging market GDP. This alone is likely unmanageable but when factoring in another 15-20% rise in the dollar against these currencies it could reach a breaking point in 2016 with massive defaults occurring. While less likely to occur but potentially more devastating to U.S. investors would be a collapse in U.S. high yield bonds as energy prices remain depressed. The closing of the nearly \$1B Third Avenue Focused Credit mutual fund to redemptions should probably be treated as a shot across the bow for high yield investors.

High volatility, low expected returns, rising defaults and a slowing economy means investors should ensure their seatbelts are tightly fastened entering 2016.

The Building of a Bubble

Asset bubbles

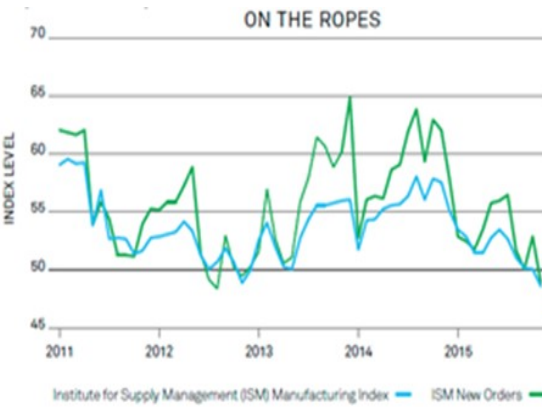
(Investor appetite for risk/high asset valuations)



Commercial real estate prices have rocketed higher, leaving many concerned that the Federal Reserve has run out of magic bullets in the event that the appreciation is forming a bubble. “Signs of valuation pressures are emerging in commercial real estate markets, where prices have been rising at a solid clip and lending standards have deteriorated, although debt growth has not yet accelerated notably,” Stanley Fischer, vice chairman of the Fed, stated in a December speech. The Wall Street Journal chart below shows that growth from heavy borrowing can precipitate recessionary pressure. The Fed is faced with the challenge of determining if it is part of the solution or part of the problem.

- U.S. commercial real estate prices are up 93% from a low in 2010. (Wall Street Journal)
- Leases for giant tower cranes from Morrow Equipment Company has grown to nearly 500 from less than 200 following the financial crisis. (Wall Street Journal)
- Esther George, President of the Kansas City Federal Reserve Bank, believes the Fed's low rate policy may have played a role in growing asset prices.

On the Ropes

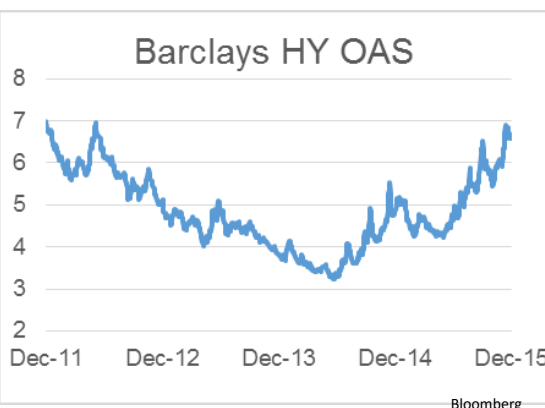


Sources: Thomson Reuters Datastream, ISM, BlackRock Investment Institute, as of 12/9/15.

A collective “Uh-Oh” was spoken when the latest Institute for Supply Management (ISM) figures were released. While both Manufacturing and New Orders components of the index have been trending lower since mid-2014, they have remained above the critical 50 level suggesting expansion; until now. The readings below 50 suggest manufacturing activity is contracting and is an ominous sign for the economy heading into 2016. Industrial activity is at the lowest level since 2009 when the economy was rising out of the global financial crisis. The New Orders component is particularly troubling because it is seen as an indicator for future conditions. These results suggest a bumpy ride for the economy in 2016.

- The strong U.S. dollar is largely to blame for the weakness as U.S. manufactured goods are less competitively priced as the dollar rises.
- In the latest reading, the PMI (purchasing managers index), New Orders, Production and Inventories all registered as contracting below the 50 level.
- The slowdown in China and plunging commodity prices create a challenging environment for manufacturing.
- There remain bright spots in the index including healthcare (medical devices) and automobiles.

The Re-pricing of High Yield



Bloomberg

The market for high yield bonds has come under pressure over the past year, mainly due heightened risk in the energy sector. The spreads on high yield bonds versus risk free Treasuries have widened to levels last seen in 2011, sending the Barclays U.S. Corporate High Yield Index down roughly -6% for the year.

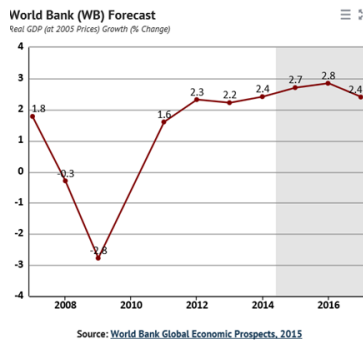
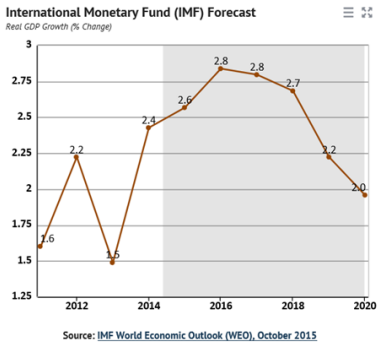
A chart of the spread on the BarClays U.S. Corporate High Yield Index suggest investors were quite complacent in June 2014, as they demanded only 300bps above Treasuries to assume the risk of default inherent with high yield bonds. In other words, the reward for assuming credit risk was not much, considering the potential downside today.

- This shift in investor behavior was no doubt driven by ultra-low yields on more traditional investment grade bonds.
- If anything, since June 2014, high yield has been repriced to more historical levels, with the spread trading around 700bps over Treasuries.
- With a starting yield of roughly 6.6%, high yield could deliver compelling returns for 2016, barring any default cycle stemming from the energy sector.

Macro View— GDP In Focus

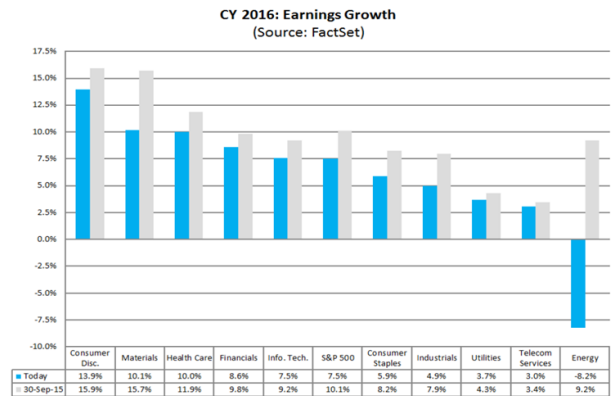
Peak Capital projects U.S. GDP growth in 2016 to come in at 1.7%. This is indicative of a slowing U.S. economy plagued by the ravaging of the energy sector, a strengthening dollar as a result of the depreciating Euro and Yen, and the Fed raising rates. The global economy is plagued largely by a languishing Chinese economy and a Eurozone and Japanese economies that simply cannot find stable footing despite quantitative easing among their central banks.

The International Monetary Fund (IMF) is forecasting U.S. GDP in 2016 at 2.8% followed by a precipitous decline to 2.0% in 2020. The World Bank, also forecasts 2016 GDP at 2.8% followed by a less dramatic move than the IMF forecast heading in to future years. Both respected institutions are in agreement of a downward trend in economic growth for the U.S.



Taking Stock— EPS Projections

Peak Capital is estimating 2016 earnings per share for the S&P 500 at \$121. For Q1 2016, analysts are currently predicting earnings growth of .9%. For all of 2016, analysts are projecting earnings (7.5%) and revenues (4.3%) to increase year-over-year. The Factset chart below shows earnings growth across every sector and the broad market have been revised down since September of 2015. The chart also show that analysts consensus is in favor of consumer discretionary, materials, health care, and financials while energy, telecommunication services, and utilities will struggle in earnings growth. This is consistent with insight provided from PCM following the Fed rate hike in December, stating that equity winners in a rising rate environment include the insurance sector, regional banks, and healthcare companies.



Fixed Income— Divergent Paths

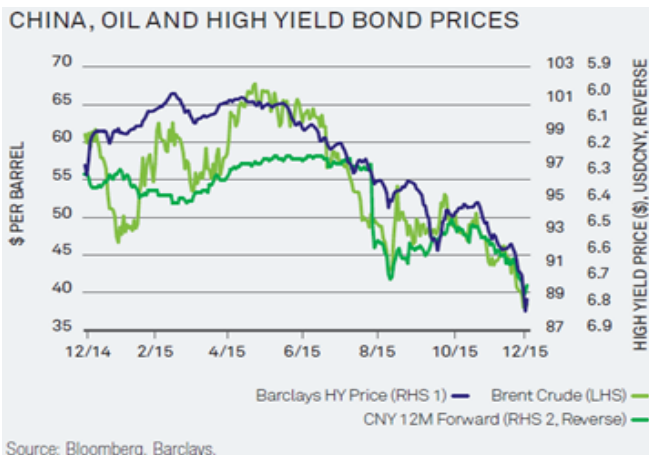
Bonds are likely to follow the least homogenous path we have seen since the recession of 2008/2009. The only interest rate we forecast entering 2016 is the yield on the 10-year Treasury that we believe will close the year at 2.30%; essentially unchanged from the current level.

We suggest we are in the early stages of a default cycle that typically takes 3 to 4 years to play out. Based on our forecast for oil prices, a default rate of nearly 50% is likely for high yield bonds specifically tied to the energy sector. Defaults doubled in 2015 from 2014 levels and we expect that to repeat with 2016 twice last year's default rate. Success navigating the bond market will be the ability to manage credit risk and courage to add duration in the face of rising rates.

Technical— Where are the Speculators

Technical analysis, at its core, is about gauging market sentiment. Successful technicians are typically determined by their ability to identify which charts are most indicative of investor psychology at any given point in time. Charts that worked in the past to identify market tops or bottoms often do not yield the same results in the next cycle.

Margin debt may be an exception to the rule. There have been 3 bear markets in the last 25 years and each time there was a noticeable peak in margin debt that precipitated a market decline. The dramatic top in March 2015 suggests to us the market has hit a cycle high. It is also ominous that recessions have often followed a collapse in margin debt.



Investing in a Rising Rate Environment

Clint Pekrul, CFA

With the Fed's decision to raise short-term rates in December, investors should consider how to position their portfolios accordingly.

There are many investment options, and some will withstand the effects of rising rates more than others. While the frequency and magnitude of the Fed's interest rate policy is uncertain, the longer-term path seems to be higher.

For now the Fed is decoupling from zero. Longer-term, the Fed's policy will likely be driven more by inflation expectations.

The Winners

At the top of the list are investments that adjust their cash flows (i.e. coupons) based on movements in short-term rates, and are commonly referred to as floating rate bonds.

Table 1	Potential winners when Fed is tightening (i.e. rising interest rates)
Floating Rate and Bank Loans	Adjustable coupons with short duration of less than one year; typically offer lower yields and are exposed to credit risk
TIPs and REITs	Real return protection against inflation; potentially higher volatility
Financial Sector Equities	Dividend growth and benefit from higher interest rate spreads; potentially higher volatility
High Yield Bonds	Higher yielding bonds generally have less interest rate sensitivity (duration); exposed to credit risk

These securities typically have short durations (i.e. less than one year) and are issued by corporations. Investors might consider hedging a longer duration portfolio with a dedicated allocation to floating rate bonds. This combination would effectively shorten the duration of the total portfolio.

Likewise, high yield bonds generally do not have the same sensitivity to duration as investment grade bonds or Treasuries. Bonds with higher coupons tend to absorb the impact of rising rates better than lower yielding securities.

Of course, investors must be mindful of the credit risk associated with high yield bonds, or floating rate bonds issued by corporations. Likewise, short duration investments will eat into income as these securities have fairly low yields.

While not an issue at the forefront today, inflation, or more specifically, a rise in inflation expectations, will tend to drive the Fed's interest rate policy higher.

Treasury Inflation Protection Securities, or TIPs, adjust their principal values based on changes in CPI. Likewise, Real Estate Investment Trusts, or REITs, can provide variable cash flows linked to rising rents.

Real return assets such as TIPs and REITs can provide rising cash flows that keep pace with inflation, which would likely correspond to tightening Fed policy.

However, these assets can be quite volatile, particularly when the Fed is just lifting off from a zero interest rate policy with inflation expectations fairly muted.

Lastly, dividend paying stocks in the financial sector could provide compelling returns in a rising rate environment, as this sector should benefit from higher interest rate spreads.

The Losers

Obviously, investments with 1) low current yields and 2) long duration will likely do poorly in a rising rate environment. The best example today is U.S. Treasuries, which are trading at historically low yields due to high investor demand.

If longer-term rates were to spike suddenly (think the Taper Tantrum of 2013), then Treasury bond funds would feel the brunt of the pain. However, for longer-term investors, this decline would be made up over time as higher yielding bonds would gradually replace lower yielding issues.

Table 2	Potential losers when Fed is tightening (i.e. rising interest rates)
Long Duration/ Lower Yield	More susceptible to interest rate risk; potential for meaningful principal reduction

Final Thoughts

In the short-term, floating rate bonds with limited duration should provide the greatest defense as the Fed lifts off from zero.

For the longer term, however, investors might consider additional exposures, such as REITs, TIPs, high yield bonds and certain dividend paying stocks

Q: What investment will be a positive surprise in 2016?



There are a couple of ways to answer this question. In terms of the consensus expectations for 2016, I think the 30-year U.S. Treasury could drop below the 2.50% level if we encounter a recession this year. This would generate double-digit returns on the long bond, something that would surprise the majority of market participants in light of the Fed in a rate hike cycle. Similarly, long duration A-rated municipal bonds could perform extremely well in 2016 as a flattening of the yield curve takes place and spreads between muni's and treasuries narrow.

Because my forecast is for the economy to slow, bonds outperforming stocks this year would not be a surprise to me. If I were to pick an investment theme that would be a surprise to my macro outlook it would be Japanese small cap stocks. The political will for Abenomics remains strong and with China very likely to step up efforts to weaken the Yuan, Japan may even intensify quantitative easing measures. Recent changes in the Government Pension Investment Fund (GPIF), cutting bond holdings in half and increasing equity exposure is being replicated by large Japanese institutions. Valuations on small caps are relatively attractive and could see strong flows driving prices higher.



Contrary to the prevailing sentiment today, long-term Treasuries and high-yield could provide surprise returns to the upside in 2016.

The Fed decoupled the front end of the curve from zero in December, but since then, we've seen a flattening of the yield curve. The bond market is not pricing in any meaningful shift in inflation expectations longer-term, but the Fed felt conditions were right to lift off from zero.

Both predictions can't be right. There's a growing concern that global growth will indeed be slower, or at least stagnate, in 2016, which could give way to an inverted yield curve. In this scenario, longer-term rates may remain unchanged (while shorter-term rates rise), or even fall back to a 2% level. Duration would then be a profitable trade.

Barring any default cycle stemming from the energy sector, high yield bonds could provide attractive returns in 2016 as well. We could argue that high yield was very expensive in 2014 (spreads were only 300bps), but is now priced more attractively (spreads are now at 700bps). The best predictor of future returns is the beginning yield, so 7% is not a bad starting point, and certainly cheaper than a year ago.

Q: What do you think of smart beta?



I am much fonder of the concept of smart beta than the name.

I was introduced to smart beta by Rob Arnott of Research Affiliates when he was still doing the research on what became Fundamental Indexation. Rob's efforts to identify alternative weightings for constructing indices rather than the traditional market cap weighted was originally dismissed by most in the investment management world. That is no longer the case today and his work laid the foundation for popular strategies like Factor-Based investing that we utilize extensively at Peak Capital.

Smart beta, or Intelligent Indexing as PowerShares often refers to, is far more prevalent with equities than it is with fixed income. Most bond indices used today provide the greatest weighting to the most indebted; a strategy that should cause investors to scratch their heads. Developing fixed income indices that weight holdings based on fundamental factors such as debt ratio coverage or debt-to-equity ratios make a lot of sense.

There are still going to be periods, like today with the FANG stocks, when old-fashioned market cap weighted indices provide the highest returns. However, I am convinced that the most attractive risk-adjusted returns over longer periods of time will involve some form of smart beta.



I like the idea of weighting your holdings using something other than market capitalization. When weighting by market cap, you can inadvertently push yourself into a concentrated handful of names.

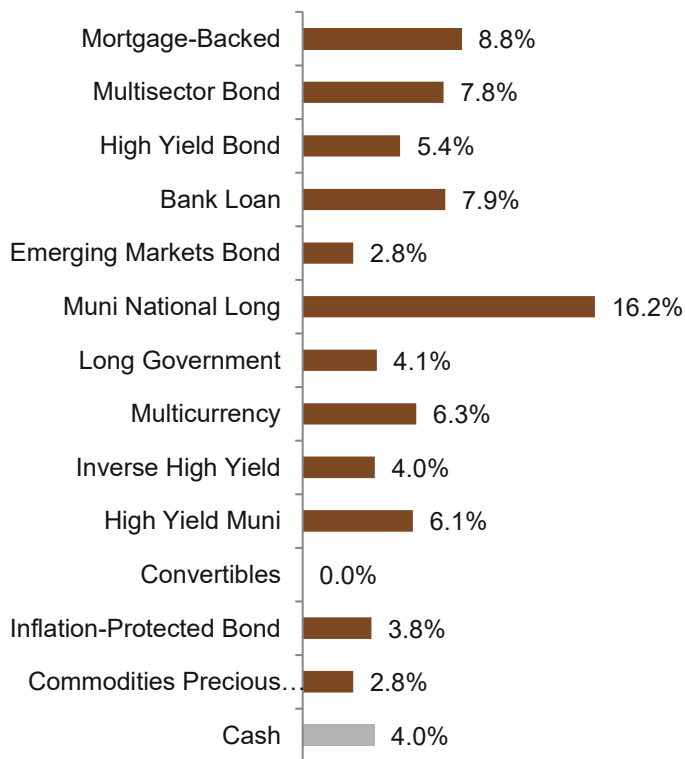
Think late 1999 with technology, or going into 2007 with financials and energy. Today, we have the S&P 500 dominated by the "FANGs" – Facebook, Apple, Netflix and Google.

What tends to happen is that you get incredible risk concentrations in just a few names. This is fine so long as they keep their momentum going. But when it stops, they tend to correlate to the downside, and the entire index is dragged down with it.

Our view is to balance risk more appropriately using different factors, and make sure to avoid overly concentrated positions, and I think this is what smart beta can provide.

Fixed Income

Segment Exposures

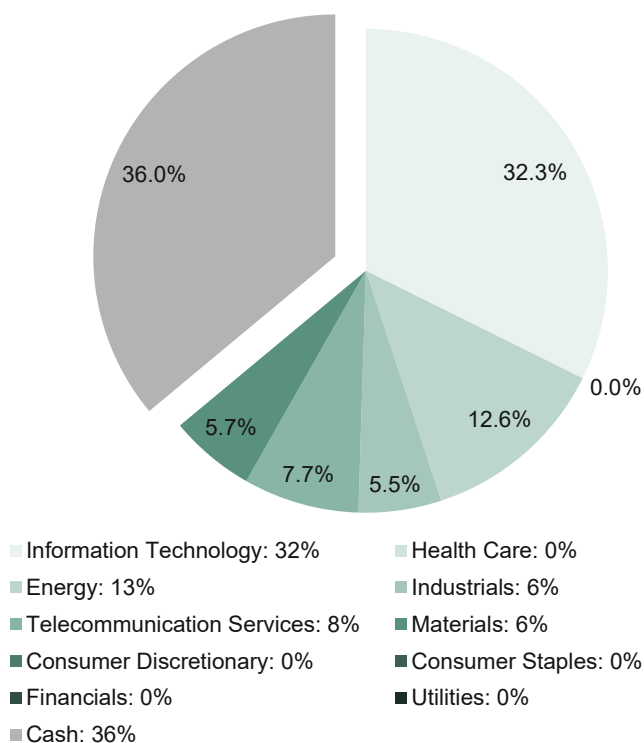


As of 12/31/2015

- Portfolio increased the overweight to Muni bonds in light of the favorable yield per unit of risk ratio in the muni sector.
- We continue to focus on raising the credit quality in the portfolio with essentially zero net exposure to the high yield sector.
- We anticipate a spike in default rates centered on high yield but including several emerging markets as well.
- Actively managed asset-backed fixed income ETF's and closed-end funds should outperform broad fixed income indices in 2016

Equity

Sector Exposures



As of 12/31/2015

- In light of higher anticipated volatility we increased our cash hedge position to 45% of the portfolio.
- We remain focused on companies with high quality earnings that are demonstrating both top line revenue growth and earnings growth.
- High multiple FANG stocks continue to be avoided in the portfolio as we see them trading at unsustainable levels.
- Financials and Insurance companies are favorably positioned if the Fed is able to continue policy normalization.

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