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Update and MCS Q3 Outlook

“Where’s the beef”

The continued path of US and Global fundamental and economic data, remind us of the Wendy’s hamburger commercial featuring a little old lady shouting, **“Where’s the beef?” Very few of the US economic and fundamental numbers have much substance thus one has to wonder how long will this illusion continue?** The size of fast food hamburgers, cereals and other food packaging are beginning to shrink just like economic numbers and S&P 500 company earnings and revenue. With the continued exit of the Federal Reserve from the loose monetary policy- other changes are already occurring in the markets; including a meandering US equity market, increasing long bond yields and possible inflation. While this situation is continuing to unfold, the cracks are evident. Our Q3 Outlook will review pertinent economic and fundamental numbers, and discuss the major markets with opportunities that will present themselves in the coming months. Distortions in the US markets will soon be coming to an end. Mal-investment is rampant, even forcing retirees into high risk or junk bonds and/or dividend stocks for yield, completely ignoring the possibility of loss of principal. MCS and many other experts see the possibility of a credit crisis on the horizon. Since the MCS philosophy and approach is tactical, protects principal and incorporates all major asset classes as potential investments, opportunities should shortly turn into investments. Exercising patience for these situations to develop has required “the patience of Job” lately, but the payoff will be well worth the wait.

Over 75% of the time, when an event occurs that causes significant harm to the stock market, the cause is either the economy or the Central Bankers. There is great concern that the next event that will impact the stock markets will be a combination of both factors. With the economy on an anemic growth trajectory, and the Central Bankers easy money policy not doing what it intended to accomplish, it is feared that excesses of liquidity in the markets- combined with slow economic growth could easily become a toxic potion. As the event unfolds, vast amounts of money can be made with very little relative risk. Those environments generally exist most of the time in the marketplace, but only when the markets are allowed to function freely without temporary distortions. We are nearing a free market once again.

Economic Situation-

The taper is progressing as expected with the June 18-19 meeting bringing the total easing for the month of June to down to $35B, on the current tapering schedule the easing will be complete in November. Thus far, Fed Chairman Janet Yelled has stuck to the script laid out at the beginning of the year and at this point in time we do not see any signs of wavering off this course. The effects of the tapering can be seen in the lackluster equity markets. To date most US equity markets are up low single digits. Interesting is the effect on the US Bond market with the flattening of the yield curve.

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GDP-The second revision of US Q1 GDP was negative at -1.0; which was then revised to a terrible -2.9% for the final revision.   Q22014 estimated GDP numbers are now between 1.8-2.3, while MCS expectations today are between 2.1-2.6 –but a healthy US GDP number is between 3.3-3.7. With the severe negative print for Q1, the rest of the year will have to be stellar to even hit the MCS numbers. The Federal Reserve has also lowered their total 2014 estimate from a range of 2.8 to 3.0, down to a lower range of 2.1 to 2.3.   Currently, the annual GDP dollar amount is $17Tplus-therefore the drastic drop in Q1 is major and significant.

Unemployment-Despite the continued drop in the unemployment numbers, there has been very little change in the labor participation rate. In the US, 18-29 year olds have a real unemployment rate of 32% and per the MCS blog post titled, "The Average Joe" on 6/12/2014,-"5.5 M workers between the ages of 35-54 have left the workforce. These jobs have been picked up by the over 55 year old crowd and have contributed to the average worker earning just $44K per year, since most of the jobs are lower paying. The over 55 crowd is using this income as a necessary supplement to pensions and/or Social Security." Read the entire blog post for additional information.

Inflation-Significant factors include both CPI and PPI which are indicating a higher inflation rate than what the Feds would like to see. Janet Yellen referred to this as "noise" in her last press conference on June 18th. We will see if it just noise, but our opinion is this cavalier attitude toward inflation could spell trouble down the road. CPI- normal is 0.2 actual 0.4. PPI is higher with a normal range of 2.1. to 2.5 and we are running at 3.6 today.

Personal Consumption Expenditure- is at a 1.5 Rate and-the Feds rely heavily on this number which generally is a lower number than the combined CPI and PPI number. They feel this number more accurately forecasts inflation, which could be a miscalculation on inflation pressure. With the updraft in the CPI and PPI in the last several months it will soon affect the PCE number in an upward way and that coupled with the stagnant growth of GDP could result in stagflation-increasing inflation with a stagnant or anemic GDP.   Most of the money printing has not made its way into the economy- (which is where the Feds wanted it to land). The banks took the money and stopped the flow –thus we have the amount of money but not the velocity of money-yet. Should all of the Central Bank printing go into the economy-it could be a major detrimental factor for inflation.

Housing- The numbers continue to come in very low. We have been reporting the economic numbers in our blog and the blog, "View Fed Meeting with Eyes Wide Open" posted on 6/17/2014 reported, "Normal housing starts are 1.4M and latest numbers are 1.001M. Building permits normally are 1.4M and latest numbers are 991K." There is nothing positive to say about a 30-35% decrease in the major housing indicators. Small increases in month to month numbers are taken out of context and are not relevant.

Consumer Spending-In April 2013 average daily consumer spending in the US was $86B per day, for April 2014 is$ 88B per day. Much of that increase can be attributed to an inflation rate which is much higher than the official inflation rate. Most of that increase is in food and fuel. This affects GDP as consumer spending is 70% of US GDP. Consumers must increase their spending if we expect any meaningful increase in GDP.

Fundamentals-

The Fundamentals of US companies continue to be relatively weak. Per our blog-"The Real Skinny on the Buyback Program part I and II-" posted May 21 and 22 reported-"US Companies have announced more than half a trillion dollars in mergers and acquisitions alone this year, and corporations have bought back $477B of their own shares, (with borrowed funds). About 80% of all S&P companies have been involved in buyback programs including Apple which has $130B in their buyback program alone, funded with debt." Total buybacks over the past few years are in the 1Trillion Dollar range. Buybacks are beginning to slow and cannot continue at this pace. We expect the buyback programs to begin slowing in the next few quarters.

Q1 earnings came in at $28.19/share on the S&P500. Companies currently continue to be overvalued based on fundamental data-primarily earnings and revenue. This scenario bodes well for increased volatility in the near term which will allow trading to occur without the threat of a sudden and severe downturn. MCS expects Q2 earnings per share on the S&P500 between $28.75 to $29.50 a share, while a consensus is $29.19 and continues to fall. We expect to see companies lowering their forward guidance in July and will report on that in our blog as earnings season unfolds.

Earnings and Earnings per Share-The MCS yearly outlook for earnings on the S&P 500 has not changed from $114 to $117, however consensus from the "other experts" has been dropping into the top of the range MCS predicted at the beginning of the year.

Revenue- increases are slight- between 1-3% YoY which is only in line with inflation. There is nominal growth but very little real growth in a macro sense in most S&P 500 companies.

The Bond Market-The yield curve continues to flatten and as reported in our last Outlook the bond spread was 182 basis points. The spread is now between 168-172 basis points which continue to be an ominous warning of problems in the economy as well as with interest rates in the future. At some point, the long end of the bond curve will have to increase and this would be the appropriate time for MCS to short the bond market. (Our apologies-tongue in cheek for this not happening yet- but it will happen on the markets schedule not the MCS schedule. Many managers have put this trade on early and were burned this year). The Fed's lowered their normal potential target for the Fed Fund Rate of 4.0 to 3.75, also not a good sign since even the optimistic Federal Reserve is anticipating slow economic growth.

Emerging Markets- are calm at the moment not moving up or down on a relative basis. At some point the volatility will return with a potential to play bounces both ways.

Developed Markets- Japan continues to pump their economy full of stimulus which is not taking hold as they would like. The monetary stimulus is huge, but has had a limited effect and at this point it is not a market we would enter. In the Eurozone-we expect the courts to rule on the legality of money printing by the European Central Bank by the end of the year. At this point it looks like the results favor a positive ruling. It appears that US stimulus will be at or near 0 when the ECB takes over printing. When this occurs, there could be an initial upward bounce on the Eurozone index, with a low risk entry point possible.

Precious Metals-Gold is still in the 1225-1340 range with no breakout yet. At this point there is no indication of a break to the upside or downside. As always it will be predicated on the factors that move precious metals; interest rates, uncertainty, currency valuation and geopolitical events.

Potential Investments and Portfolio Review 2014-

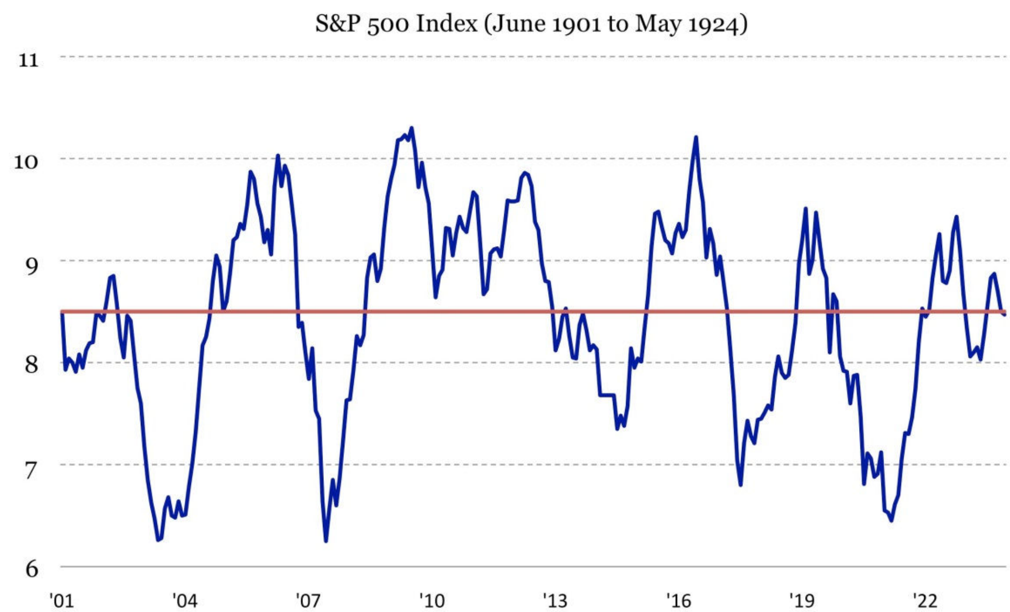
The MCS theme has not changed from our Q2 Outlook. MCS is monitoring opportunities to short the US bond market, for a long and short play in the US equity market-(upside potential during this topping process and on bounces), a long and short play in emerging markets, and a newly added opportunity based on the EU court ruling-a long play on the European indices. A precious metal play could also develop in the intermediate term.

Portfolio Review- All of our portfolios are invested in low risk instruments/mostly defensive positions (just like most tactical managers today). Factors in the US markets are becoming more aligned with the exit of the US Federal Reserve and we do not expect the portfolios to be defensively positioned in the next few quarters, but rather fully invested. The indicators are strong for entries in the next quarter.

In closing, professional investors, Central Banks, the IMF and World Bank today are all asking-"Where's the Beef?" Despite unprecedented money printing, the economic numbers are weak. Productivity needs to increase to stimulate the economy. Stock buyback programs that also assisted in levitating the US markets should be slowing, which is a major negative development. If these companies had invested the money into capital expenditures instead of buybacks, the future would be rosier. The US equity markets are positive approximately 20% since 2007 and 30% since 2000 respectfully, which result in weak annualized numbers. The likelihood of the continued disconnect of the US market from the economic and fundamental numbers is almost nonexistent. The MCS negative outlook on the US economy has been confirmed over the past two weeks through the GDP downgrades by the IMF, World Bank and even our own US Federal Reserve. This increases the likelihood a credit crisis could develop within the next 18 months. Since much of the money that has been infused into the system is leveraged, it only takes one player to begin to topple the dominos. While it is impossible to predict the exact timeframe for the next correction, the fact that the US markets have not had even a minor correction in the last couple of years favors a sooner rather than later time frame. These factors indicate more severe downturn could develop. **As** MCS **stated in our Q2 Outlook, should a credit crisis occur it could make 2008 look like a walk in the tulips before the current cycle is complete.**

As always, MCS keep's both of our goals at the forefront of our investment philosophy-protection of principal and double digit appreciation over the full investment cycle to allow our clients portfolio's protection, growth and compounding. We fully understand investors do not generally appreciate protection until they really need it and then it is usually too late. The US markets are not in a different environment –we have been in this cycle over a decade, and have had multiple complete economic cycles since the founding of our country. The topping process in the US markets will complete itself in the near-term and on its own schedule with the very best case for US markets resulting in a sideways channel for years to come (1400-2100 for the S&P) and the worst case a severe third leg down in the US equity market. The numbers favor a third leg down (75%) to the channel-(25% likelihood). A good example of a percentage channel chart is the Shiller data chart 1901-1924 below:

U.S. Stocks: June 1901 to May 1924



Source: Gerring Capital Partners, Shiller Data

Should the third leg down develop, the lows could approach the 700 range for the S&P500 yet again. We are approaching the end of a financial meltdown cycle that began in 2000, and that end will not be complete for several more years. A full economic cycle takes about 80 years, during which there are four distinct seasons approximately 20 years each in duration. We are in the final cycle (winter), which can be devastating before it is complete. Those investors that keep their capital and grow it, in real terms vs. nominal returns at the completion of the cycle are the winners. Most everyone understands that sports teams can be "ahead" at certain points in the game, but don't always win. Many don't equate that knowledge into their investing lives. Nothing illustrates this concept better than the equity, bond and real estate markets during the current economic cycle investors are all "playing" in. MCS has had many entry and exit points during the entire 14 years of this cycle and expect many more until this cycle is complete and we all move into the next phase of the cycle.

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