The Solari Report

MAY 8, 2014

1st Quarter Equity Overview

with Chuck Gibson

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C. AUSTIN FITTS: Welcome to the equity overview for the first quarter. I am glad to welcome Chuck Gibson, my partner at Sea Lane Advisory, and managing member of Financial Perspectives. Chuck, it's been a very interesting first quarter. We're going to start with a roundup, and then we're going to move into intermarket analysis. So first, let's start with the first quarter. Take it away.

CHUCK GIBSON: Thanks Catherine. It's great to be here. Let's roll right into the charts because we have 25 of them to look at tonight. The first chart is just a summary of what the indexes did during the first quarter. You could see that the stocks were slightly up or slightly down.

Index	Mar 2014	QTD	YTD	High	Low	Description
S&P 500	0.7%	1.3%	1.3%	1878	1742	US Largest 500 Company stocks
DJIA	0.8%	-0.7%	-0.7%	16567	15373	Large-cap stocks
Russell 2000	-0.8%	1.1%	1.1%	118.2	108.7	Small-cap stocks
MSCI EAFE	-0.5%	0.1%	0.1%	68	62.3	Europe, Australasia & Far East (EFA)
MSCI Emerging Mkt	3.9%	-1.9%	-1.9%	41.8	37.1	Emerging Markets stocks (EEM)
Barclays U.S. Bond	-0.1%	1.8%	1.8%	108.4	106.4	Total US Bond index (AGG)
Barclays H/Y Bond	0.0%	2.9%	2.9%	41.53	40.41	High-yield Corporate Bonds (JNK)
Gold	-2.6%	7.2%	7.2%	1385.0	1204.5	Gold Spot Price
Silver	-6.1%	2.4%	2.4%	22.05	19.27	Silver Spot Price
US T-Bill	0.0%	0.0%	0.0%			3-month T-bill

All returns are estimates through March 31, 2014. Return numbers are inclusive of dividends.
High and Low columns reflect closing prices from the period 1-01-2014 to 03-31-2014 for the commensurate Index, exchange traded fund or spot price.

The interesting thing was, up until the last week of the quarter, all the stock indexes were down. We had some mysterious buyers step in at the last minute and bring the indexes positive for the quarter. The other thing that was interesting was bonds were up strongly as well as precious metals.

C. AUSTIN FITTS: Right, and gold was better than silver.

CHUCK GIBSON: Absolutely. That made me a little concerned because if you expect that precious metals continue to rally, you would hope to see silver leading gold. In this case, it seemed more just the opposite, so I'm concerned whether that was more geopolitical issues.

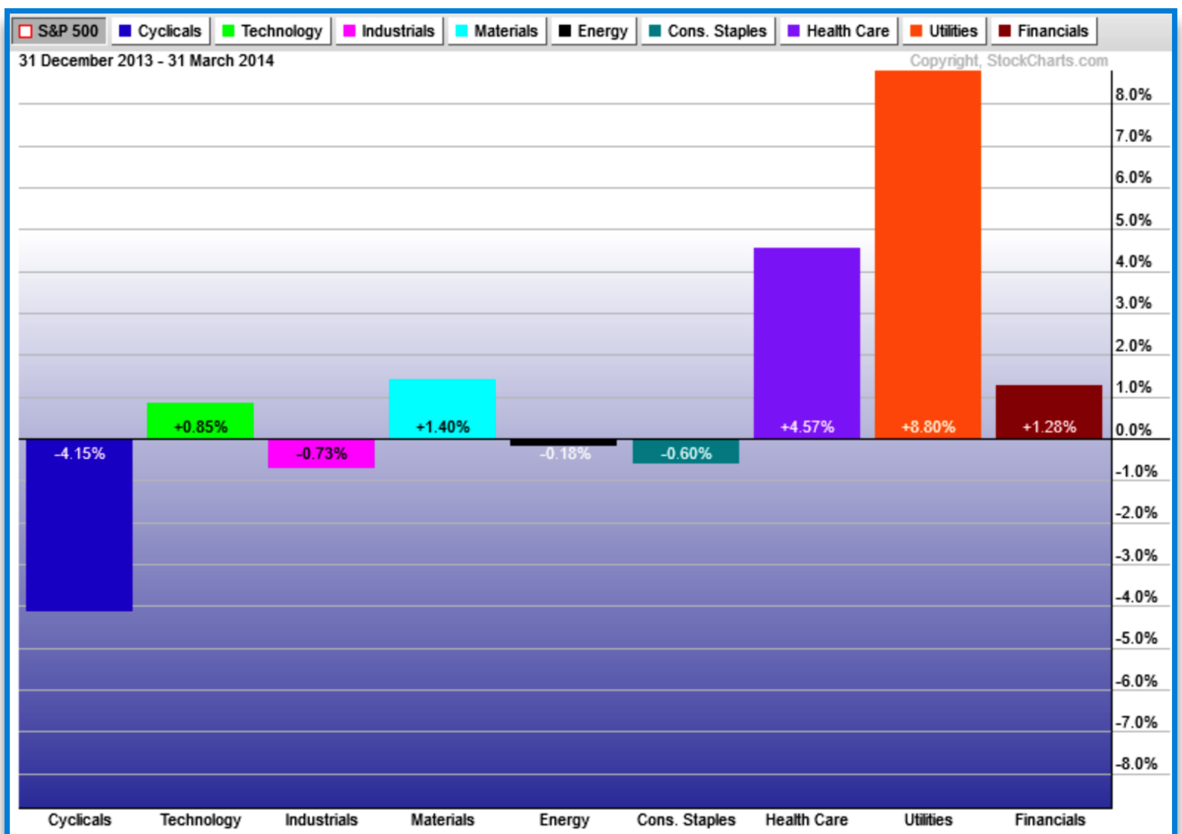
C. Austin Fitts: Right, and that was precious metals off a bottom at the end of the fourth quarter last year?

Chuck Gibson: Yes.

C. Austin Fitts: The bonds were a little bit of a surprise because we had Chairman Yellen saying interest rates were probably headed up. Suddenly, bonds start dropping, outperforming stocks. I would describe the first quarter as very choppy.

Chuck Gibson: Yes, and are we acting as if we don't know what's happened since then? Because we continue that same path.

C. Austin Fitts: Choppy, choppy, choppy…



CHUCK GIBSON: Yes. Let's roll right into the second chart, which is the U.S. sectors and how they did. What you see here is that healthcare, utilities, materials and financials actually were the strong winners for the quarter. The big losers were the cyclicals, and, although it doesn't show it here, the industrials. The first quarter was the start of a rotation out of the higher beta stocks and into the safer, dividend-paying, less volatile stocks.

C. AUSTIN FITTS: At the end of the quarter, the announcement was that there was essentially no growth for the quarter. This is where everybody goes when they're worried that we're starting to go into a slow economic period.

CHUCK GIBSON: Correct. I don't have it here, but we've talked about it before: the cycles of the economy. At the end of your bull market part of the economy, when you're starting to go from a growth period into a recessionary period, what you tend to see are utilities, healthcare, and cyclicals leading the market. That was a big warning plight for us.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: Let's move onto the next chart. A real eye chart here for everybody. This is just a look at the global markets and what they did across the world. A couple of winners out of there were Italy, Argentina, and Egypt, and the losers, of course, were China, Japan, and Russia.

C. AUSTIN FITTS: Yes, the sanctions in the Ukraine were very hard on Russia.

CHUCK GIBSON: Yes. It did not help there. That's continued on for the last couple months too. Let's move right onto chart number four. This is a new chart that I'm going to bring forward and present continuously here. It's very important to watch where the money flow is going, and this is just a flow of ETF money. It doesn't include mutual funds, but it does include a very large portion of the dollar.

It's important to watch where the money is flowing into. What you see

Index (Region/Country)	Q1 % chg	52 wk % chg	3-yr % chg
Global			
The Global Dow (World)	0.7	19.2	4.6
DJ Global Index (World)	0.8	15.2	6.3
DJ Global ex U.S. (World)	0.2	10.7	1.7
Asia Pacific			
DJ Asia-Pacific TSM (Asia-Pacific)	-1.7	3.9	0.8
All Ordinaries (Australia)	0.9	8.5	3.1
Dow Jones China 88 (China)	-7.7	-16.9	-12
Shanghai Composite (China)	-3.9	-9	-11.4
Hang Seng (Hong Kong)	-5	-0.7	-2
S & P BSE Sensex (India)	5.7	18.7	4.8
Jakarta Composite (Indonesia)	11.6	-3.5	9.8
Nikkei Stock Avg (Japan)	-9	22.2	15
Topix Index (Japan)	-7.6	20.2	11.4
Kuala Lumpur Composite (Malaysia)	-1	10.9	6.2
NZSX-50 (New Zealand)	8.5	16.2	14.3
KSE 100 (Pakistan)	7.5	48.6	32
PSEi (Philippines)	9.1	-6	16.6
Straits Times (Singapore)	0.7	-3.6	0.9
Kospi (South Korea)	-1.3	-0.5	-2
Colombo Stock Exchange (Sri Lanka)	0.9	4.6	-6.2
Weighted (Taiwan)	2.8	12	0.6
SET (Thailand)	6	-11.2	9.5
Europe			
Stoxx Europe 600 (Europe)	1.8	13.8	6.6
Stoxx Europe 50 (Europe)	-0.1	8.1	4.1
ATX (Austria)	-0.9	7.3	-4.3
Bel-20 (Belgium)	7	20.7	5.5
PX 50 (Czech Republic)	1.8	4.5	-7.1
OMX Copenhagen (Denmark)	13.5	31.5	14.1
OMX Helsinki (Finland)	0.2	19.8	-0.8
CAC 40 (France)	2.2	17.7	3.3
DAX (Germany)	0.04	22.6	10.7
BUX (Hungary)	-5.6	-1.8	-8.7
FTSE MIB (Italy)	14.4	41.4	-0.1
AEX (Netherlands)	0.4	15.8	3.3
All-Shares (Norway)	3.2	20	7.5
WIG (Poland)	2.1	16	2.4
PSI 20 (Portugal)	16	30.7	-0.6
RTS Index (Russia)	-15.2	-15.4	-15.7
IBEX 35 (Spain)	4.3	30.6	-0.7
SX All Share (Sweden)	3.9	17.3	6.5
Swiss Market (Switzerland)	3.1	8.2	10
BIST 100 (Turkey)	2.9	-19	2.7
FTSE 250 (U.K.)	2.1	16.9	12
Americas			
DJ Americas (Americas)	1.4	17.4	9.5
Merval (Argentina)	18.2	88.5	23.4
Sao Paulo Bovespa (Brazil)	-2.1	-9.8	-9.8
S & P/TSX Comp (Canada)	5.2	12.9	0.5
Santiago IPSA (Chile)	1.3	-16.6	-11.9
IPC All-Share (Mexico)	-5.3	-7.9	2.6
Caracas General (Venezuela)	-7.8	301.1	229.8
Other Countries			
CASE 30 (Egypt)	15.1	54.3	12.6
Tel Aviv (Israel)	5.5	13.3	2
Johannesburg All Share (South Africa)	3.3	19.8	14.2

Follow The Money

Region	January	February	March	Q1 Total
Equity Funds Fund Flow Breakdown by Region				
Asia-Pacific	$ (1,040,000,000.00)	$ 135,080,000.00	$ 220,800,000.00	$ (684,120,000.00)
Developed Markets	$ (562,620,000.00)	$ 159,840,000.00	$ 755,370,000.00	$ 352,590,000.00
Emerging Markets	$ (513,840,000.00)	$ 707,410,000.00	$ 1,520,000,000.00	$ 1,713,570,000.00
Europe	$ (46,010,000.00)	$ (69,500,000.00)	$ 608,490,000.00	$ 492,980,000.00
Frontier Markets	$ 14,376,000.00	$ 34,358,000.00	$ 58,942,000.00	$ 107,676,000.00
Global	$ (280,180,000.00)	$ (167,470,000.00)	$ 136,970,000.00	$ (310,680,000.00)
Global Ex-U.S.	$ (23,020,000.00)	$ 64,920,000.00	$ 162,770,000.00	$ 204,670,000.00
Latin America	$ 45,440,000.00	$ 127,340,000.00	$ 119,150,000.00	$ 291,930,000.00
Middle East & Africa	$ (5,440,000.00)	$ 9,460,000.00	$ 5,330,000.00	$ 9,350,000.00
North America	$ 5,030,000,000.00	$ 2,560,000,000.00	$ 1,100,000,000.00	$ 8,690,000,000.00
				$ -
Equity Funds Fund Flow Breakdown by Sector				$ -
Basic Materials	$ (110,390,000.00)	$ 46,650,000.00	$ 198,430,000.00	$ 134,690,000.00
Consumer Discretionary	$ (348,710,000.00)	$ 338,950,000.00	$ 117,180,000.00	$ 107,420,000.00
Consumer Staples	$ (383,860,000.00)	$ 51,340,000.00	$ 50,980,000.00	$ (281,540,000.00)
Energy	$ 39,720,000.00	$ (79,300,000.00)	$ 339,850,000.00	$ 300,270,000.00
Financials	$ 306,990,000.00	$ 91,860,000.00	$ (142,850,000.00)	$ 256,000,000.00
Health Care	$ (636,900,000.00)	$ (1,390,000,000.00)	$ (283,010,000.00)	$ (2,309,910,000.00)
Industrials	$ 158,440,000.00	$ 180,880,000.00	$ 103,940,000.00	$ 443,260,000.00
Natural Resources	$ (14,450,000.00)	$ 34,160,000.00	$ 110,580,000.00	$ 130,290,000.00
Technology	$ 525,490,000.00	$ 272,660,000.00	$ 82,560,000.00	$ 880,710,000.00
Telecommunications	$ (27,360,000.00)	$ 16,770,000.00	$ 21,080,000.00	$ 10,490,000.00
Utilities	$ 226,210,000.00	$ 58,980,000.00	$ 83,600,000.00	$ 368,790,000.00
Commodity Funds Fund Flow Breakdown				
Absolute Returns	$ (92,520.00)	$ (11,230.00)	$ (21,500.00)	$ (125,250.00)
Agriculture	$ (54,110,000.00)	$ 213,410,000.00	$ 240,430,000.00	$ 399,730,000.00
Broad Commodities	$ (144,960,000.00)	$ 80,170,000.00	$ 63,490,000.00	$ (1,300,000.00)
Energy	$ 70,640,000.00	$ (25,900,000.00)	$ (117,990,000.00)	$ (73,250,000.00)
Industrial Metals	$ 14,550,000.00	$ 49,220,000.00	$ 3,260,000.00	$ 67,030,000.00
Metals	$ (57,780,000.00)	$ 93,590.00	$ (63,670.00)	$ (57,750,080.00)
Precious Metals	$ 1,090,000,000.00	$ 3,890,000,000.00	$ (1,320,000,000.00)	$ 3,660,000,000.00

here, at least in the regional areas, is that North America was strong, but what popped up at the last two months of the quarter were the emerging markets.

C. Austin Fitts: So the emerging markets started to perk up.

Chuck Gibson: Absolutely, and you can see that. We'll show the chart of the emerging markets stock market later on, but you notice that in the emerging market stocks.

C. Austin Fitts: One of the things I find interesting about looking at these flows is, in the last chart, you showed healthcare as being up, but when you look at the ETF flows, we're watching money flow out of healthcare in every month of the quarter. All three months.

Chuck Gibson: Yes. Not only that, you see healthcare was the big loser for the quarter, and you saw the strength was in technology. That continued, but you saw a weakening demand. The first quarter was $500 million, then it went to $200 million, and then it went to less than $100 million. So what you're seeing is, while technology was strong for the quarter, in its self, it started to get weaker and weaker as the quarter went on.

C. Austin Fitts: When you look at the numbers; the North America market is so huge compared to everyone else. I went back historically and looked at how the emerging markets did. Over the entire period, they were kind of flat, but it was like a yoyo. All it takes is a little bit of money.

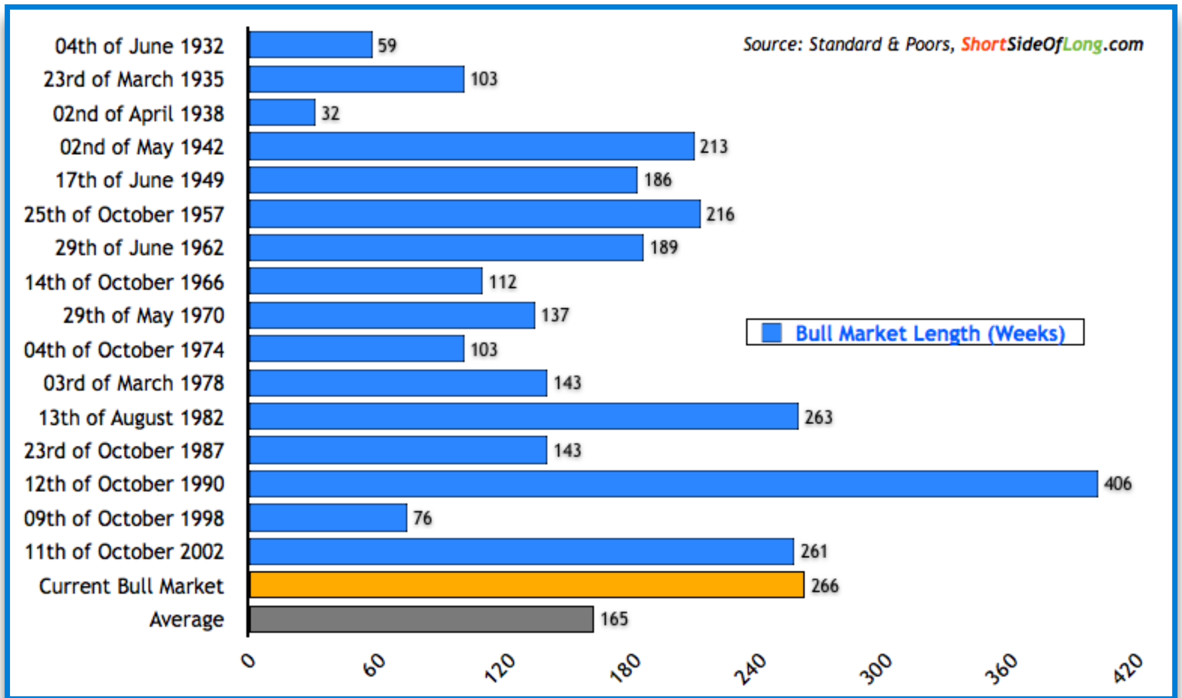
Chuck Gibson: In the final sector there are the commodity fund flows. What you see is the precious metals were the big winner for the quarter when you look at the quarter in total. But we saw something that wasn't a good sign, which was a growth from January to February, but then a quick reversal in money being pulled out of the precious metals market.

C. Austin Fitts: Well, the big loser is me when I go to the grocery store.

Chuck Gibson: That's true.

C. Austin Fitts: What I want to know is how can I invest in food because my prices are going up. What's the flip-side? The food commodities were up a lot in the first quarter.

Chuck Gibson: Absolutely, and we'll talk about that a little bit later. One real quick touch on that: coffee was up over a hundred percent for the quarter.



C. AUSTIN FITTS: Just on my purchasing alone!

CHUCK GIBSON: That's true. Let's go right into chart number five. This is just a reference of where we are in today's bull market. What this tells us is that the current bull market is going on 266 weeks, which is the second longest bull market in history.

C. AUSTIN FITTS: So let's go back. The longest was after October 1990, and that was 406 weeks.

CHUCK GIBSON: Correct.

C. AUSTIN FITTS: Then, until recently, it was the one that started in October 2002. That was 261 weeks. We're now at 266 weeks.

CHUCK GIBSON: Now, keep in mind this is a couple of weeks old, so we are now clear of that benchmark, and we're now going towards that old record that was in the 1990s.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: So, again, this just puts it in perspective. What people need to consider is that we are getting long in the tooth. How much longer can it go? Nobody knows, but we're getting close.

C. AUSTIN FITTS: Well, if you look at this, it's life before Alan Greenspan, and life after Alan Greenspan.

A history of Declines (1900-2014)

Type of Decline	Average Frequency	Average Length	# of Days Since Last Occurrence	# of Days Exceeding the Average
Routine **(-5% or more)**	About every 100 days	47 days	**0**	**0**
Moderate **(-10% or more)**	About every 365 days	115 days	**847**	**482**
Severe **(-15% or more)**	About every 730 days	216 days	**847**	**117**
Bear Market **(-20% or more)**	About every 1300 days	338 days	**1726**	**426**

CHUCK GIBSON: Only you can come up with those analyses. But now that you've pointed it out, you're right. I keep putting this chart up here because this is something everybody needs to be aware of. This is just a history of declines and how long it's been since our last decline of ten percent or more, 15 percent or more, or 20 percent or more. What you see is that we are way beyond what is normal.

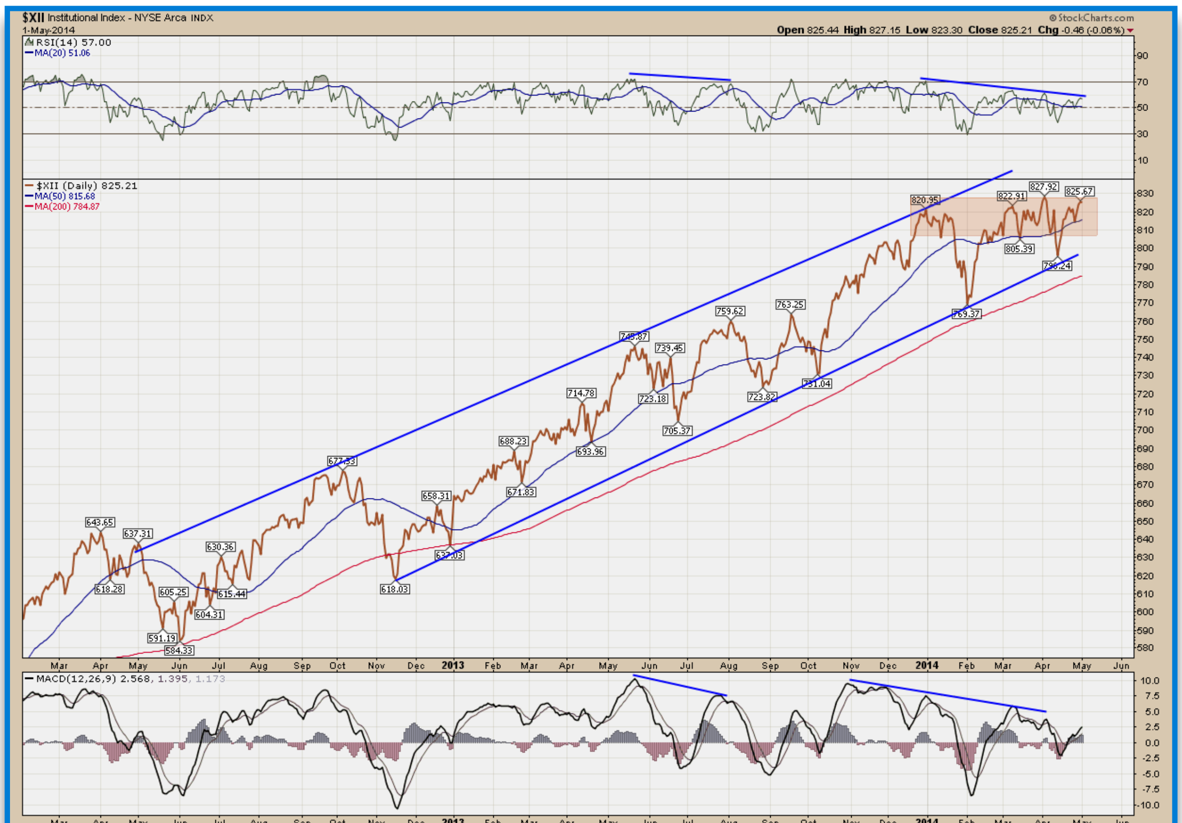
C. AUSTIN FITTS: Now, I would like to point out though, that the last time we showed this chart, we were way beyond normal on a five percent correction.

CHUCK GIBSON: Correct.

C. AUSTIN FITTS: We've wiped the slate clean on the five percent. Now we're 482 days overdue for ten percent or more correction, right?

CHUCK GIBSON: Yes, and I will say that, again, this only measures the S&P, but on some of our indexes that we're at today, we are at that ten percent. From this benchmark, yes, we are still very stretched from the average.

C. AUSTIN FITTS: Okay.



CHUCK GIBSON: I wanted to introduce your listeners to this index chart. We tend to reference the S&P 500 or the Dow. People have heard of that. Those are good proxies for the U.S. Stock Market, but if you're an investor, you really want to watch where the money is and where the money flows. This is called the S&P institutional index. This is the top

75 most widely held stocks by institutions. Since institutions hold approximately 80 percent of all the invested money, it's important to watch what they're doing with their money.

C. AUSTIN FITTS: So this is what the very biggest investors in the United States, the pension funds, the mutual funds, this is what they hold? This is their biggest holdings – the hedge funds too.

CHUCK GIBSON: Yes, the top 75 of their holdings. If they're selling, you're going to see it reflected in price. You and I know that price is really most important here. So we watch this closely to see what it's doing. I've highlighted this little pink area, and you can see we're in the clear consolidation time. We made a high in April, and it's about a week late. We tested that high and we keep trying to get above that, but we can't.

C. AUSTIN FITTS: Yes, but look at that high, that is just a tiny bit more than the last three highs.

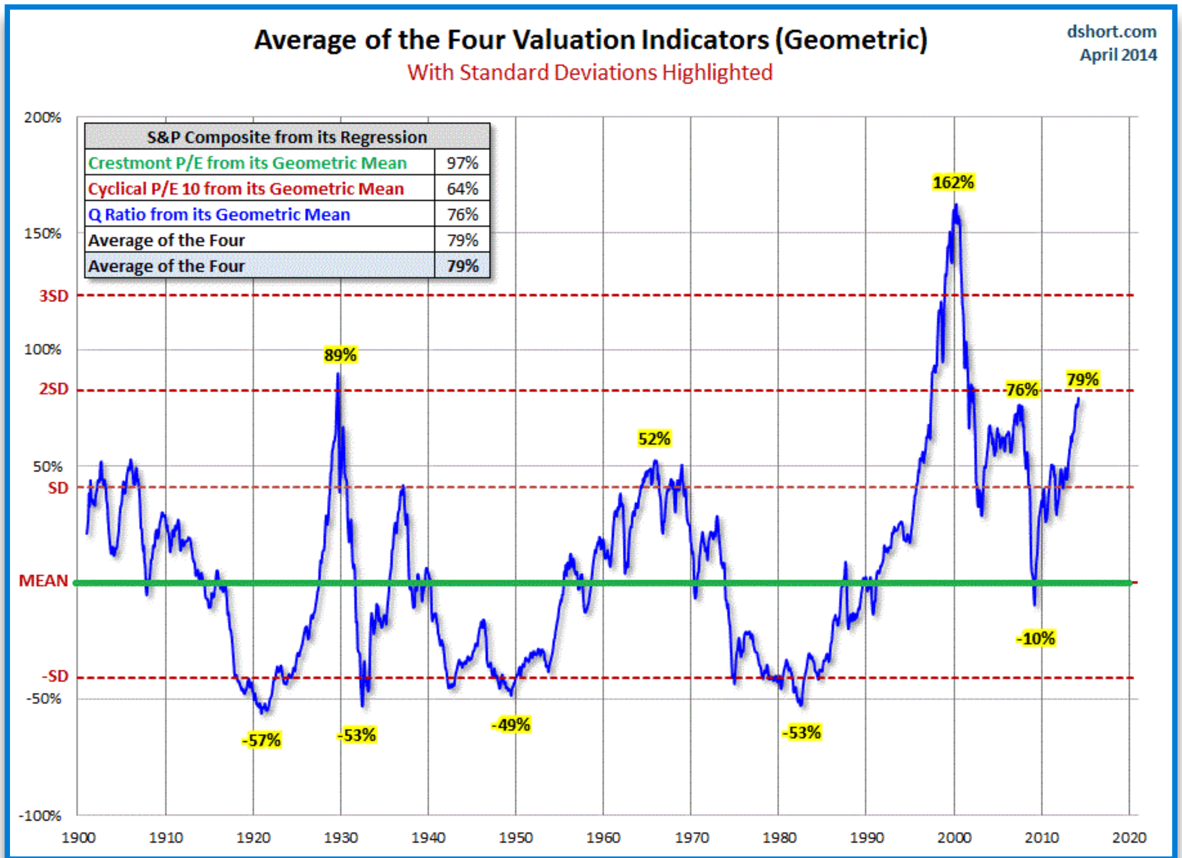
CHUCK GIBSON: Absolutely.

C. AUSTIN FITTS: That's what I describe as choppy. We're going sideways.

CHUCK GIBSON: Well, the other thing that you notice is that's a one-day or two-day spike. It's not a big deal. You're always going to get those highs and those lows, and they're not going to be perfect in terms of matching. That right there tells me that you've got a triple top in place. Before we call a top, what we want to do is get confirmation.

Just remind yourself and the listeners that consolidation is actually good for the market. This is where the bulls and the bears are fighting it out trying to figure out who's going to win. We don't know who's going to win next, but the longer the consolidation period, the bigger the next move.

C. AUSTIN FITTS: We did a Solari Report about six reports ago in the equity overview where you talked about a sideways market, remember?



CHUCK GIBSON: Yes. This is a very narrow range sideways market, but it's a sideways market. The longer the sideways move, the bigger move after that is going to come. This is something to keep an eye on. Let's go to chart number eight. I think I brought a different measurement. This is a measurement of valuation, stock market valuations. Last time, I think I brought to you one methodology. The problem with one methodology is there are holes in every single one of the ways you can analyze it.

C. AUSTIN FITTS: The last one we looked at was the Shiller P/E?

CHUCK GIBSON: Yes. This includes the Shiller P/E, but also three others. So this is an average of an average, and it's trying to smooth out the ups and the downs. People can look at the Shiller and say, well, the Shiller is fine except it's got this weakness. So what we're trying to do here is bring in all of them, take an average, and then compare that against history.

What it shows you is that we're currently at 79 percent, and that number doesn't really mean a whole lot, but what you should take note of is that it's the third highest it's been.

C. AUSTIN FITTS: Let me say it this way. What this is measuring is what kind of a multiple valuation you get from a dollar of earning. A dollar of earning translates into how much stock market value.

CHUCK GIBSON: Correct.

C. AUSTIN FITTS: What we're saying is there have been really only two times in history that you got a bigger bang for your buck in the stock market. One was in the roaring '20s, and the other was the tech bubble. We're at 79 percent, the roaring '20s was 89 percent, and the tech bubble was 160 percent. So it's more than double where we are now.

CHUCK GIBSON: Yes, and that's a really good explanation. This is telling you that the green line is the mean. That's the average. The further you get away…

C. AUSTIN FITTS: We're a way above these.

CHUCK GIBSON: Exactly.

C. AUSTIN FITTS: Now, here is my other argument. The last two times we saw it spike were periods of introduction of new technology.

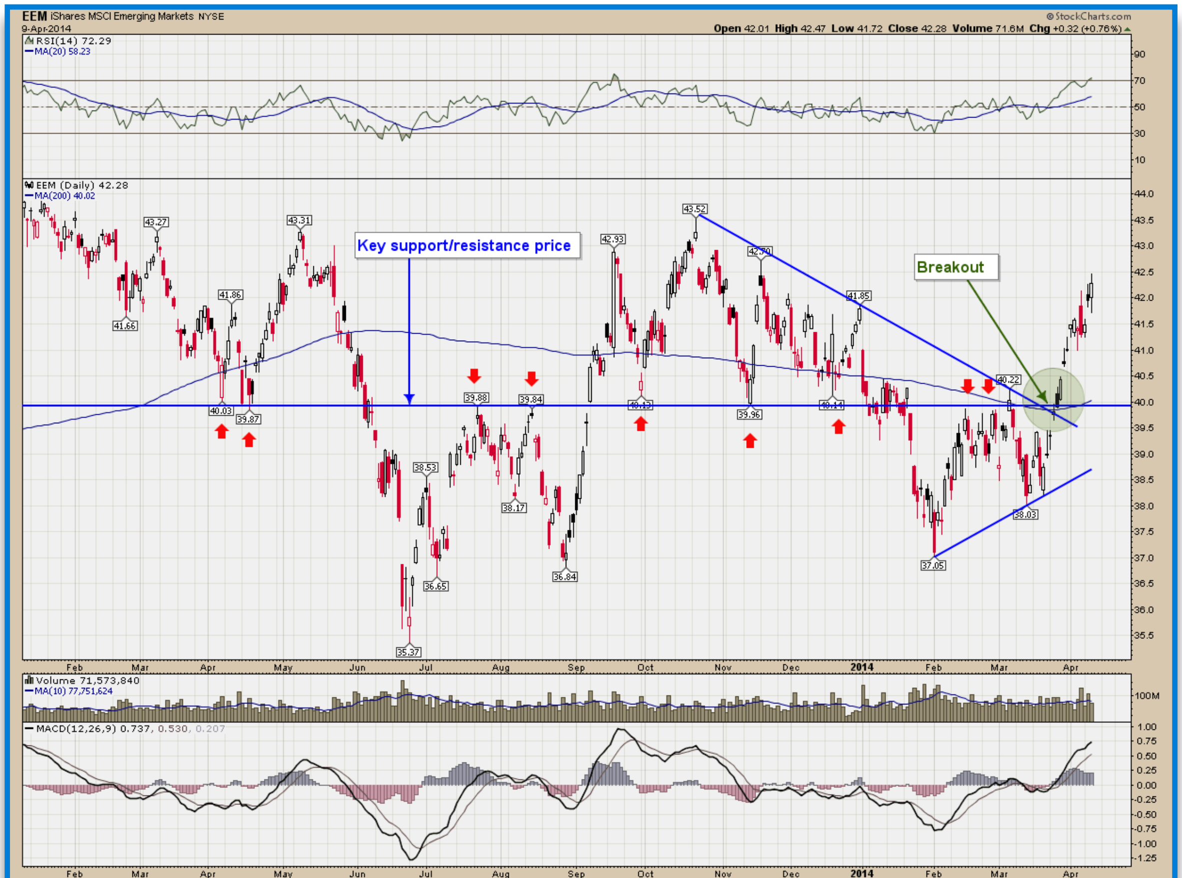
CHUCK GIBSON: What was the new technology?

C. AUSTIN FITTS: The roaring '20s: telecommunication.

CHUCK GIBSON: Oh yes.

C. AUSTIN FITTS: The same with the tech bubble.

CHUCK GIBSON: One of the things that I'll let the listeners in on, because they may not know this about you, is a week doesn't go by where



Catherine doesn't say, "How are the emerging markets doing? Is it time to invest in the emerging markets?"

C. AUSTIN FITTS: You know why? I like sales. Think about it. I like the January sales. You're paying a multiple of 24-25 times for a dollar of income in the developed world in the S&P. If we go to the emerging markets, you've got great companies in markets with great growth rates that are trading at a multiple of 11.

CHUCK GIBSON: Yes.

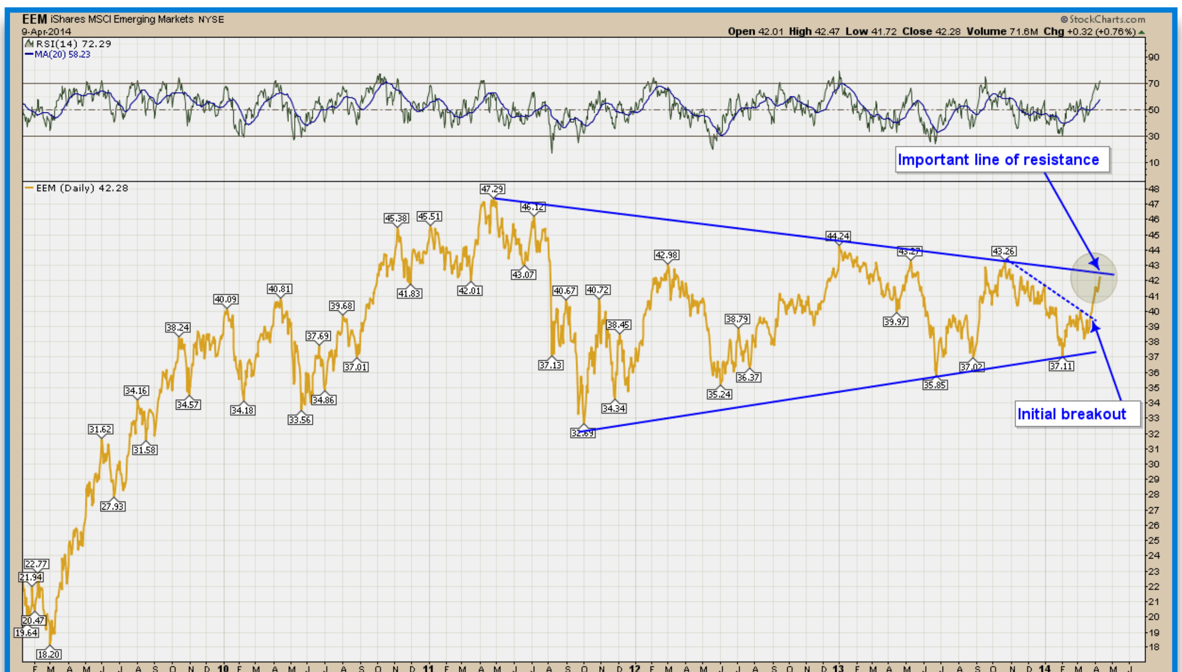
C. AUSTIN FITTS: So it's my natural inclination to say why should I pay 25 when I can pay 11? I'll buy 11. But then you'll say, "No, no, no, it could still be going down." So, when is the sale on?

CHUCK GIBSON: I'm full in agreement with you. But we want to make sure that we don't catch that falling knife.

C. AUSTIN FITTS: Right. I keep saying why not buy 11, and you say, "Because we could buy at eight."

CHUCK GIBSON: Yes. I'm a bigger tightwad than you are. What we saw in March was a breakout. You had a downtrend that was consistent from the end of last year into this year, and that downtrend blue line was resistance. What happened is we had a breakout of resistance at that point in time. That was a big flag to us to say this is a potential buying opportunity, but we didn't take it.

C. AUSTIN FITTS: Right.



CHUCK GIBSON: There is a reason why. I want to introduce the next chart, which is the same chart as what we're looking at, except it's a much longer period of view. What this is, on chart number ten, is a period that goes back since the bottom in 2009. What you see is we had a huge run up from the bottom in 2009, and it was up more than 100 percent. Then we started this sideways chop, and that sideways chop has been trending down. That trend, you can see is defined by that upper solid blue line. If you take a look at the dotted blue line that I have there, that's the point from the prior chart where we broke out.

C. Austin Fitts: Right.

Chuck Gibson: If we would have bought that breakout as an investment, we would have run up against this potentially much bigger and much more important line of resistance.

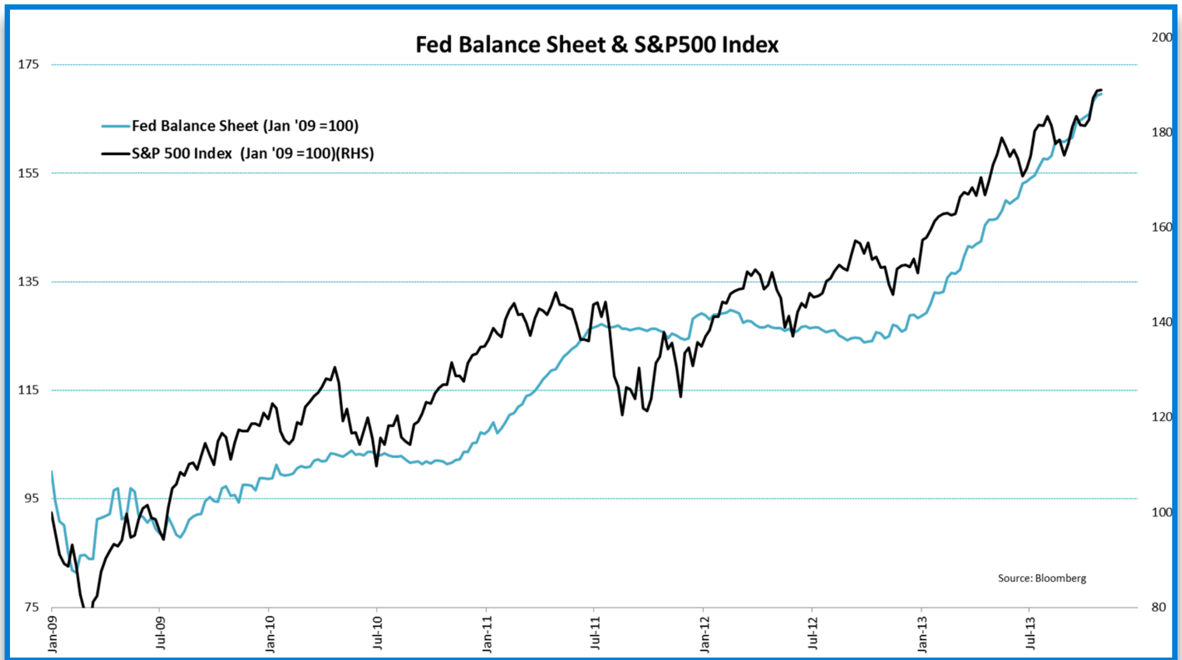
C. Austin Fitts: Right, and I want to add another concern. We're way overdue for a ten percent or more correction in the U.S. market. If we get a ten percent or more correction in the U.S. market, what are the chances that the global equities, including the emerging markets, could also correct with it?

Chuck Gibson: Well, if we go historically, it'll correct along with it, but not only will it correct along with it, it'll correct more. That's why you have to be nimble. We looked at this and said the upside potential is seven to eight percent, and where we're going to run into potential resistance, did we want to take that risk? Well, we elected to step aside and said if we break this trend line support, we'll go ahead and jump in. I have real doubts whether I wanted to do that.

The emerging markets has to continue to draw in money, but more importantly, look at where we are in the momentum. The momentum is overbought already, and it's real hard for you to continue to push up farther when your momentum, the number of buyers, is at a max. This is just a little bit of a learning experience on how we elect to pick and select investment opportunities. All right, you asked me to put this chart up.

C. Austin Fitts: Yes, the post-Alan Greenspan years.

Chuck Gibson: Yes, this is since 2009. The blue line is the fed balance sheet, and the black line is the S&P 500, our proxy for the United States Stock Market. What you see is this unbelievable perfect correlation.



C. AUSTIN FITTS: Right.

CHUCK GIBSON: What this tells you is that as long as the Fed keeps printing money, stocks are going to go up to the moon.

C. AUSTIN FITTS: Right. Now they have been tapering, and as they've been tapering, we've been going sideways.

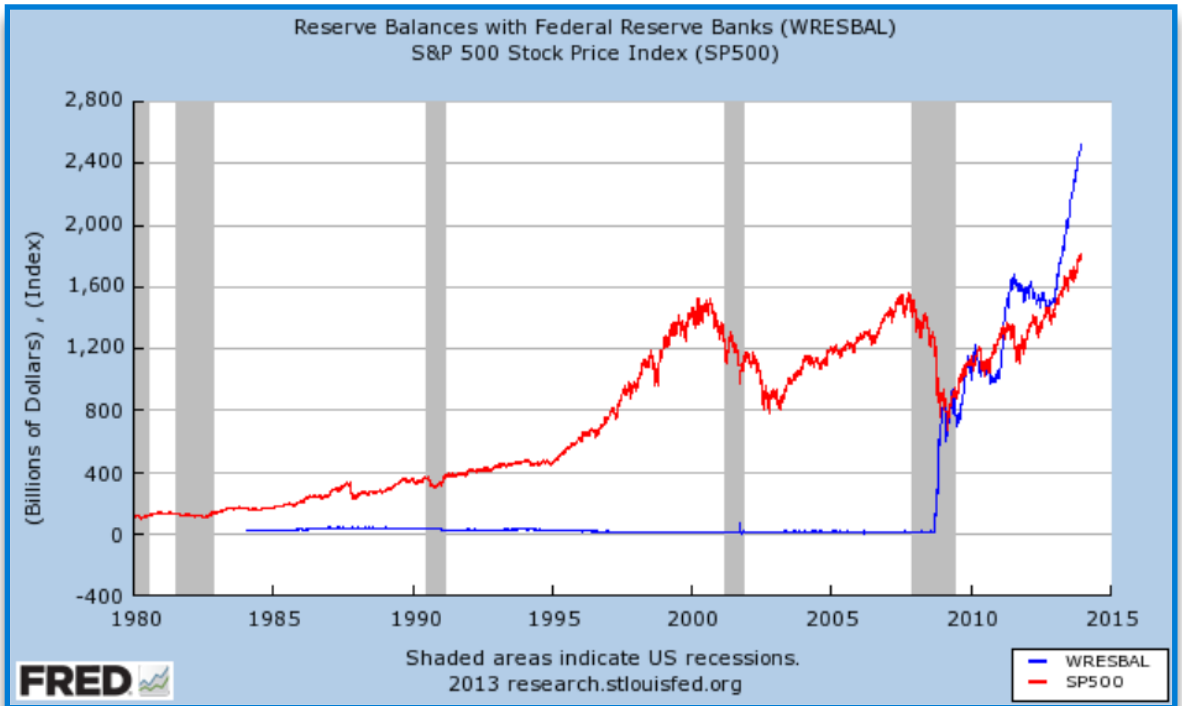
CHUCK GIBSON: Coincidently. Isn't that interesting?

C. AUSTIN FITTS: Yes.

CHUCK GIBSON: Now, this is where I'm going to throw in this next chart because I like to play the devil's advocate. I just think that you have to be careful on how you interpret these kinds of charts. There is saying in science and statistics that says that correlation does not imply causation.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: What this says is that there is a great correlation here, but let's look at the next chart, which is the exact same chart, except it goes



back all the way to 1980. What you see is there is no correlation at all until 2008.

C. AUSTIN FITTS: Although what I would say is that if you look at that as a correlation, the law of diminishing returns is set in.

CHUCK GIBSON: Absolutely. It was called the Greenspan Put, and now it's referred to as the Yellen Put. You really have to be careful in making the assumption that as long as the fed is continuing to expand their balance sheet, that stocks are a good pick. That's all I'm saying.

C. AUSTIN FITTS: Right. I agree. So essentially what we've had is very choppy, and we know we're coming into summer.

CHUCK GIBSON: Yes.

C. AUSTIN FITTS: We should mention 95 percent or more of the gains on the S&P traditionally have come between when?

CHUCK GIBSON: It's normally May. Sell in May, and go away. The reference time period is May to October. But I will say this, you kind of have to discount May because May is the second strongest month of the year. December is the first. So it's really not May. It's really June from October.

C. AUSTIN FITTS: Right. So we're way over due for correction, the market has reached an all-time high, but it's going sideways; the fed is tapering, and we're coming into summer.

CHUCK GIBSON: Yes.

C. AUSTIN FITTS: Is there any other reason to be nervous?

CHUCK GIBSON: Look at the underlying components. The underlying components of the actual stock market are getting weaker. You look at the number of stocks making all-time new highs. You look at the number of stocks below their moving averages. It's just not a pretty picture. That's the underlying part that tells me that unless that changes soon, we're going sideways right now, but the bottom…

C. AUSTIN FITTS: The bungee rope of corporate earnings has gone about as far as it can go.

CHUCK GIBSON: Oh, there is one other point that I forgot to mention since you were asking for negatives. We forgot to mention the second year of a presidential election year, and it's even worse on a mid-term election year. So we have not only the second year, which the worst year, but you have mid-term elections, which compounds all that. Other than that, it's rosy.

C. AUSTIN FITTS: Intermarket analysis; you are the person who introduced me to intermarket analysis. I did portfolio strategies that included things like this, and you got me to read an excellent book that I want to mention. So why don't you start off and tell us what intermarket analysis is, why it's important, and tell us a little bit about the book that you used to introduce me to it.

Chuck Gibson: I'm going to split this into two sections because you look at intermarket analysis, and it's more like economic theory, but it's a little bit better. That would be the first section, just to introduce your listeners to that. The second section is, let's apply some realistic real-time applications and see what happens and how we can use it.

C. Austin Fitts: Right.

Chuck Gibson: Let's go into the story behind intermarket analysis. It's the study of how various financial markets are related to each other. While it's widely accepted and considered a very popular branch of technical analysis now, it hasn't always been that way. The father of intermarket analysis is John Murphy. He started writing about it back in the early 1990s. The interesting thing was, the body that manages the technical analysis, the wide body of technical analysis study, when John submitted his first paper to the MTA (which was the body), they rejected it for lack of proof.

"Intermarket analysis is the study of how various financial markets are related to each other."

C. Austin Fitts: You're kidding.

Chuck Gibson: No. He looks back on that today, and now he's a member of the MTA and he is one of the founding fathers of this branch. It's so funny because of that reason. He didn't have enough data and support to be able to do it back then, but now it's fully encompassed within the MTA.

C. Austin Fitts: Wow.

Chuck Gibson: Anyway, let's go on. Intermarket analysis revolves around the four main asset classes. What we're going to look at is stocks, bonds, commodities, and then the currencies. We're not going to look at all currencies; we're just going to look at the dollar. Actually you can use it to look at anything.

C. Austin Fitts: Well, I don't know if you remember, one of my favorite commercials was the Pillsbury doughboy. Where you squeeze one place and it pops out another. One of the reasons I love financial markets is because everything is connected. When you work on portfolio strategy, when you work on investment, you're dealing with markets where you can have something happen over here, and major impact on the other side. Everything is connected. Intermarket analysis is simply trying to create a rigorous disciplined way of looking at the connections between things.

Chuck Gibson: Yes. That's a good explanation. But you're absolutely right. I will go back to one point. Everybody thought that they were independent markets of themselves.

C. Austin Fitts: You're kidding.

Chuck Gibson: No. There was no relationship prior to the 1990s. There was no relationship between bonds. There was no relationship between stocks. Everybody thought each market was in and of its self.

C. Austin Fitts: Well, I'll tell you a very interesting thing. That period in Washington, I was responsible for portfolio strategy for the FHA first as the FHA Commissioner, and then as their financial advisor. What was interesting was there was a group of people who were very knowledgeable about federal credit and federal budget. We would talk about what would happen if government policy did this, and this would happen to these markets.

So we were doing intermarket analysis, not from the point of markets, but from the point of view of government policy related to what it would do to the markets. We always spoke that way. I didn't know that the market guys weren't doing it because the federal weenies were doing it.

Chuck Gibson: Well, I'll leave it at that. You can call them that because you were there. One example would be to show the relationship between stocks and bonds. If you're investing in stocks, you kind of have to watch bonds. It's a much bigger market. What tends to happen is that bond yields tend to trend in the same direction as stocks. We'll go look at some examples with this. I'm just giving you a quick overview.

The other thing of why it's important is because in many cases, the bond market will lead the stock market. You'll start to see a move in yields before you start to see a move in stocks. So a move in yields lets you know that you should be careful because you're squeezing the doughboy down here, and you're moving stocks.

C. Austin Fitts: Right. Now, when you're saying that, do you mean stock prices or the yields that you're getting from stocks?

Chuck Gibson: Good question. Stock prices, because everything that we talk about are prices here. Now, what I've done is, on the charts, I've taken prices out so we can just focus on yields.

C. Austin Fitts: Okay.

Chuck Gibson: There are other correlations, such as if you're a bond investor, you really need to watch the commodity markets because as bond yields rise, commodities rise too, so that's an inflationary issue. The bad thing, I would say, about intermarket analysis is the fact that there are no guarantees because what you have is this trend, this relationship, but that relationship doesn't always hold. So not only that, when it does hold…

C. Austin Fitts: It speaks to probabilities.

Chuck Gibson: Correct. That's why when you look at this, you can't just hang your head and say whatever it says, I got to do. Not only does it not always hold, but when it does hold, it doesn't give you an alarm clock telling you exactly this is the time to make the move. So it's really just about the relationships, but they are important relationships. Let's close out this section. I wanted to bring up the fact that the economists tend to look at statistics to determine the direction of the economy.

The chart of intermarket analysis actually looks at the markets themselves. There is a big difference because the economic statistics are, by nature, backward-looking.

C. Austin Fitts: Well, they used to be. Now, they're just made up.

Chuck Gibson: Okay, now they're backward-looking made up. But the markets are forward-looking entities, right? They're always referred to as a discounting mechanism. So stocks anticipate the economic trends six to nine months before they actually move.

C. Austin Fitts: Right.

Chuck Gibson: So this is why it makes bonds an even earlier economic indicator than stocks.

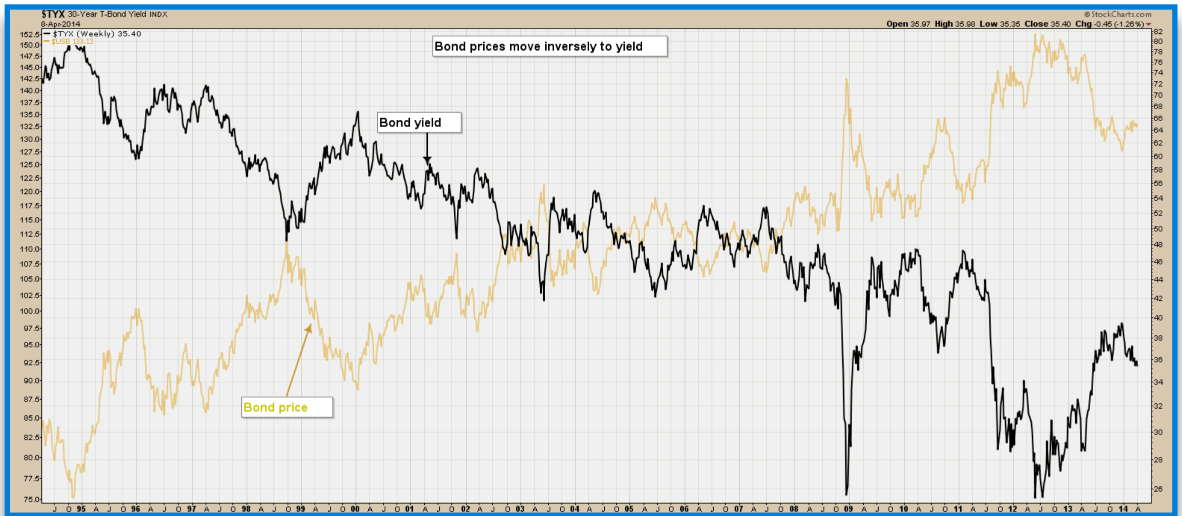
C. Austin Fitts: Right.

Chuck Gibson: The way I look at it is that this analysis can help provide an investment edge. It's not guaranteed. It's like if you're able to count cards. You can actually do better than the house when you're in Vegas. But in my mind, you got to arm yourself with as many tools as you possibly can, and this is one of those tools that provide you greater odds to beat the high frequency train of computers.

C. Austin Fitts: Right.

Chuck Gibson: Let's take a look at just the relationship on a chart standpoint. So let's take a look at first chart number 13. Everybody knows this. This is just confirmation to reflect that. What this shows is bond price and bond yield. We all know that bond prices and yield move inversely. This is just a visual.

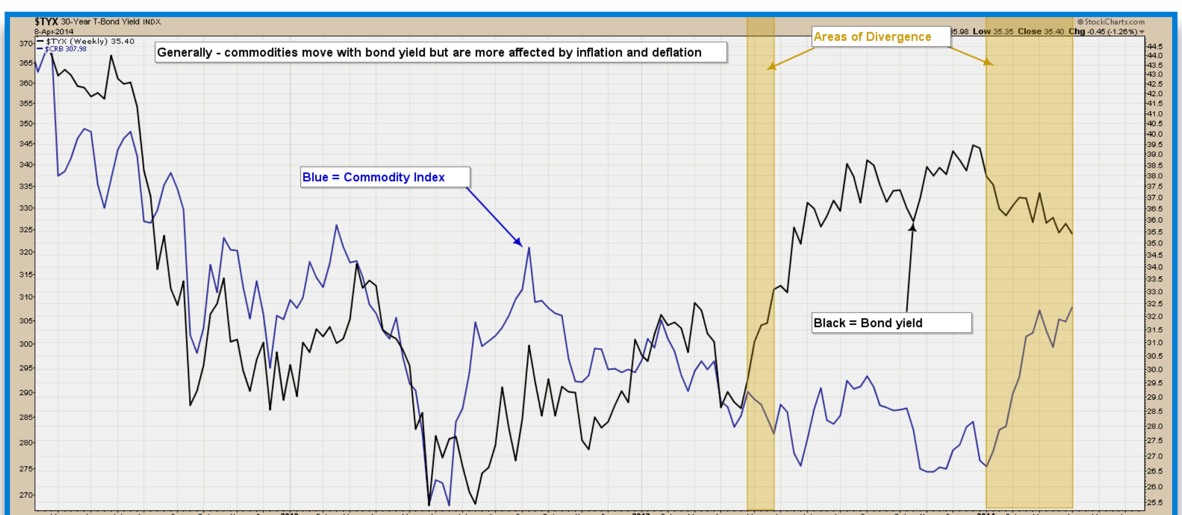
C. Austin Fitts: I would like to point out, when I went to Wharton Business School, it took me nine months to get this into my head that when the price of a bond goes up, the yield goes down. When the yield



goes up, the price of the bond goes down. I don't know why it took me nine months. Once I got it, it was like riding a bicycle.

CHUCK GIBSON: Don’t feel bad because I had the same problem too. Let’s move onto to chart number 14. This is a chart that shows bond yield versus commodities. The blue line is the commodity index and the black line is bond yields.

C. AUSTIN FITTS: This one has always surprised me because I always thought if interest rates went up, then the carrying cost of commodity inventories would get more expensive, and commodities would go down. But that’s



clearly not what this is saying.

CHUCK GIBSON: You threw me curve there because I wasn't expecting that. I didn't think about that. The way I think of it is this: when interest rates are rising, you are in an inflationary environment.

C. AUSTIN FITTS: Right. So the value of commodities come on up.

CHUCK GIBSON: So the value of commodities tends to stay constant as is with inflation.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: So commodities are more of an inflation hedge than they are anything else. You notice that I've highlighted a couple of gold areas there that are areas of divergence, where yields and commodity prices haven't moved in the same direction.

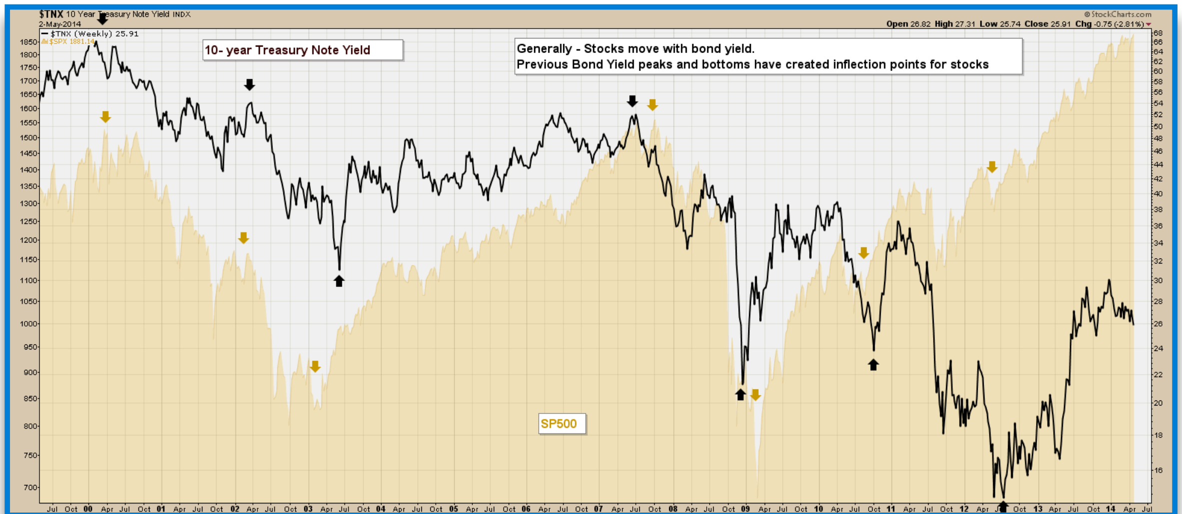
C. AUSTIN FITTS: Right. So starting in spring of 2013, we saw yields move up, and commodities stayed flat. Now they're moving up and yields are coming down a little.

CHUCK GIBSON: Yes, and normally when that happens, it's because of inflation or a deflationary move. The bond market is really smart. They're the biggest market in the world, and they anticipate those things first. It's always good to watch them.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: Now, it could be just a fake out, but it's something that's raising a flag saying what's going on here?

C. AUSTIN FITTS: Right. I've said this on The Solari Report before; I love Jim Carville comment, "When I die, I want to be reincarnated as the bond market because you can control everybody."



CHUCK GIBSON: Absolutely. The next chart is the chart of bond yields, which is in black.

C. AUSTIN FITTS: Okay. So the black is the ten-year treasury yields?

CHUCK GIBSON: Correct. The reason why I switched was because there was a very, very good correlation that is well known on the stock market, that the traders use, and that's the ten-year yield. So they move in the same direction, just not as much as the longer materials.

One thing that you can see here is that generally stocks tend to move with bond yield. The other thing that you can take from this is that you can see that bond yield peaks and bottoms have created good inflection points, early warnings that stocks have hit a bottom or had hit a top.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: So interestingly enough, if you just look at where we're at today, we saw…

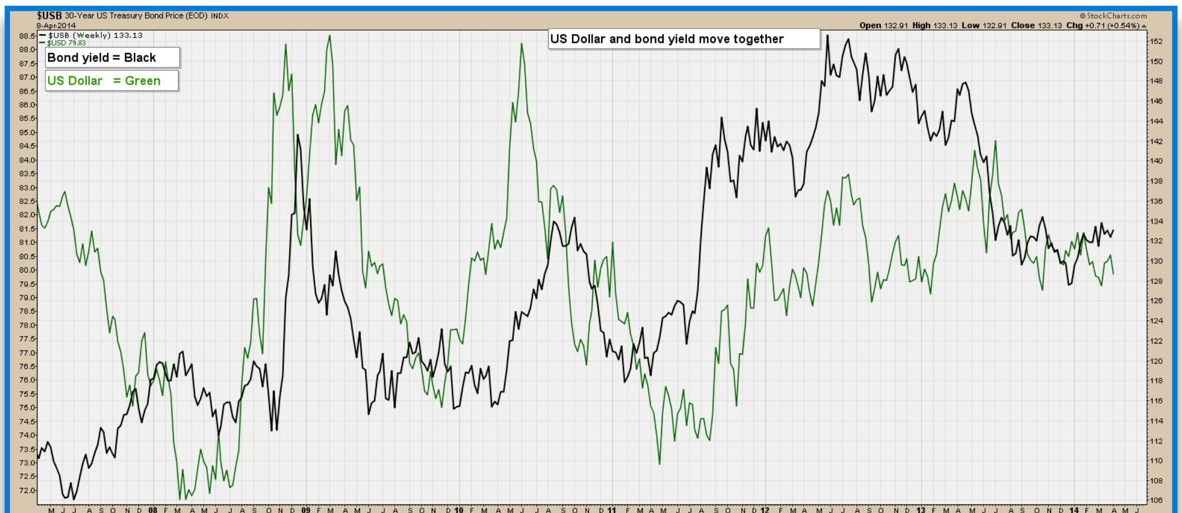
C. AUSTIN FITTS: Rates are falling.

CHUCK GIBSON: Yes, we saw a bond yield that started to fall.

C. AUSTIN FITTS: Janet Yellen warned us that yields were going to go up, and so that's why they're coming down obviously.

CHUCK GIBSON: Exactly. We had a peak in January or December of 2013, and we started to see bond yields fall, and this is when we're starting to see a little weakness. Now, what there tends to be is a little bit of lag from the time that bonds move to the time that stocks actually react. So this is right in line with what we're saying.

C. AUSTIN FITTS: So if the historical patterns hold, which they can or cannot, stocks would start to come down.



CHUCK GIBSON: Right. If we start to see bonds fall even further, that's not such a good time for stockholders. The last chart I have for this is actually the bond yield to the dollar. I'm not sure which drives which, but what you can see is there is a very good correlation.

C. AUSTIN FITTS: There is am amazing correlation.

CHUCK GIBSON: Yes, there is, and that's kind of what you'd expect.

C. AUSTIN FITTS: Now obviously we are looking at bond yields on dollar-denominated debt?

CHUCK GIBSON: Correct. So if you were to look at other currencies, then you'd have to – it would throw you a completely different curve. Their market analysis study can be applied to anything, but I just wanted to look at the framework of what we warned. We were warned by Janet Yellen that we potentially could have higher rates, and what the impact would be to other investment vehicles or markets.

C. AUSTIN FITTS: Right. Now, what's interesting is the dollar looks very soft right now. We almost wonder if we're not coming into an inflection point.

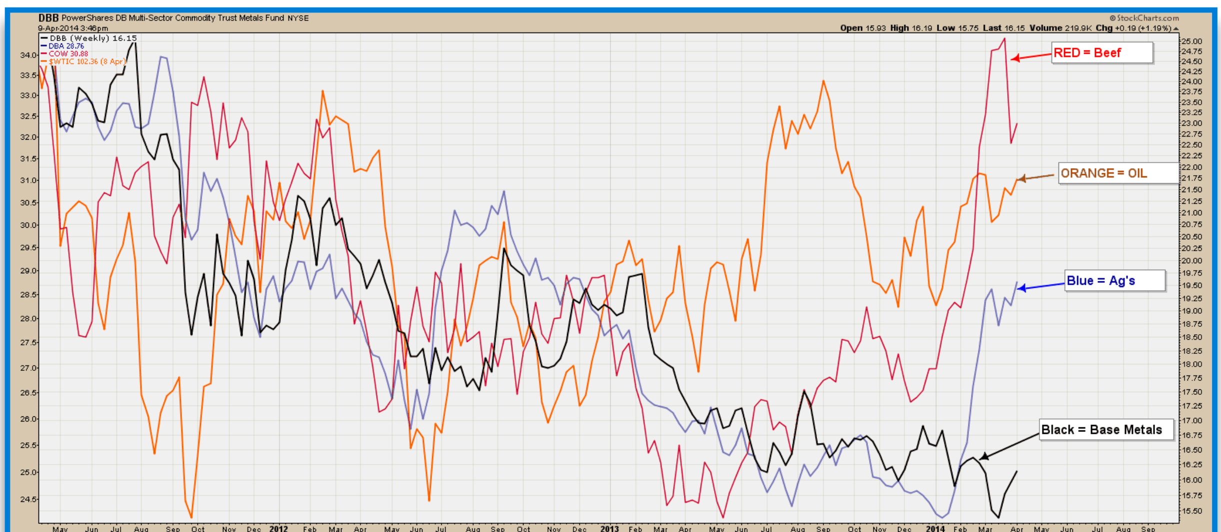
CHUCK GIBSON: Yes, but the miserable thing is that the dollar moves so slowly normally, and you just want to hurry up and, "would you get off the dime and do something because the sideways move is killing me."

C. AUSTIN FITTS: No. It's chop, chop, chop. We're going sideways.

CHUCK GIBSON: Yes, but watch out when it makes a move though. Let's move onto the next section, and this is where I'm going to come up with some real life applications of how to use intermarket analysis and historical examples. What we have here is a chart of the CRB, which is the commodities index. You can see it's been in a severe downtrend since 2011.

C. AUSTIN FITTS: Now, that's a basket of all the different commodities so it's got the base metals. It's got the energy commodities. It's got the food commodities. It's a pretty wide basket.

CHUCK GIBSON: Absolutely. That's why we look at it. So there are things within, and the next chart will show you that. There are things within the basket that might be moving against the general trend. That's why I'm using this example.



C. AUSTIN FITTS: Right.

CHUCK GIBSON: What you see is the early part of this year, we had a breakout from that downtrend line. What that was caused by, we don't know yet, but let's take a look at some subcomponents of the CRB here, and these are just four that I presented. You can see that beef is up substantially. Oil was up and Agriculture. All the ones that you were talking about. So that's corn and wheat.

C. AUSTIN FITTS: Right.

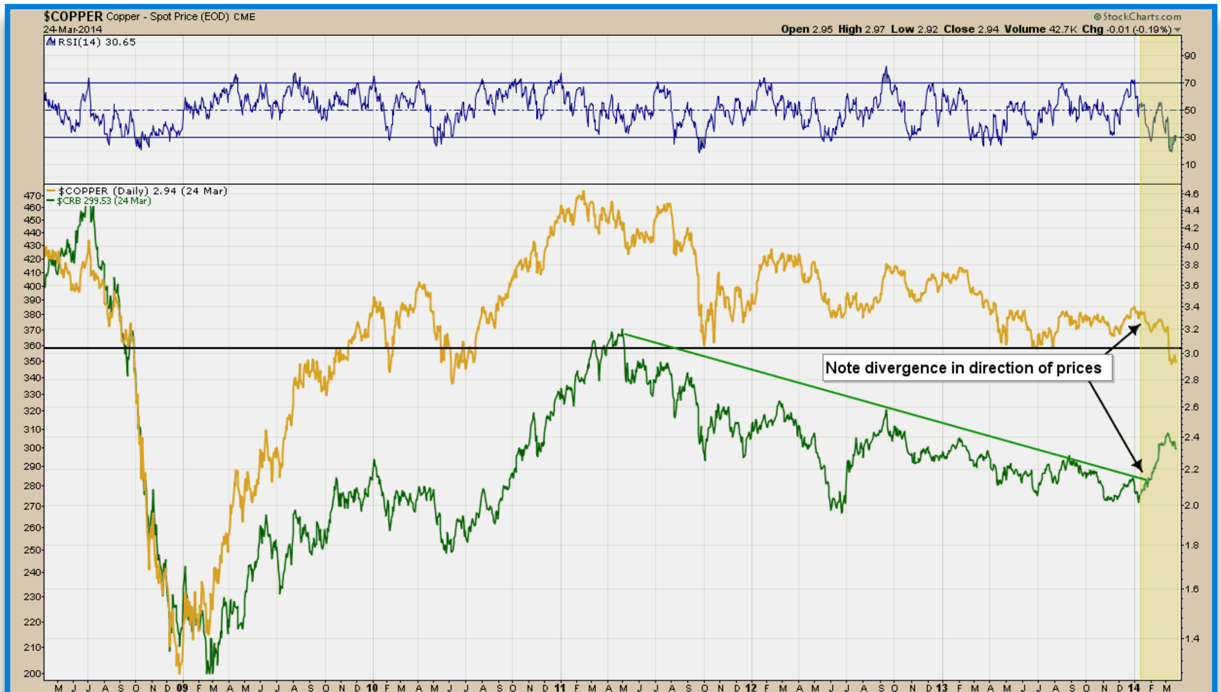
CHUCK GIBSON: Then we look at the base metals. What's going on?

C. AUSTIN FITTS: This looks just like my grocery bill.

CHUCK GIBSON: Well, buy base metals for groceries instead.

C. Austin Fitts: Too bad I don't need copper. I'd be much better off.

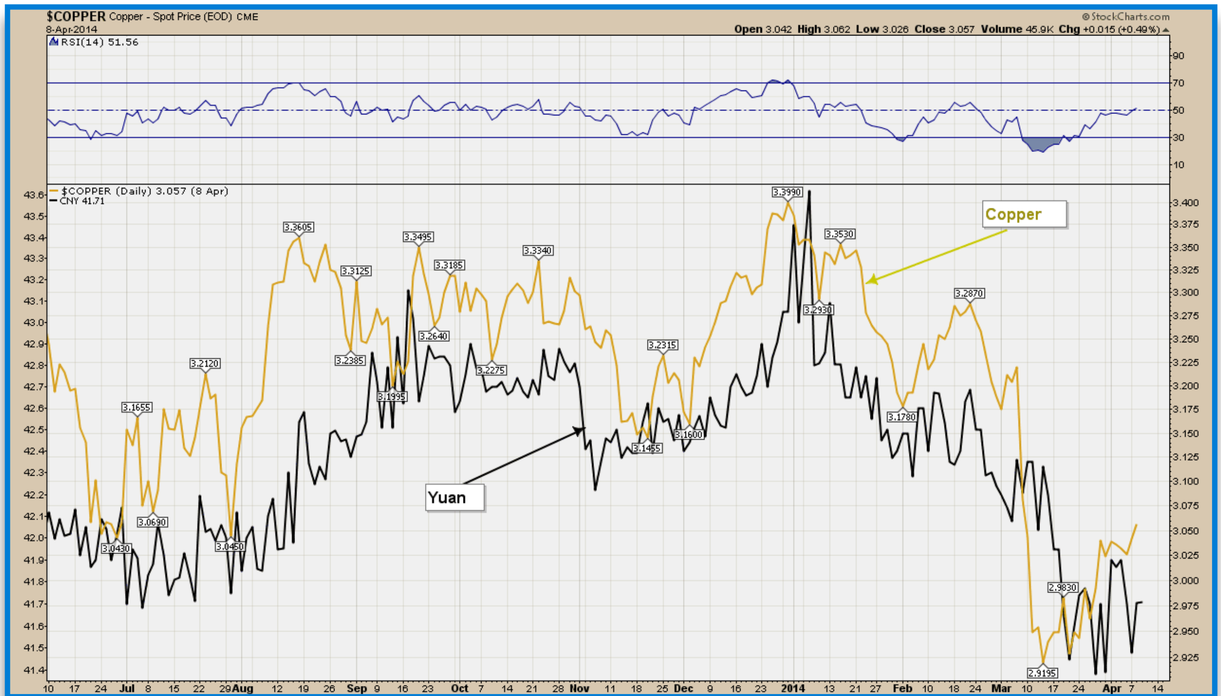
Chuck Gibson: Exactly. So what you see here is a divergence. What I want to do is look at the base metals and see what's going on. Let's take a look at the next chart. It's a comparison of copper, which is the gold line, and you have the CRB Index, which is the green line. You can see they move very consistently.



They were both in a downtrend since 2011, and lo and behold, early part of 2014, we had a breakout in the CRB, which is the index, but we had the divergence and copper is coming down. So what's the cause of that? That's intermarket analysis. So you have to look no further than the next chart.

C. Austin Fitts: China.

Chuck Gibson:: Yes. This is the relationship between copper, which is the gold line, and the Chinese currency, the Yuan, in the black line. It kind of makes sense because China is the largest consumer of copper. Their demand is going to be dictating the price of copper.



C. Austin Fitts: Right.

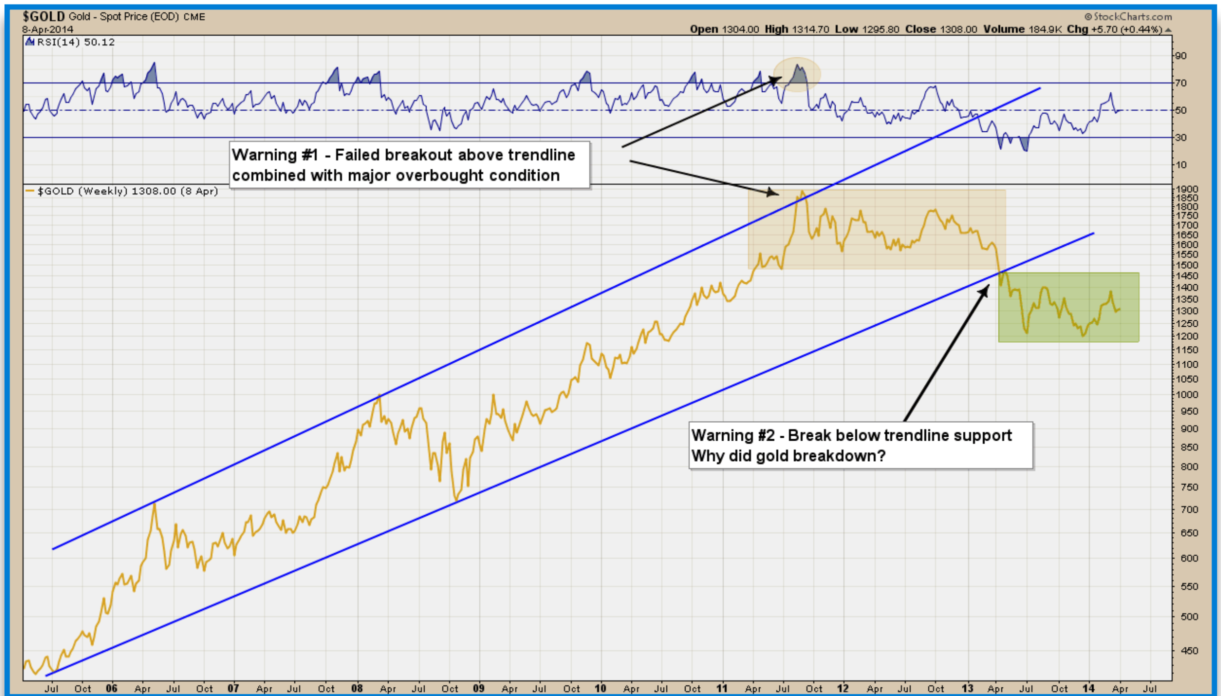
Chuck Gibson: This is something that, if you were a copper trader, you would be more willing or more apt to be watching the Chinese currency than you would the actual Commodity Index. That's the first example. Let's move onto the next chart. Everybody's favorite.

C. Austin Fitts: Gold.

Chuck Gibson: Gold. This is a long-term trend line of gold. You can see it wasn't a very nice up trend. The gold line is the price of gold, just to let everybody know, and those blue trend lines actually contain the movement of gold through its up and down movement.

C. Austin Fitts: Right.

Chuck Gibson: What we had was a breakout of that trend line in the middle of 2011. That's called a throw. You can also see right at that same point in time, if you look at the very top pane, we had a major top



in the momentum index. That's why it's worthy of watching that. So we had a fall back down into the trend line, and we went chop.

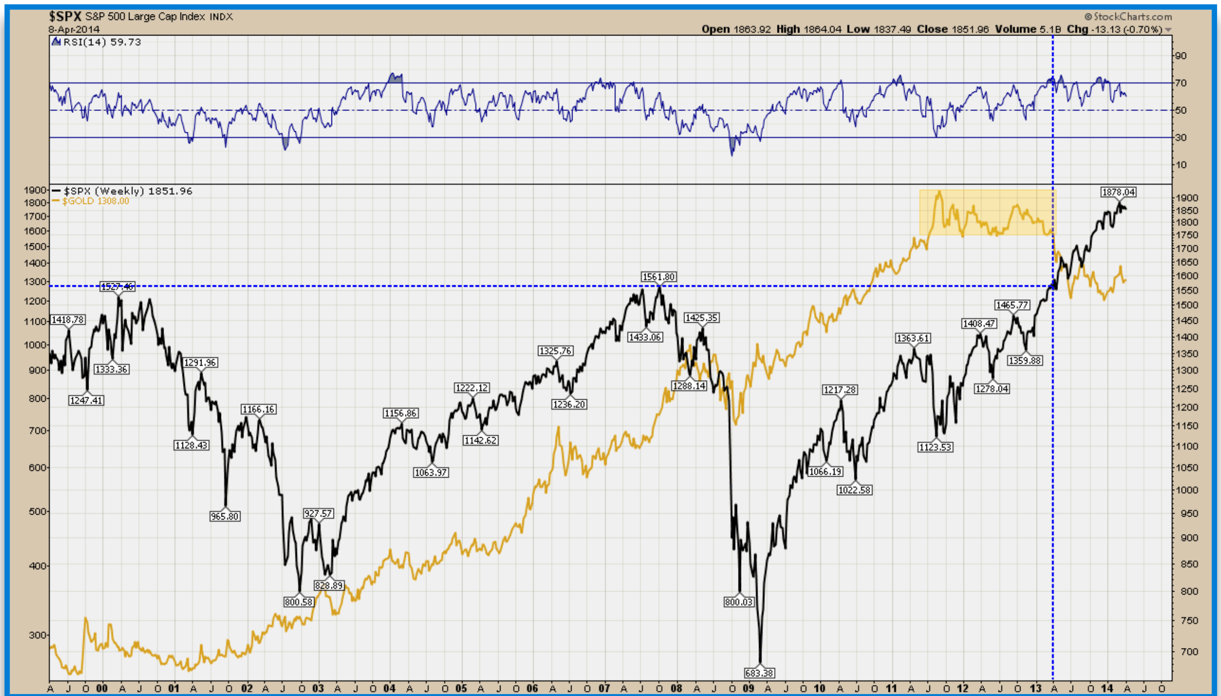
C. Austin Fitts: Right.

Chuck Gibson: Right? That chop was quite a long period of time, and it was miserable to be in.

C. Austin Fitts: I remember.

Chuck Gibson: I know you do. So do I. We had a break of that trend line right in about April of 2013. So why don't we take a look at the next chart, which gives some support as to the possible reasons why. I know there are some other people that have maybe other reasons, but let's take a look at the next chart. This is a chart of gold. The gold price is the gold line, and the black line is the S&P 500. Look at what happened.

C. Austin Fitts: This is what was so mysterious to me. As the Fed was engaged in quantitative easing, they were both moving up together.



CHUCK GIBSON: Yes.

C. AUSTIN FITTS: Then suddenly, the S&P kept going, and we know commodities started dropping and gold goes sideways, and then down and they cross.

CHUCK GIBSON: So look at how interesting this is. We were in that consolidation period, and I want everybody to remember we were talking about stocks. The lighter the consolidation, the bigger the drop or the rise. Look at the way it dropped, where it broke that trend line, which was in April of 2013, and bring your eyes down to where it intersects with the S&P 500. That was exactly the time when the S&P broke out to new highs.

C. AUSTIN FITTS: Right.

CHUCK GIBSON: So my theory behind this is that investors are looking for gains. They're going to go wherever the strongest market is.

C. AUSTIN FITTS: So you're saying they're rebalancing out.

CHUCK GIBSON: I'm just saying I'm going to go wherever gains are and wherever the strength is, and we've broken out to all-time new highs. That tells me that we have potentially higher to go in the stock market. Why do I want to be in gold if I'm, at best, going sideways?

C. AUSTIN FITTS: Right.

CHUCK GIBSON: I view the world as one big investment pool, and money is shifting and rotating at all times. You've got to be going where the money is going.

C. AUSTIN FITTS: I don't see it as one big investment pool. I see it as one big investment pool, where the pool has expanded in size dramatically in the last ten years.

CHUCK GIBSON: Well, that's true.

C. AUSTIN FITTS: If you look at what's swinging around and looking, I think part of the choppiness in the markets is you have so much cash. One survey at the beginning of the year said families with wealth have 40 percent of their money in cash.

CHUCK GIBSON: Oh, yes.

C. AUSTIN FITTS: You have so much money looking for a safe place to go.

CHUCK GIBSON: Yes, and gold was that safe haven for the last decade prior to 2013.

C. AUSTIN FITTS: Well, it's very interesting. If you look at the Gallup poll that I had up on the blog recently, gold has come down. It was in the mid-thirties in terms of preference by American investors. It's come down to 24 and the stock market has come up to 24. Now 24 percent say it's their preferred investment. But we know 30 percent say it's real estate. So now housing is slowing down. It's almost as if all three of them are merging, and we're getting into a position balance.

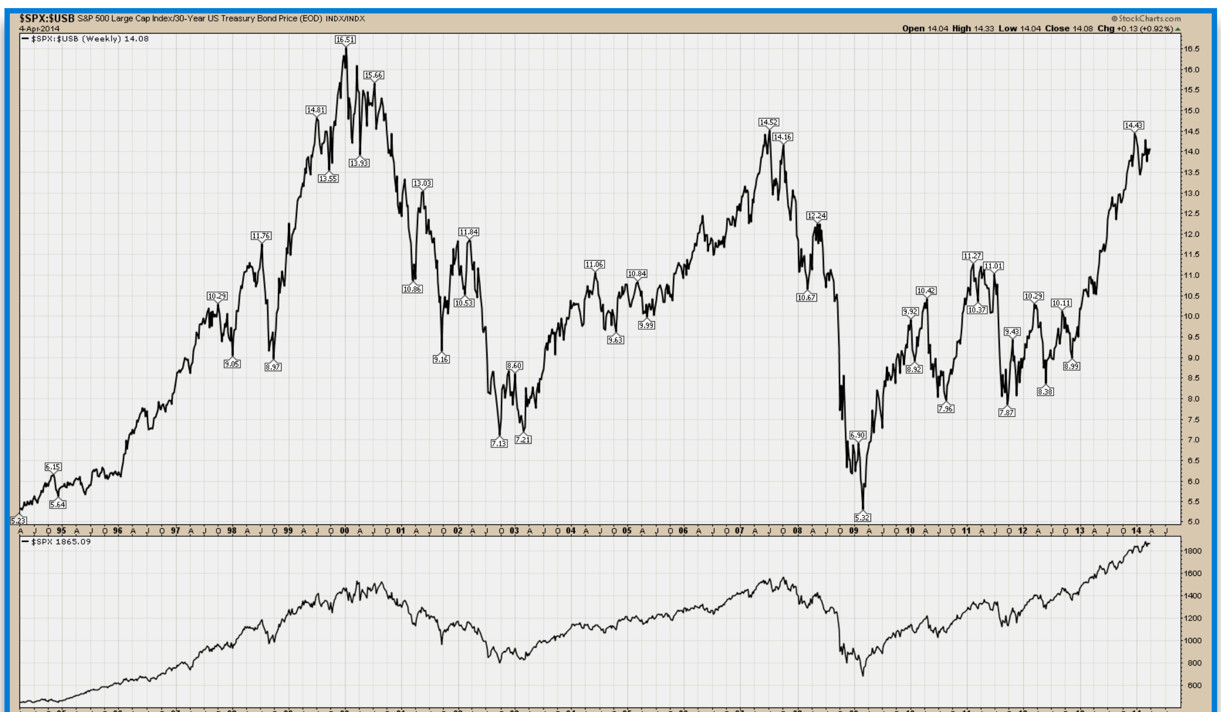
CHUCK GIBSON: Yes. Well, things tend to get into excess, right?

C. AUSTIN FITTS: Yes.

CHUCK GIBSON: It's how far stretched you are away from that mean, and then they move back. So in my mind, gold was in a huge up trend for a very long period of time, and you expect a windfall.

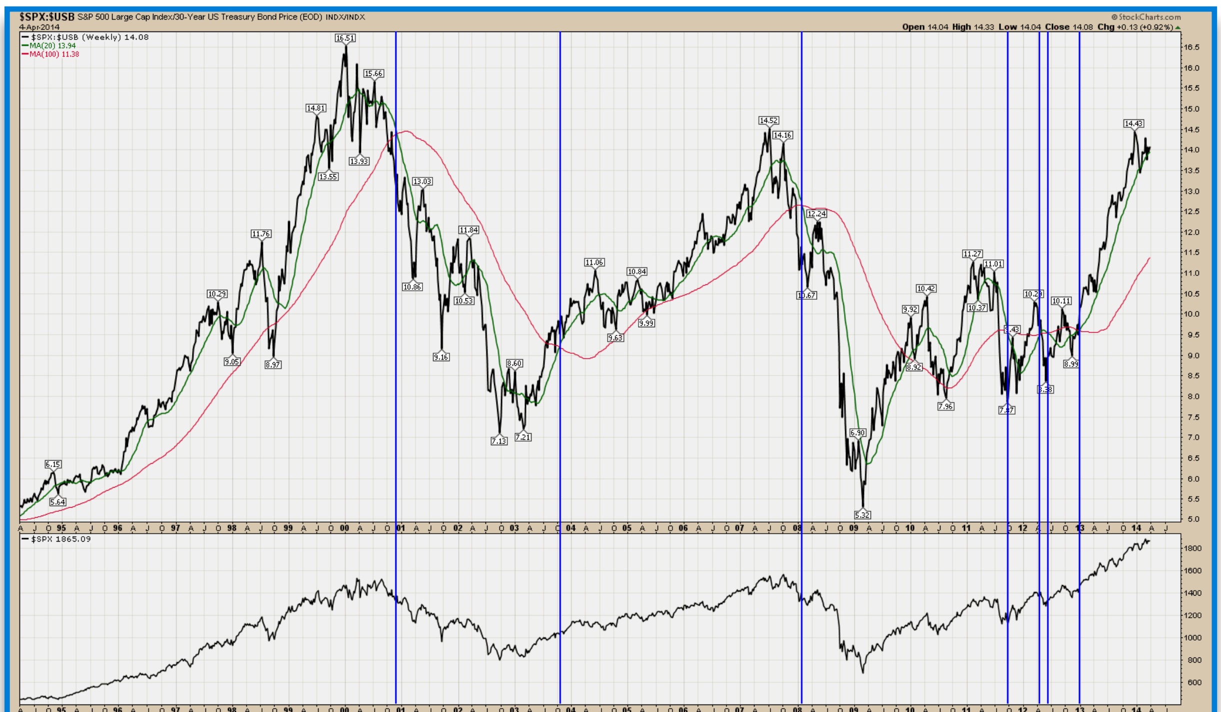
C. AUSTIN FITTS: Well, if you see what's happening to physical, you're getting a much broader ownership of gold. Gold was a very thin market, not just in terms of size, but in terms of ownership of gold. Very small, low participation rates. You're getting a much healthier participation rate.

CHUCK GIBSON: That's good for the long-term value, absolutely. This is my final, real life example. I'm a geek when it comes to these kinds of things, and I really love these kinds of opportunities. So what I did was I put together a little model for everybody: How to use intermarket analysis. This is just a chart of the relationship between the S&P 500



and a 30-year treasury bond. As you can see, it goes up and it goes down. That's in the first top pane.

The lower pane is the S&P 500 just so you can reference it. So remember that chart because I'm going to move on and I'm just going to add to it. The second chart for this thing, all I've done is applied the slow moving average and the fast moving average.



The green line that I've added there, it may be hard to see, is a 20-week moving average. The red line is a 100-week moving average. There is nothing magical about those. I just pulled them out of the air, and because those are typical averages that investor's or treasurers use.

C. Austin Fitts: Right.

Chuck Gibson: So those vertical blue lines are the points at which the 100-week moving average has crossed over or under the 20-week moving average. That is a model. So I've said when the 20-week moving average crosses under the 100-week moving average (the first one would have been the end of 2000), you get out of stocks and you go into the 30-year treasury bond. You stay in the 30-year Treasury bond until you get a crossover. That happened in latter quarter of 2003. You stay in the United States stocks until you get the next crossover, and now you go all the way over to 2008.

C. Austin Fitts: Okay.

Chuck Gibson: You would have gotten out of stocks and into the 30-year bond. So you continue this forward all the way to present.

C. Austin Fitts: I was a chicken. I just stayed in cash all the way there. I got out of stocks in April, just about here, but I stayed mostly cash.

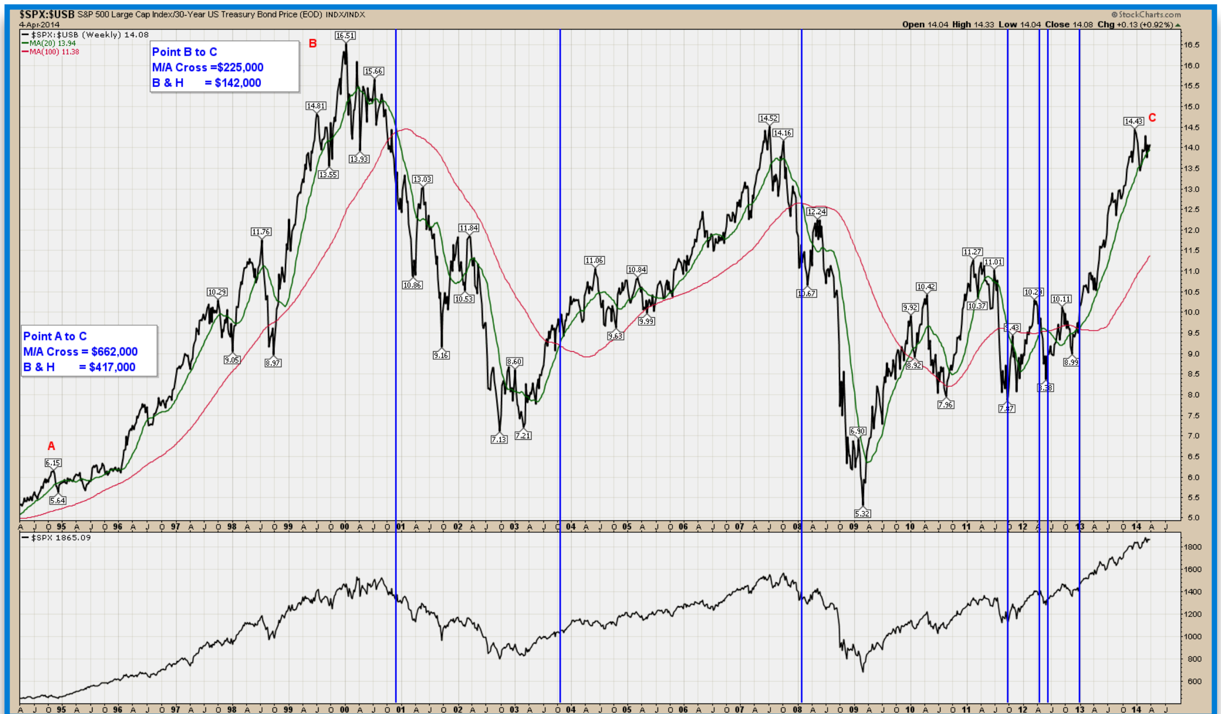
Chuck Gibson: In which case, cash was okay, but you would have done much better with a 30-year bond.

C. Austin Fitts: Yes.

Chuck Gibson: Then there are four blue vertical lines compressed there together. That's called a whipsaw, and I incorporated that in. So I just created this simple model and said if you would have followed this simple model, and invested your money 100 percent in the stock market when the model says to, or you move 100 percent to the 30-year treasury bond, let's take a look at the chart and see how that worked out for you.

What I'm comparing it against is if you went and just bought and held. Investors don't necessarily have methodologies. What I'm doing is creating a very simple methodology that you can use. The final and last chart. I didn't want somebody to say, "Well, you're selectively picking the absolute most beneficial, wonderful entry point." I've used point A and point B, which was the bottom in 1995, and the top in 2000. I picked those as worse case examples, and I've ended it where we are today.

If we just take point A, which is the start in 1995 to where we are today, and you follow that same methodology that I tried to describe there (if



you would have bought and held), your $100,000.00 investment would today be worth $417,000.00. If you had followed the simple moving average crossover, you would have had $662,000.00: a substantial difference. Now, if you had taken point B, which was a much worse scenario, buy and hold would have gotten you $142,000.00.

C. Austin Fitts: So if I took my $100,000.00 and I just stayed in the stock market, I would have $142,000.00?

Chuck Gibson: Correct. So you're up. But if you would have followed the model at this point and time, instead of $142,000.00, you're going to have $225,000.00.

C. Austin Fitts: So it's basically saying risk off/risk on.

Chuck Gibson: That's exactly what this is. This is my risk on/risk off chart.

C. Austin Fitts: I'm going to take risk during this period, and then I'm going to take risk off.

Chuck Gibson: Yes.

C. Austin Fitts: So let's go back to what you said about sell in May and go away. That's basically saying June through November is risk off time.

Chuck Gibson: Correct. Now if you look at today where we are, it's not anywhere close to having a crossover, but that can change real quickly if the market starts to fall. I'm not saying that's what it's going to do, but you can do much more refined methods to improve this simple trading methodology, or investing methodology.

Here is what I find that most investors struggle with. They can buy; they just have trouble selling. This actually provides you a good time to sell, but it also provides you a good time to buy, and it also removes all the thinking out of it.

C. Austin Fitts: It's simple.

Chuck Gibson: And you don't have to rationalize and justify why you're doing it because the model tells you what to do.

C. Austin Fitts: Right, and what it says is what we know, nothing goes up forever.

Chuck Gibson: Right. You need to be nimble when determining that time to enter and exit, which this will help you do.

C. Austin Fitts: This is one of the charts or the concepts that persuaded me out of buy and hold.

Chuck Gibson: Yes. I did want to give one final kudos to John Murphy, who was the godfather in intermarket analysis, and I wanted to reference his book.

C. Austin Fitts: This is a wonderful book. I love this book. It's on my den table.

CHUCK GIBSON: What I'm actually doing is not referencing the book you have because he has made three books since then. It's basically the same book that you have, but it's a more recent version. It's the exact same thing, it's just a little bit prettier and cleaner. It's called, *Trading with Intermarket Analysis: A Visual Approach to Beating the Financial Markets Using Exchange-Traded Fund*. He threw in the exchange-traded funds.

C. AUSTIN FITTS: Well, you know me; I'm not that big on exchange-traded funds.

CHUCK GIBSON: I know, but the fact is all he was trying to do is use examples to illustrate his intermarket analysis.

C. AUSTIN FITTS: Right. Well, actually I love to use exchange-traded funds to track things.

CHUCK GIBSON: Yes.

C. AUSTIN FITTS: Yes, so they're very good to track things.

CHUCK GIBSON: That's it.

C. AUSTIN FITTS: Well, Chuck, I can't thank you enough. This has been fascinating.

CHUCK GIBSON: Well, it's been fun. Thank you and I look forward to next quarter.