



# SENTINEL CAPITAL SOLUTIONS

## YEAR END - DOUBLE ISSUE

DECEMBER 2015

**“Toto, we’re not in Kansas anymore!”**

- Dorothy (Judy Garland), *The Wizard of Oz*, MGM, 1939.

### Then, where are we?

I am employing a famous line from this celebrated movie to send a message: we are not in the same economic and global environments that the U.S. enjoyed during the '70s, '80's and '90's. Below, I list many of the radical and unwelcomed changes that much of the developed economies have adopted ...if that's the correct term. Whether our U.S. economy has shot itself in the foot or caught a stray bullet... doesn't really matter. We'll just have to limp along with all the other war veterans. I'll call these our "headwinds", because they impede the U.S.'s progress (think: GDP growth). "Tailwinds" are those factors that enable or aid GDP growth. GDP is a nation's most vital statistic. It determines its wealth, standard of living, and future opportunities. Per the Bureau of Economic Statistics, today's rate of economic growth has slowed. Generally, I feel that 3%+ indicates a healthy pace of economic growth, a 2¼%+ to 3% denotes a so-so to decent rate of economic growth, and anything below 2¼% into negative territory signals a less than so-so stride to one that's in real trouble. While the U.S. still wins all three Olympic medals in the world GDP competition, we can't even approach the record-setting pace we commanded from the '70s through the '90s. But it's not so bad, because many other runners are laboring just to finish the race. GDP numbers are adjusted for a nation's rate of inflation, so that it can provide an apples-to-apples comparison with all other countries. That way, the GDPs from U.S., India and Brazil denote their varying rates of improvement on an impartial scale.

### The U.S. GDP – Sentinel's plusses and minuses as well as their current environment.

We believe the restraining forces of the headwinds are overwhelming the forward-push of the tailwinds ...even though some of the advances were awesome! Here we list them as we see them.

**HEADWINDS** or key changes that occurred after 2000 that are now restraining our GDP growth:

- Dramatic increases in outstanding debts, both public and private.
- Dramatic increases in spending related to healthcare & Social Security entitlements, Homeland Security & surveillance, and foreign wars.
- Lower productivity gains and loss of global market-share due to cheaper foreign labor and trade disadvantages.
- Lower total employment as well as smaller increases in the average wages and salaries.
- Rising taxes or business overhead due to greater regulation.
- Unfavorable geopolitical events.
- Lack of fiscal stimulus.
- Huge declines in oil and gas prices resulting in layoffs, unprofitable operations, defaults, and business closures.
- Highly speculative activities by Banks and Wall Street firms that resulted in losses that impaired their solvency.
- Ineffective monetary policies.
- A strong U.S. Dollar.
- Ineffectual Congress and Administration.
- Smaller advances in technology.
- Higher levels of identify theft, credit card fraud and cyber attacks on websites.
- Bernie Madoff.

**TAILWINDS** or favorable factors include:

- Massive monetary easing including the creation of \$4.3 Trillion from Quantitative Easings (QEs).
- The Fed provided a ZIRP (zero interest rate policy) environment that fostered an era of "cheap money".
- Very liberal FTC regulation that produced record M&A activities providing consolidations with huge cost savings.
- Labor saving robots.
- Huge advances in "chip" technology and software applications.
- Huge advances in healthcare technology that saves lives and extends lifetimes.
- Significant advances in aircraft and train travel.
- Significant advances in genetic seed and farming technology.
- Significant advances in personal phone, tablet and social media technology.
- Significant and plentiful advances in the leisure, entertainment and media arenas (for those who consider that an important achievement).
- Steve Jobs, Bill Gates & Bill Gross.



## Our GDP - putting it all together and looking at the consequences!

The U.S.'s annual GDP forecast for 2016 is +2¼%. Our range is +1¾% to +2½%. Yes, the mid-point exceeds the average. From 2009 to 2015, **each year's** GDP has averaged between 2% and 2½%<sup>1</sup>. During the same timeframe, the mid-point of **each** of the U.S.'s forecasts also fell within the 2%-2½% range. It's notable that all these forecasts were made and published each January. Data from the CBO indicates at least \$10 Trillion greater indebtedness than 2000.<sup>2</sup> Our huge debt-load is a "key drag" along with the war costs, mushrooming entitlements, and Homeland security related outlays. All these represent huge budget categories and all are ongoing outlays! That's a deadly combination. According to the Bank Credit Analyst (BCA Research), every economic recovery since WWII has registered at least one +3% quarterly gain (or better) before the next recession occurs.<sup>3</sup> We're still waiting! Sadly, today's GDP's pace is a shadow of its former self. As we've noted, the Headwinds won! Their negative force is stronger than the positive Tailwinds can deliver. Every time the U.S. borrows, our debt load rises. It will remain that way until we create a budgetary surplus! This is the corner that we have painted ourselves into and it gets smaller every year. Unfortunately, we are not doing a thing to rectify it!<sup>4</sup>

## Assessing at the real size of the problem and its consequences!

So, Congress has looked at this problem. In the 1990's, they fashioned laws to fund the debt (at that time) between 2014 and 2020. They played, "Kick the Can." When that date got too close, they pulled out that playbook and booted it into the 2020's. Someone should start kicking their cans! For more than 10 years, Congress has acted irresponsibly. Since 2008, the U.S. has increased its debt load by more than \$10 Trillion.<sup>5</sup> Over the last five years, more than a dozen books and numerous articles have been published by recognized experts and highly-respected economists<sup>6</sup> ...some of whom are Nobel Laureates. Virtually all those whom we've cited believe the U.S. has *already* reached the "Tipping Point" ...wherein our ability to remedy the damage has already expired. Thus, the "Tipping Point" will prevent any solution from working in time. Bloomberg tried to bring this critical issue to the public's attention. The February 24, 2011 edition of Business Week published an exposé on this matter. It was entitled "USA, Inc. Red, White and Very Blue". Its then-current data is now 5-years old. The various other studies I've seen provide estimates (of our future liabilities) that stretch from \$38 Trillion to \$96 Trillion. All assessments include future entitlements already guaranteed by law. The variance is so wide because no one uses the same assumptions: there are at least eight variables: the timeframe measured, new U.S. debt issuance with its corresponding carrying costs, demographics, lifespans, medical cost inflation, general inflation, GDP growth and tax revenues!

## The size overwhelms any reasonable solution.

Ladies and Gentlemen... where will the funds to dig us out of our hole come from? If we utilize the printing press, we only have to look at 1919-1923 Germany's history to see how that turned out. I often hear pundits say that it's size is too big to tax and too big to cut spending elsewhere... without severely hampering our GDP growth. Besides, these are ongoing payouts, not one-time expenditures. "Kicking the Can" buys time... but at what price? Yup, it's more and more debt. By now we hope you can understand why we see this threat as a real and substantial risk. The fact that the U.S. is not confronting it now, does not change the nature of the threat. We believe some level of protection is required, even though the likelihood of an abrupt, out-of-nowhere crisis is small at the present. We put that likelihood of occurrence at 10%-15%. Yet, an accident could happen in a vulnerable foreign entity... spread to others, and then here... then, the global deflation forces would have a foothold and risks would be materially higher.

## JANUARY 2016

**"Where is she in terms of what happened in Japan? Where is she in terms of commodity prices on a global basis? Where is she in terms of monetary policy on the continent of Europe? To me, she is an old-fashioned central banker and she needs to modernize her and her staff's thinking"**

- Bill Gross, former PIMCO Managing Director,  
...currently Fund Manager, Janus Capital Management, LLC,  
December 17, 2015.

## The Fed tightens!!

Yup! ...Bill is quoting himself as a valuable source in this Bloomberg's "must read" posting that appeared on December 17<sup>th</sup>. And the "she" in the quote above is Federal Reserve Bank Chair, Janet Yellen. For a long time, I've read Bill's Commentaries and found value adding content in them. He's outspoken, brilliant, ...and stubborn when he's wrong. But, I agree with those who take that view that he wouldn't have held his vaulted positions for as long as he did if he wasn't adding to the bottom-line? When it comes to 'Macro-Economic' reasoning, he's truly one of our most original theorists, period! He provides

<sup>1</sup> BEA (Bureau of Economic Statistics) and WSJ's website.

<sup>2</sup> CBO (Congressional Budget Office)

<sup>3</sup> Data or conclusions cited above are stated in the text, graphs or tables from BCA's 54-page Special Report: "Stuck-in-a-Rut" dated December 17, 2015.

<sup>4</sup> Historical tables from the U.S. Office of Management and Budget show total deficits every year since 2001 and projections of deficits through 2020. 2015 official data not yet posted. January 7, 2016.

<sup>5</sup> CBO (Congressional Budget Office)

<sup>6</sup> Publications by *Larry Summers, Gary Schilling, Paul Krugman, James Rickards, John Mauldin, David Stockman, et al.*



solid reasoning and unique analysis for his conclusions. Bill is calling our attention to the Fed's rate hike. He believes the Fed's move was wrong and dangerous. I agree. I think they did so more to save their sagging creditability than because it was the proper move. After all, how many times had they indicated a rate hike only to find a reason, it seems to some, any reason would do, to not take the promised steps forward. Investors hate uncertainty and the Fed was full of it. The market became Fed-up with the Fed!!

**“Rather than recognize the likely drivers of these developments - namely, a seemingly chronic shortfall of global aggregate demand amid a supply glut and a deflationary profusion of technological innovations and new supply chains... the Fed continues to minimize the deflationary impact of global forces.”** (Our emphasis)

- Stephen S. Roach, Former Chief Economist, Morgan Stanley, and currently Senior Fellow, Yale University's Jackson Institute of Global Affairs.

**There are deflationary forces... and, the Fed is ignoring them.**

The above “must read” (regardless of whether its perception is clear) appeared on Bloomberg-TV on October 28<sup>th</sup>. While economists are often accused of speaking in “double talk” and “mystic issues,” we may have to declare Mr. Roach, “guilty as charged.” I'll explain... In effect, he is asserting that the global economy, and thus, global GDP is in the grip of “deflationary forces”, and the Monetary Authorities, along with Key Politicians had better begin to realize that “**deflation is the problem!**” He may have been referring to the proposed Fed hike, but it's hard to determine that without more of his thoughts. The U.S. is the least likely place to find any deflationary roots. Instead, look to the Emerging Markets, or Japan or Europe. EU countries are much more prone to deflation. Their GDP is miserable and has been for years. Their monetary union is greatly hampered by the absence of a fiscal union.<sup>7</sup> There is an implied message: the powers-that-be better fix it! While I completely agree with his assessment... Stephen, it's a lost cause! The EU and ECB are too fragile in its political structure ...too divided to agree to a “tough love” solution. The EU's most recent GDP, +0.3% (vs. +0.4% anticipated) resulted in much greater expectations from Draghi's ECB than he delivered. The DAX reacted with displeasure by dropping 1.2%.<sup>8</sup> It seems “Super Mario” as he has been christened, didn't provide his promised, “Whatever it takes!” Perhaps “Whatever it takes” was already taken!! Draghi, and his predecessor Jean-Claude Trichet, have been trying to achieve a 2% rate of annual inflation target since 2003! Twelve years, and its less than ½%.<sup>9</sup> We think the culprit, deflationary-forces, are overcoming the ECB's efforts. With the assistance of BCA data and conclusions, we will provide a close examination of deflation and the risks it presents.

I was elated to find BCA Research's latest special report, “The Global Economy... Stuck in a Rut”, when I recently checked my incoming research. Since I'll be referring to their research heavily from here, I feel we need to provide some background info on BCA. In 1967, when I worked for Merrill Lynch, I subscribed to a monthly research report from *The Bank Credit Analyst*. In '73, when I was in a large trust department, they issued a stern warning that (then Fed Chair) Arthur Burns had cranked-up the printing press and lowered interest rates to such a degree, that the US would eventually suffer from a huge increase in inflation. They were almost alone on that call, and I had access to most major Wall Street research. They advised the sale of all bonds with medium and long-term maturities, and said to keep all maturities between 1-3 years. They were right about the danger and wrong about how bad it would be. It was much worse. Low coupon 30-year municipal bonds lost up to 45% of their par value. By 1979 inflation had spiked to double-digit levels.<sup>10</sup> Paul Volcker raised the Fed funds to about 17%. It put a swift stop to that. Today, BCA is a world-renown think tank. About 20 years ago, a new owner took over and supercharged BCA with the careful hiring of more than 60+ macro-thinkers. All are listed in the index (along with their specialties) in their “Stuck in a Rut” report. Every December, a fictitious “Mr. X” conducts a very intensive and assertive Q&A session with their huge macro team. The 50-75-page assessment contains their mistakes from the preceding year and their successes. Mr. X is a very savvy, informed, and risk adverse guy. These three attributes form a terrific combination, for it slants the emphasis to a more conservative than needed evaluations and resulting advice. He's a tough cookie. This year's “clear and present dangers” included deflationary forces and high level of sovereign-debt. Their seminars sell out to standing room only crowds of more than 1000 attendees. They are able to draw the most brilliant and respected economic experts. Their most recent NY gathering featured (as key speakers) Stanley Fischer, the Fed's current Vice-Chair, and Ben Bernanke, its past Chair. Using their research, let's get back to the deflationary concerns.

I've already blasted Congress and the Administrations for their “Deficits and Debts Gone Wild!” Huge debt loads impair GDP growth. Here's my point ...the larger the deficits, the greater the debt load, and thus, the greater the deflationary forces and their ever-present risks! I believe the debt load has grown beyond our ability to repay it with dollars that will have reasonable preservation of their purchasing power. While I will shift focus to deflation, please remember: the risks of these two entities are joined at the hip. Deflation is the continuous decline of prices in goods or services. In essence, your Dollar attains greater purchasing power... everyday. This can occur one of two ways: most of the time, there is a sudden, unexpected triggering event that produces a sudden loss of business and investor confidence. However, deflation can slowly set in after an extended period of economic decline<sup>11</sup>, although history indicates this is a less frequent cause. Either way, a lot of moving parts kick in as the lack of confidence hits the stock market first and, to a lesser degree, the more risky classes of bonds. Selling begets margin-calls, which beget more selling, etc. Business owners start to see sales dry up, especially in non-essential goods and services. The media churns the bad news, and lack of confidence accelerates and begins to engender fear. Layoffs from thinly capitalized sectors and highly leveraged firms occur. This news impairs demand for all except essential necessities. In effect, supply has not intentionally increased much at all... instead, demand has almost collapsed for some goods and services but very little at grocery and “Dollar” stores. Banks

<sup>7</sup> Data or conclusions cited above are stated in the text, graphs or tables from BCA's 54-page Special Report: “Stuck-in-a-Rut” dated December 17, 2015.

<sup>8</sup> *ibid.*

<sup>9</sup> BEA (Bureau of Economic Statistics).

<sup>10</sup> US Bureau of Labor Statistics.

<sup>11</sup> Wikipedia – Deflation



experience withdrawals from savings. Real estate showings slow quickly. Government offices assure the public that all is well and whatever is happening is a temporary “bump in the road” ...and certainly, not a “Stuck in a Rut” problem. However, as matters have hit a “Tipping Point” things start to spread globally. Mind you, in this example, I did not name a country or even a continent and see no reason to go further. Matters follow the course and trends that fall into place. Once the deflationary forces reach the level in the latter stages described above, there is very little The Authorities can do to “put Humpty Dumpy back together again.” One last explanation of the global reach of a deflationary event.

While the U.S. is the least likely country to start a deflationary progression, no nation can be totally exempt in today’s global economy, where what happens in one arena can and will affect others in distant lands. World trade incorporates global parties and the contractual agreements that all parties rely on. Events can start elsewhere and spread here. Remember, for every debt out there, someone owns it and perceives it as an asset. If that asset is considered to be solid, its owner can pledge it as collateral for a loan, to leverage-up to make more money. The new lender takes possession of the “asset” with the understanding, that he has the right to sell it at any time that they determine its value is impaired (relative to the loan’s balance). While the agreement provides for the courtesy of a margin call and the time to respond to such call ...the lender has the power to sell whenever he wants. This is how the Lehman collapse grew into a global loss of hundreds of billions of dollars.

### ***Oil stocks - our view***

Sentinel has received a large number of questions indicating that our clients believe oil stocks are a screaming buy, citing their low PEs, their high yields and their sizable price declines. They wonder whether we’ve changed the “sell ‘em all” opinion we had a year ago? No we haven’t. We’ve noted the numerous CEOs who’ve addressed or replied to the status of their dividend or payout. Under today’s circumstances, it’s the #1 topic on every energy-shareholder’s mind. From the current shareholders’ viewpoint, if you thought you’d get a truthful answer, you were wrong! And from the vantage point of a potential purchaser of their stock, if you thought you’d get a truthful answer, you were wrong too!! And, in this instance, two wrongs won’t make a right. Telling both sides of the coin (stock trade) that a dividend cut loomed, or was even a reasonable prospect, means you’d be generating sellers while discouraging potential buyers. The stock would crater, and your board would be upset, to say the least. Not only do we still profess our “sell ‘em all” opinion... but we also we have stronger reasons justifying our position.

The key and vital determinant to oil prices is the excess amount of global production that must be stored. BCA addressed the energy crisis question and stated there are at least 1½ million barrels of excess **daily** production.<sup>12</sup> They foresee another million barrels per day from IRAN’s start up, a 500,000 barrel per day (b/p/d) increase from other Mid-East producers and about 250,000 barrels (mostly from Frackers) in North America.<sup>13</sup> That approximates a total of 3,250,000 b/p/d of global excess. BCA sees a slower global GDP for 2016, so demand will, at best, be flat. Let’s be generous and assume the estimated 91 million b/p/d to 103 million b/p/d consumption rate persists. The 3 million b/p/d excess still requires storage. Estimates of storage capacity from various business TV-shows (with no references of its source) have reported between 80%-92% of all available (global) storage was already filled.<sup>14</sup> Since the number increases daily, those numbers should be too low.

Regardless of what the real numbers are today, two things seem certain: 1] During 2016, the world will be producing an excess of oil vs. its consumption; 2] whenever all the storage spaces are filled, then all the excess production has to stop ...somewhere. And, those firms, and its creditors, suppliers, and workers will be in deep trouble. When there is a lack of storage facilities, then only those entities that are lucky enough to be supplying the current consumers will be able to continue pumping. All the others will have to shut down their production because they will have nowhere else to put it or sell it!! At that point, the real price war will start, as the fight for survival begins, as any price is better than no price at all. Think about it... don’t buy or hold these stocks.

### ***Where BCA and Sentinel come together and agree.***

We agree on three critical factors: 1] deflationary forces and high levels of sovereign debt due to ongoing budget deficits are potential high-risks factors. 2] these risks have recently accelerated; and 3] each of our 2016 outlooks call for a slower level of GDP growth for much of the world including China, the EMs and some of the more exposed EU nations. Thus, less exposure is warranted, and avoidance of vulnerable sectors is recommended in all portfolios.

I would like to include a few additional remarks. I believe the fallout from the oil crisis is likely to get worse. I was surprised to learn that the U.S. leads the world in the largest numbers of defaults. On Bloomberg, last Monday, S&P noted that, out of 111 major global-defaults, 60% emanated from the U.S. issuers. The Emerging Markets accounted for 11%. Most U.S. investors consider U.S. debt to be secure. Evidently, the rest of the world’s bankers think so to.

### ***Here is Sentinel’s risk-averse philosophy, our defensive investment strategy and our resulting portfolio mix.***

Having held the concerns noted above for some months now, our latest major move was to increase our cash and “diversifiers” positions. The latter refers to relatively high paying issues, by today’s standards, along with the sectors that we believe incorporate the best sectors by using funds withheld from those sectors we are avoiding. It’s a four-legged strategy: 1] avoid the underperformers; 2] instead own the best looking issues in the sectors whose earnings are likely to (in our opinion) outperform the S&P 500’s performance; 3] we utilize above-average dividend payers to enhance your income; and 4] we maintain a high cash reserve for future buying power.

---

<sup>12</sup> Data or conclusions cited above are stated in the text, graphs or tables from BCA’s 54-page Special Report: “Stuck-in-a-Rut” dated December 17, 2015.

<sup>13</sup> *ibid.*

<sup>14</sup> For example, a chart from Citibank’s article “Oil: How Low Can It Go?” from December 14, 2015, places it at 85% using data from EIA, IEA, and Citi Research.



Let's add some detail to that portfolio positioning. We have no representation in the following sectors: utilities, telecom, materials, or energy. By completely avoiding what we classify as under-performing areas, we neutralize their weak and negative results. Next, we utilize the funds that would have been allocated to those sectors to (relatively) overweight: technology, healthcare (with a special focus on the biotech sub-sector), consumer staples, financials and consumer discretionary holdings. Industrials are represented to a lesser degree. For our stock-selections, we look for certain fundamental 'traits' such as: future above-average E.P.S. growth-rates; reasonable valuations relative to our growth expectations; strong management teams; and finally, major competitive advantages. We think our diverse, but solid, portfolio positioning provides a 'best-of-all-worlds' defensive stance. We also think it has the best likelihood of preserving your capital and, at the same time, achieving a reasonable opportunity to grow your principle.

Until next time, we thank you for your interest in your investments and your continued confidence in our ability to, first protect your principle and then, enhance its performance. We welcome any and all inquiries. We want to wish you and yours, a Happy New Year and hope that you enjoy a very Healthy and enjoyable 2016.

-Charles A Knott, Jr., Co-CIO

If you have questions or require more information regarding any of the opinions or facts presented in this letter, please contact your advisor for more information.

This material is intended to provide an update to current clients regarding Sentinel's account management strategies and views. It is not intended as financial advice or an offer to sell any product, nor is it intended to be an exhaustive discussion of the issues mentioned herein; additional information regarding specific topics may be found in other publications by the Advisor. To access copies of some of Sentinel's past publications, visit the Resources section of our website – [www.sentinelcapitalsolutions.com](http://www.sentinelcapitalsolutions.com). Our information is based on data we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete.

The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Sentinel reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

Sentinel Capital Solutions, Inc. is an independently owned registered investment advisor. More information about the advisor including its investment strategies and objectives can be obtained by visiting [www.sentinelcapitalsolutions.com](http://www.sentinelcapitalsolutions.com). A copy of the Sentinel Capital Solutions, Inc. disclosure brochure (Part 2 of Form ADV) is available, without charge, upon request. Our Form ADV contains information regarding our firm's business practices and the backgrounds of our key personnel. Please contact us at (301) 665-9038 if you would like to receive this information.

Sentinel Capital Solutions, Inc.  
38 S Potomac Street  
Suite 203  
Hagerstown, MD 21740  
p. 301.665.9038  
f. 301.665.9039  
[www.sentinelcapitalsolutions.com](http://www.sentinelcapitalsolutions.com)  
Inquiries to [info@sentinelcapitalsolutions.com](mailto:info@sentinelcapitalsolutions.com)