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The Advisor

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Latest Market Madness Shows Our 'Gambling Addiction' Runs Deep

Last year, we compared investing in the stock market to gambling on sports through websites like *FanDuel*. We believe that what has happened in the markets recently not only supports that premise but is symbolic of the fact that we, as a nation, have a gambling *addiction*.

As you probably know last month, the Federal Reserve reset short-term interest rates again for the second time in 2017, raising their benchmark rate to a range of 1–1.25 percent. The move was expected and supposedly represents a show of faith that the U.S. economy is moving in the right direction. In a statement, Fed Chairman Janet Yellen cited modest job growth and the fact that economic activity has been "rising moderately so far this year," as key motivators.[1]

That's hardly compelling data. The fact is, GDP growth actually fell in the first quarter compared to the fourth quarter of 2016, and inflation is still lagging behind the Fed's stated goal of 2 percent.[2] More importantly, long-term interest rates have not moved in accordance with the Fed's confidence or with the apparent optimism shown by Wall Street since Donald Trump's election. Although the stock market has hit new record highs multiple times since November, the bond market has mostly been flat. The 10-Year

Continued on page 2

Looking for Signals to Buy and Sell

While practiced for more than 100 years, the methods of technical analysis aren't nearly as familiar to the investing public as those of fundamental analysis. Fundamental analysis tells the company's essential story —who runs it, what it does or makes, how much money it spends, and how much and fast it earns money.

Technicals, though, sound altogether different. Instead of talking about the company, technicians focus on the statistics about the stock: how the price has changed and how many shares were bought and sold as the price changed. Their domain is lines drawn on a chart and the patterns they make, and their job is to infer where the stock price is likely to go next.

The difference between the approaches is defined by Wall Street like this: fundamental analysis tells you *what stock you should buy*, and technical analysis tells you *when to buy it*. Here are a few of the signals technicians use to make buy-and-sell recommendations.

Changes in price and volume. Technical analysis is grounded in the concept that stock prices are determined much in the way the prices of any other goods or services are set: by the relative balance of supply and demand. In the case of stocks, it's a matter of how many people are anxious to buy or sell shares at any given price point. If more people want to buy, the price will go higher; if more want to sell, the price will go down.

By looking at whether volume was higher or lower when the stock price changes, technicians can make a reasonable inference as to whether the buyers outnumbered the sellers or vice versa. Generally speaking, if volume increases on a day the price goes up, the inference is that the buyers outnumbered the sellers, and the stock price is likely to continue going higher. If the stock price rises on lower volume, the inference is that fewer and fewer people are eager to buy the stock, and the upward movement is likely to slow

Continued on page 3

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Latest Market Madness

Continued from page 1

Treasury rate did rise from 1.8 to 2.6 in the month following the election, but it hasn't gone higher since. In fact, it has not topped 2.5 since mid-March.[3] (*CNBC* said in December of 2015 that raising short-term rates wasn't going to force long-term rates to move; the 10-Year was at 2.25 at that time. So while short-term rates have gone up a whole point since then, long-term rates have barely budged.)[3]

Gambling with the Yield Curve

That's significant because it means the Fed has been pushing ahead with its commitment to raise rates despite not only a low inflation rate but also the risk of flattening the yield curve. As explained before, the yield curve is based on the differential between long-term and short-term interest rates. Banks need long-term rates to rise ahead of short-term rates in order to make lending worth their while. A flat yield curve can create a disincentive for lenders, which can cripple economic growth.

In other words, the Fed is basically *betting* on the idea that long-term rates are going to start rising, in much the same way that big investors — who've driven the stock market up 15 percent since November — are betting that Trump is going to make good on his promise of 4% annual GDP growth. They're betting that he's going to be able to pass his ambitious tax plan, health-care plan, and budget — all of which have many critics, even within the Republican party.

As we've seen time and again in this new era of artificial economics, ever since the financial crisis, our government and Wall Street have been gambling on the idea that appearances will spawn reality — that illusion can fix fundamentals. But in the end, it is gambling because they're betting on a certain outcome with no control over whether it occurs. The Fed can't force long-term rates to rise or inflation to increase, and even Wall Street's biggest investors have no real power to push Trump's tax plan through Congress. They're merely crossing their fingers and toes in hopes that these things occur and their bets pay off.

All of this is indicative of the way many Americans have been educated — or, more accurately, miseducated — about investing over the past 30 years or so. Ever since 401(k)s replaced most traditional pension plans, many people have been taught that the stock market is an investment strategy in which they have a fair amount of control.

Investing vs. Gambling

We believe that's wrong. When Warren Buffett invests in a company, he's generally buying a controlling share: a seat on the board, in other words, which gives him a level of control over that company's fate and a say in whether it succeeds or fails. The average investor, on the other hand, has no such say and no such control. Investors are usually putting money into a company in the mere *hope* that it succeeds; thus, compared to Warren Buffett, they're not investing, they're gambling.

It's an even bigger gamble if that everyday investor is putting money into mutual funds; because in that case, the investor is not only betting that the company's managers will do a good job, they're betting that the fund manager will also do a good job choosing the right companies. The further removed you are from decisions made about your money, the more you're gambling instead of investing.

That's why we continue to use *FanDuel* as a fitting analogy for explaining the difference. As sports fans, if we were to go on *FanDuel* and place a bet on the New England Patriots to win on Sunday, those goals would be aligned with those of Robert Kraft, the team's owner — because if the Patriots win, we both make money. But that's where the comparison ends. We have no control over the team, and Robert Kraft does. He's hired the coaches and the players, and he may even have a say in strategy. He's investing; but we're gambling, pure and simple, in the same way that — compared to Warren Buffett — we're gambling when we play the stock market.

By contrast, if we invest in our own business, in a house we plan to renovate, or in any financial strategy that involves contracts and assurances on behalf of the investee — those are legitimate investments. In those cases, we have transparency and a certain degree of control.

With a fixed-income strategy, for example, we may not have control over whether the total value of our investment rises or falls from month to month based on fluctuations in the market, but we have a contract assuring us that it will generate the same level of income regardless. That's a true investment compared to the gamble we take as minority-interest stockholders.

And even though the government and Wall Street have yet to break their gambling addiction, in our experience, investors at or near retirement age are breaking the habit!

[1] Gensler L. "Fed Raises Interest Rates for Second Time in 2017." *Forbes*. June 14, 2017. Retrieved from: www.forbes.com/sites/laurengensler/2017/06/14/fed-raises-rates-june/#683bdb516987

[2] *www.usinflationcalculator.com*

[3] *ycharts.com*

Looking for Signals

Continued from page 1

down or reverse.

Levels of support and resistance. These are price points where the trend in a stock price either hesitates or reverses. If the stock stops going up, it's said to be meeting resistance; and if it stops going down, it's encountering support. While this sounds like an architectural feature, in reality these points are prices in which a shift occurs in the balance of buyers and sellers.

Levels are visible on stock charts when the price goes sideways for a period of time or the price line forms peaks and valleys below and above certain levels. Technicians identify these points by looking at the chart history. Often, when a level of resistance or support is broken — especially on higher volume than the day before — the stock may seek that next price level.

Moving averages. Technicians draw lines on charts that plot moving averages of a stock's closing price. These are calculated as the average closing price over a given period of time. Among the most popular are 20-, 50-, and 200-day moving averages. They're useful in two ways: they serve as additional points of support and resistance and can be used to identify buy-and-sell signals.

For example, when a stock price crosses the 200-day moving average, a very important signal is generated. If a stock crosses its 200-day moving average from above to below, it's often taken as a sell signal, which occurs after a long downtrend that is getting worse. When the price crosses the 200-day moving average from below to above, it's often seen as buy signal — a sign that a long down trend has ended and a new up trend is beginning.

Moving Average Convergence and Divergence (MACD). This indicator is of a level of complexity above the three concepts we have just reviewed. It's a barometer of the momentum a stock's price trend has and how it changes over time. Technicians use it to forecast changes in stock trends and recognize the difference between a relatively meaningless fluctuation in a stock's price and the beginning of a meaningful new trend. Identifying new trends is another way technicians recognize buy-and-sell signals.

Interestingly, technical analysis is equally useful when analyzing stock indices as well as individual stocks. The benefit to analyzing indices is technicians can identify broad market trends. Since most stocks move in the same direction as broad indices, technicians can help investors decide when it's a good time to act on buy-or-sell signals generated on individual stock charts.

Please call if you'd like to discuss this in more detail.

Tactical Allocation and Market Timing

Your investment strategy should include a long-term plan for dividing your portfolio among the major asset classes: stocks, bonds, and cash. The term for this is strategic asset allocation, and it entails an annual review to bring your portfolio into alignment with your strategy. Over time, some asset classes perform better or worse than others, causing your actual holdings in each class to be larger and smaller than your strategy calls for.

You can resolve this discrepancy by selling off some assets that grew to be more than the plan calls for and use the proceeds to buy assets that became a smaller portion than they're supposed to be. In this way, you maintain the risk level that's needed to meet your objectives.

But there's another way to go about managing your portfolio that takes a different approach. It's called *tactical* asset allocation and involves making changes in your portfolio to take advantage of emerging up trends in one asset class and avoiding the damage a new down trend in another asset class could cause. If you're successful, you can achieve higher returns than by sticking with your strategic allocation plan.

Notice, however, the word "if." It's extremely difficult even for professional money managers to succeed in tactical asset allocation, and the consequences of being off on your timing can be devastating.

As most financial advisors tell their clients, the best portfolio returns are often achieved not by timing the market, but by how much time your money is in the market. Even though market up trends can last for months if not years, studies show that the biggest returns come in spurts of short periods of time. If you miss these spurts, you could be missing the bulk of the benefits of any upturn.

The table below illustrates the benefits of remaining in the stock market and risks of being out of it, even for relatively short periods of time. It shows returns from a portfolio entirely invested in the Standard & Poor's 500 Index for all 5,038 trading days from the first day of 1997 through the end of 2016, compared to the returns that investor would have had if he/she had been out of the market for its 5, 10, 20, and 40 best days. The differences in returns are striking.

Average Annual Total Return: 1997–2016

Invested…	
All 5,038 days	7.68%
Minus 5 best days	5.49%
Minus 10 best days	4.00%
Minus 20 best days	1.57%
Minus 40 best days	-2.42%

Source: Index Fund Advisors, 2017

What's the main message here? Your best strategy is to invest your money in a diversified portfolio, reallocating periodically to maintain your strategic balance. Need some help with your strategic asset allocation? Please call.

Business Data

Indicator	May-17	Jun-17	Jul-17	Dec-16	Jul-16
	Month-end				
Prime rate	4.00	4.25	4.25	3.75	3.50
3-month T-bill yield	0.96	1.02	1.11	0.56	0.32
10-year T-note yield	2.27	2.16	2.27	2.55	1.58
20-year T-bond yield	2.68	2.49	2.61	2.86	1.90
Dow Jones Corp.	3.04	2.99	2.96	3.17	2.54
GDP (adj. annual rate)#	+2.10	+1.20	+2.60	+2.10	+1.40

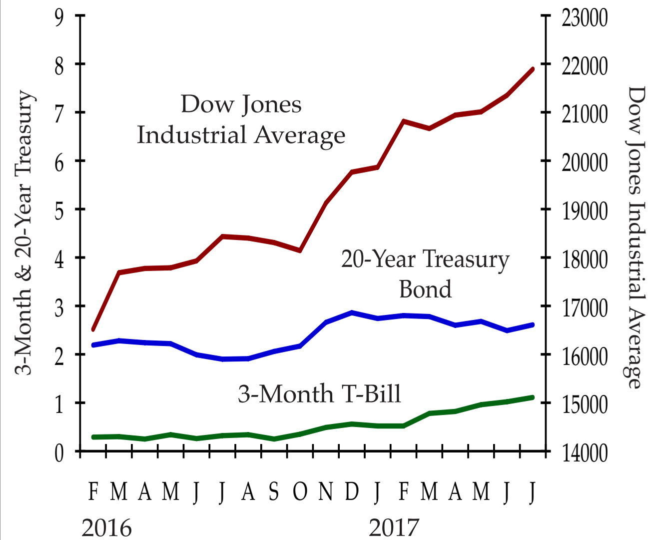
Indicator	May-17	Jun-17	Jul-17	YTD	12-Mon.
	Month-end			% Change	
Dow Jones Industrials	21008.65	21349.63	21891.12	10.8%	18.8%
Standard & Poor's 500	2411.80	2423.41	2470.30	10.3%	13.7%
Nasdaq Composite	6198.52	6140.42	6348.12	17.9%	23.0%
Gold	1266.20	1242.25	1267.55	9.4%	-5.5%
Unemployment rate@	4.40	4.30	4.40	-4.3%	-10.2%
Consumer price index@	244.50	244.70	245.00	1.5%	1.7%
Index of leading ind.@	126.60	127.00	127.80	3.1%	3.2%

— 4th, 1st, 2nd quarter @ — Apr, May, Jun Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

February 2016 to July 2017



Watching Your Stocks

No matter how often you prefer to monitor your stocks' performance, there are certain items you should consider. Here are five things to review:

- **Earnings** — Pay attention to each company's quarterly and annual earnings statements, which include comparisons with the recent past and often reviews of what management expects for the next quarter and year. Review that stock's earnings trend and how the company performs compared to analysts' estimates.
- **Price and dividends** — Follow a stock's price compared to its 52-week highs and lows. Examine its trailing total returns year to date and over the last one-, three-, five-, and 10-year periods. Look for changes in the absolute dollar amount of dividends and the current yield.
- **P/E and PEG ratios** — Price/earnings (P/E) and price/earnings to growth (PEG) ratios are often better indicators than the stock price as to how relatively expensive or cheap a stock is. The P/E ratio is useful for comparing the stock to other stocks and the market in general, while the PEG ratio is a strong indicator of whether the stock is overpriced or underpriced compared to its projected earnings growth rate over the next five years.
- **Insider transactions and stock buybacks** — A company buying back its own stock or whose senior executives and directors are accumulating more shares is a bullish sign. On the other hand, when insiders are selling off major holdings of their own stock, it's quite often an indication that the stock price has peaked.
- **Sudden and large price changes on high volume** — When a stock makes a sudden, high-volume move — particularly when it opens much higher or lower than the previous day's high or low — it can be the start of a new, long-term trend.

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