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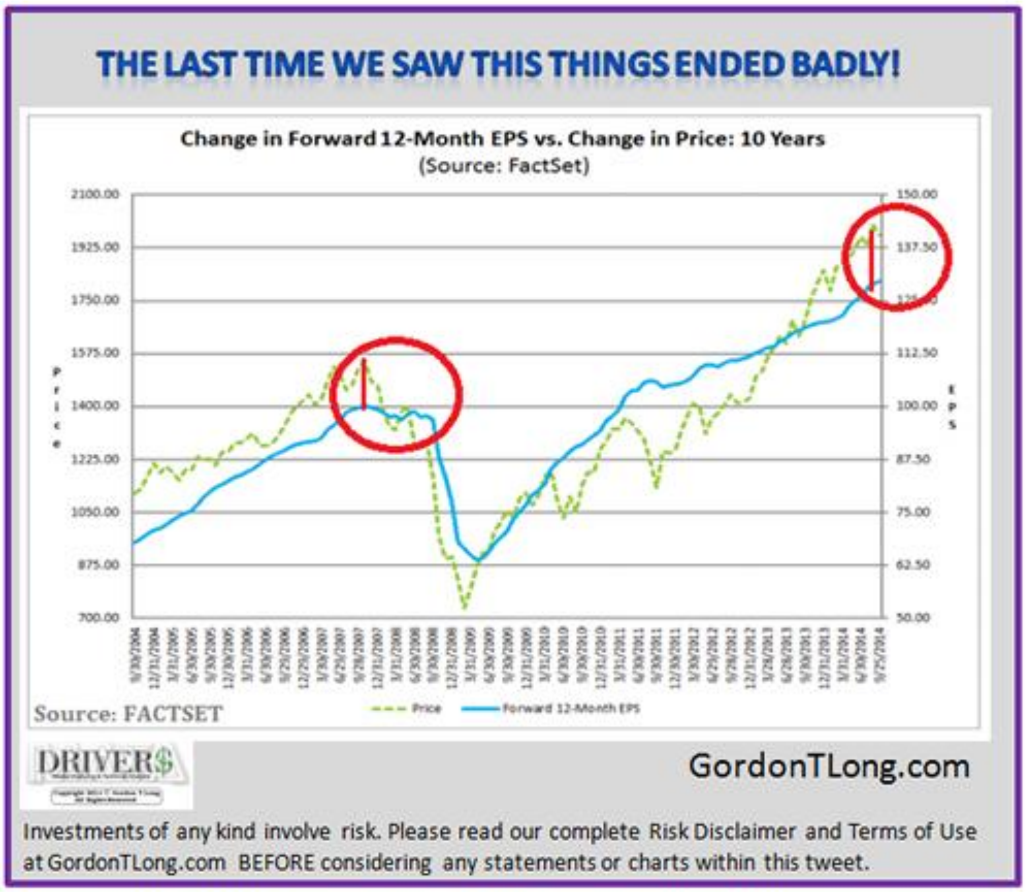
SLOWING GLOBAL DEMAND

TRIGGER$ - November 2014



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SLOWING GLOBAL DEMAND

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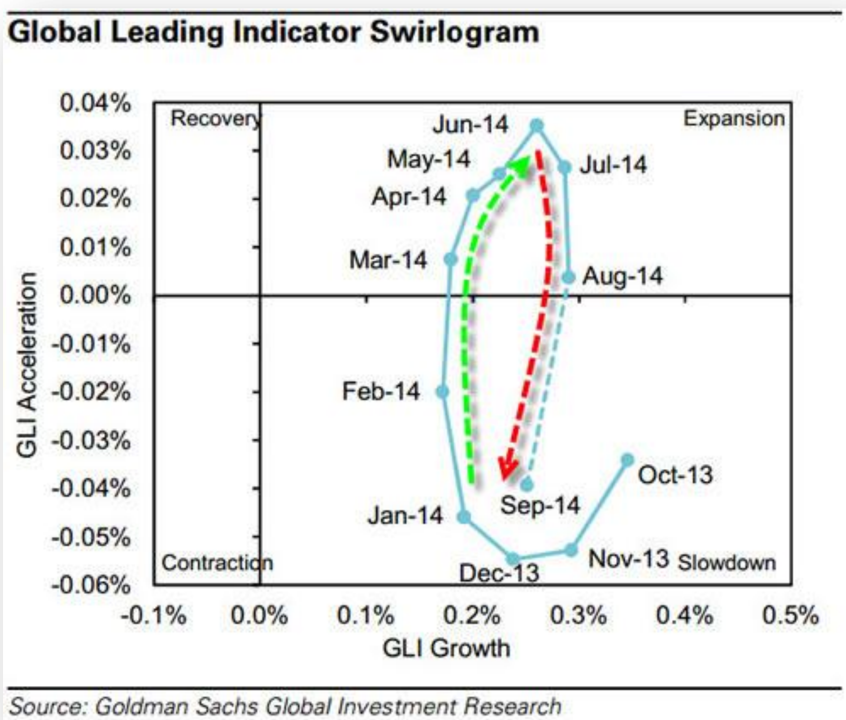
We suddenly have slowing global growth expectations & a flattening yield curve to support this new shift in market sentiment. The warnings have been there for some time but now bad news is seen as bad news and not simply the good news that this is sufficient reason for the central banks to pump more liquidity and keep the party going.

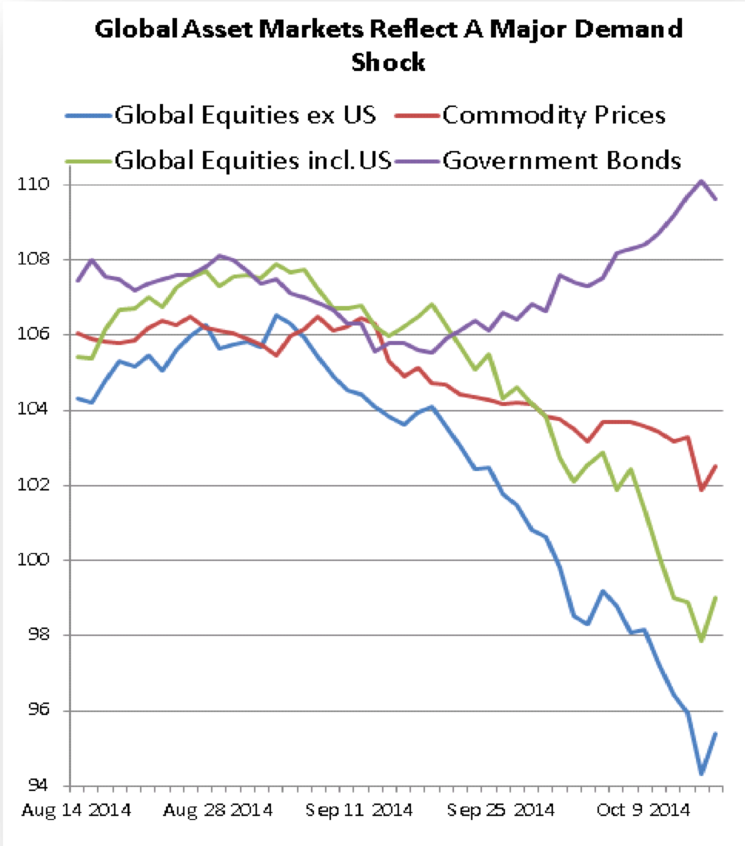
The reality of slowing global demand is beginning to sink in. Slowing demand and a strengthening US dollar is not good for US corporate earnings.

GOLDMAN'S GLI PLUMMETS

Goldman Sachs' Swirlogram of the Global Leading Indicator is somewhat frightening in how fast it has dropped since June.



The global markets have been reacting and global asset markets clearly reflect a major demand shock. The following chart from Macro Economist Gavyn Davies illustrates this:



Gavyn Davis writes in "[What is global market turbulence telling us?"] in the UK Financial Times:

> The [extraordinary volatility] in all financial asset classes in the past week can only be described as ominous. On Wednesday, the US ten year treasury, perhaps the most liquid financial instrument in the world, traded at yields of 2.21 per cent and 1.86 per cent within a matter of hours. This type of volatility in the ultimate "risk free" asset has previously been seen only in 2008 and other extreme meltdowns, so it clearly cannot be swept under the carpet.
>
> A few weeks ago, investors had widely expected a strengthening US economy to lead to a rising dollar and a tighter Federal Reserve, with an amazing 100 per cent of economists saying they were bearish about bonds in a [Bloomberg survey]in April. Instead the markets have started to act as if the world is about to topple into recession, and an abrupt reversal of speculative positions has probably led to exaggerated market moves, in both directions.

"The stock market is at an all-time, but economic activity is not at an all-time," explains billionaire investor Sam Zell to CNBC

> "Every company that's missed has missed on the revenue side, which is a reflection that there's a demand issue. And when you got a demand issue it's hard to imagine the stock market at an all-time high." Zell said he is being very cautious adding to stocks and cutting some positions because "I don't remember any time in my career where there have been as many wildcards floating out there that have the potential to be very significant and alter people's thinking." Zell also discussed his view on Obama's Fed encouraging disparity and on tax inversions, but concludes, rather ominously, "this is the first time I ever remember where having cash isn't such a terrible thing."

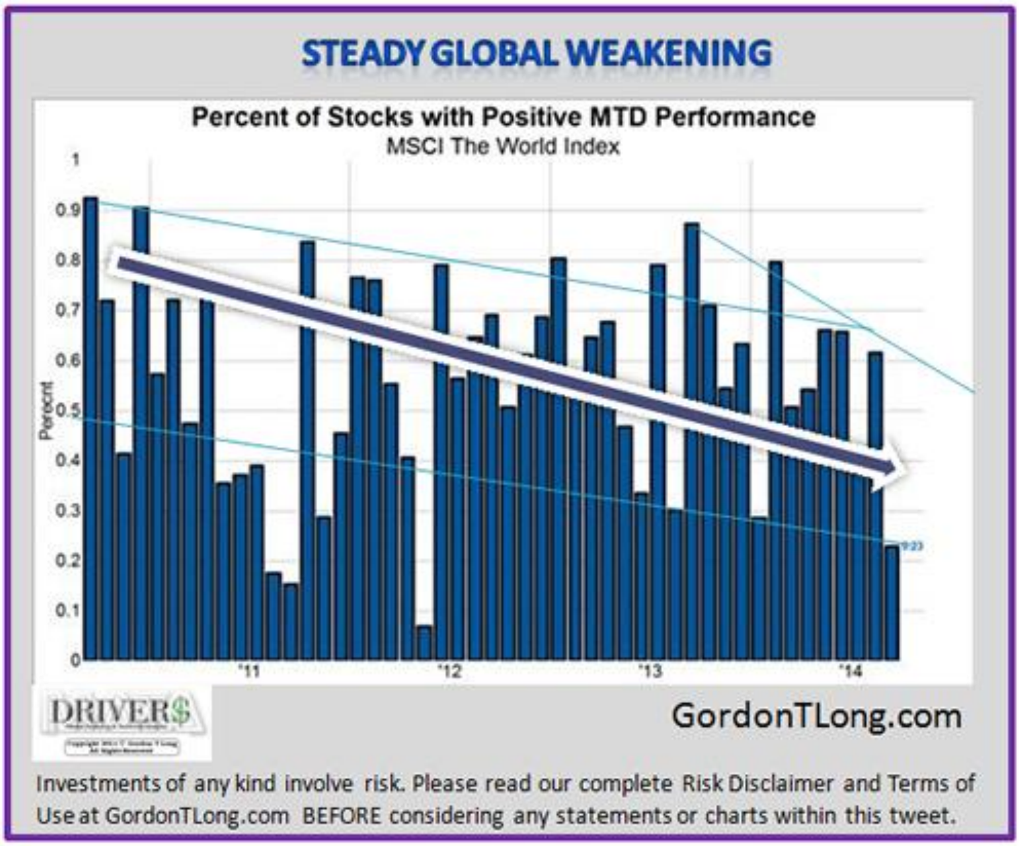
Zell's calls should not be shocking following George Soros. Stan Druckenmiller and Carl Icahn's warnings that there is trouble ahead.

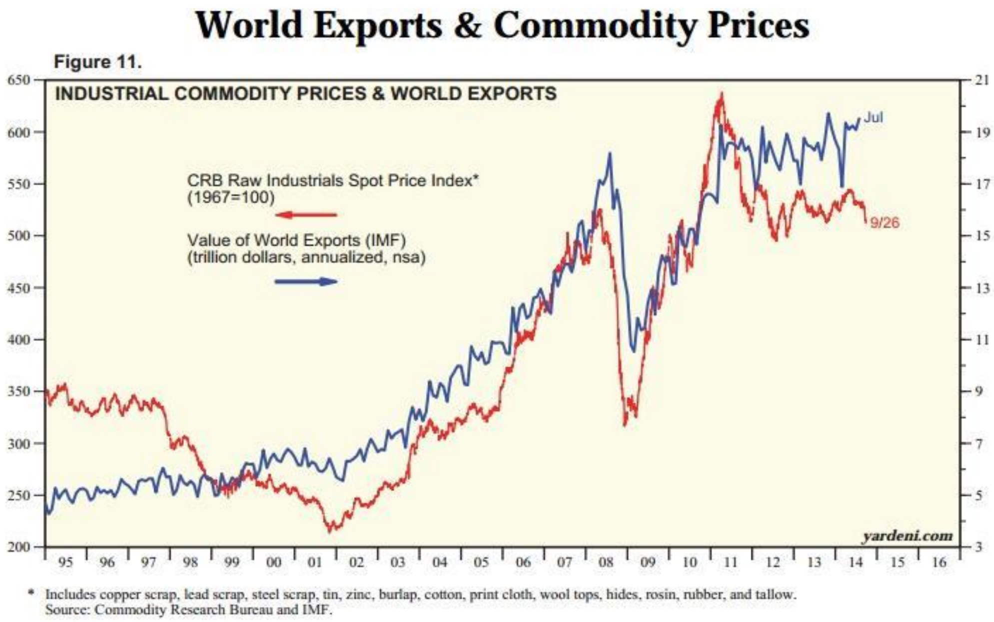
Even market guru Robert Shiller is concerned about the potential for a crash, even though he doubts the value of his cyclically adjusted price earnings ratio (NYSEARCA:CAPE) to forecast the timing of one.

"As of yesterday my price earnings ratio - I call it CAPE for cyclically adjusted price earnings - was 26.3. There's only three major occasions in US history back to 1881 when it was higher than that," says Shiller.

"One is 1929, the year of the crash. The other is 2000, which I call the peak of the millennium bubble, and it was also followed by a crash. And then 2007, which was also followed by a crash.

Asked for a worst case scenario, he says: "Well, the price earnings ratio reached its all-time low in the United States in 1921, when it fell under 6. So we're at 26. It could go to 6.



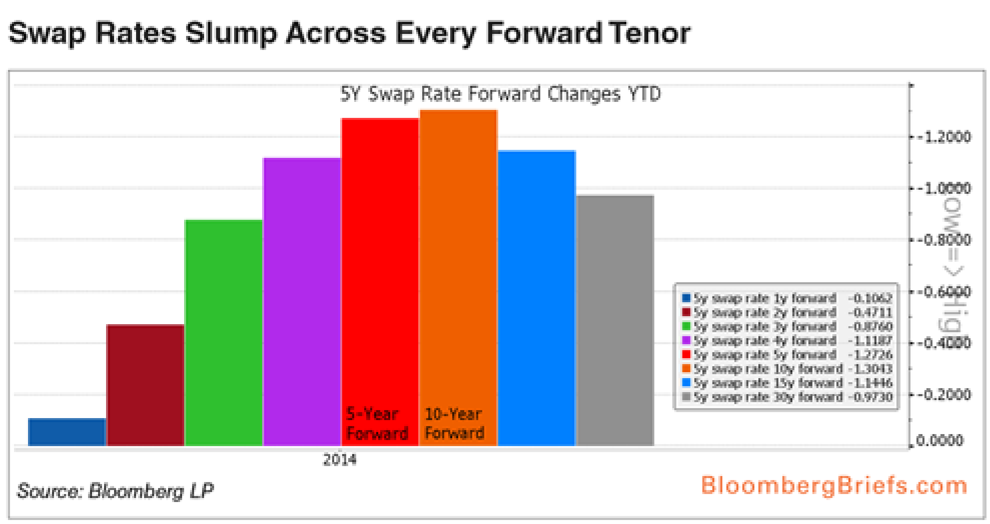


BOND MARKET REACTS - YIELD CURVE FLATTENING

Changes in forward five-year U.S. swap rates indicate increased pessimism about future U.S. GDP growth.

The thinking goes that if the market accepts forward five- year rates significantly lower than those that prevailed at the beginning of the year, weak growth and the Fed response is being priced in on those future dates. The implied slower growth or recession is most pronounced between five and 10 years where the five-year swap rate, five years forward, has declined a whopping 125 basis points this year. Said another way, the curve is flattening.

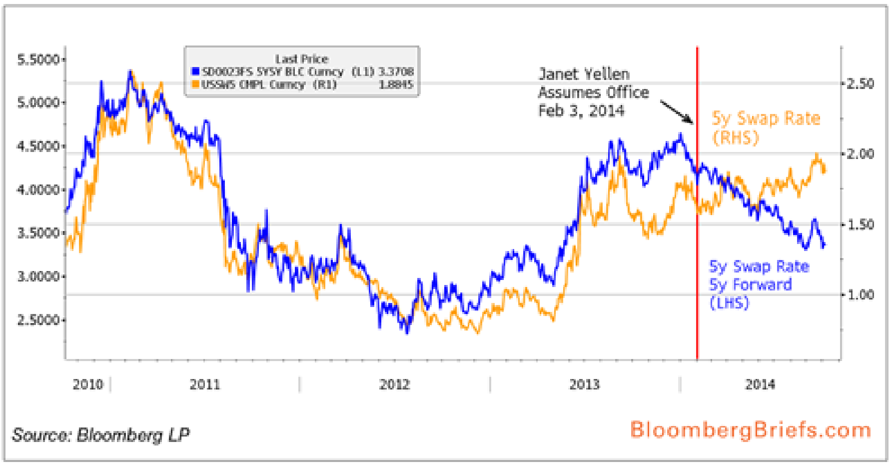
The three-year Treasury yield has widened 24 basis points while the 10-year yield has tightened by 61 basis points year to date despite rising equities, declining unemployment, improving financial conditions and Fed tapering. And the market is not only taking a negative stand on rates five years hence, it is doing so in every forward tenor from one year out to thirty years.



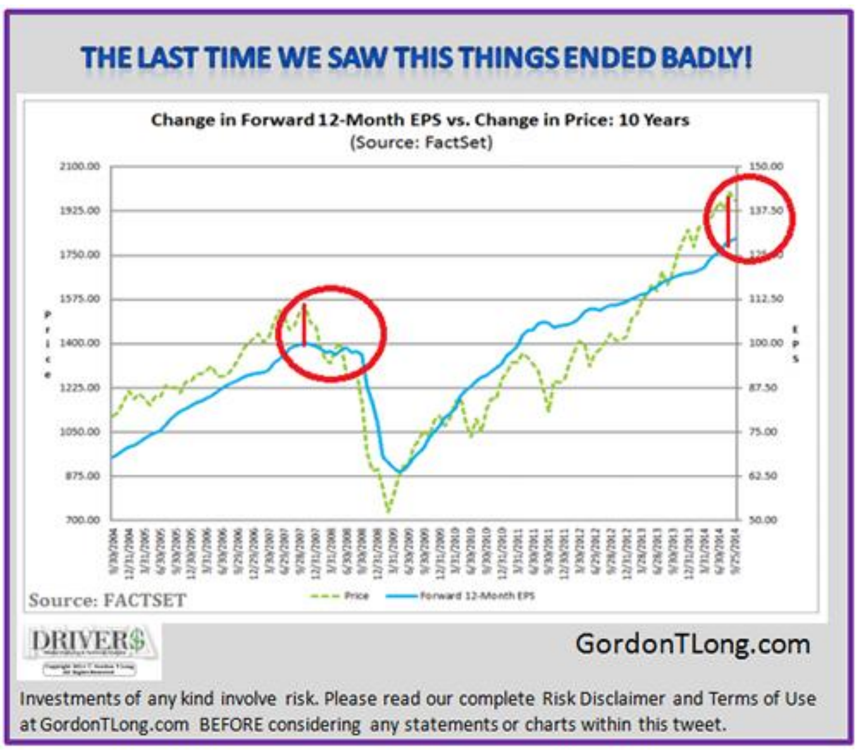
Economists' consensus GDP forecast for 2016 saw only one small adjustment in August — so despite the rate market speaking loudly, few seem to be listening. Last weekend Jim Grant, the publisher of Grant's Interest Rate Observer, exclaimed that we're in an "Era of Central Bank Worship." And though it has been hard to argue otherwise for a long time now, it may no longer be for the U.S. The expectation for reduced economic growth coincides with the start of Janet Yellen's tenure as Fed chair.

The five-year swap rate and the five-year forward flipped from moving in lock step for many years, to moving in opposite directions — unusual for its timing and sudden change.

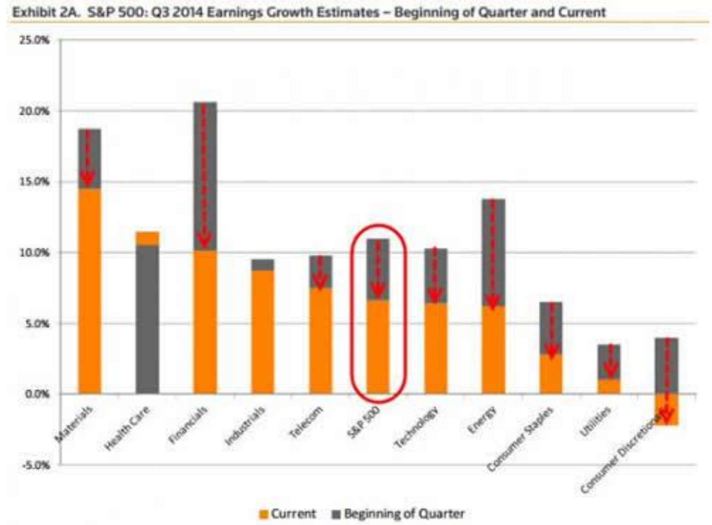
Gloomier Outlook: 5-Year Swap, 5 Years Forward Has Tracked Lower



EARNINGS GROWTH RATE CUT NEARLY IN HALF SINCE JUNE 30th

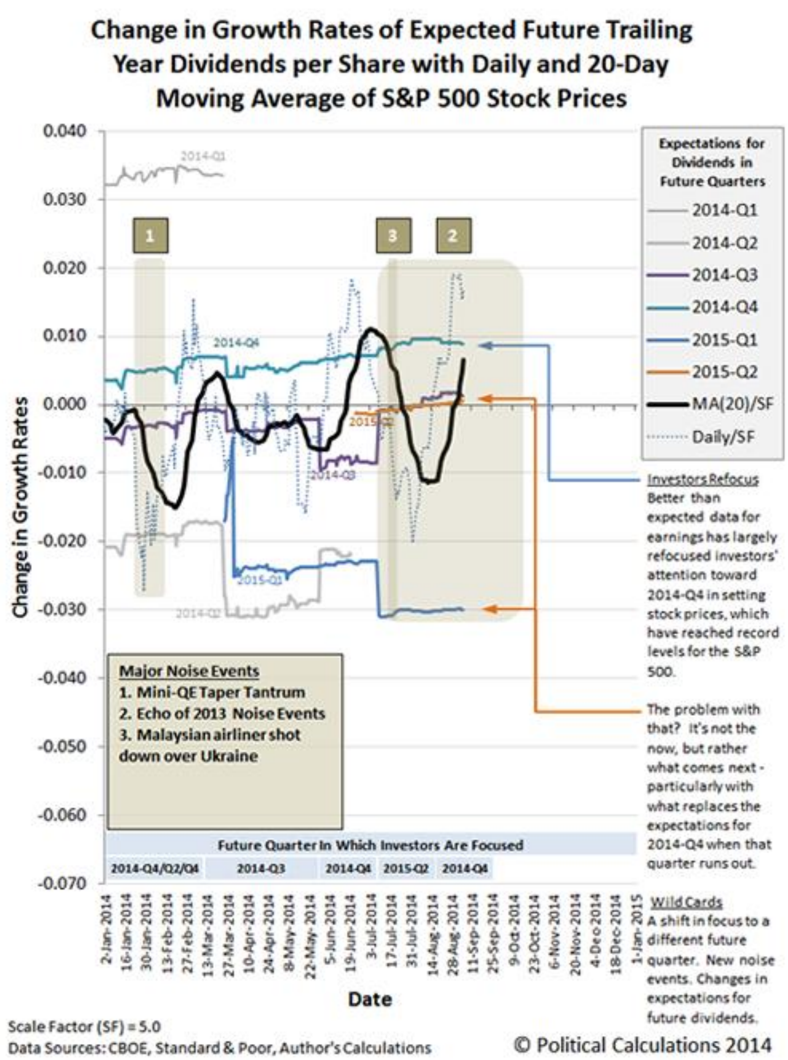


Since the start of July, S&P 500 Q3 earnings expectations have collapsed from 11.0% to just 6.4% with 9 of the 10 sectors lower and Consumer Discretionary now expected to see negative growth.



The chart to the right (below) shows the change in the growth rates of expected future trailing year dividends per share (a.k.a. "rational future expectations") for each quarter from the present through 2015-Q2 (we'll start getting the data for 2015-Q3 later this month).

What we observe is that at present, investors would appear to be focused on 2014-Q4 in setting today's stock prices, which is a relatively recent development - one that has come about largely as a result of better than expected earnings reported by many companies in the S&P 500 in recent months. Prior to that development, investors had been largely focused on 2015-Q2, which is the period during which many believe the Fed will begin hiking short-term interest rates.



But the danger in focusing on the fourth quarter of 2014 is such that any shift in focus by investors to another future quarter would be associated with either flat or falling stock prices. And then there is the question of what expectations of the future will replace those of the soon to expire 2014-Q3. Or the next to expire 2014-Q4. Investors can hold their attention on 2014-Q4 through the end of the third quarter of 2014, but that won't be an option for long in the fourth quarter.

It's that kind of scenario with expectations that explains why the month of October is historically feared by investors, because it can come with the greatest downside potential when compared with every other calendar month. If those new expectations are more negative than the ones they replace, then the stock market's reaction will likely be as well. So we actually do have some idea of when stock prices will change. How much they will change will hinge upon three factors: the future point of time to which investors turn their attention next, the expectations that correspond to that future point in time, and how those expectations might themselves change.

Sorting it all out is complex, but not difficult. It's not like stock prices haven't always behaved this way.

As if this isn't clear enough, Barclays is making a call that " Barclays Warns "King Dollar" Could Crush Earnings"

WE HAVEN'T CHANGED OUR POSITION

It is strongly likely that three separate factors are at work in concert:

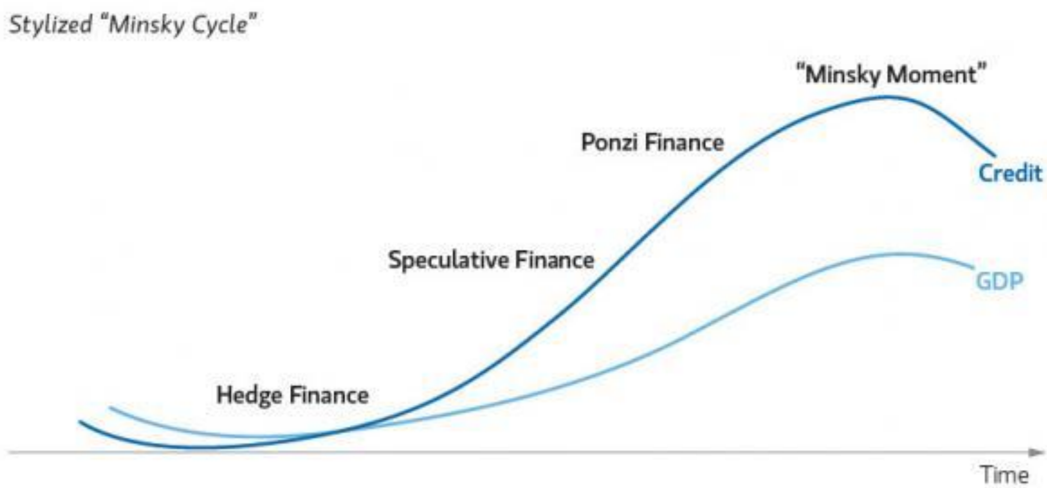
- A reversal of speculative positions, which has had temporary effects on asset prices;
- A contractionary and deflationary demand shock in the euro area;
- An oil shock that will also be deflationary, but will be expansionary for many economies.

The markets are beginning to recognize that secular stagnation may be gripping the world economy (see Robert Shiller). If so, the recent risk sell-off might have been reflecting a decline in medium term GDP growth expectations throughout the global economy. A market shock will itself tighten monetary conditions sufficiently to cause a slowdown in global growth, as happened in previous euro crises.

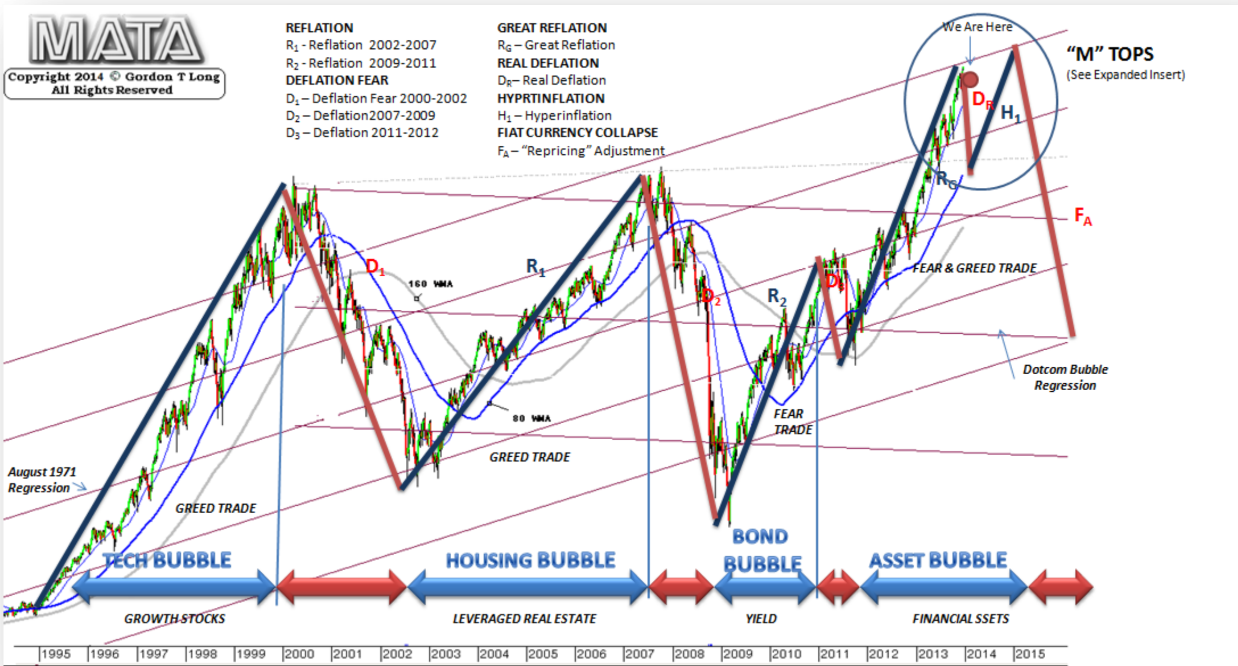
As Gavyn Davis writes:

> The markets may be starting to doubt whether the central banks actually have the weapons needed to stop global deflationary forces in their tracks. Robin Harding reminds us that Ben Bernanke once said, wisely, that quantitative easing "works in practice but not in theory". The implication is that it only works because it shifts inflation and other economic expectations in the desired direction.
>
> If markets start to doubt this, they have entered much more dangerous waters. But the relief rally on Friday, triggered by the merest hints that central banks may consider further asset purchases, suggests that we are not there yet.

After the near term expected correction we still expect markets to head higher towards a "Minsky Moment" in 2015.



We are still looking for higher highs in 2015 once "D_X" (below) is complete.



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