RCN WEALTH ADVISORS

Semiannual Market Outlook
January, 2015

2015 Outlook: The Risk of Deflation

- › How Japan is triggering the next global crisis
- › Why falling oil prices may not necessarily be a good thing
- › Why volatility is about to return with a vengeance

Dear Clients,

I'd like to start with a big "thank you" to everyone for a quick and smooth transition over to TD Ameritrade. This move is part of RCN Wealth Advisors' ongoing mission to help you (our clients) with a far higher level of investment management within your portfolio than the "traditional" brokerage industry. TD Ameritrade offers us the ability to better incorporate stock option strategies that will add a lot of value and flexibility to our long-term returns in a cost-effective manner. I can say with confidence that TD Ameritrade will be a great home for us for a long time to come.

2014 proved another rewarding year for investors and I was very pleased with total performance. On the growth side of portfolios, we experienced relatively strong returns with roughly two-thirds the volatility of the S&P 500. On the income side, the market hadn't changed and was still "upside down" where investing more aggressively (holding dividend paying stocks in place of bonds) proved smarter until late in the year and it appears this notion may be tested in 2015 as well.

Before discussing our outlook for the year ahead, I think it will be helpful to review how we view the global economy and its potential impact on the investment markets. Such a vital component of successful investing is about avoiding major risks that could create potentially large drawdowns in your portfolio. Too often, investors are incorrectly focused on trying to "beat" the market (not us of course) when all that is required to produce outsized returns over the long-term is to avoid the losses; gains will take care of themselves. At RCN Wealth Advisors, we view investing as a spectrum of risk probabilities since very few things in this world are certain. Understanding this construct will not only help in how you view economic and market news, but also give you a better understanding of why we're positioning your portfolio a certain way.

A very popular question I'm often asked is "how will stocks do this year?" The answer, unfortunately, isn't as simple as "good" or "bad" because there is always more than one scenario which might occur and each scenario will have a different probability of occurring. Only one may realize, or multiple, or something totally unexpected. And so we go down the list of possible events and think about the potential impact, often times not knowing how things are going to play out until they begin to unfold. Usually multiple scenarios will occur each year creating either a cancelling effect or they'll coincide together to create a magnifying effect (think Great Recession of 2007-2009). This is why we believe it's so important to be flexible in one's investment thesis, have cash available and be nimble in managing risk (why we're now utilizing stock options). Ultimately, things that represent the largest risks with a relatively high probability of occurring are either avoided completely or hedged, and investments that present the lowest perceived risks, relatively speaking, are held with an overweight allocation.

3161 SOLOMONS ISLAND ROAD, SUITE 1 | EDGEWATER, MD 21037
PHONE: 410-956-6003 | FAX: 410-956-6004

A Look at 2015

What I will do in this letter is discuss some of the major, global economic themes unfolding right now across the risk spectrum and the potential implications for your portfolio. I'm going to outlay both what could go right and what could go wrong. The one thing that I am certain about is that we are entering a period of higher volatility for all asset classes. We're at an interesting point in the stock market where the path in 2015 is far less certain. I see scenarios emerging where stocks could either *accelerate* to the upside or begin another nasty move lower; either way, volatility will be higher moving forward than it was the past few years. But keep in mind, volatility is only your enemy if you're fully invested and not able to capitalize on the opportunities that it creates.

The direction of stocks will ultimately depend on investor perception and capital flows. Economic fundamentals should start to turn lower as early as this year – it's inevitable (more on this below). If investors begin to worry about bond defaults and quickly move their money into the perceived safety of well capitalized, high quality, "blue chip" stocks, we could see the market climb higher rather quickly with a disregard for the deteriorating fundamentals. Or, as one would expect, deteriorating economic fundamentals are recognized as a problem and stocks come under pressure. The events of the second half of 2014 and early days of this year currently lead me to believe it's the latter of these two scenarios that will take hold in 2015.

However, history begs to differ: the pre-presidential election year of the 4-year presidential cycle (third year of the four) is the best on average out of the four years. We haven't seen a down year since 1939 (on war concerns) and the only time we've experienced major losses occurred in 1931 during the Great Depression. This political economic cycle can be contributed to the administration doing everything it can to boost the economy before the election year in hopes of holding (or their party) the White House. Most down years are seen during the first or second year of a presidential term, especially when there's a change of party because the new president needs to undo all of the "mistakes" of the last president.

Global Economic Environment

The current story of the global economy is one of deflation. Simply put, there is not enough demand and too much debt. This is the reason Central Banks around the world have needed to print trillions of dollars. However, with the US Federal Reserve ending the last round of Quantitative Easing (QE), we're seeing a divergence in Central Bank policies which is creating some major shifts in capital flows around the world. The US is ending its easing while Europe and Japan are still increasing theirs, leading to a much stronger US dollar. While this sounds like a good thing, and is good for US citizens that want to buy foreign goods or take vacations abroad, it's a nightmare for the rest of the world and especially for the Emerging Markets.

A rising US dollar is the greatest risk the world currently faces. As the world's reserve currency, the greenback is the most important asset in the world. We, in the US, often don't think about the US dollar as an asset because it's the cash we use, but the rest of the world does because they're constantly converting their currency into US dollars for business, trade, and to buy raw commodities (because they're all priced in US dollars). From an economic growth perspective, businesses that export goods to the rest of the world want a weak currency so there goods become cheaper relative to other competitive nations. Because of this dynamic, along with globalization, what we so often see is that a country will try to weaken their currency when their economy hits a rough patch in an attempt to boost economic productivity. This isn't an easy thing to do in a world short on demand when everyone wants a weaker currency at the same time.

The larger and more dangerous effect though is the amount of US dollar-denominated debt that has been accumulated throughout the world. Since 2009, Emerging Market debt is up approximately 50%! This is what happens when the Fed makes it easy to borrow money. Whether these nations want it or not, hot money has been consistently flowing into the Emerging Markets in search of higher yields. Low interest rates, Central Bank money printing, and a US dollar that has been falling since 2000 have created potentially the largest carry-trade in the history of the world, now

estimated to possibly be as high as $9 Trillion. You see, when you have debt, you are effectively short the currency in which you have borrowed. If that currency falls in value between the time you take out the loan and repayment, you keep the difference as an added profit. Conversely, if that currency rises, it creates a loss that effectively increases the amount you have to repay. Consumers usually don't think about this in the US because we do everything with US dollars. We borrow in dollars, use dollars, and make payments in dollars. We never convert it to another currency which means we don't have to worry about foreign exchange rates – the only difference in value we see is "hidden" as inflation. Other countries do have to worry about exchange rates. If the US dollar continues to rise, it could create some serious pain for foreign entities that have borrowed a lot of money in US dollars. We're facing a situation that has the potential to snowball very quickly leading to Emerging Market bond defaults and capital flight into the US.

This is a very similar outcome to what occurred a few years ago during 2007-2009. Back then, it was weakness in the housing market that led to a banking crisis that caused the event. This time around, if it occurs, the trigger event will certainly be something else.

How Japan is About to Trigger the Next Global Crisis

The divergence in Central Bank policies is most dramatic between the US and Japan. After nearly 25 years of recession, government stimulus and outright deflation, Japanese government debt is now at approximately 250% of GDP. They simply can't afford an increase in interest rates, which is why their 10 year government bond yields less than 0.3% at the time of this writing, so they're printing yen to buy the government bonds (called "monetizing")to essentially eliminate them. They've decided to simply inflate away their debt by devaluing their currency. **This is a process that will take many years** to get their debt-to-GDP down to a manageable level where they can afford an increase in interest rates. The paradox is that they *need* higher interest rates today to help the economy with subtle inflation, higher wage increases and income on savings. Unfortunately, this is a similar situation that basically all western nations face. But why would Japan decide to take this route? Because they have no other choice. They're fighting a terrible demographic structure (too many retirees, not enough workers) and fiscal stimulus has repeatedly failed to jumpstart the economy. Printing yen to cancel their debt and hopefully boost exports seems to be the best remaining option.

Other countries are already responding to the weaker yen by weakening their currency as well. Japan is essentially trying to export its deflation to its competitors while capturing their export production. Countries that compete directly against Japan for exports (autos, electronics, etc.) aren't going to sit back for long and allow Japan to do this very easily. And this is how currency wars begin. In a world with too much debt and not enough demand, everyone tries to get a leg up by weakening their currency in the short-term to make their products cheaper for the rest of the world. The world hasn't experienced a currency war since the 1970's but we're on the verge of the next. Unfortunately no one wins in a currency war. Everyone acts in their own best interest in the short-term but this unfortunately creates massive problems in the long-term.

This will create immediate problems for Japan's largest competitors – namely, Germany, South Korea, China and a few smaller Asian nations. The effect on Germany will have the greatest impact as they are viewed as the strength of Europe. The irony is that this German "strength" has come at the expense of the southern European nations through the same process of artificially suppressing its currency. With Europe on the brink of another recession, weakness in Germany could be the straw that breaks the camel's back, raising the possibility that serious issues (economic, political and civil) will emerge. At a minimum, we'll see the Euro currency continue to depreciate against the US dollar. The effect will be felt across many other countries as well, leading to a depreciation of their local currency against the US dollar. This is where it all ties back to the Emerging Market countries and companies that have borrowed trillions over the past 5 years in US dollars. Worst case, this could quickly compound into cascading defaults. Best case, the rise in the US dollar is slow and gradual allowing the markets to adjust and manage. Either way, a rising US dollar will put pressure on international investments and likely lead to many sovereign bond defaults. It will also put pressure the US economy as our exports begin to slow. Depending on how quickly this process unfolds

will determine how volatile markets become, and this applies to all markets – it starts with currencies, moves through bonds and lastly stocks. This is why we've been overweight US assets and will continue to be for quite some time.

Other Potential Triggers

This letter is already getting long so I'll summarize some other potential events that could trigger the next crisis with a rush into the US dollar:

- **Falling oil prices** – The price of oil has dropped approximately 50% in the last 6 months – not a good sign of global demand. In the US, while lower energy prices are great for consumers, it will have some serious negative effects for the energy industry which has been the largest contributor to job growth and economic productivity. Additionally, and perhaps the larger risk, how will energy exporters, like Russia, respond? Their economy, which is already under major pressure from sanctions, is sustained almost solely by energy exports. Lastly, lower oil could impact other energy exporters to the point that it leads to default. If a nation is forced to default on its debt, it could trigger a move into the US dollar that creates a wave of other nations to follow.
- **China -** China has some big problems with their "shadow" banking system. Real estate has already been falling the past few quarters and the risk that they **devalue** the yuan (not revalue to a higher rate as so many politicians are demanding) to remain competitive with Japan is rising. This would quickly cause additional capital flight into the US dollar.
- **Europe** – Europe is already in recession and on the verge of outright deflation. If the Euro continues to fall from a loss of confidence, it could send the US dollar high enough that we hit a "breaking point" in other nations that can't afford the rise as much as Europe.
- **Peer-to-Peer online lending -** On a longer term outlook, the growth of peer-to-peer online lending is causing a contraction in the money supply at a time when we need more liquidity. I think the ability to circumvent traditional banks, which are so heavily regulated that the time and cost to obtain a loan is outrageous (if you even can meet the ridiculous qualification standards), is wonderful and will continue to grow. However, this ultimately means a slow contraction in credit (the money supply) over time which will slow economic growth for two main reasons. First, unlike our current financial system of fractional reserve lending, this form of banking is effectively 100% reserve lending – meaning people can only lend what they have in cash (in full), unlike banks which are able to make a loan worth 10x their amount of reserves. Second, I would assume that a lot of these loans are being made with excess savings in an attempt to earn a rate of return greater than the paltry interest rate banks are paying. Reducing ones savings at a bank reduces the reserves the bank holds which ultimately contracts the amount their able to lend by 10x! This is all part of the evolution of our monetary system, which is moving toward electronic means at a rapid pace and offers huge benefits to the consumer in the form of faster, cheaper transactions. A new era of peer-to-peer lending, payments and transactions is upon us (whether it's PayPal, Apple Pay, Bitcoin, etc.) which is great for consumers, but spells a lot of trouble for the traditional banking industry and the monetary system as a whole. This also means that we're likely to see global money printing by Central Banks for years to come. I understand this is often hard to comprehend, but despite the trillions of printing over the past few years, we've actually seen a contraction in the velocity of money from deflationary economic forces and the contraction in lending by banks. Central Banks need to print money just to hold the money supply constant and if peer-to-peer lending continues to grow, which it almost certainly will, Central Banks will have a lot more printing to do. This ultimately leads to a higher US dollar. As a side note, but very related to the topic, within the $1.1 trillion spending bill passed by Congress last month, our wonderful politicians decided to repeal the provisions of the Dodd-Frank Act that restricted banks on the use of derivatives and the Volcker Rule, once again allowing them to make speculative investments on their own books. It only took 5 years for Wall Street to get Congress to revert right back to the same system that magnified the Great Recession and puts the taxpayer on the hook again for the next time the banks blow themselves up. The worst part is how they always try to hide things buried within other bills

so most people aren't even aware of what's going on. It just goes to show how bought and paid for our politicians really are.

What I'm Optimistic About

- 2015 is a pre-presidential election year, which is usually positive for stocks
- Capital flows, for the time being, are still pouring into all US assets, including stocks
- Lower energy prices will provide a very nice boost to consumer spending (positive for consumer spending related companies, travel, etc.)
- Recent developments in the biotech industry the past few years have been outright amazing
- There's a good chance we see Congress take action to reform the corporate tax system and allow money held overseas to be repatriated at a lower rate – a positive for large, multi-national stocks
- The rising tide of civil unrest is leading to a lot of political change throughout the world. We're seeing a growing trend where the current leaders are being thrown out of office (for either corruption or stupidity), leading to some important structural changes. Long term, a handful of Emerging Market nations are beginning to implement some very important reforms that will greatly improve business and ultimately their economy. Examples include Mexico moving to privatize their energy industry last year and Narendra Modi being elected in India on the basis on major reform making it easier and cheaper to do business. Also, Greece is another country we can point out in particular. There's a strong chance we see Greece leave the Eurozone – something it should have done long ago. If it occurs, they'll instantly devalue their currency, restructure their debt, and be in a position to return to a path of growth within a short period of time. AFTER the devaluation, an independent Greece would be one of the most appealing places to invest for the following decade.

Conclusion

The intent of this letter was not to scare anyone but simply make you aware of the global environment in which we live. Economically speaking, things are tough and are going to get worse. But that doesn't mean there aren't smart investments where money can be made. It's all about finding the right countries, industries and companies that are seeing positive trends. The US has been relatively insulated from the turmoil overseas but unfortunately that won't last forever and the risks of the next global crisis are building. **However, please keep in mind that I believe the next crisis will be in government bonds not stocks**. New problems usually cause stocks to drop in the short-term, but ultimately if investors begin to fear the "safety" of government bonds, they could turn to corporations with the strongest balance sheets and physical assets like real estate. I'm not predicting that any specific event will occur in 2015, or even at all, but the events mentioned in this letter either have a high probability of occurring or large consequences for the global economy. My job is to monitor this giant, complex system of the global economy and to position your portfolio accordingly.

Ultimately, it appears the forces of deflation are taking hold as currencies, commodities and government bonds have all reacted accordingly during the second half of 2014. US stocks are just about the only asset that hasn't, which is a sign of their strength, but also means we're looking at much higher volatility moving forward. This is the main reason we're now incorporating stock options. We stand ready to mitigate risks while benefiting from any opportunities that may arise.

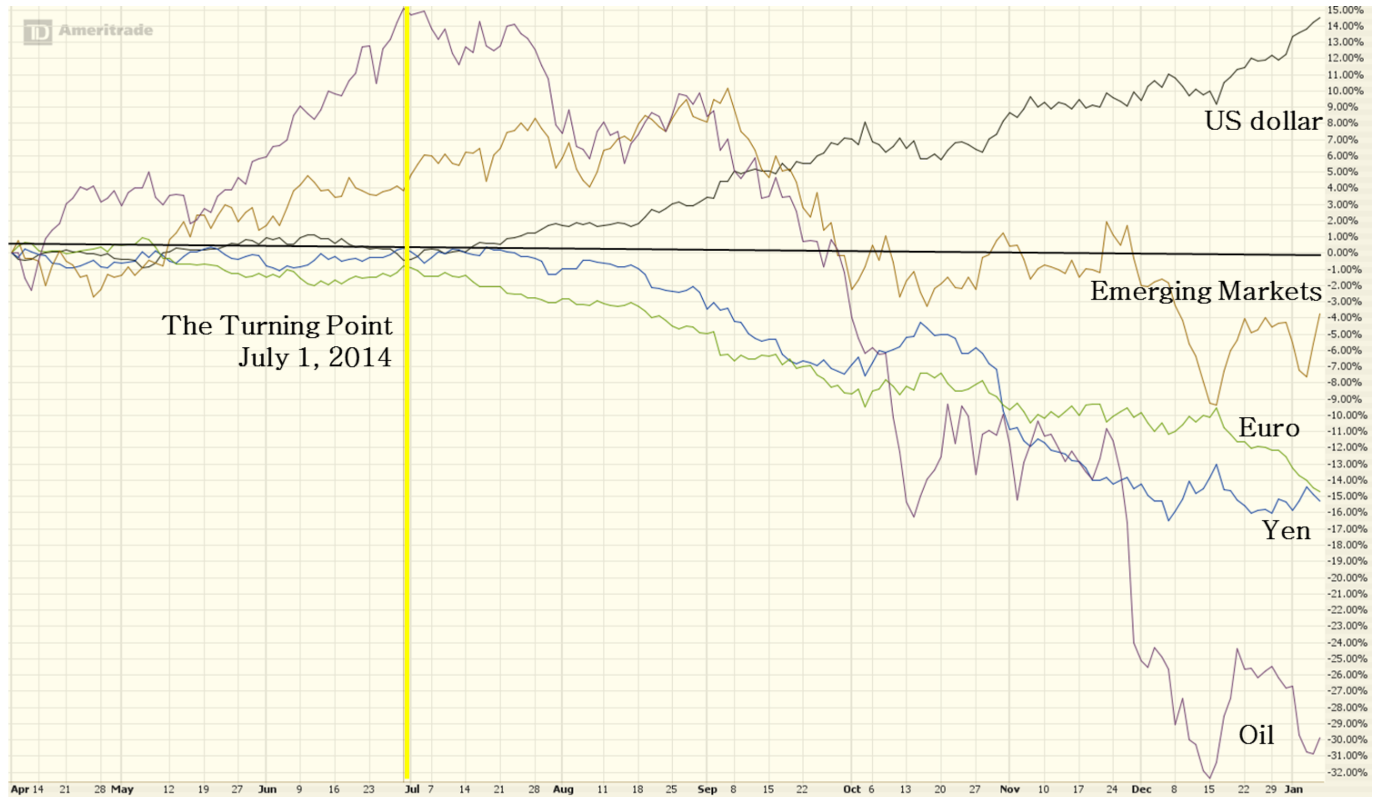
All the best to you in 2015,

Nicholas R Lumpp

P.S. don't miss the chart on the next page

What Global Deflation Looks Like

The story of 2014 with the turning point occurring at the start of July:



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3161 SOLOMONS ISLAND ROAD, SUITE 1 | EDGEWATER, MD 21037
PHONE: 410-956-6003 | FAX: 410-956-6004