1st QUARTER 2013 EQUITY REPORT

The Solari Report

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Equity Overview with Chuck Gibson:

Secular Trends in the US Equity Markets
Date: January 17, 2013

Chuck Gibson

Catherine Austin Fitts: It is always a pleasure for me to talk with Chuck. Chuck is the managing member of Financial Perspectives, which is an investment advisory firm in the East Bay of San Francisco in Silicon Valley. He is also my partner at Sea Lane Advisory, a money management firm that is a partnership of Solari Investment Advisory Services and Financial Perspectives. The fact that he is my partner tells you that I think the world of him. I am always delighted to talk to him, which I do several times a day every day.

Chuck joins us on the *Solari Report* quarterly for an equity market report. The U.S. equity markets have surprised and frustrated and this is a good time to take a long hard look at where we are. Without further ado, Chuck, are you with us?

Chuck Gibson: I am. I wanted to break this discussion up into two pieces. The first is a market overview of 2012. The second is a perspective on a secular view of the U.S. markets.

Catherine: Let's dive in!

Chuck: Like most world equity markets, the U.S. had a really good year in 2012, but most of the gains came in the first three quarters. It was very unique in that the S&P opened the year at 1259 and never had a daily close that was below the yearly opening bid. There had only been eight other years that this occurred, and the last one happened in 1979. That brought out the other thing that was very unique about 2012. What I had expected to be a very, very volatile year was not.

We will see it in the charts below. We had relentless ramps up, small minor corrections, relentless ramps up, small minor corrections, and all of the wild volatility that I had predicted in 2012 really wasn't there.

Catherine: Right —I was very concerned about a serious correction in the equity markets in 2012. We never got one.

Chuck: No! Unlike the rest of the year, the fourth quarter turned out to be one of major indecision. Investors took a breather, and they really wanted to spend some time looking at the new events that they had on the immediate horizon. We know the markets hate uncertainty, and the fourth quarter pro-

vided three major unknowns — all eyes were on these three things. The first one was in October when the Fed Open Market Committee met. Investors were patiently waiting the outcome and they got exactly what they wanted — more free money. Not only that but also a change in FED policy where they were going to re-shift their focus to the unemployment rate rather than just inflation. As such, it became clear the FED was committed do whatever they could and whatever they had to (in terms of printing money) to be able to get us to the unemployment target. Bottom line what we heard was, "its QE (quantitative easing) to infinity."

Federal Reserve

Catherine: Right. What came out of Operation Twist, then QE3 and then in federal budget reengineering, whether it was the fiscal cliff at the end of the year or what's going on now, is that there is a message sub rosa that keeps coming out that corporations and corporate earnings will be protected at all costs. That very much tracks with what we've been seeing in the U.S. equity market all year long.

Chuck: That's literally what's happening. Then in November, we had the election, of course. Then quickly after that was decided — and the market actually got what it wanted there, because they don't like uncertainty. Obama was a known. Investors knew what they were going to get because they've already had four years of it. Romney was an unknown. So the election was positive for the markets.

Investors didn't like it enough to drive the markets higher, because as soon as the election was over, it became a focus on the fiscal cliff. I don't know if it was like this where you are, but here where I am it was all fiscal cliff news all the time. You couldn't go anywhere, do anything, or be any place without people talking about the fiscal cliff. The interesting thing was most people didn't understand what it was, because the major news outlets really didn't explain it. But they got the grasp that it had potential dramatic impact to not only the future their personal world, but the investing world, too.

One final thing that I can't go without mentioning regarding a 2012 market recap was the ongoing story of the success of Apple. As we got deeper into the year I kept reading articles on how it was going to be the next $1,000 stock. I saw the first article on September 19th followed by one on October 16th then another on October 18th and again on November 21st. And like so many in the past where unrealistic, frothy headlines tend to precede a stock's decline, as soon as Apple hit $700.00 it quickly retreated 25 percent the last few months of the year. The real story though was not so much the decline but rather the huge effect Apple had on the markets run over the past few years. Because it is such a large market cap stock, its success not only affected the technology sector but all the major indices.

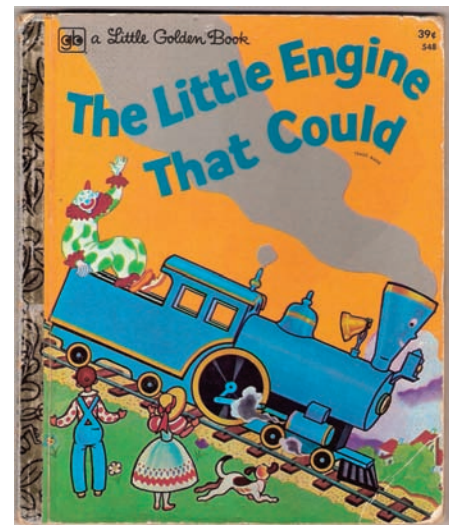
Many thought Apple was going to $1,000.

Index	Dec. 2012	QTD	YTD	High	Low	Description
S&P 500	0.9%	-1.1%	11.5%	1419	1257	US Largest 500 Company stocks
DJIA	0.6%	-2.5%	7.3%	13332	12190	Large-cap stocks
Russell 2000	3.3%	1.4%	14.6%	864	737	Small-cap stocks
MSCI EAFE	3.8 %	6.3%	25.0%	56.9	45.5	Europe, Australasia & Far East (EFA)
MSCI Emerg. Mkts.	5.3%	6.4%	10.3%	44.2	36.3	Emerging Markets stocks (EEM)
Barclays Agg. Bond	0.3%	0.7%	4.9%	111.5	107.6	Total US Bond index (AGG)
Barclays H/Y Bond	1.5%	1.2%	11.0%	40.2	38.3	High-yield Corporate Bonds (JNK)
Gold	-4.0%	-6.7%	8.3%	1781	1598	Gold Spot Price
Silver	-12.6%	-13.6%	6.3%	37.2	28.8	Silver Spot Price
US T-Bill	0.0%	0.0%	0.0%			3-month T-bill

All returns are estimates through Dec 31, 2012. Return numbers are inclusive of dividends.
High and Low columns reflect closing prices from the period 1-01-2012 to 12-31-2012 for the commensurate Index, exchange traded fund or spot price.

Chuck: Let's go to Slide 1.

The S&P 500 was up double digits. The Dow was up seven percent. The small caps were up almost 15 percent, and interestingly the international markets were up 25 percent; so they bested the U.S. by double. I thought that the emerging markets were going to continue their downtrend because the last two years, they were really in a downward spiral, but surprisingly they ended up double digits. And of course, bonds continue to be the "Little Engine that Could."



Bonds continue to be the "Little Engine that Could."

Bonds continue to have decent years. Now, that's another topic for another day. High-yield bonds, which are the junk bonds, had an incredible 11 percent return. I think that that tells all about the 2012 markets in that it was "risk on." You see risk on because people were investing in the small caps and in junk bonds — people were looking for yield. And as such, gold and silver had good years, but they did lag the market in general.

I do track gold versus the Dow. Since 2000, this is the twelfth year in a row that gold has outperformed the Dow.

Catherine: Right — which is an amazing performance. It's not just that it's outperformed; if you look at how much it's outperformed by, it's quite dramatic.

Chuck: Yes – exactly. You want to move on to Chart 2 now?

Catherine: Yes – Chart 2 is the one that takes my breath away. You always come up with these charts that take my breath away. If you had any doubts that Operation Twist and QE3 and FED and Treasury policy were supporting the fraudsters, this chart removes any remaining doubt.

Chuck: Absolutely! In confirmation of that — you know, look at the utilities! The poor utilities were the only group that had a down year. They tend to be what most people consider — those investments that people want to —

Sector	Q4 Peformance	Year Performance
Financial Services	5.13%	**28.45%**
Health care	-1.28%	**16.68%**
Communication Services	-4.97%	**15.52%**
Industrials	3.85%	**15.26%**
Real Estate	0.45%	**13.84%**
Technology	-6.79%	**10.67%**
Consumer Defensive	0.67%	**9.51%**
Basic Materials	2.36%	**7.79%**
Consumer Cyclical	-2.60%	**7.42%**
Energy	-3.18%	**2.54%**
Utilities	-4.04%	**-2.95%**

that are most risk-averse.

Catherine: Yes, think about it. The utilities were shutting down coal plants, converting to gas and doing all the things that are wonderful for the world, and they're down three percent.

Chuck: Exactly! It was a Bizarro world! Chart 2 — the first column are U.S. sectors; this is the U.S. market only, and it looks at the performance — first quarter performance in the first column, and the second column was the year performance. And as you said, financial services had the best performance. Part of that is because they're starting to turn around and be able to — I hate to say this — make money because of the spread that they're getting between the free money they're getting from the Fed and their outrageous fees that they're charging their customers.

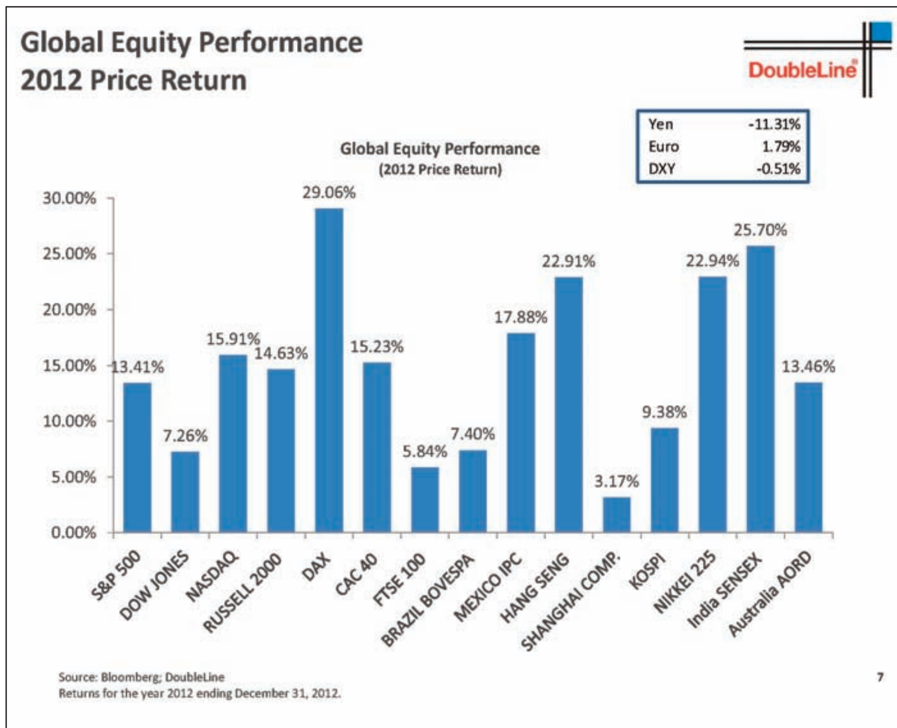
Utilities were shutting down coal plants.

And so this was one of those areas that really defined a market of "risk on." If you to look at where we were in 2010 – 2011, financial services were in real dire straits, and here we are: they're in an outperformance mode.

Catherine: What you're looking at in the first two best performing sectors — both financial services and healthcare — are industries enjoying a very significant infusion of government subsidy. So the financial services are really arbitraging the federal credit. That's one of the reasons that the fiscal cliff negotiations and the reengineering of the federal budget are so difficult. The market is so dependent for performance on government subsidy.

Chuck: Yes, especially in the financial services sector — absolutely.

Chuck: Moving on to Chart 3.



This is a look at the major equity markets around the world. Interestingly enough, you can see that Germany, India, Japan and Hong Kong had gang-buster years. Now the one that didn't make sense to me was the last one I expected to do so well — Japan. They've been in a 20 plus -year downtrend. Of course, they're going to have cycles where they are going to do okay, but that one I didn't expect. In addition, I didn't expect that China was going to be the worst performer of the world's largest markets.

Catherine: That is a surprise — China underperforming Hong Kong and Japan.

Chuck: Yes. I would have thought that Japan and Hong Kong would have been reversed. And speaking of Bizarro, let's move to Chart four.

International Stock Indexes

Index (Region/Country)	High	Low	% Chg
Caracas General (Venezuela)	476415.28	116141.83	**302.8**
Istanbul National 100 (Turkey)	78579.08	49836.98	**52.3**
KSE 100 (Pakistan)	16943.19	10909.12	**49.8**
CASE 30 (Egypt)	5969.39	3627.8	**48.4**
SET (Thailand)	1397.19	1025.32	**35.8**
Manila Composite (Philippines)	5832.83	4371.96	**33**
DAX (Germany)	7672.1	5898.35	**29.1**
ATX (Austria)	2427.37	1854.79	**26.9**
OMX Copenhagen (Denmark)	461.11	356.71	**26.9**
WIG (Poland)	47920.75	36653.28	**26.2**
Bombay Sensex (India)	19486.8	15517.92	**25.2**
NZSX-50 (New Zealand)	4080.9	3210.64	**24.2**
Hang Seng (Hong Kong)	22666.59	18185.59	**22.9**
Nikkei Stock Avg (Japan)	10395.18	8295.63	**22.9**
Johannesburg All Share (South Africa)	39427.13	31985.67	**22.7**
FTSE 250 (U.K.)	12422.77	10102.9	**22.5**
Straits Times (Singapore)	3191.8	2646.35	**19.7**
Bel-20 (Belgium)	2500.66	2049.25	**17.1**
IPC All-Share (Mexico)	43825.97	36548.56	**17.1**
Merval (Argentina)	2914.93	2121.52	**15.9**
Swiss Market (Switzerland)	6973.69	5713.34	**14.9**
S & P/ASX 200 (Australia)	4671.3	3985	**14.6**
PX 50 (Czech Republic)	1041.3	859.2	**14**
CAC 40 (France)	3674.26	2950.47	**13**
Jakarta Composite (Indonesia)	4375.17	3654.58	**12.9**
SX All Share (Sweden)	351.52	297.41	**12**
RTS Index (Russia)	1754.81	1227.65	**11.9**
All-Shares (Norway)	511.9	423.98	**10.9**
Kuala Lumpur Composite (Malaysia)	1688.95	1504.22	**10.3**
Kospi (South Korea)	2049.28	1769.31	**9.4**
Weighted (Taiwan)	8144.04	6894.66	**8.9**
OMX Helsinki (Finland)	6291.35	4802.12	**8.3**
AEX (Netherlands)	346.6	283.07	**8.2**
FTSE MIB (Italy)	17133.42	12362.51	**7.8**
Sao Paulo Bovespa (Brazil)	68394.33	52481.44	**7.4**
BUX (Hungary)	19900.88	15978.64	**7.1**
Tel Aviv (Israel)	1244.51	1045.22	**7**
S & P/TSX Comp (Canada)	12740.47	11280.64	**4**
Shanghai Composite (China)	2460.69	1959.77	**3.2**
PSI 20 (Portugal)	5746.47	4408.73	**0.8**
IBEX 35 (Spain)	8902.1	5956.3	-6.4
Colombo Stock Exchange (Sri Lanka)	6074.87	4737.75	-7.1
Santiago IPSA (Chile)	4694.86	3558.96	-11.1

When I downloaded the data to put it together, I had to do it twice because I wasn't sure I didn't get it wrong. I thought I had it upside-down. If I were to have predicted at the start of the year what markets would have done best

and what markets would have done worst, I would have at the top of or very close to the top of my list, if not at the top, would have been Chile.

We all know the benefits of Chile. Yet it had the worst performance out of all of the markets around the world. If you had asked me which ones would have done the worst, I would have said, Well, Venezuela, of course, because we have Hugo Chavez who is America's benevolent favorite dictator, and they've been struggling with massive 20-plus percent inflation. This chart just blows me away!

Catherine: Right — well, this chart, the chart of the sector performance of the U.S. market or the review of the global markets, — its message is in the short run there is little relationship between economic fundamentals and economic performance.

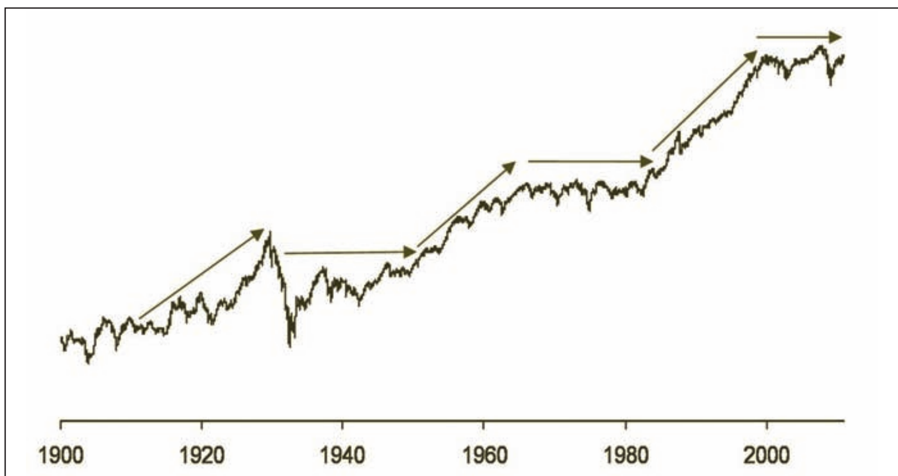
It's hard to see.

Chuck: We do know that it matters in the long run, but we have short terms where you're just scratching your head and wondering what's going on.

Chuck: All right — that wraps up the first section. Let's move on to Part 2, which is the "Secular View of the U.S. Markets?"

So just a quick definition — secular does not have anything to do with religion. There are really three types of cycles in the economy. There's the short-term cycle and intermediate term cycle and a long term. Now, while there's not really an agreed-upon definition of a time period for each one of those, what I tend to use is short term is in the zero to three-year time frame, intermediate is three to ten years, and the secular is ten-plus. So really secular is the longer-term chart, and that's where we're focusing our view tonight.

I pulled this definition, "the term 'secular' is most often used to distinguish underlying long term trends from seasonal variations in the effective normal economic cycles." So with that as a baseline, let's take a look at Chart 5.



Chile would have been on the top of my list.

This is a chart of the Dow Jones Industrial Average since 1900, so it is intended to represent the U.S. stock market. Now, I know there are some various listeners out there that are going to send in messages that say, "Look, you know, Chuck, 30 stocks does not represent the United States stock market." The problem is that we don't have any indices that go back far enough to do these long-term secular trends, and all we have is the Dow. And so that's why I'm using that in this chart; so I wanted to make that clear.

I will be switching during these charts from the Dow to the S&P 500 when I can, because the S&P is more reflective of the U.S. stock market. But this analysis starts off with the Dow. So what you can see here is that the secular trends really have two cycles. There's a bull cycle, and there's a bear cycle. We tend to refer to them as bear cycles. But if you look, they're really not bearish. If we're going to stick with an animal, let's call it a "cowardly lion," because what you have is a rise —

Wall Street in the 1900s.

Catherine: It's a grind sideways.

Chuck: Yes — it's a consolidation period followed by a push up, and then another consolidation, and then another push up etc. This is the common theme in the long-term views of the U.S. stock market. Now, the interesting thing is if you do some parsing out of the data, you're going to see that secular cycles last on average about 16 to 18 years. Now, the shortest is a little less than 14, and the longest is around 20.

So keep that in mind, because we're going to come back to talking about the two secular segments more in depth in just a while.

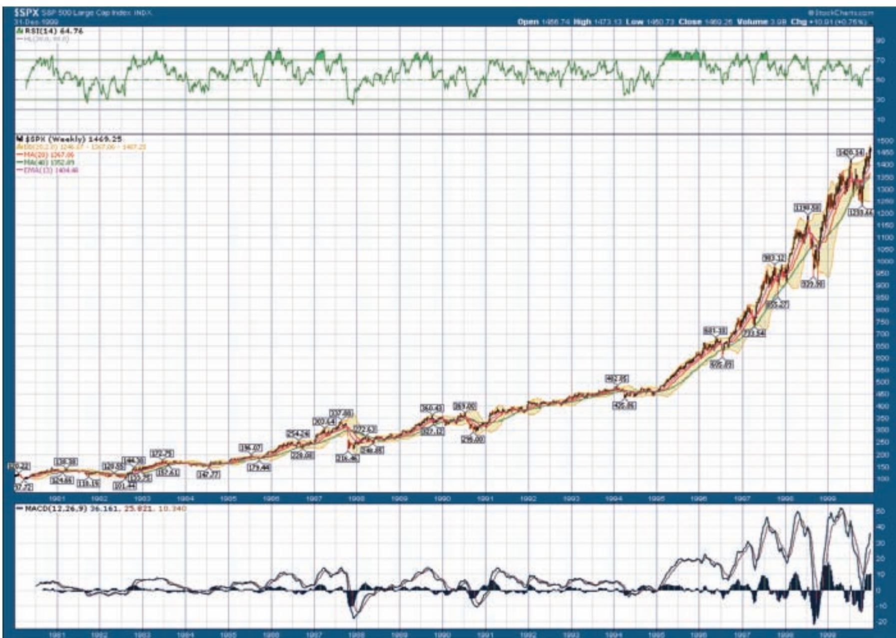
Catherine: I want to step back before we go onto the next chart. Whenever I look at this chart I get nervous, because if you look at the federal budget from World War II on, what you're talking about is massive borrowing and intervention that supports corporate earnings. What's happening now is a fundamental reengineering of that process and system. And I think in the '90s, a lot of what I've talked about and written about is the extent to which in anticipation of that change the leadership pulled their money out of this economy and reinvested in the emerging markets and elsewhere.

So when you look at this rise ever since World War II, and you think, "Well, if the federal budget isn't going to be borrowing money and pumping money into corporate earnings what's going to do it?" To me, the big question mark beneath this is, "Is there also a fundamental shift in the governance system and the allocation of resources going on underneath the carpet that will impact this particular grind sideways?"

Chuck: That's interesting. I did want to go back and just say that, I wanted to

set the tone because what were going to do is now that we know how the market has performed historically, it doesn't guarantee that its going to do that going forward.

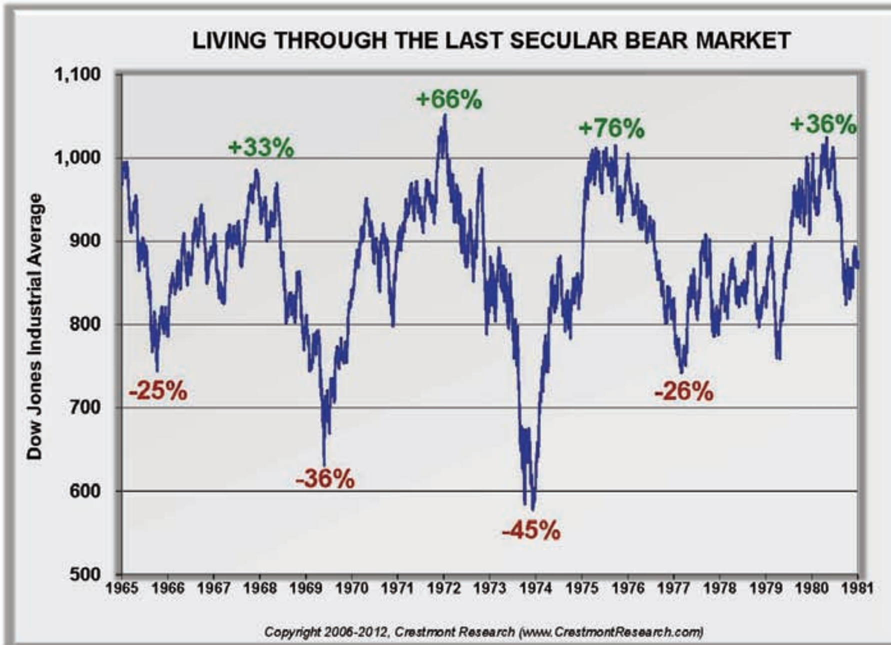
I want to step back and look at the bigger historical picture and then drill down for a closer look into each of the two different secular segments to see if there is some sort of pattern that is consistent within each. Identifying and understanding any pattern gives us a framework, which should help give a clearer perspective on where we might be today. So let's jump to the Chart 6, which is the secular bull.

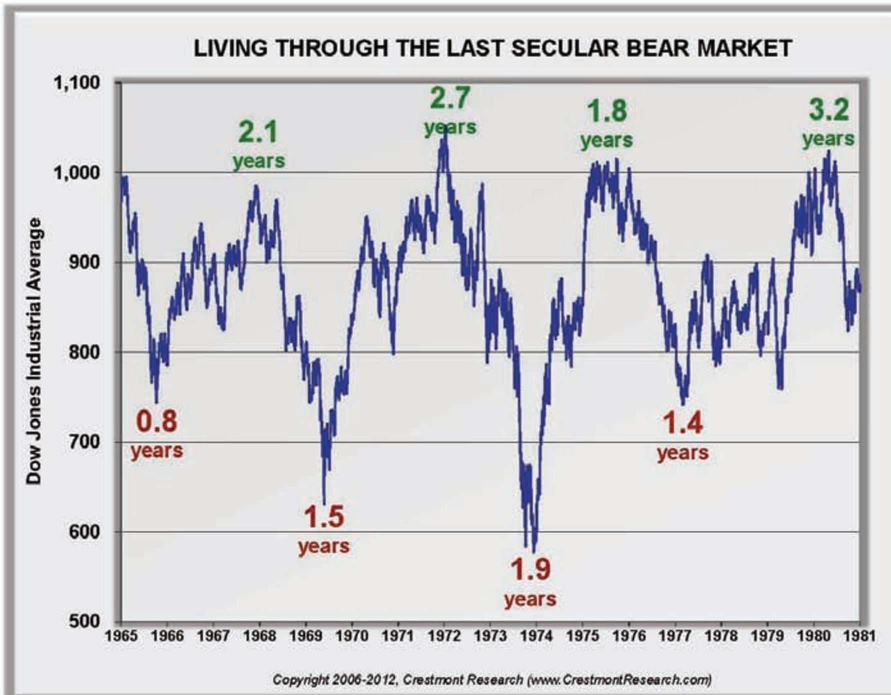


Chuck: So the secular bull is very consistent on how they look. A bull market is really defined by a period of successive higher highs and higher lows. And what I mean by that is that each successive peak — and if you kind of look at the chart you'll see that each successive peak are higher than the last peak, because they go up, and they go down, and you look at the peaks and the valleys, and each succeeding low are higher than the prior low. That's the definition of a bull market. Now, the interesting thing is that most of these bull market secular cycles are broken down into two segments.

In this case, you'll see a nice, slow, gradual ascent from the start of the chart, which is about 1980, until it goes to about 1995, and in which case you see this hockey-stick bend in the chart. It no longer has a linear rise, and you see what I call a "parabolic blow-off." And this is the time to recognize when you run into these parabolic blow-offs — and we'll talk about other ones and what it comes down to: indices or individual stocks or other things — that's the time when investors should be recognizing that and saying, "You know what?

"It's time to either take a little bit of money off the table or take my money and put it elsewhere So let's take a look at a secular bear market, and that would be Chart 7.





Chuck: This is a snapshot of 1966 through 1982, and this chart is actually — there are actually two of them there on top of each other. And let me see if I can describe it. The blue line is the Dow Jones Industrial average price during that period of time, and what you see is that there are cyclical bulls and cyclical bear markets within a secular market. And hopefully that's understandable.

Catherine: So as it grinds sideways, it goes up and down within that sideways trend.

Chuck: Yes — exactly.

Catherine: So we're not in a primary trend up. We're in a primary trend across, but it's going up and down and up and down within a defined range.

Chuck: Exactly. Thank you for making that clear. I was going to have a tough time trying to explain that, but that's exactly right. You see a couple things. One is that the bull market portion lasts longer than the bear market. So keep this in mind. It takes a little while to go from the bottom of a bull market to the top of a bull market.

Catherine: And then you come down hard and fast.

Chuck: That's exactly right. I did the average here. The bull market during this period of time lasted about two and a half years. It rose an average of 53 percent. The bear market lasted on average 1.4 years and fell an average of 33 percent. But the interesting thing was to look at where it started and look at where it ended. There isn't that much difference. So what you did is if you bought and hold that index for that whole 16 period of time, you got nothing.

Catherine: Right — if you look back over the last 12 years —

Chuck: Ah, you're getting ahead of me, Catherine!

Chuck: So the question one needs to consider is if you are in this type of market how do you make money? It's very difficult, as you have to be able to time the market by selling at the top and buying at the bottom.

Catherine: Hard to do. .

Chuck: So — it's very hard to do. The other thing is that you can buy dividend paying stocks, and it really doesn't matter — you know, the stock's prices are going to go up and going to go down. If you have a five to seven percent dividend paying stock, you're going to get paid five to seven percent whether it goes up or goes down, and you have a — it's not guaranteed, but at least you're getting something — you're getting that constant return of dividends independent of what the price does. So if you're going to be a buyer and holder, at least get paid to buy and hold.

Catherine: Right.

Chuck: It really is hard to make money in this kind of environment. So for me, this is one that you kind of want to avoid. I'm going to repeat this a couple times; for every place that there's a bear market, there's a bull market somewhere in the world. So it's easy to avoid these kinds of markets; just go focus on the markets that are in bull markets. So now that we've done a

breakdown of what a secular bear looks like and a secular bull, let's jump to Chart 8 which shows where we are today.

This chart starts off in 2000. We're currently in 2013. We've been through 12 full years. What happens if you remember what I said about the secular cycles is that they last on average 16 to 18 years with a minimum of 14 and a maximum of 20 years then if this cycle is consistent with the past we've got at least 2 more years with the potential of up to 7 to 8 more.

Chuck: So again, we don't know whether these cycles are going to hold, but the pattern here is one of a "cowardly lion" market.

Catherine: If you look at what's causing the rises or what's supporting the rises, we have the tech bubble. We have the housing bubble. We have the QE bubble. You know, you almost feel like we need a new infusion of something to bubble it. We know the housing bubble wasn't based on solid fundamentals and neither was the QE bubble.

Chuck: And definitely the tech bubble wasn't either.

Catherine: Right! Now, as I said in the wrap-up, I believe because they have gotten so many of the criminal liabilities cleaned up with QE3 and the various bank settlements, the leadership is looking at a serious commitment to re-inflation. And so they can continue to bubble. The leadership has created the platform to do it.

Chuck: Right — but does that QE — does that bubble actually equate to higher stock prices?

Catherine: That's a big question.

Bubbles are not based on fundamentals

Chuck: That's the question for me. If you drill down on this one, again, we've been through two bear cycles within this secular cycle. So we had two cyclical bears, and they've lasted an average of 2 years and fell an average of 53 percent each time.

Interestingly enough, this pattern was consistent because we've had two cyclical bulls, including the one that we're in today, and they rose more than 100 percent, but as the prior cyclical bears, it took longer to go to their peak, and they averaged about 46 months for a cyclical bull versus the 24 months for a cyclical bear. Again, this is alternating cyclical bull/bears within a secular bear. This is not unlike '66 where we started at one point and we ended almost at that exact same point many, many years later.

You really made no improvement over where you started, and that's where we are today. That's exactly where we are today. This looks exactly like the '66 bear cycle to me, except for the fact that it's not quite run its course yet.

Catherine: The other thing is we're looking at prices in nominal dollars, not in real dollars. That's why you'll always see Franklin Sanders put up the Dow in gold dollars just to show that phenomena, because in fact if you had your money in the S&P and been flat during this whole time essentially using the indices, then you're purchasing power has diminished significantly.

Chuck: Yes — that's a good point. My problem is — you know, we've talked about this before. My problem is always, "What do you use as your benchmark to compare against? Do you use oil or Twinkies or Wonder Bread?" We've talked about that. So gold is what most people use, but it just adds another variable to the discussion; that's all.

Catherine: Right.

Chuck: So you pointed out for me that we had the tech bubble in 2000 and the housing bubble in 2008; those are two, and interestingly enough those are two major tops. And if you look, they ended just— you know, they hit the top about the same level each time. What's interesting about tops is that basically the sellers come into the market, and there are no buyers, so you have this decline. You can't ignore prior periods at which a market has lost all of its buyers.

So here we are getting close to retracing where the last two tops were. It's something that should cause people to take notice and question as to whether or not they want to continue to keep totally involved in this market. There are no guarantees about this because there are so many things that could push this thing up and beyond the tops that we've experienced so far. But it is something that's a warning sign.

Gold is what most people use.

Catherine: Well, if you just take all the increases in the money supply since the –

Chuck: Yes!

Catherine: — the housing bubble popped, and you just multiply by a factor of how much the Fed has expanded the money supply, you're going to get a much bigger number than you had at the beginning of 2008.

Chuck: Yes — yes. Well, let me quickly go to Slide 9,

I love this chart because this is a breakdown of the most current bull cycle that we're in. What you see is we have a massive ramp up, and then a slight correction, and another massive ramp up, and then a slight correction, and another massive up and a slight correction. It just keeps repeating itself. What's interesting about it is that each and every successive ramp up is not only shorter in time period, but it's also lower in the amount of gains that it makes. What this is showing is the sign of a market that's exhausted and stalling.

While the markets rallied strong for four straight years, and if history is any guide, the current price structure of the trend indicates we could be due for quite a correction ahead. This is one of those ones – we'll show a chart later – that this is one of those ones that's a 20 percent + type of correction. This is what this chart is saying to me.

Catherine: Right. In a sense, it parallels the reports of the extent to which the economy is not responding to massive monetary and fiscal stimulus. Every dollar of stimulus is getting less bounce, and you're getting a flat-lined response.

Chuck: Yes — diminishing marginal returns — isn't that what it's called?

Catherine: Yes — diminishing marginal returns.

Chuck: All right — so that's it for the secular analysis. Let's go to a couple of other things quickly. Let's go to valuations, because in the long run valuations really do matter. If we pull up Chart 10,

let's take a look at where — you know, historically, we're going to go back and look at the S&P 500 because, again, I have this data, and it's good. Instead of the Dow, I'd much prefer to use it. If you're using the S&P, what you have is you can see you have massive spikes and declines, but the average is 18.3. So the average P/E ratio is 18.3.

Now, where are we today? We are at 22.6, so we're not excessively overvalued, but we're still overvalued nonetheless.

Catherine: Yes, we're still above the line.

Chuck: We are still above the line. Robert Schiller did some great work on P/E analysis. Let's go to Chart 11

Results For S&P 500 From Different Starting Shiller P/Es 1926-2012

Starting P/E Low	Starting P/E High	Avg. Real 10 Yr Return	Worst Real 10 Yr Return	Best Real 10 Yr Return	Standard Deviation
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
21.1	**25.1**	**0.9%**	**-4.4%**	**8.3%**	**3.8%**
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

because what he did was he went back and looked at time and said, "If you had a P/E — a starting point P/E, what could you expect for returns going forward for the next ten years?" So this gives you a snapshot of what could be — there are no guarantees, of course, but what could be ahead. What you're

going to see on this chart is — you know, it's pretty clear that the lower the P/E, the greater your returns over a period of time of the next ten years with the opposite holding true too.

If you look at where we're at today, I've got it highlighted and circled — 21.1 to 25.1 starting P/E, we are in the ninth decile there which is one from the bottom. What the Shiller study tells us is that for the next ten years the average real return, looking back historically, has been 0.9 percent per year. That's a number that is not really all that interesting to me. Now, the worst real return during that 10-year period was a 4.4 percent loss per year, and the best 10-year — outcome was 8.3% which is actually pretty good; Of course I wouldn't be complaining if we could get the best 10-year, but the odds of that are low.

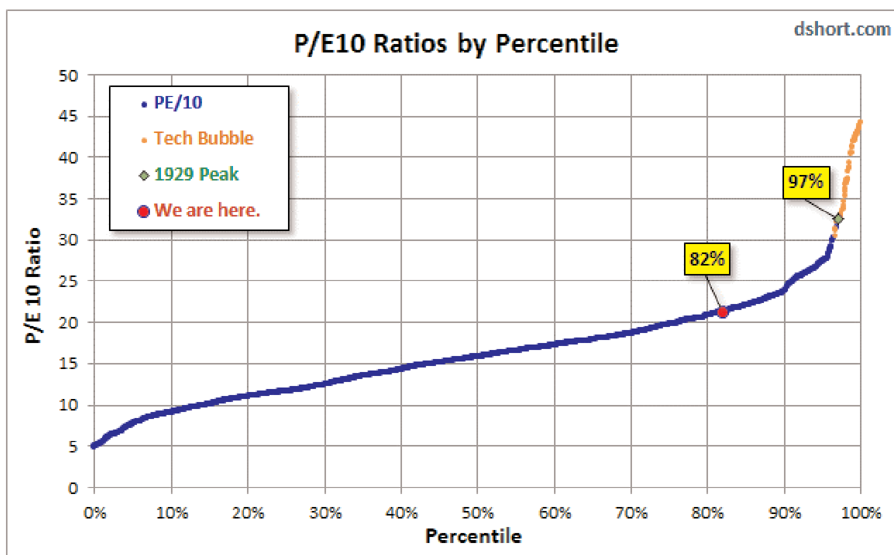
So what it says is that P/E's matter. The lower the P/E — when you're buying things, the lower P/E for the market, the higher the probability you're going to have a good return.

Catherine: Right. What this is saying is if you're going to invest now, investing now at these sorts of general market levels could really give you pause.

Chuck: Well, it should – yes.

Catherine: I look at the average being 18.3. We're above the average in tough economic times coming into some major changes, both positive and negative. And we're looking at a pretty high PE that we'd be buying in at now. You look at this, and you say, "Hmm, that does give me pause."

Chuck: Exactly. So just as another perspective, if you look at Chart 12,



this is a plot of the P/E ratios and the decile — the percentile. As you can see we are currently in the 82nd percentile. From an historical perspective just before the 1929 crash we were in the 97th percentile and the tech bubble saw

levels exceeding that.

So while again we're not in excessive territory, we are in the territory that should make you ask "whether now might the time you might want to consider taking something off the table or shifting it to other places that might have more attractive P/E's or more attractive levels for longer term returns."

Catherine: That doesn't mean necessarily out of equities, but it may mean out of U.S. equities.

Chuck: We're investment advisors, and we can't give a general recommendations. But, yes, that is something that one should really look at. I'm not saying at all "avoid equities." I'm saying broaden your horizon and look at other opportunities, because there are some around the world that are actually pretty interesting right now.

Catherine: Yes. Let me just put the counterpoint in here, though.

Chuck: Sure.

Catherine: I see how high the tech bubble went. If the leadership is committed to re-inflation of the real estate markets, and the Fed continues to buy the way it's buying, and inflation is used to manage the sovereign debt issues, then we could see the stock market rise tremendously, not because of any fundamental value, but simply as part of the general inflation.

Chuck: I absolutely agree with you 100 percent. That's what my fear has been ever since back in 2009 when they started just pumping money into the economy. I was afraid inflation was going to take off. Now, I'm early. I'll put everything that I have on the table saying, "At some point in time we're going to have massive inflation. But I don't believe it's today or anytime immediate."

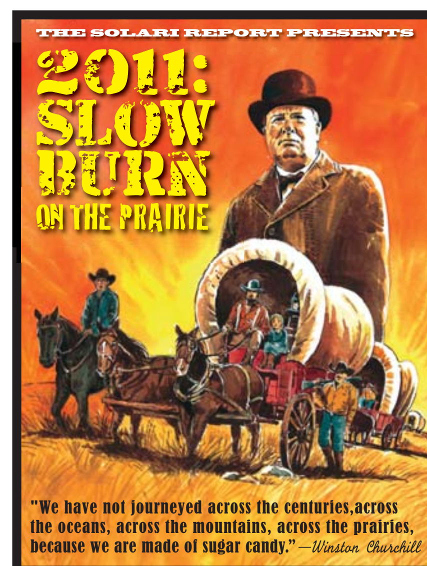
Catherine: The slow burn burns on.

Chuck: Exactly. All right. You can't talk about – even though it's not cyclical in nature, you can't talk about ramps or markets without talking about psychology. The one thing is that emotions play a large role in influencing market direction and most importantly the magnitude of the move. So the greater the move in whatever direction, then the more people are willing to either get in if it's going up or to get out if it's going down.

Humans move in herds. The herd takes a while to get going, but when it does, everybody piles in. And normally, that is the time — when you start to see those rises —

Catherine: The parabolic rises?

Chuck: Yes — the parabolic rises — that's exactly right. In the 1980 to 2000 rise that we saw, that's what causes those parabolic rises. So knowing that —



The slow burn burns on.

if there's a way to measure that — that's a contra-indicator. That's one of those times where you say, "All right, I'm looking at all these indicators around the world" — whether it be P/E's, I'm looking at these contra-indicators, and I'm saying — "This one — if it comes up and it registers on the radar, then this is something that we shouldn't ignore."

So I'll give you a couple examples. Look at the tech bubble. We saw that in the chart. I lived through that. I was relatively new in the investment advisory business then, I had people coming in, they were taking loans on their homes. They were doing everything they could to free up money so that they could jump into these tech stocks that were just going to the moon. We know how that one ended. Then in 2007, I saw the exact same thing happening when everybody wanted to sell all of their stocks and all of their bonds because they wanted to invest in housing!

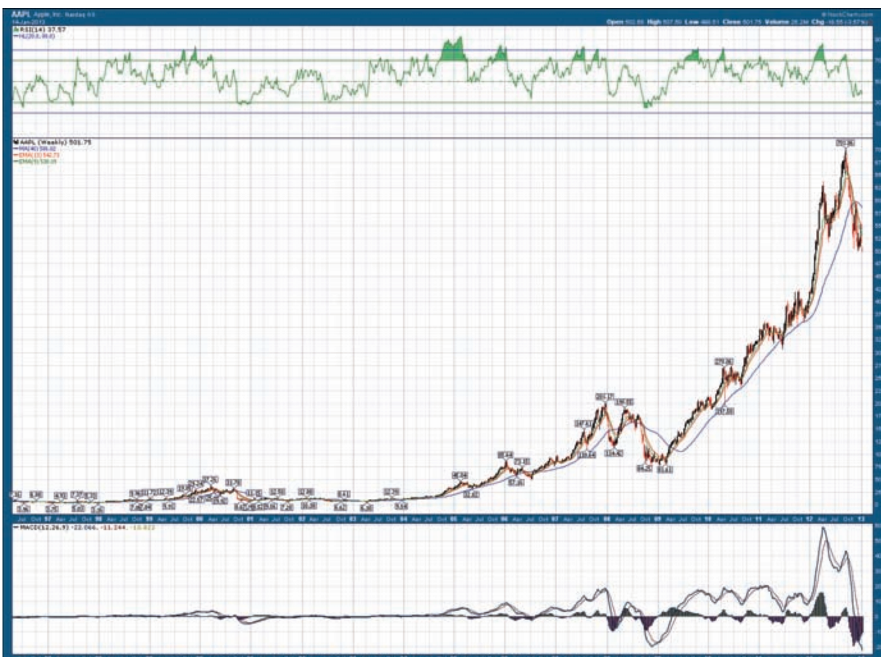
Real estate was the next thing! I can't tell you how many people took everything they had and put it into housing. We know how that one ended.

Catherine: Right.

Chuck: A couple of other examples: silver. Back in 2011, you remember when it went to $50.00?

Catherine: Oh, yes, I remember. I was busy swapping into gold.

Chuck: Well, that that's the difference between you and the herd. You understand it, you recognized it, and you took action. That reinforces my point. Let's take a look at Chart 13 and see if you see any similarity.



So watch for the inflation – re-inflation of the real estate market, because something is up.

Chart 13 is a recent chart of Apple. Does that not look like the 1980 to 2000 secular bull market all over again?

Catherine: Right.

Chuck: This doesn't mean that Apple's going to zero. This doesn't mean Apple's a bad company. It doesn't mean anything bad about Apple. What it means is we had over-exuberance in Apple. It had driven it beyond what normal valuations and normal — what people would normally pay for it. I'm not saying it's going to crash and burn any further than it currently is. It closed the day at $500.00. I'm just saying when you get into this kind of environment — when you hear, "Apple's going to $1,000.00," and it's all over the place, or you hear, "Silver's going to the moon," those are the times when you should be taking heed and doing something to protect yourself.

Catherine: You know, the *Solari Report* subscribers have heard me say this many times, but the week after they said that Apple equaled the total market capitalization of all the companies in the PIGS in Europe combined, I was on a plane to Europe to due diligence companies in Europe. That's when I said, "Okay, out of U.S. tech, into Europe, here we go!"

Chuck: Exactly! The problem though is that it can take a while for that bubble to pop.

Catherine: It did. It took two or three quarters for that shift to occur. But now it's happening.

Chuck: That kind leads me into Chart 14.

Table 1: Top 10 biggest wkly inflows of all time

	Date	All equity funds ($mn)
1	9/19/2007	22,823
2	1/9/2013	22,208
3	12/12/2007	18,512
4	6/18/2008	17,701
5	3/19/2008	16,011
6	12/20/1995	15,334
7	9/19/2012	15,186
8	11/28/2012	14,861
9	6/16/2010	14,717
10	11/10/2010	13,896

Source: BAML Global Investment Strategy, EPFR Global, Lipper FMI

They were doing everything they can to free up money so that they could jump into these tech stocks that were going to the moon,

Andrey Bayda / Shutterstock.com

One prediction that occurred at the beginning of the year that Apple would hit 1,000. It didn't.

This is a snapshot of last week — this is the flow of money into equities. This is the second largest weekly flow of all time. Now, one data point doesn't make a trend, but this is something that you should say — we're talking about exuberance, we're talking about sentiment and watching out for when it goes "over the top" — beyond normal, this is one where one should keep an eye out.

Catherine: Here's why this surprised me, Chuck — because U.S. investors were pulling money net out of equity funds as the market was rising in 2012. They were pulling money out, and there was great concern for a variety of reasons. So they were selling into the rise. Then to see in the beginning of 2013 this reverse surprised me. The only thing I can think is they took a look at the year-end performances and said, "Well, maybe the stock market has finally turned around." But this one surprised me. I didn't expect it.

Chuck: I was trying to come up with a rationale as to why this happened. My first argument is it's one data point, so we shouldn't bet the house on it. But if it continues, I think you hit it on the nose, it's got to be that the money managers around the world are lagging, and they are especially lagging if they put a whole lot of money in Apple, which many of them did. So they have got to find a way to diversify themselves and to get back on the performance train, because we know that money chases performance.

Catherine: Well, I do believe the real political message of the fiscal cliff negotiations is, "No matter what happens we're going to protect corporate earnings." That's a very strong political signal in support of the U.S. equity markets. Now, again, it's too early to see.

Chuck: I agree with you but in the meantime we might have a hiccup or two.

Catherine: Oh, I can flat guarantee it! Beware the Ides of March!

Chuck: Exactly! I'm done with the charts on the secular side, but let me just do a quick wrap-up here. In my analysis, there are really only two types of secular markets. There's bull and then there's the range-bound cowardly lion. Being able to recognize which one of those you're in can greatly assist in you being able to not only protect but also grow your wealth. Additionally, recognize that investment styles that work during bull markets rarely work in the bearish range-bound cowardly lion markets.

So you have to recognize and then adjust your investment strategy if you are going to participate. In equity bull markets, the best thing you can do is to put your money in as soon as possible. Now, it doesn't have to be equity. Use gold as an example. Don't try and time your entry point when you're in a bull market; you just put your money in.

The Cowardly Lion as illustrated by William Wallace Denslow (1900)

Catherine: You get in, and you stay in.

Chuck: You get in, and you stay in. Then you spend all your time focusing on trying to find when the end of that bull is up, because all bulls end; it's just a matter of finding out when. And hopefully, you can spend your time doing the analysis and looking at that rather than trying to figure out a time to enter. And the other thing we learned was that in equity bear markets, entry points matter and dividends matter just as much, if not more.

Catherine: Right — and I would say something else: quality matters.

Chuck: Absolutely.

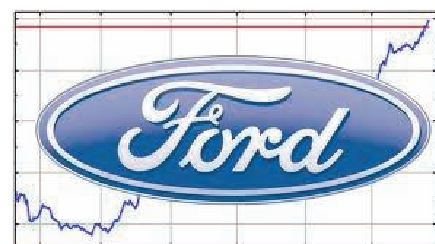
Catherine: You know how much I care about quality leadership and quality companies, the quality of governance, the quality of management, and the quality of all different aspects of the operation. Fundamentals count for a lot. They really count — all companies go through difficulties. Bad things happen, and that is when the quality of the company and the product make an enormous difference. So the message of the sector analysis for this year is "government subsidy counts." I would say over the long-term, quality and fundamentals count - in what you're calling the "cowardly lion," they count for a lot.

Chuck: Oh, absolutely — I couldn't agree more. And during a bull market, almost every board and every management style and every company looks good. What differentiates you is when we're going through the periods that we're going through right now.

Catherine: Right.

Chuck: So the other thing we learned was valuations are critical, and so when you are in excessive valuation mode, you really ought to consider reducing your exposure and moving it to other things that are less valued. And the other thing is, while it's very hard to do, don't be afraid to become a buyer when valuations are at a low. That's the hardest time to do it because our emotions are telling us otherwise. But that's the time to be a buyer.

Catherine: Well, at the very bottom in 2009 — end of 2008 — 2009, the mayor of Hickory Valley came slamming into my office driving up in a brand new red Ford pickup, and he walked in and he says, "I just bought Ford stock, and you should, too."



Chuck: He turned out to be pretty smart, huh?

Catherine: I think he caught the exact lowest day. Good call by the mayor.

Chuck: Just to close up, the last two things I have is that emotions are a major factor in moving equity prices. So the best thing you can do while you

have other people that are driving the markets, the best thing you can do is keep yours in check and move counter to the herd. And finally, look for those parabolic moves for time to reduce your risk. And just in general, if there's always a bull market somewhere, why try and navigate these bears — or these cowardly lion markets? It just doesn't make sense.

Catherine: Right.

Chuck: So that closes out, but I did want to say that most of what I've talked about in my mind here tonight is really about a bearish outcome. It's the bearish side of the potential for the U.S. stock market. One last chart I want to show you — because you and I have gone through this a lot of times, and it always makes you take pause and reflect back, because this is just — this is cyclical in nature. Let's take a look at Chart 15.

A history of declines (1900-2012)

Type of decline*	Average frequency	Average length†	Last occurrence
Routine (-5% or more)	About 3 times a year	47 days	November 2012
Moderate (-10% or more)	About once a year	115 days	June 2012
Severe (-15% or more)	About once every 2 years	216 days	October 2011
Bear Market (-20% or more)	About once every 3-1/2 years	338 days	March 2009

* As measured by the unmanaged Dow Jones Industrial Average

It's a history of stock market declines in the United States. So this is the Dow Jones Industrial Average, and it breaks it out into four different types of declines: a 5 percent or less decline, a 10 percent or more decline, a 15 percent or more decline, and a 20 percent or more decline. And it shows you the average length. So a 5 percent decline averages about 47 days, and the last one we had was last November. So a 10 percent — a moderate decline — lasts on average 115 days, and the last one we had was last June.

And a severe decline of 15 percent or more averages about 216 days, and the last one was in October 2011. And then of course, the dreaded bear market, which is a 20 percent decline, averages 338 days, about once every 3.5 years.

Catherine: And we're overdue!

Chuck: Exactly! We're overdue. So what I've done is built a number of bear-

ish cases for why people should be cautious — it doesn't mean to go out and sell everything you have, because that's not what I'm saying. But be cautious about the U.S. stock market in 2013.

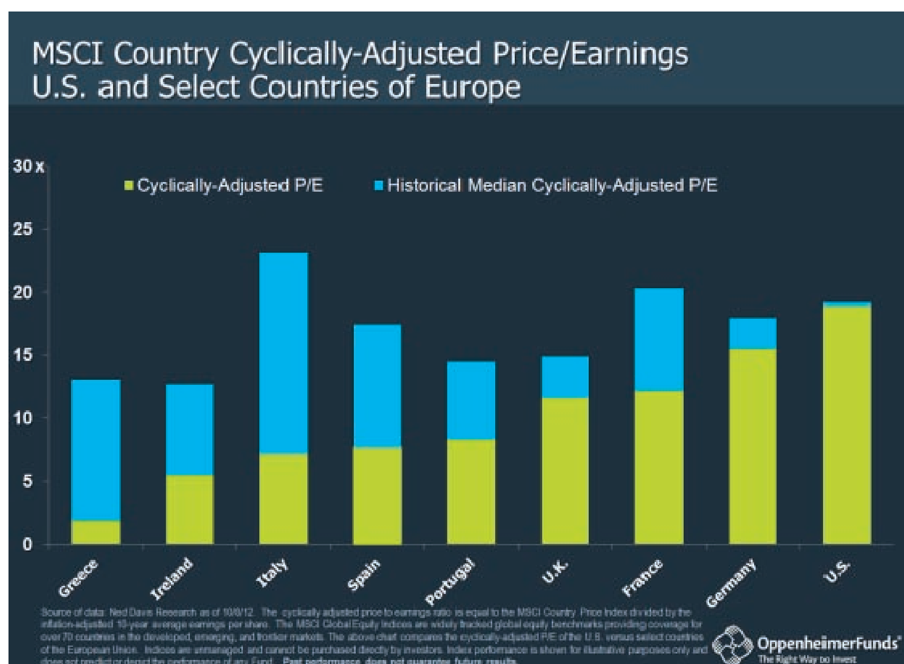
Catherine: This chart is one of the reasons the quote that I put on the update that we sent out for tonight's *Solari Report* was from someone I like to quote a lot, Sir John Templeton, "The four most dangerous words in investing are, 'This time it's different.'"

Chuck: That's right! As soon as you hear that, it's time to take your money and run!

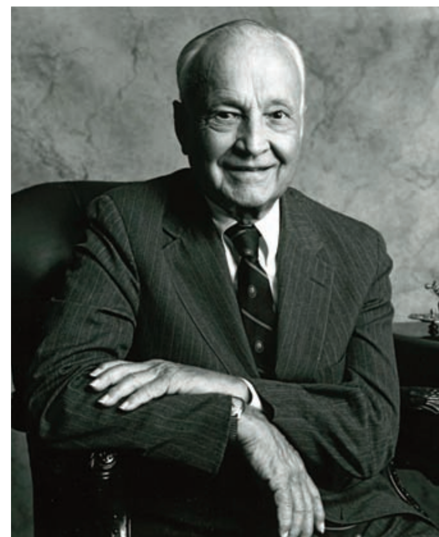
Catherine: You had a couple other charts up. I didn't know if you wanted to go through them as well.

Chuck: Yes, I did, but I just wanted to say, most of the charts we have looked at were the U.S. markets. While I'm very cautious about the U.S. markets, there are some very compelling reasons why equities in general — not necessarily the U.S. — are a great place to put some of your money. Part of that is what we're going to talk about on next quarter's call. But let me just throw this out again, and there's a quiz.

So what have we learned about? We learned that valuations matter. Let's take a look at Chart 16.



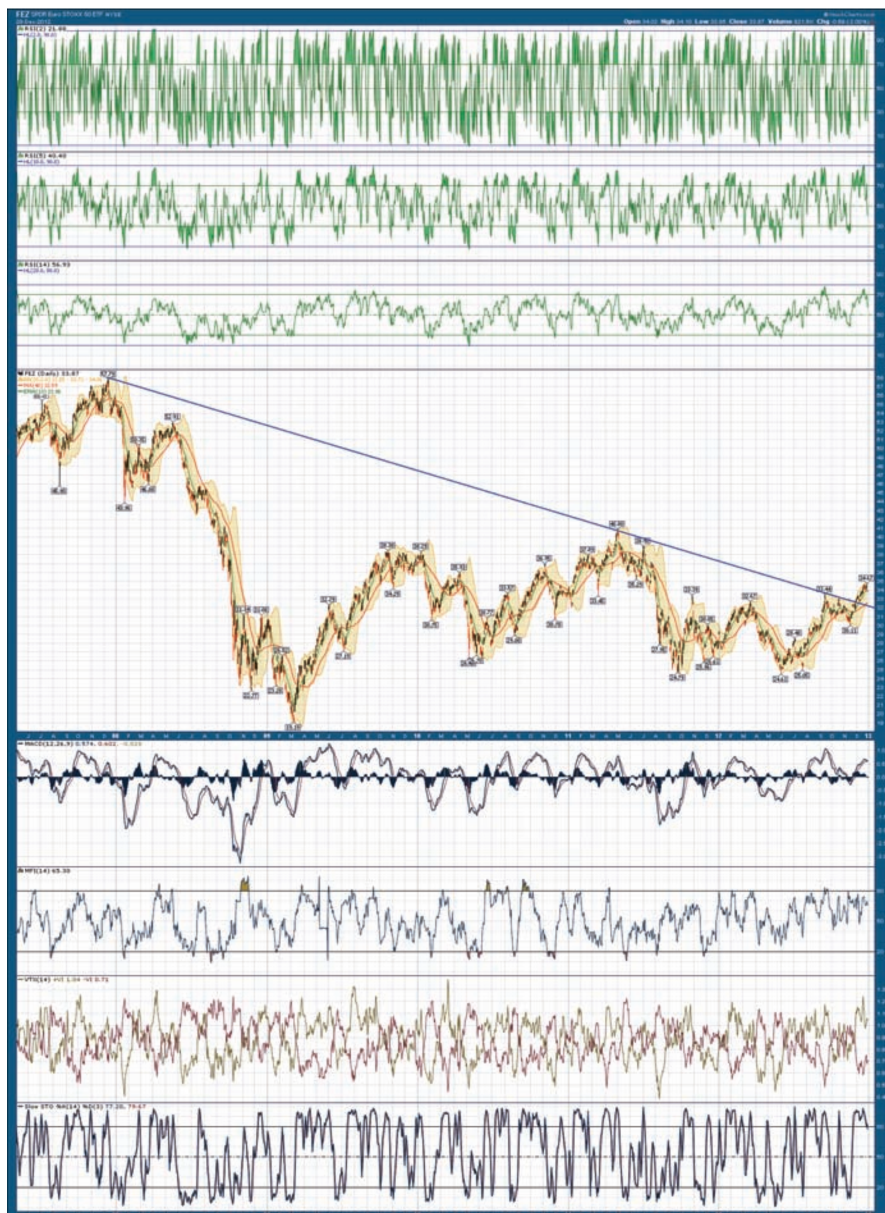
Now, I'm not giving this as a recommendation, but let's take a look at Chart 16. And what this is is a chart of the European countries' valuation as compared to the U.S. And the green portion is how the U.S. is valued — I mean, that's compared to how they were valued to the U.S. So you can see Germany


Sir John Templeton

is undervalued, and France is even more undervalued, etc., etc.

So what that's saying though is just look at Europe, because Europe is well undervalued as compared to the United States. So if one were concerned about the U.S., then one might want to look at Europe. Now, would I want to go and take all my money and put it in Greece? No, that's not what I'm saying. But you could look at a mutual fund or something that gives you a basket of funds or a basket of countries in Europe that should do very well. Now, valuations we know are longer-term trends, and they don't always really give you good entry points.

They just tell you that now might be a good time. What I like to do is I like to get confirmation, and that confirmation is to look at Chart 17,



Would I want to put my money in Greece?

and this will be my last one. This is an exchange traded fund. If you look at it, Europe has been in a downtrend since 2011. It had lost about 40 percent of its value. And what you look for is a change in valuation; we got that.

And then you look for a breakout in price. So you could see that that down-trend that I had drawn there in the middle section was a very consistent, strong trend that had a very tough time breaking out. Well, it finally broke out in Q4, and to me that was my signal to say, "All right, if I'm going to put some money now seems to be the time as I've got undervaluation and I have a trend break that supports the theory money seems to be flowing back into European equities.

So we have a break of the lower lows and the lower highs. Now it's shifted to higher highs and higher lows. This is how bull markets start.

Catherine: Chuck, I can't thank you enough for this. Do you want to describe what we're going to talk about on the next equity overview, because I think it's a very fascinating topic and dovetails with what we've been talking about tonight.

Chuck: Yes — I think it's an evolving topic. I know where I wanted to start. There are some very compelling reasons why these secular trends may not hold because the world is way different today than it was back in the '60s and back in the '80s when we were looking at the past secular bears and bulls. What has changed and why, and is it large enough to affect the markets; so therefore, maybe it is different this time.

Catherine: The big question in many of our minds, and we certainly ask it a lot in precious metals, for decades now we've printed more and more paper, whether it's currency or bonds or derivatives. And by and large, the stock market represents real stuff — real companies out there doing the world's business. At some point, as yields have dropped and dropped and dropped and dropped, if the money should leave the bond market, where is it going to go?

"Some days I just don't feel bullish."

We know it's going to go to something more tangible, whether that's the stock market, whether that's real estate, whether that's precious metals. The reality — the size of the bond market and the derivative markets, the asset backed markets — all the fixed income markets — is that it doesn't take but a little bit of money to spill over to drive up some or all of the equity markets. It takes even less of that to drive up the precious metals markets. So we're looking at a potential waterfall.

When does that water start to flow out of the bond market into equities, into precious metals, into real estate? Big question mark.

Chuck: Absolutely. Bonds have been in a bull market for 30-plus years, and

so spend your time recognizing, trying to find out when they're going to change, because at some point in time the bull is dead. We're getting in my mind very, very close to that time. I don't know when it will be, but I have to keep a very, very close eye out on that for 2013.

Catherine: Well, you don't have to live to experience my mortification, because every month I do Coast-to-Coast AM, and George Noory says, "Could interest rates possibly go any lower?" It's like the interest rate limbo dance — "how low can you go?"

Chuck, thank you so much. You've done a terrific job. We can't thank you enough for joining us on the *Solari Report* this evening.

Chuck: Thanks, Catherine. Have a good one.

"Could interest rates possibly go any lower?"
—George Noory

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