Sentinel
CAPITAL SOLUTIONS

The Commentary

June 2014

JUNE 2014

"The Fed's manipulations have left it in the position of a tightrope walker with no net, one who must exert all his energy in a concentrated effort just to keep moving forward, even as the slightest slip or unexpected gust could cause a catastrophic end to the enterprise."

**"The Fed must promote inflation (while not acknowledging it) and must inflate asset prices (without causing bubbles to burst). It must exude confidence while having no idea whether its policies will work or when they might end. In short, the Fed is caught between its roles as proprietor of the debt-as-money contract and as the singular savior of sovereign debt.
It is unlikely to succeed in only one of these roles; it shall succeed, or fail, at both."**

James Rickards, The Death of Money, 2014

June's Focus

Maintaining a risk-averse stance in the "New Normal" lethargic GDP global-environment

What are the goals we set for the readers of the publication you are now reading? Do you know? Let's us present an analogy.

It's a beautiful day! But, we are not ones who want to comment on its splendor and the enjoyment one may obtain from this fresh and vibrant spring day. No, we don't offer suggestions how you can spend a few hours enjoying its 'soon-to-be-evaporating' benefits …we are just not at all interested in the milieu of the day's environment. However, many who inhabit the investment-world utilize its media to constantly rant about the present circumstances and the obvious reasons why things are the way they are! If it was a stormy day, these "talking heads" would have a prepared script with equally cogent reasons for that occurrence. But what is the benefit of this? To our view, it's a waste of time!

Instead, we'd rather direct our efforts to noting the changes in barometric readings, analyzing the undercurrents of the winds and tides, and gauging the prevailing high and low pressure forces. We do this, not to learn tomorrow's meteorological conditions or forecast, but to determine the most likely-prevailing climate (read: economic) outlook six months away and, if possible, the following 12-18 months also. This is very useful knowledge and will allow us to hypothesize, far in advance, whether sunglasses and shorts

…windbreakers and umbrellas …or full-slickers and galoshes are the proper dress code. It will allow us craft an appropriate investment strategy. Since we are a risk-averse money-manager, avoiding threatening or ongoing storms and hurricanes is our primary focus. On rare occasions, the best haven may be a perfectly safe and secure bunker. Whatever the forecast, the clear choice is to be prepared well ahead of time… whether it is with suntan lotion or goggles.

Although "Commentary" was the moniker I chose in 1993 for this chronicle, which may imply a current events type publication, we expend our labors, time, analytical efforts and valuable research dollars on determining the more distant economic forecasts along with their risks and rewards relationships. Our output needs to be both accurate in its outlook and value-adding in its results! How do we do that? Let us explain!

While economic outcomes (and their financial impact and repercussions) seem unpredictable and arbitrary to many observers and investors, the results constantly turn out to be simply the time-tested product of the laws of supply and demand (read: economics). These consequences emanate from the combined economically-based decisions the masses make every day of their lives. These include whatever goods and services they buy (or don't buy) …sell or retain …invest or save, and so on. On the whole, consumers' decisions are based on only three factors. In their order of importance, they are:

✦ One's financial status - primarily their ongoing income level and their asset-to-liability ratio.

✦ Second, the ongoing cost of their essential needs: food, shelter, energy and healthcare.

✦ Lastly, their willingness to accelerate (or delay) any transaction-decisions related to non-essential goods: notably big-ticket items.

We concede that the current economic environment affects confidence levels, but this only plays a minor role. Trends in place usually remain so, unless a shock like "9-11" or a big bank failure occurs. Whereas investment decisions always involve greed and fear, the latter will always be a much greater motivator than the former. Finally, until recently, bubbles were rare! They are only possible when all three factors are present: easy monetary conditions, a friendly economic-environment and rising asset prices. Now that we have outlined the data required for top-down assessments, let's look at the ingredients needed to successfully determine forward-looking economic forecasts.

So …you may ask, how did you (and others) learn, adopt and hone your skills? First and foremost, there are a very small percentage of analysts who specialize in macro-economic forecasts for the 6-18 month timeframe. There are a lot of reasons for this:

✦ Because the economic data-base is so immense and the conclusions so variable, the chances for errors are very high, hence the success ratio is rather low

✦ Without a doubt, this is the most difficult research task, both as to event outcomes and to timing

✦ Even if one comes up with a value-adding strategy, was it for the reasons that the forecast predicted? If not… "you were right for the wrong reasons" and that is luck, not skill

✦ Clientele find your output to be boring with a useless set of conclusions. The typical investor is looking for names to buy, not future trends in unemployment or inflation figures.

✦ Wall Street has its typical response to any strategy that requires repositioning: "We advise staying in for the long-term."

It is important to remember: we are not predicting the future! Those who trudge up our narrow and difficult road must deal with the huge amounts of (now global) data, as well as devise a means to successfully examine this info and accurately project its outcome with some semblance of proper timing. We are using the laws of science, just the same as a doctor does, when he examines a terminally ill patient and tells him, "You've got 6 to 9 months to live." And, neither is the physician predicting the future. So, how do the best of breed obtain their results? While a few gurus have crafted computer-programs to assess all this info, virtually none of these platforms are designed to generate a reliable outlook beyond 3-months. So, all the consistently value-adding practitioners craft their output through "interpretative reasoning." Those who do so (and who we follow closely) include: David Rosenberg, A. Gary Schilling, Ray Dalio, and James Rickards (cited above). Of these, only Dalio utilizes large numbers of regressive studies to refine his preliminary findings. Nonetheless, we all start with daily released economic data to form (and constantly reform) our forecasts. Thus, it is always an ongoing process. The next step is the critical one: it's extremely important to constantly verify our conclusions as well as validate the investment strategies we are employing to ensure their soundness. Now, I'll shift to some of the extra steps I utilize in my process.

Years ago, I developed a twist that helps me reduce the huge data-base down to more manageable data. I reasoned that if my final forecast would involve a critical change (in its outlook), it would have to be influenced and governed by a critical factor! And, that dynamic would have to be the decisive element in the analytical assessment! So, I focused on what to focus on! These key factors became (what I call) critical indicators (C I). My next step is: "Will the C I's new data change my forecast, and, if so, by how much?" In other words, will the new variation be meaningful enough to be a catalyst that alters my former assessment? Then, we must repeat the step again, because the laws of economics are all interconnected! For example, if demand falls …supply, production, raw materials, labor, etc. …all these are affected! I ask myself, "How does this alteration affect: interest-rates, GDP, jobs, the Dollar as well as monetary and fiscal policies?"

Since the 2008 crisis and the Fed's QEs and print more Greenbacks therapies, a new unknowable but key focus has emerged. It's also a C I! In fact, today's biggest challenge is not knowing exactly what unintended consequences and huge risks lie behind the Fed's QE's, the EU's lack of fiscal union and under-capitalized banking system. You can also add Japan's experiment with the Yen's devaluation! These "rabbit-out-of-the-hat" antidotes that "the Authorities" conjure-up will have an impact! Since we have no past history to examine, we don't know, "Where or when!" The crisis in Greece demonstrated that small repercussions can (but not necessarily do) have a worldwide impact! Thus, when new problems emerge, global remedies are called-for!

We are aware that this was a rather lengthy, but we believe necessary introduction to outline why we write our monthly tome. But it now brings us to our Q&A segment.

We return to the layout that our long-time readers have endorsed… the question-answer format. With this, we find it useful to "play the devil's advocate," asking "tough" and critical questions of ourselves! It also lends itself to quick shifts in subject matter and reviews of past editions.

Q&A

James Rickards

Who is James Rickards, and what is "The Death of Money" all about?

In my opinion, Rickard's book, *The Death of Money*, is one of the most important, farsighted and well-written books in decades. Yet, we suspect it won't garner the media attention it deserves, even though his earlier book, Currency Wars, was on the Business Bestseller list and translated into eight languages. Why? Because many of his assessments and conclusions are extremely complex requiring high levels of economic theory, as well as innate money and banking knowledge. Except for those grounded in those two fields of study, his analysis goes beyond most readers' levels of comprehension. While his earlier book is the perfect introductory tome to this brilliant work, it too, necessitates the same skills. His analytical logic and elimination of the various possibilities make for informative reading, but only to those who have a burning interest in its subject matter. Rickards has been able to simplify large numbers of financial components that interplay within a labyrinth of complex connectedness. Then, he successfully navigates the byzantine paths that lead to their "end-game results" from all these economic forces. While a chess game has millions of variable moves, Rickards is the well-heeled chess-master whose foresight and logic have already placed "the Authorities" key pieces into vulnerable positions where few choices exist and none are pleasant or allow for escape.

Then, tell us, what does the passage you quoted mean? What should we understand?

In the first paragraph, his opening quotation is a rather well-fashioned scenario of the Fed's predicament in a tightrope-walker's terms. The second paragraph examines the irony of the Fed's necessity to inflate the bubble dilemma and therefore its unintended and unknowable consequences. Within the next five years, he believes the World's Reserve Currency (our dollar) will be replaced by a "basket of currencies" of the major economic powers. He also thinks this basket will be tied to the IMF's gold assets, due to governments' unwillingness to tie their currencies. Our opening quotation follows several chapters involving the Fed's myopic concerns over the threat of deflation due to our oversized debt-load. The Fed and "Helicopter Ben" have been vocal about this threat. Most experts have arrived at the conclusion that our debts won't be repaid in Dollars that are tied to today's purchasing power. Thus, the US is inflating its way out of debt by devaluing the Dollar versus the other major currencies. As his tightrope-walker's scenario implies, the Fed is employing a highly risky remedy that has unknowable side-effects in its attempt to cure the budget and trade deficits "hangover", which we've induced by our inability to curb our "hair-of-the-dog-that-bit-you" spending habits. Meanwhile, the Fed has to be the defender of the Dollar at the same time it's printing trillions of them. And, they must prevent any bubble-popping damage in the event the market goes into a deep or lasting swoon! Finally, Rickards notes that the Fed sees the Greenback as a US-liability to whomever holds it and as a "transfer of wealth" when it is tied to our sovereign debt but only when it is held by foreign interests. Today, more and more (non-Fed owned) Treasury paper is held by foreigners. China is complaining that we are devaluing our (their) Buck! The late '70s' phrase, "Yes, it's our currency, but it's your problem!" was a popular retort. That because inflation had reach 10% to 12%!

Does he say anything about the current poor economic GDP data? The seasonally-adjusted negative one percent was a lousy result.

He's convinced one of the unintended consequences (of the QEs) is a "New-Normal" existence that won't ever obtain a sustained "escape-velocity" that allows the US to grow ourselves out of our current (deflationary-threatening) environment. Rickards has concluded the Fed's risk-models don't include the unforeseeable threats from all the currency wars, global-trade and printing-press issues that constantly get us nowhere. He sees other risks caused by the huge financial leverage being utilized by large banks, hedge funds, etc. In effect, the Fed doesn't realize it has painted itself into a corner. He sees the current interest rate environment in place for the next 3-5 years. He notes that in 2009, the Fed's initial assessment as to when interest rates would be allowed to return to their "normal levels" was originally 12-18 months. As a "sustainable recovery" proved to be elusive again and again, their forecast has been constantly pushed out again and again. Recently, Yellen has pledged a "2015 or later" timeframe.

His is a minority view, isn't it?

Yes, it is, but you can't expect any one who is employed in Wall Street or the many branches on that tree to be a supporting voice. He is trying to convince investors and those who have the ability to make changes that we are not solving our problems. While many disagree with him, he points out that these pundits not only lack "skin in the game", but have also been wrong for many years. Rickards spends many chapters debating the theoretical challenges to his conclusions. Like Ray Dalio who was criticized about his dire outlook: he defends his viewpoint by presenting his outstanding record that was earned by his economic analysis.

Here's Rickards' bottom-line: these problems may take more than 5 years to occur. The economy has fallen into the "New Normal" and can't get up. Thus, it won't generate enough GDP in time for the US to pay its debts in uninflated (current purchasing power) Greenbacks. There are three choices: default, devaluation or deflation. The only rational choice is to devalue and repay our debts. The Fed must inflate to allow repayment at values that allow us to maintain sufficient wealth within our nation. Eventually, our overseas Treasury-Bond holders will be unwilling to hold longer-dated maturities. At that point, our market-determined yields will rise and, as a consequence, the Dollar will fall. At an unknowable point, a tipping point will be realized, and the Fed will have to print dollars for maturing debts. At that point, our currency will be vulnerable.

What are the economic and investment outcomes to his conclusions?

What is your assessment of the economic and investment repercussions to Rickards conclusions?

Mind you, we did NOT say we fully agree with all of his conclusions and their related scenarios. However, his arguments are solid and his record superlative. Even if his economic assessments are correct, which are enhanced by our governments' unwillingness to adequately address the problems, we think the timing is key to investors. Five years is a long-time. Thus, we should look at the here and now and monitor what occurs. Rickards agrees with our assessment: the US is still the cleanest shirt in the laundry. However, he points out that we owe trillions of dollars to foreign interests and have still more trillions of dollars of future entitlements on the books. People are counting on those promises, as they see it. Realistically, the key factor is our inability to grow ourselves out of our dilemma. Without attaining "escape velocity" we will not be able to reach the 3½ %-4% level of (real) GDP growth. The longer we kick-the-can, the higher the cost of the remedy. Fiscal policy is ineffectual due to political infighting. Monetary policy isn't working. And, the normal rebound that is usually generated by the consumer is hampered by three headwinds:

- ✦ the lack of gains in the average (per-capita) incomes;
- ✦the consumer's deleveraging from an over-indebted balance sheet; and
- ✦the poor dispersion of the asset recovery from the March 2009 stock market bottom and the almost 30% decline in home prices.

Since the bottom of these two most important assets held by consumers, their value has increased by $24 Trillion, yet 81% of that appreciation has gone to the top 15% of Americans. The US consumer accounts for 71% of our GDP. For whatever reasons, he either can't or is unwilling to borrow and spend or reduce his savings and spend. Solid data points to the fact: adjusted for CPI inflation, the average worker has gained less than 1% after taxes during the past 5 years of economic recovery. The consumer is all we have! No other component (government, investment, exports) can pull us out of our predicament. The latest real GDP was a negative 1%. Investments fell 6% and exports sank 3%. Last month, we took more defensive steps.

Let's turn our attention to the financial markets!

Well, I understand the conclusions you highlight, and I think with those threats being of a longer-term nature, I'd like to turn matters to the financial markets. Last month, you shifted your investment strategy to a more defensive one that favored the less cyclical sectors and favored the energy and healthcare sectors. Why don't you give us a quick update on bonds, stocks and cash reserves?

Last month, we became more defensive due to our reduced outlook for GDP here in the US and in China. In addition, average workweek income appears stuck in neutral even though the number of those being employed on a part-time basis is increasing. That reflects more a shift to avoid healthcare coverage legislation rather than a real pickup in demand. Finally, when you remove the strong German numbers, the EU still has problems with their GDP and their lack of a fiscal union and united banking regulatory system.

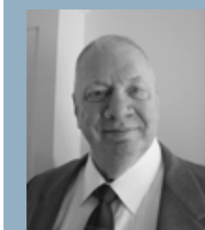
We've become more risk-averse! We've added more "value" (versus "growth") holdings. We've also focused on the consistent (non-cyclical) growth companies. Given the outline of our concerns and our preferences, our current guidelines include: low PE stocks, some 3%+ dividend-payers, solid growth stocks, appealing special-situations (with a strong top-line and monopolistic pricing characteristics) as well as a limited number of developmental hi-tech or healthcare firms. Last but not least, we have a strong representation of inflation protecting stocks. This last theme is very important; for if the Fed continues to print money to avoid deflationary pressures or large credit default risks, these issues should have the strongest relative performance, in our opinion.

Now, we will answer the second part of your inquiry. Our cash reserves are primarily for buying opportunities in stocks. We strongly believe equities are the best investment for those seeking appreciation with a risk-adverse investment strategy. Since we see quality bond yields at low, unrewarding yields, we have no traditional holdings in fixed income securities. Thus, equities with the above characteristics comprise almost all of our clients' holdings. Currently, and for some time, we've avoided

the telecom, utility and material sectors. The remaining sectors have overweighting in healthcare, energy with lesser so in industrials and the two consumer-related issues. We think this strategy will produce the following portfolio attributes: predictable earnings-flow and dividend increases with defensive properties due to their non-cyclical nature and low-P/E valuations. This foundation is complemented by an array of solid growth stocks whose long-term records are enhanced by their pricing-power, high returns on equity and growing-market leadership. Next, we seek a few leading-edge technology candidates for the longer-term. We wrap it up with companies with known and long-lived assets in the ground.

Charles A Knott, Co-CIO
Author
June 3, 2014

THE COMMENTARY



This publication is written by Charles A. Knott, Jr. with the support of the Sentinel staff. Mr. Knott has been writing his monthly investor updates for more than two decades and strives to provide readers with unbiased and utilitarian research and advice.

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Investor Newsletter

The Commentary

Over a 35 year span, Charles Knott has developed and improved on a unique, macro-economic based investment process that utilizes risk-reward relationships to determine its investment strategy. He recognized as an expert on the economy, investments and other financial matters. Mr. Knott has been writing his monthly investor updates for more than two decades and strives to provide readers with unbiased and utilitarian research and advice.

Sentinel would like to invite you to receive this monthly publication, dubbed "The Commentary" which brings investors information on our investment philosophy, processes, and current view of investment-related events. If you would like to receive "The Commentary", please opt-in by sending your email address to info@sentinelcapitalsolutions.com. If you would prefer to receive via mail, please notify via the address or phone number to the left. Back issues available upon request.

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