Churchill Management Group

Market Perspective

August 30, 2017

Despite endless political banter, geo-political concerns over North Korea, discussions of rate hikes, and worries over economic growth, the stock market has continued to edge higher. The bottom of the last Bear Market was back on March 9, 2009, making this the longest running Bull Market going back to 1921.

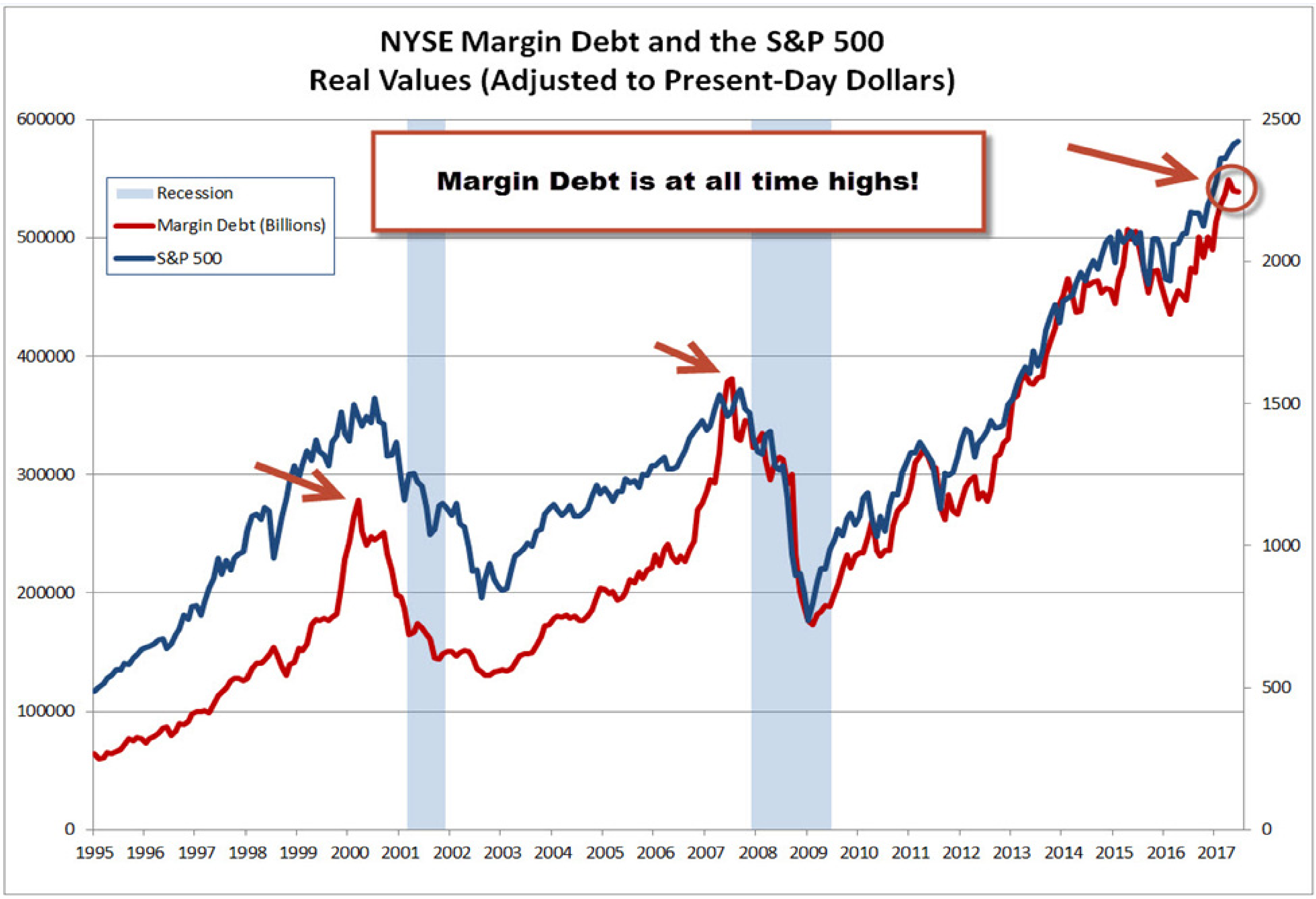
Not only has this market marched higher and longer, but it has done so with historically low volatility. This year, market volatility collapsed to its lowest level since 1993. Investors have been shrugging off any economic apprehensions, making the market appear bullet proof. Given the above concerns, it has certainly been a good year thus far in the stock markets.

Driving the market higher has been a combination of an improving outlook for better economic times, a pretty solid report card from corporate earnings, and the fact that investors don't have a multitude of other options given very low interest rates and expensive real estate. To date, we have been participating in the market's run for the year. And while sending mixed signals, our indicators are not yet Bearish, allowing us to keep a higher percent invested in our tactical strategies.

Fundamentally, corporate earnings have had a nice rebound after struggling for most of 2015-2016. The increased earnings have not translated to strong growth in the broad U.S. economy, though we did get a better than expected 3% GDP growth number for Q2. Additionally, consumer and business optimism have been on the rise while low interest rates have continued to attract money toward stocks though it has also stretched valuations.

Technically, the internals of the market remain healthy. The breadth on the NYSE (the advanced/decline line) confirmed the most recent highs in the major indices, and the leaders continue to hold up well. There are some preliminary concerns over the New Highs indicator failing to confirm the major indices and the lag in the Small Caps vs the Large Cap names. But overall, the technicals are positive.

On the sentiment side, this 'teflon market' appears to have led to investor complacency creeping higher. The investing public is heavily on margin (borrowing money to make money) like it was in 1929, 2000 and prior to the 2007 Bear Market. We are seeing even more margin being used than the peak in October of 2007 that led to the biggest bear market since 1929. We know that even investment advisors are largely bullish to an extreme. When the public's use of margin is at such an extreme and the professionals are also bullish to an extreme it is an orange warning light.



It is easy to get caught up in the short term euphoria and hope this positive market lasts forever. But while we are participating in this market, we are also cognizant of some of the longer term concerns that are plaguing the environment.

The most prevalent problem is the underlying secular theme that inflation has no staying power and deflationary forces are preventing prices and economies from thriving. Just as the stock markets ebb in cycles, so do the inflationary and deflationary cycles. We are currently in the deflationary part of the cycle and that is putting pressure on a large part of the world.

Recent technological breakthroughs are playing a large role in the current deflationary cycle which is similar to the Industrial Revolution. The late 19th century Industrial Revolution brought about the automobile, radio, telephone, and airplanes which ironically played a role to set up the Great Depression. That revolution pushed the supply of needed goods and services to an extreme.

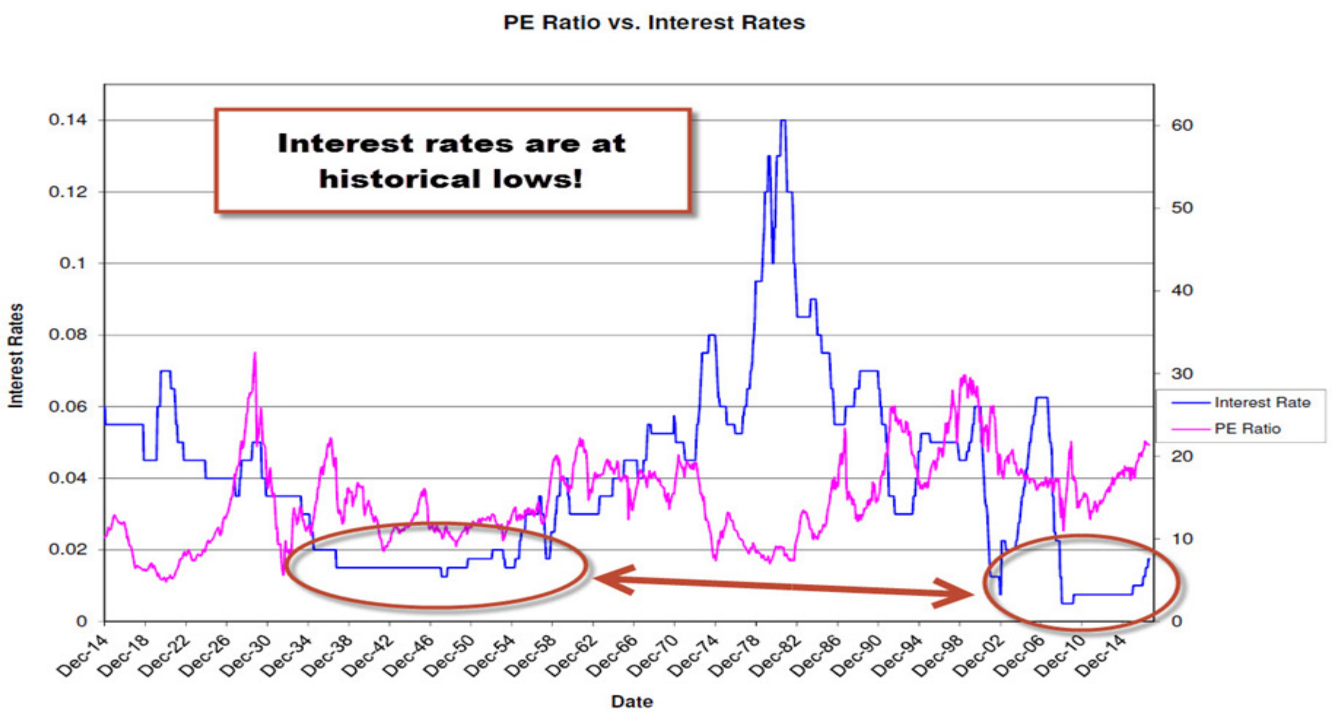
Today, fracking and horizontal drilling technology have created severe deflation in the Oil Industry while electric cars are crimping demand for oil and gas. Amazon has single handedly put the retail brick and mortar industry on high alert. While luxury stores and restaurants have held up well, reports estimate U.S. retailers must eliminate 1 million square feet of brick-and-mortar space just to grow their sales per square foot back to where it was a decade ago. On top of this, robotics and machine learning are displacing swaths of manufacturing and low end jobs around the world. While technological enhancements are great and increase efficiency, they are inherently deflationary for economies and we are seeing this in full effect today.

Central Banks around the world have been working for years to avoid a deflationary spiral like the 1930’s. However, we know that not even the greatest monetary experiment of all time in Quantitative Easing has been able to prop up inflation. To keep demand up, Central Banks have cut interest rates to a dramatic low level just like what happened in the late 1930’s and 1940’s. The low interest rates have pushed Fixed Income investors into the Stock Market as those investors chase yield to avoid losing purchasing power. This has resulted in excess demand for stocks that have pushed stock prices and their valuations higher. Will this cycle lead to a Bubble and a crash? Hopefully not.

Churchill Management Group

Market Perspective

August 30, 2017



Churchill Management Group - Research #29
Past performance is no guarantee of future results

As of 8/1/2017

We have a number of charts in our Chartroom at Churchill that help us address the fundamental, technical and sentiment indicators that are necessary when attempting to identify high risk markets, allowing us to get more defensive or even bearish to an extreme in the tactical portion or our client's portfolios. We are not seeing enough signals to tell us to get overly defensive just yet and, fortunately, the areas of leadership in which we are exposed are doing well. Like we have done for over 50 years, our goal is to reduce market exposure and preserve capital in times of perceived high risk for the majority of our clients that have chosen a tactical approach as part of their investment plan. Likewise, we aim to get defensive in our fully invested strategies when our indicators dictate us to do so.

We will keep you informed.

Churchill Management Group