Market Update

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Subject: Where to Now?

We expect a ***strong*** move in the markets may be imminent. We know, we know … which way, right?! Alas only time will tell. Possibly *both*. Of course as always it all depends on whether the increasingly wild actions of Central Banks are successful or not. Just consider June to be 'Central Bank' month. In the U.S., the Fed is going to attempt Rate Hike #2, another 0.25% hike, one that was delayed after the first one in December conveniently wrought 'the Worst Start to a Year Ever" as the chart below reminds us. We find it quite probable the January dive was designed by Wall Street to force (or allow) the Fed to back off of Rate Hike #2 after they pretended they would be delivering four hikes in 2016.

"We front-loaded at the Federal Reserve an enormous rally in order to accomplish a wealth effect. The values are very richly priced here, so I could see significant downside… It was, the Fed, the Fed, the Fed, the European Central Bank, the Japanese Central bank." Richard Fisher, Former President of the Dallas Federal Reserve

Arguing for the next big move as 'UP' is the scheme concocted by the Fed and the European Central Bank. The ECB will, *just before* the Fed hikes in June, begin 'buying' corporate bonds. This scheme works like this: the ECB prints money to buy corporate bonds (loans to European companies). The companies then use that borrowed money to buy back their own stock shares (instead of building new plants or otherwise growing the businesses in ways that bring the workforce along for the ride).

As we challenged in our last letter, if anyone can pick a better word than "ponzi" for such a scheme, we'd like to hear it. Nonetheless, that is the Fed-endorsed plan. The Fed used it in 2013 causing the S&P 500 to soar nearly 30%. Much of the increase in stock prices has come from buy-backs. The deliberately revealed 'hidden objective'of their policy is postured as a noble one amusingly in that it will generate a 'wealth effect' enriching those who have assets who, in turn, will 'trickle down' some morsels to the rest of the populace. Meanwhile, pension plans and other balance sheets can conveniently be 'rescued' by the rising asset prices and thus promises can be kept. Of course, in reality the policy has caused massive price distortions, exploded debt, spiked wealth inequality and caused real inflation, but hey, what's a brilliant central banker to do?!

In the corner arguing that the next major direction being 'down' is this:

"last week, BofAML clients were net sellers of US stocks for the 18th consecutive week, continuing the longest uninterrupted selling streak in our data history (since '08)."

- Bank of America / Merrill Lynch

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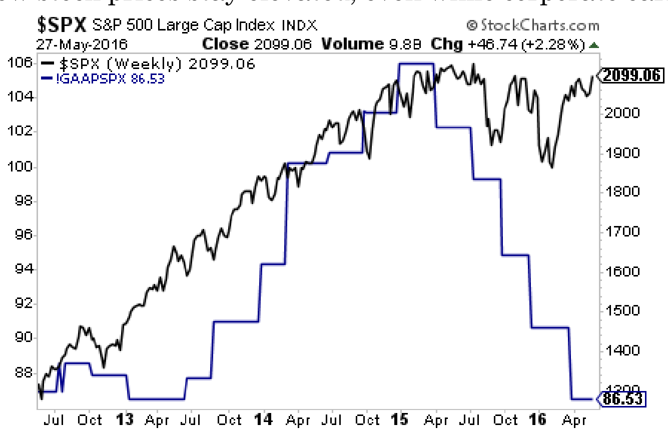
So, the question here is whether investors should care about the fact that the big boys, the alleged 'Smart Money', is selling stock hand over fist? Or, should they instead focus on the seemingly calm state of the markets and the fact that prices on several major indices are back near their highs?

If ever we feel the need to get a wild look from someone about the stock markets, we can simply discuss the scenario when there is heavy selling into a rise in price. That is a *very* tricky concept to understand, even for those who know intricately how the stock markets and its participants work. … But ***it happens …*** regularly. It almost always happens at major turning points. And, *it is happening now* as BofAML just reported. Before we get into what to do about it, here is how it works:

'Market makers' are major participants in the markets, paid to transact on various stocks. In fact, they are *required* to transact on certain stocks regardless of whether the price is trading up or down. Their role assures there is always a seller when somebody wants to buy, and a buyer when somebody wants to sell. They are compensated by 'the spread', the difference between what someone will pay for a security and that at which someone will sell it. In their private businesses, much compensation comes from the *big firms,* those with big positions, the 'Smart Money'. Naturally, if they want more business, they need to 'do a good job' which in that role means getting a good price for the customer: if the customer is selling you want to deliver them a high price; if the customer is buying you want to deliver them a low price. Therefore 'market makers' use their own capital to actually move prices into a desired range where they then fill the orders for their customers … selling to other buyers there.

In a low-volume environment, like the Summer marketplace where many Wall Street participants take extra-long holiday weekends (like their traditional 5-day Memorial Day weekend) and go on extended vacations, it is *very easy* for price to be moved on the back of only a few shares. Thus, a market maker can buy just relatively few shares, move the price up, and hold price there while retail investors take over, chasing that attractive upward moving price by buying the shares. If price begins to fall a bit, the market maker just buys a few more shares and simply pushes price back up again until done. That's also how stock prices stay elevated, even while corporate earnings hit 4 year lows:



SO … what is an investor to do? With the ECB beginning its 'corporate-bond buying' program next week, in a low volume market they may well spark another leg to this 'bounce'. Not only might it take major indices past prior highs, it has the potential to be quite impressive. BUT, in our view it is very probable that BofAML's big clients will be selling into that low-volume, central bank induced rally, extending their record 18-week sell-a-thon. (When they finish selling the shares they own, that's when some will 'short', borrowing shares and selling those shares too, in order to profit later by buying them back cheaper and returning them.

We think it is quite possible we get two major moves: up, perhaps strongly, then likely down. This is our view of the days ahead. *Do not* take this as specific trading advice. Do consider rallies may be opportunities to lighten up risk exposure. And *do* contact us however if we can review this view against your specific situation to see if any allocation changes make sense. You can of course call us at (614) 734-WLTH (9584). Don't forget to visit our website for links to current articles and recent Market Updates.