1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

JUNE 2014 INVESTMENT COMMENTARY

A RENOWNED MARKET TIMER THROWS IN THE TOWEL, CALLING HIS ATTEMPTS TO TIME THE MARKET SILLY, & RISING SUMMER TEMPERATURES WILL BRING ABOUT A RESUMPTION OF RISING BOND YIELDS

In previous commentaries, I have discussed how it is not advisable to take investment direction from financial media pundits. Although listening to financial news from broadcasters, such as CNBC or Bloomberg, can provide useful information, many of these pundits are often placed on television to represent a specific, pre-conceived opinion that was made for primetime debate. Thus, many of these talking heads end up giving specific buy/sell advice to an audience with differing financial objectives.

Recently, Larry Fink, CEO of Blackrock, the world's largest asset management company, published an article titled Want to be a better investor? Tune out the noise. In this article, Mr. Fink correctly states that, "With all the information swirling around us, it's easy to get obsessed with watching the market's gyrations. And it's tempting to think you can outperform everyone else if you just listen closely enough. The truth is, most of what's out there is just noise." As described, this constant stream of information and "noise" is what makes successful investing such a complex business.

One example of Fink's media "noise" is renowned commodity investment expert, Dennis Gartman, who has recently grabbed the spotlight with his on-again and off-again predictions of a meaningful stock market correction. However, with major stock market averages pushing up against all-time highs at the end of May, Mr. Gartman has finally given up trying to call a correction. In his latest newsletter, Mr. Gartman said "simply put, we've been wrong…badly…to have expected the market to correct." It is one thing for a pundit to admit what any observer already knows, that he or she was wrong. However, it is another very noteworthy thing to admit that trying to predict the market is futile which Gartman did when he stated that, "it's so silly for me to think I can call a correction. The market will correct when it corrects. That is what I've learned in my 40 years in the business." Thus, I applaud Dennis Gartman for not only admitting that he was wrong, but for finally telling the investing public the truth about the inability to time the market.

Throughout this commentary, I will convey my observations regarding some important dynamics that have surfaced in the markets over the last few months. Specifically, this discussion will center on the remarkable and somewhat confounding direction of recent interest rates, as well as the rotation away from growth stocks towards defensive oriented equities.

Since the second half of January, when the Federal Reserve began tapering their extraordinary bond purchases, interest rates have fallen significantly. Conventional wisdom, based upon sound reasoning, was that the beginning of the "tapering" process by the Federal Reserve would mark the end of crisis level low interest rates. Yet, the U.S. 10-year Treasury Note reached a multi-year high just north of 3% as 2013 came to an end and today, the 10-year Treasury Note rate is just south of 2.50%. Thus, this drop in bond interest rates has many economists and investors searching for answers because, on the surface, falling interest rates

seem counter-intuitive, given that the Federal Reserve is scaling back its bond buying.

I have heard many theories about why interest rates have fallen, but the most popular theory seems to be that the government is issuing less new bonds due to the rapidly shrinking budget deficit. This theory is built on the assumption that a lower issuance of bonds to fund deficits results in the Federal Reserve effectively buying 100% of the newly issued Treasuries. However, in spite of the logic underpinning this theory, the argument does not pan out. It is true that the U.S. issued $38 billion less in Treasuries in the first four months of 2014 than the last four months of 2013, but the Federal Reserve has bought $30 billion less in bonds so far in 2014 versus the four month period that ran from September through December last year. Thus, the relationship between bond issuance and bond buying over the last eight months has not materially resulted in more bond buying as a percentage of issuance. However, it is worth noting that on a percentage basis, the tapering effect has not really reduced Fed bond buying as a percentage of issuance.

I believe that there is evidence that rates have come down due to the program trading (algorithmic trading) that is used by hedge funds and large institutional investors. The binary equations used in quantitatively driven trading include variables such as the Gross Domestic Product. Over the last several months, readings of GDP and related statistics have consistently surprised on the downside. To simplify why I suspect that algorithmic trading is the root cause of 2014's falling interest rates, I have listed below the data points that are likely variables within many trading algorithms:

ENTERING 2014:

1. Logged a 30% + annual advance in the major U.S. stock indexes.
2. Imminent bond purchase tapering.
3. Above average strength in monthly job creation.
4. Relative calm global geopolitical backdrop.

BY THE END OF JANUARY 2014 DATA POINTS TURNED NEGATIVE:

1. A negative month for U.S. equities.
2. A sharp deceleration in job creation.
3. Disappointing retail and auto sales reports.
4. Violent protests breakout in the Ukraine.

In a span of the first thirty days of 2014, many of the algorithmic variables, which directed computer programs to take long positions in equities and to short or sell bonds, have been reversed. Not only did this change in variables exacerbate equity selling, it also triggered bond buying. This trading activity would have pushed the prices of stocks down; the prices of bonds up, and ultimately, lead to falling bond yields.

Looking back over the last five months, the Ukraine crisis and the extraordinarily harsh winter weather that plagued much of the country in December and January, caused a negative shift in investor sentiment and a material weakening in many of the closely watched economic statistics. In my opinion, these events factored into trading algorithms and would have been sufficiently impactful to cause macro driven trading to move to a more defensive posture (e.g. rising bond prices/lower bond yields, correction in high multiple growth stocks, and a rally in defensive equity sectors such as utilities).

This relationship between economic data points and bond yields was very evident just prior to the release of the second estimate of the first quarter GDP on May 29th. On May 28th, the 10-year Treasury note dropped to 2.44%, moving down a dramatic .08% the day before the release of GDP. Sophisticated traders know exactly how GDP is calculated and with the help of an economist, can fairly accurately predict the direction (good or bad) of a revised GDP release before it is made public. This ability to forecast economic revisions was evident between the time that the first initial estimate of first quarter GDP was released showing a negative 0.10% annualized GDP and the second revision. During that period, the consensus of polled economists showed

an expected negative revision, as the consensus forecast fell to negative 0.50%.

Given my aforementioned thoughts on the likely root cause of the non-consensus fall in interest rates since the beginning of 2014, I believe that the computers are missing the context of weather and have over-played the impact the Ukrainian situation on markets. In fact, I believe that when the economy re-emerges from winter hibernation in the second quarter and when Ukraine is no longer an everyday headline, we will see a sharp snap back in interest rates.

My second observation is related to the first, but has to do with the virtually unprecedented internal rotation that occurred in the stock market over the last couple months. This rotation led to a correction in growth stocks and outperformance of defensive stocks. In addition, a rotation occurred from small and mid-cap stocks, which outperformed in 2013, to large and mega-cap stocks that were relative underperformers last year. These changed dynamics within the equity market further support my contention that weather induced economic weakness and heightened geopolitical tensions triggered a shift in trading tactics toward more defensive asset classes. When the rate of growth in GDP falls or stalls, as it did in the beginning of 2014, economic and trading models automatically increase the probability of an impending recession. This increase in the probability of a recession within trading models would result in the aforementioned trading dynamics.

Once these trading dynamics take root in the market, they will become self-reinforcing until such time that the economic data begins to contradict the models. I expect a fairly abrupt reversal of the weakening thesis that drove down growth equities and bond yields during the first several months of 2014 when the economic statistics begin to show that the first quarter was an aberration. For this reason, Seven Summits Capital portfolios have not and will not chase the erratic price movements driven by reactionary trading strategies. As always, we will continue to seek out relative value opportunities that are created by the short-term orientation of many large institutional investors whose models are driven by month-to-month data and geopolitical flash points.

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com

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