Second Quarter 2014

Clark Capital Management Group

navigator REPORT

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The Eveready Market

IT JUST KEEPS ON GOING

For those readers who are a bit older you might remember the old Timex ads which said: "Timex takes a licking and keeps on ticking." (Am I showing my age?) The same thing could be said about today's stock markets. With 94% of world markets enjoying rising 200 day moving averages (as in bull markets), it has been hard for any negative news to have an impact on this persistent advance. I am definitely not complaining as I much prefer a bull market to the other alternative as I am sure you do.

> Investment Advisor optimism is higher than in 2000 or 2007 and also higher than the peak in 1987.

So the question of the day is, and has been for quite a while "When will the inevitable correction begin" and how deep will it be? As Jim Stack of InvesTech Research says, "The remarkably persistent bull market continues….but not without developing some storm clouds." Are we going to escape this summer and defy the adage, "Sell in May and go away?" I certainly hope so because the sell in May phenomenon is more pronounced in mid-term election years As you have read here before, since 1934 the market has had a correction, in a mid-term election year, averaging 21.7% from a top during the year to a bottom later in the year usually occurring during the second and third quarters. **Will the third quarter make up for the advance so far and produce a significant correction?** As Jim Stack mentioned above, storm clouds are forming. In this Report we will look at the possibility of a significant correction in stocks, what's happening in the bond market, and whether the economy will recover from the surprising decline of – 2.9% in GDP during the first quarter.

Since I am writing this report on July 4th, I can report that the equity market achieved an all-time high on July 3rd with the

SUMMARY

Equity Markets:
The quotes below are from the two market analysts that I respect the most.

Ned Davis from Ned Davis Research says, "The market is speculative, over-believed, and overvalued. **The weight of all the market evidence is still bullish,** yet risks of a big correction are growing."

James Stack of InvesTech says **"The remarkably persistent bull market continues**…but not without developing storm clouds."

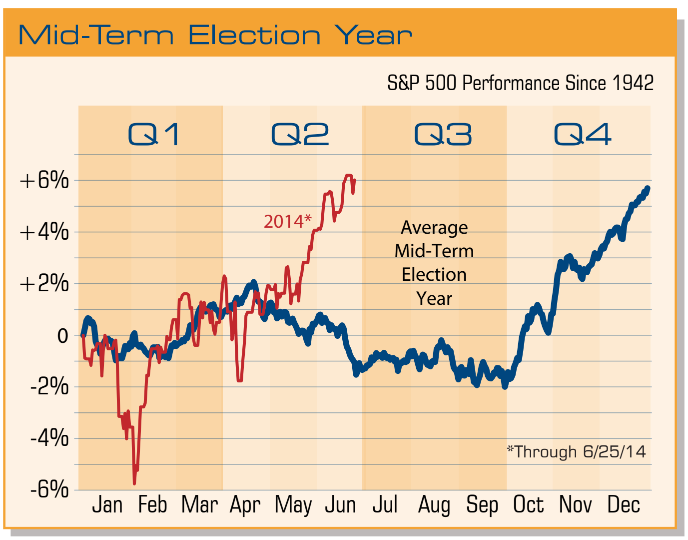
This bull is remarkable with market breadth (advancing stocks/declining stocks) soaring to new highs almost daily. Divergences that normally appear before a major correction are not present just yet. But they can develop rather quickly. Advances of over 1000 days, as we are now experiencing, are rare with this being only thefifth time since 1928. Chances are that we will have a correction in the third quarter. The question is what event will trigger a correction and how deep will it be? I believe the correction will be over -10% but will not approach bear market territory of -20% **before the usual fourth quarter rally begins.**

Bonds
The yield on the 10-year Treasury note has declined to 2.56% at the moment. It is only a matter of time until the decline in bond prices resumes and yield breaks out above the 2.50 to 3.00% trading range.

Economy
While economists are still giving very rosy predictions for the rest of the year, I believe that we will be fortunate to end the year with a GDP of 2.0% even if we can achieve a GDP growth of 3.5% for the remaining three quarters. The -2.9% GDP of the first quarter will be very hard to overcome.

Dow breaking above 17,000 and the S&P nearing 2000. The NASDAQ, which had been trailing, is also close to finally overtaking the old high made in 2000. While the S&P 500 advanced 7.1% (total return) for the first half, it was still the weakest first half since 2011. However it still bettered the median first half gain since 1928 of 5%. Bespoke Investment Group tells us that when the S&P 500 has been positive by May 13th in a mid-term year, it has gained another 8.3% on average by the end of the year. The market was up 3.43% by May13th so that suggests that we might have a reasonable gain of 11.73 % for the year.

The Chart from InvesTech shows the year so far compared to a typical mid-term election year. There was a 5.8% correction early in the year and a small one in April but otherwise this has been a very strong advance.



Source: InvesTech Research

The current advance just passed its 1,000th day since experiencing a 10% correction. **This 1,000th day advance is the fifth-longest streak without a 10% correction since 1928.** The longest, and most recent, move without a 10% correction was from July 1984 to August 1987 that spanned 1,127 days and ended in August 1987.

More storm clouds: Investors Intelligence reports that the level of bullishness among investors is the highest since 1987. While this shows the high level of optimism, I prefer to characterize it as a high level of complacency. In addition to investor confidence, consumer confidence is also running at a six-year high of 85.2. T**o top it off Investment Advisor optimism is higher than in 2000 or 2007 and also higher than the peak in 1987.** This data could mean absolutely nothing, but historically speaking, high levels of bullishness and confidence are some of the clouds that are gathering. Speculation, as measured by margin debt, is higher than in either of the last two major secular market peaks in 2000 and 2007. This could be a problem when the market starts to correct as investors selling to bring down their debt could exacerbate any decline.

Investors, in general, have their lowest allocation to equities since 1959 (as far back as data goes) at only 37.7%. This is because so many investors abandoned the equity markets following the meltdown of 2008. Everyone, retail and institutional, is sitting on their hands waiting and hoping for the good correction that they think is inevitable. This usually means that a correction, when it comes, could be milder because of all the pent up demand for stocks. A good thing to keep an eye on is the Market Volatility Index (VIX). This index is currently at a seven-year low of 10.61 In the five cases where the VIX turned up and exceeded 28.5, the world index (ACWI), which includes the U.S., has sold off 20% or more. That does not mean that the U.S. would necessarily sell off by that much as other, weaker, markets could sell off more while the U.S. sells off less.

SIMILARITIES TO 1987?

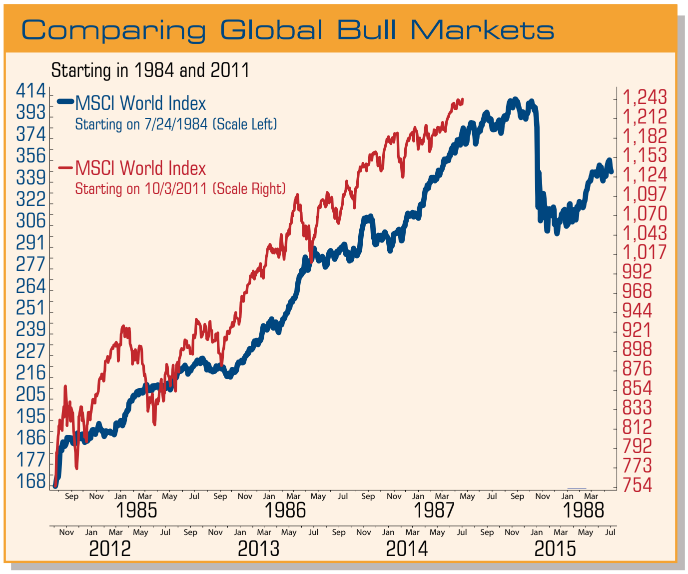
I have often been asked about the similarities of the current market advance to that of 1987. And, yes, there are several and they are striking. This data comes from Ned Davis Research.

The rally into 1987 had advanced for three years without a 10% correction and for five years without a 20% correction. Ditto to the rally of 2014.

After the secular market bottom of 1982 the market rallied smartly into the mild cyclical bear of 1983-84. Another advance followed into the 1987 top. It is the same today as the market rallied off the 2009 secular bottom into a mild bear in 2011, and then has rallied smartly ever since.

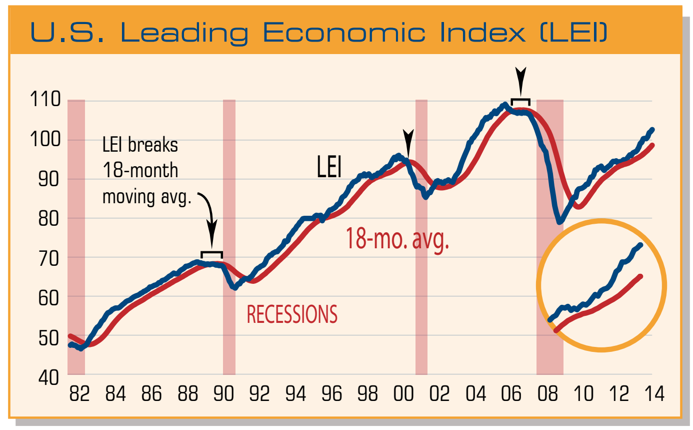
Valuations in 1987 began at a P/E of 18.9, and advanced to 22.9 by the market top. The current P/E is 18.9 and will most likely move higher as the market continues to rally.

The two big differences today compared to 1987 are bonds and the Fed. Bonds were in a bull market in 1987 as the Fed was cutting rates. We believe that bonds are on the verge of a bear market now and, of course, interest rates are about zero and the Fed is bending over backwards to be accommodative. Is this enough to break the similarities and avoid a big drop? We will have to wait and see. Chart is still scary!!



Source: InvesTech Research

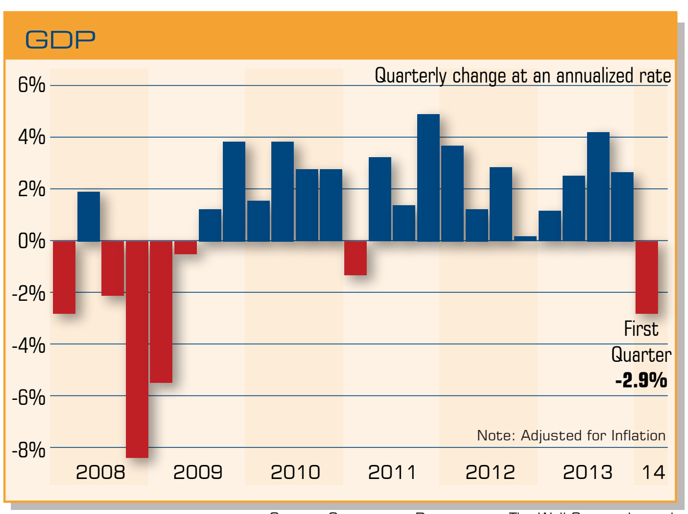
from InvesTech shows the U.S. Leading Economic Indicators. A recession has never begun until at least four months after the indicator dropped below the 18 month moving average and the average time to recession has been twelve months.



Source: InvesTech Research

THE ECONOMY AND VALUATIONS

As we all know by now, first quarter GDP took a nosedive and declined by 2.9% (see Chart). This has to bring into focus the weakness of the economic recovery since the 2009 end of the recession as this has been the slowest recovery since the depression era.



Source: Commenrce Department; The Wall Street Journal

This was the largest drop since WWII that was not part of a recession. But if we get another negative read, it will be classified as an official recession. There have been 15 other contractions in GDP of at least this magnitude since WWII. In 14 of the 15, hiring contracted along with the GDP. This time hiring was accelerating so maybe it will be a one-time phenomenon. Chart

Encouraging economic signs are:

- New home sales are at a six year high
- New home prices are up 6.6% y/y.
- The Case Shiller 20 City index is the highest since 2008
- New job openings are the highest since 2007.
- Consumer confidence is the highest since 2008.
- Industrial production has been stronger than normal during the current expansion.

In addition, **S&P 500 corporate profit margins are very near record highs at 9.44% vs the high of 9.55%** (Data goes back to 1987). Corporate earnings estimates are holding up at $29.29 for Q2 and 119.40 for 2014. The estimate for 2015 is $137.52 according to Dow Jones Indices. At 18.9 times earnings (the current multiple), the S&P 500 would be at 2,256 at the end of 2014 and 2,599 by the end of 2015.

At the present time, with the S&P 500 approaching 2000 and the Dow at 17,000, valuations are getting historically high. Warren Buffett says, "Probably the best single measure of where valuations stand at any given moment is to compare market capitalization with GDP." Since 1950 the median has been 0.65. At the market peak of 2000 the ratio was 1.55 and at the 2007 peak the ratio was 1.15. At the 1987 peak it was on the median at 0.65. **Today the number is 1.28, the second highest level since 1950. Caution is heavily advised.**

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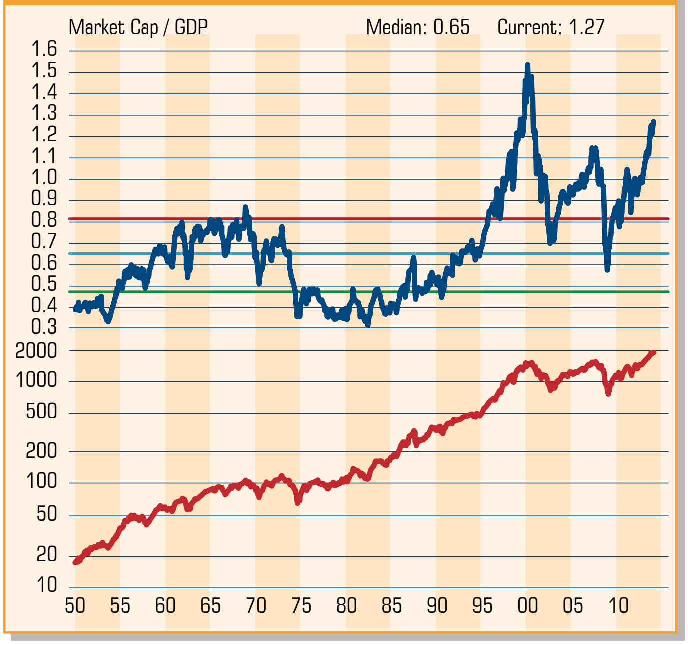
Market Capitalization to GDP



Source: Board of Governors of the Federal Reserve System and U.S.Bureau of Economic Analysis

BONDS

Bonds have been the real surprise so far this year returning 3.93% on the Barclay's Aggregate Index, 5.20% on the 7-10 yr. Treasury and 5.46% on the Barclay's High Yield Index. The consensus at the beginning of the year was for bond pricing to continue declining while rates rose, exactly the opposite of what transpired. Contributing to rising bond prices and suppressed yields was lack of new long maturity bond issue, foreign buying because of international tensions, yield differential between Europe and the U.S. and U.S. investors pouring into bond funds seeking yield. That search for yield has prompted bond fund managers to stretch maturities in an attempt to provide more yield. **We believe that this may be a disaster waiting to happen as rates will begin to rise again at some point.** The massive buying will become massive selling as the public races for the door when rates move higher and bond fund prices move lower. As a result of this chase for yield, bond fund assets have ballooned to $3.5T. Yes, Trillion!! As a comparison, the Fed's security holdings total $4.1T.

We believe that a way to avoid a potential disaster is to invest in a program of risk managed high-yield bonds. Over the past many years overall yield have spiked higher by 1% or more seven times. **As you might expect all bond types declined in value as rates increased except high-yield bonds which actually appreciated in price. While it is risky to own high-yield bonds** because they can act as equities and decline severely on occasion, we have a program that moves between high-yield bonds, high quality bonds (U.S. Treasury bonds, and Treasury Bills (cash) based on a proprietary model. This program has a nine-year track record. The program is available as a separate account (SMA) or a mutual fund. At present the model is very strongly allocated to high-yield bonds.

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