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Real Investment Report **The Seemingly Bulletproof Market**



- ***The Bullet Proof Market***
- ***The Great Fed Unwinding***
- ***401k Plan Manager***

For the last couple of months, we have discussed the risk of the narrowing of leadership as money piled into an ever reducing number of primarily large-cap technology stocks. [To wit:](#)

"This really is a more bizarre clustering of markets and sectors that I have witnessed in quite some time. **However, for now, the rotation between sectors remains tight and it is the #FANMAG stocks that continue to elevate markets because of their sheer size. (\$FB, \$AAPL, \$NFLX, \$MSFT, \$AMZN, \$GOOG)** The question that continues to linger over the markets is just how stable is the advance? **The answer to that question is unclear, but it is quite likely the spat of earnings growth seen over the last couple of quarters will soon end as year-over-year comparisons get decidedly tougher.**"

Last Friday, a [news headline questioning valuation levels](#) triggered algorithmic trading programs to reverse and dump those stocks in mass.

"Goldman's Robert Bouroujerdi writes that 'while FANG has dominated investor focus, the nature of the acronym has expanded more broadly to encompass mega-cap tech. Indeed, the bigger story in our view is FAAMG ? Facebook, Amazon, Apple, Microsoft, and Alphabet ? a group of five stocks which have been the key drivers of both the SPX & NDX returns year-to-date. **This outperformance, driven by secular growth and the death of the deflation narrative, has created positioning extremes, factor crowding and difficult-to-decipher risk narratives (e.g. FAAMG's realized volatility is now below that of Staples and Utilities).** The run in large-cap tech stocks (with the top 5 accounting for a stunning 55% of the Nasdaq's YTD gains) has evoked memories (nightmares?) for some investors of the last euphoric NASDAQ run."

Exhibit 1: SPX and NDX returns are increasingly dependent on five Tech stocks

FAAMG YTD performance and index contribution, as of June 7, 2017

Ticker	YTD Price Perf (%)	% of SPX	% of SPX Move	% of NDX	% of NDX Move	Market Cap Created (\$,bn)	Equivalent to the Mkt Cap of:
AAPL	34%	4%	13%	12%	18%	200.1	CMCSA
GOOGL	26%	3%	7%	9%	11%	145.4	IBM
AMZN	35%	2%	6%	7%	11%	125.1	UPS + KR
FB	33%	2%	5%	5%	8%	111.0	BA
MSFT	16%	3%	5%	8%	7%	78.7	MS
Top 5		13%	37%	42%	55%	660.4	
S&P 500/Total	9%					1,808.1	

FAAMG is 13% of the SPX but responsible for ~40% of the YTD perf.

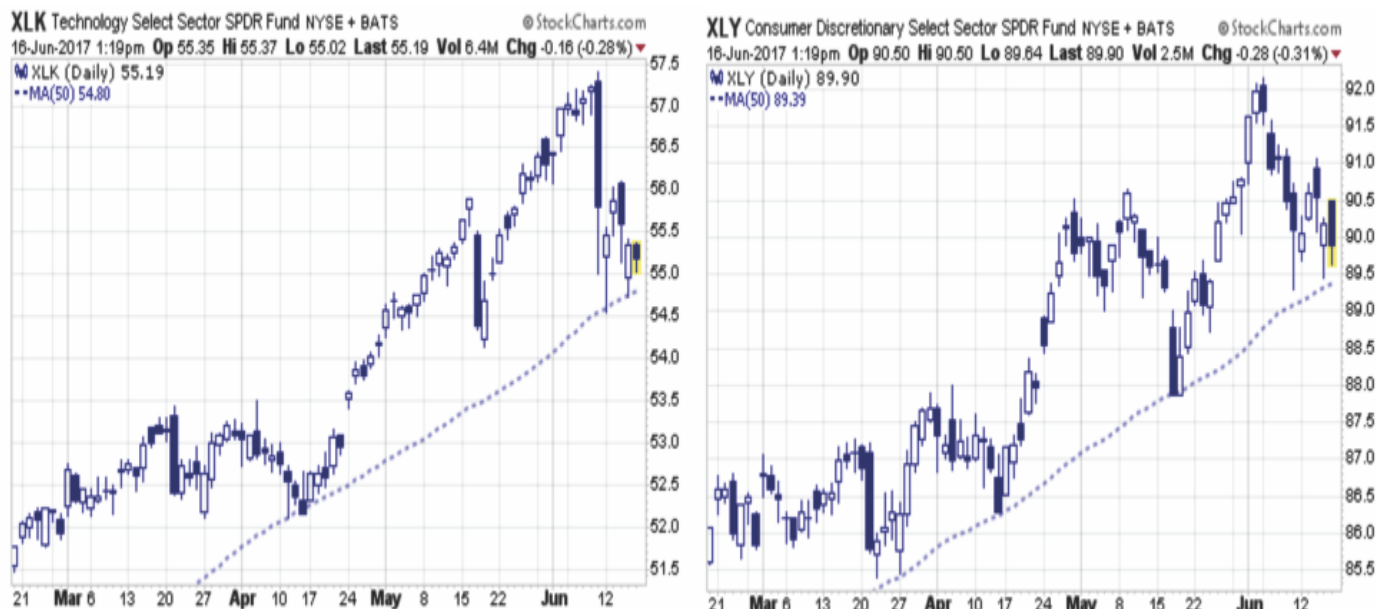
FAAMG is 42% of the NDX but responsible for ~55% of the YTD perf.

Note: For purpose of this exercise we combine GOOGL and GOOG.

Source: FactSet, Bloomberg, Goldman Sachs Global Investment Research.

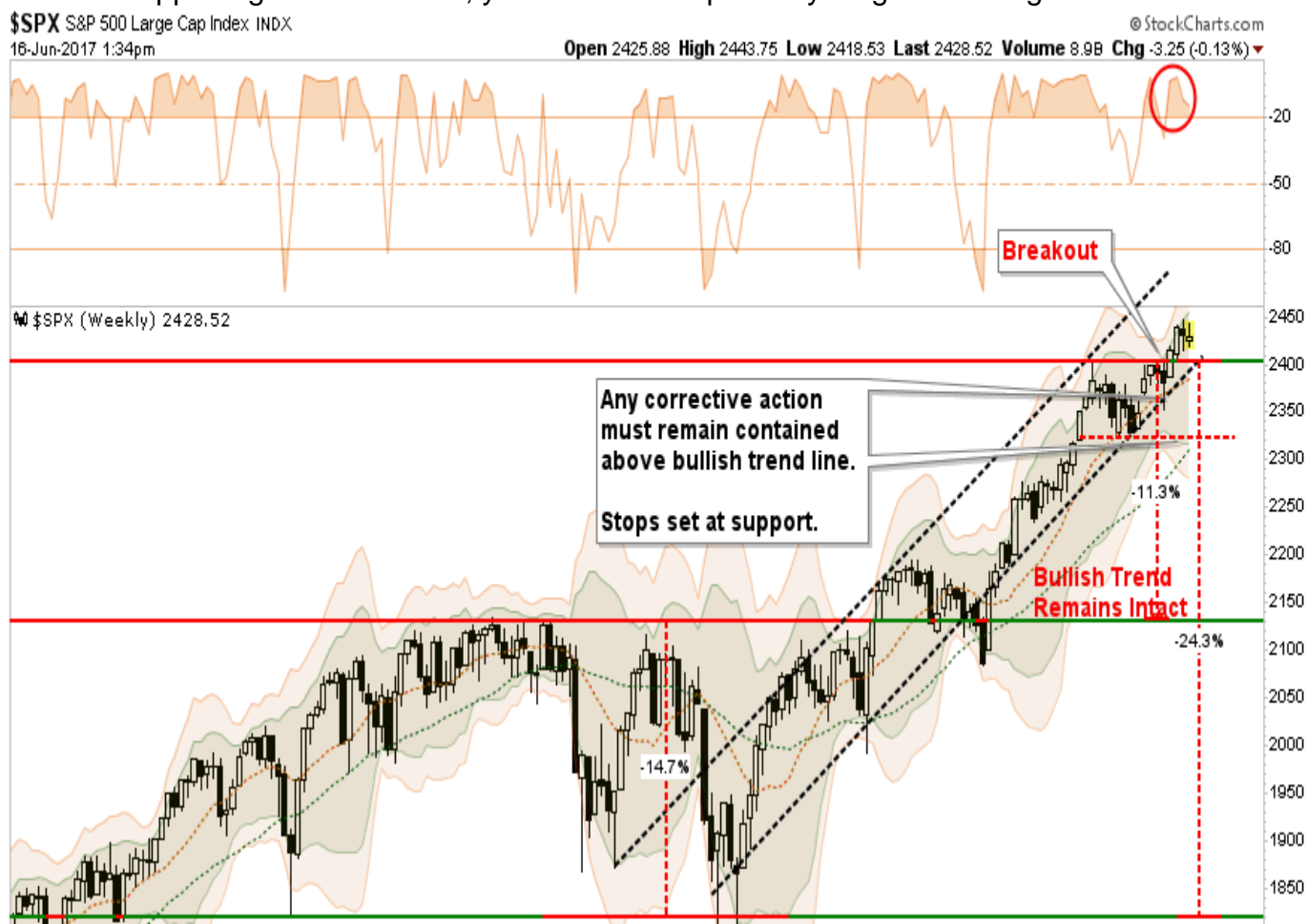
"Goldman notes that downside risk increases when factor valuations are stretched vs. history. To that end, the current P/E of the long/short Momentum factor is 1.8 std. deviations above its 3-year average, which is a level last seen in early 2016 just prior to 'Factormageddon' ? a period in late Q1:16 when the momentum factor fell sharply amidst a spike in factor volatility."

While the valuation call sent algo's into "selling mode," the "bloodbath" in Technology and Discretionary stocks, as shown below, was simply a reversion to 50-day mean following an extreme deviation.



It is worth noting that the 50-dma has been critical support for these sectors so a downside violation of that support would be important to pay attention to.

However, stepping back from the sector-specific action, if you only looked at the S&P 500 to judge what was happening in the markets, you wouldn't suspect anything was wrong.



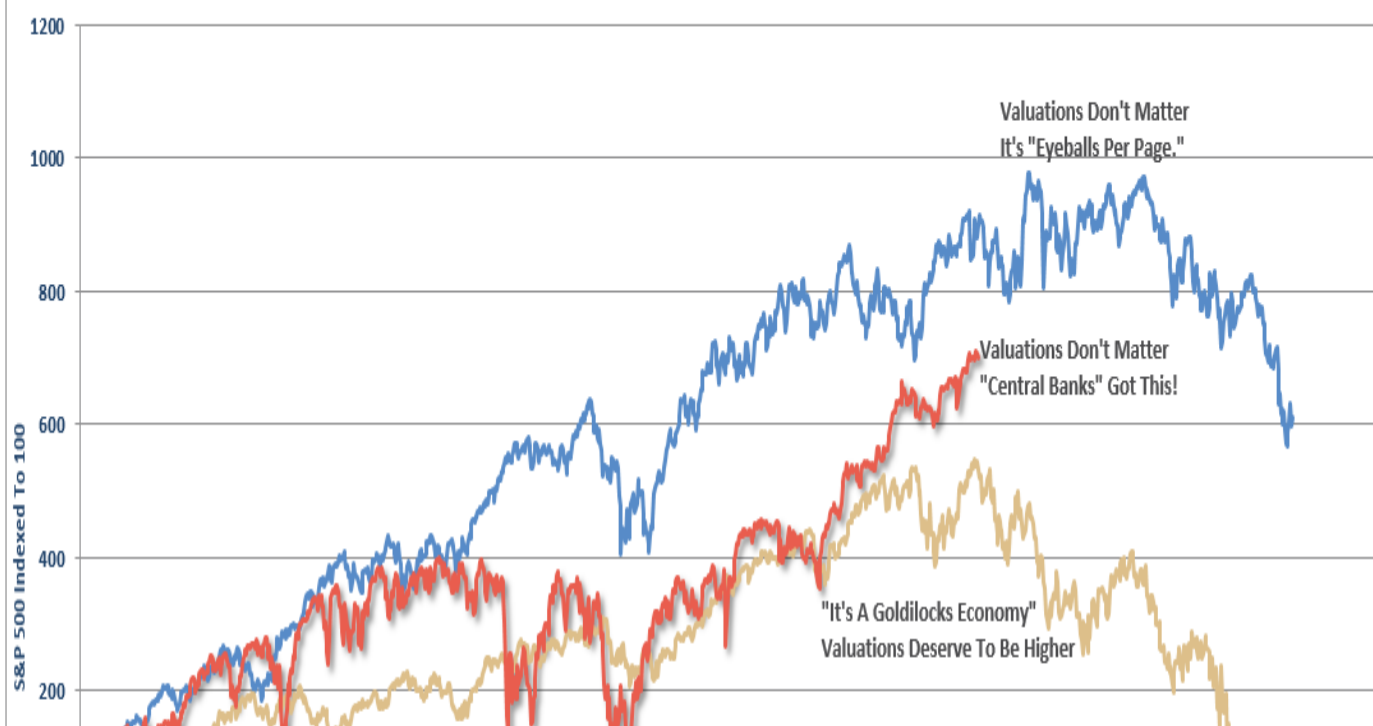
The market breakout remains intact currently with support at 2400 holding firm. The bullish trend line, which also intersects at 2400 remains critically important as the secondary buy/sell signal remains in positive territory. **The only negative currently, despite improvement, is the "weekly sell signal-1" remains triggered which keeps us on "alert."** *(It is also worth noting both signals remain at VERY high levels which suggest current upside remains somewhat limited.)* You can understand why more and more commentary is beginning to succumb to the "siren's song" of why "this time is different." Whether it is terrorist attacks, poor economic data, geopolitical tensions, or plunging oil prices, the market has continued its advance. **It certainly seems to be "bulletproof."** But therein lies the problem. The longer the market remains seemingly "bulletproof," the greater the complacency becomes with investors. **This complacency, or lack of fear, leads to an unwitting rise in the "riskiness" of portfolio allocations as the "can't lose" markets draws more and more capital out of "safety" and into "risk."** As noted last week, [valuations, equity allocation, and negative "free cash" balances](#) are pushing extremes.



Historically speaking, such levels of exuberance have tended to have poor outcomes for investors who did not realize the level of "speculative risk" that had built up in portfolios over time.

S&P 500 Comparison 1996, 2004 & 2014 (Present)

REAL INVESTMENT ADVICE

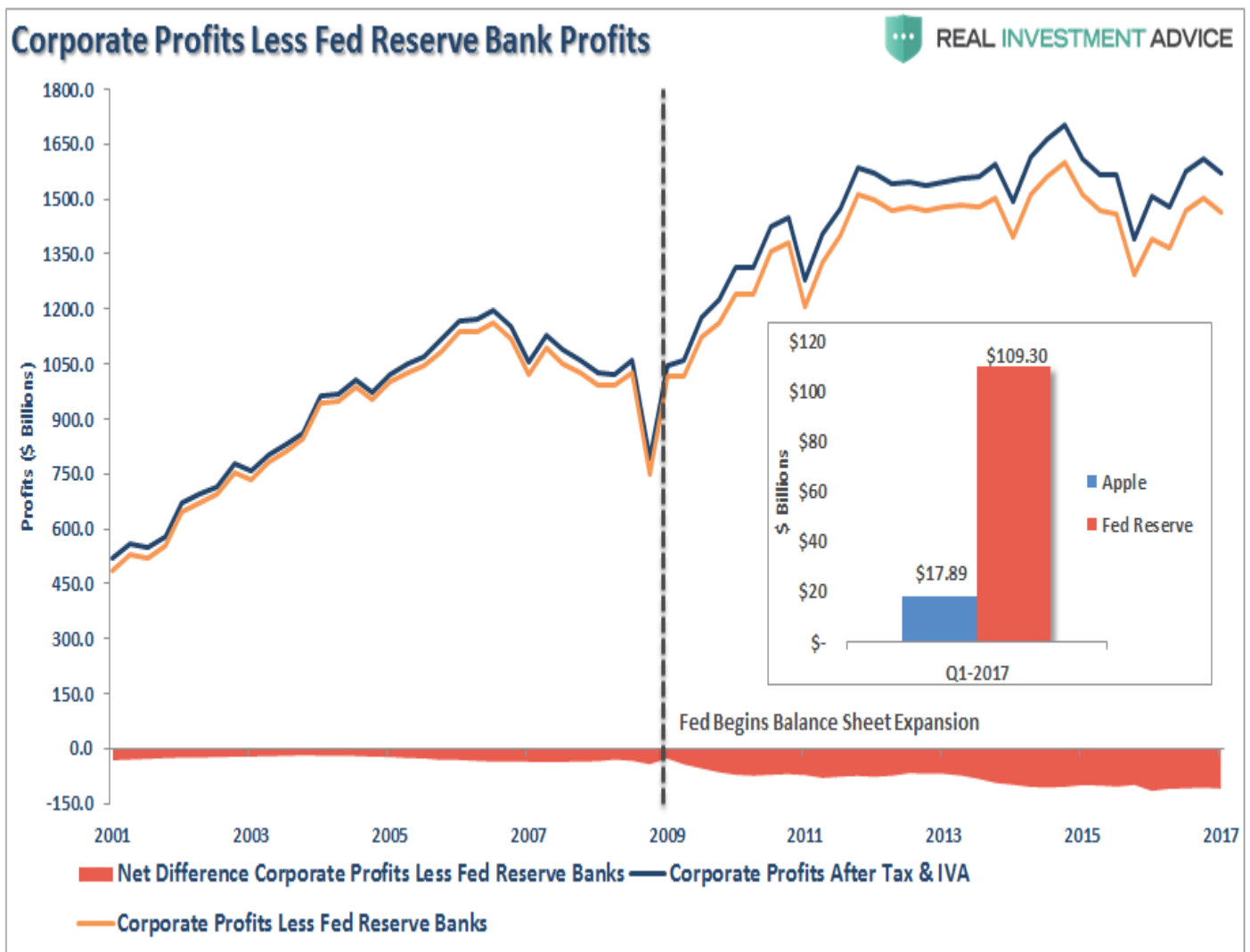


This "time" will not turn out any differently - it is just the "timing" and the "catalyst" that will be.

Volatility, Markets & Fed Unwinding

Last week the Fed hiked their lending rate 1.25% which is the highest level since the financial crisis. More importantly, they announced they will consider beginning to allow their \$4.5 Trillion balance sheet to begin to reduce by not "reinvesting" proceeds from redemptions and interest payments. First, just so you know, the Fed's balance sheet inflates two important things besides asset prices: **1) corporate profits, and 2) government revenues.** I addressed in ["Earnings Vs. Profits & The Bull Market"](#) the impact of the Fed's balance sheet on corporate revenues. To wit:

"The profits generated by the Federal Reserve's balance sheet are included in the corporate profits discussed here. As shown below, actual corporate profitability is weaker if you extract the Fed's profits from the analysis. As a comparison, in the first quarter of 2017, Apple reported a net income of just over \$17 billion for the quarter. The Fed reported a \$109 billion profit."

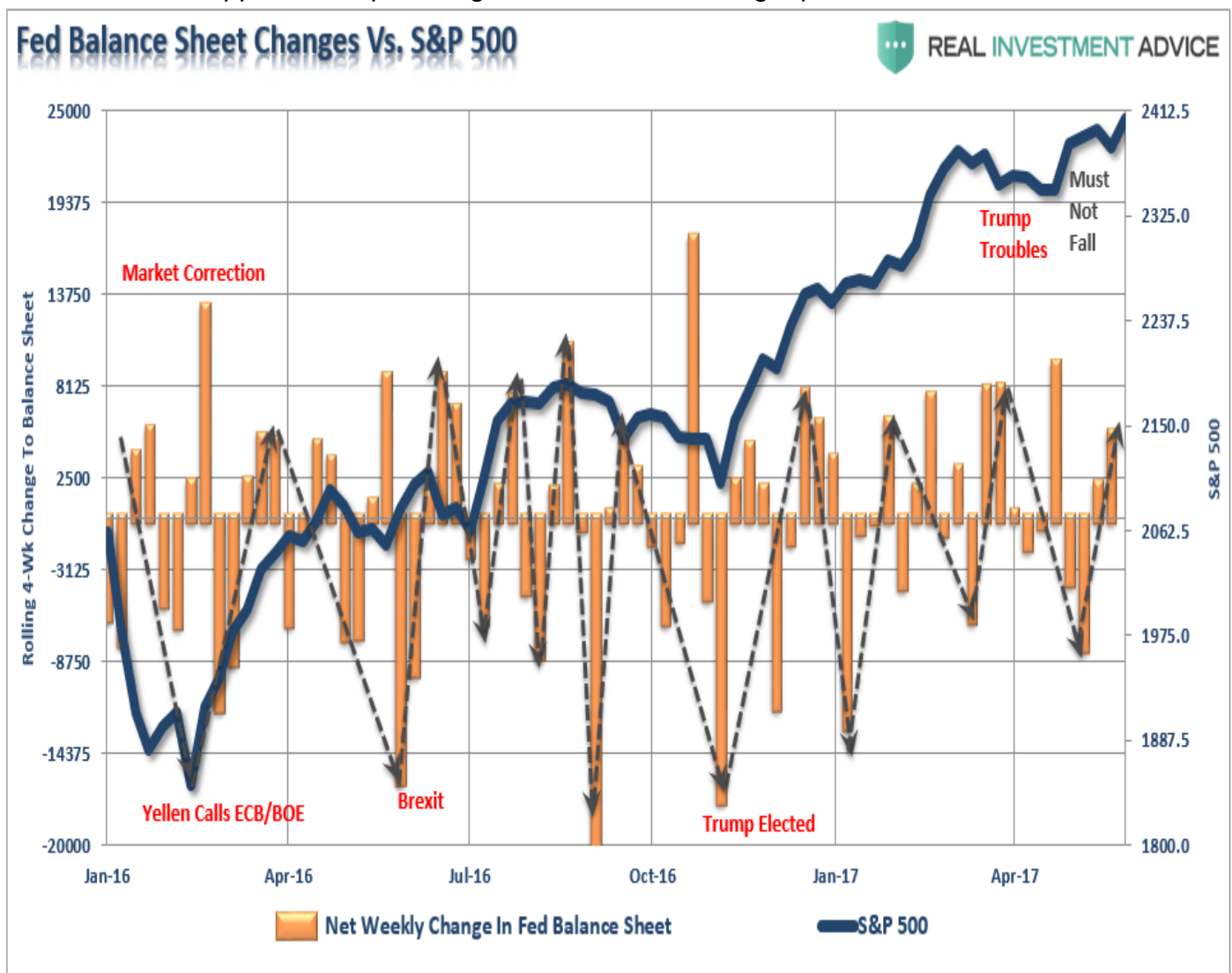


With respect to government revenues, it is also not a minor issue. The Federal Reserve can NOT buy bonds directly from the Treasury. When the Treasury issues bonds to fund the difference between Government revenues and expenses, the deficit, those bonds are sold to the 20-primary dealers. When the Fed is active doing "Quantitative Easing," the Fed creates a "swap" with the primary dealer by crediting their reserve account and the Fed now owning the bonds. Here is the interesting thing. When the Treasury pays the interest on the bonds, that interest is accounted for as an "expense" for the Government. Periodically, the Fed remits "profits" back to the Treasury

which is essentially returning to the Treasury the interest payments received by the Fed. These profits, or returned interest payments, are then counted as "revenue" for the Government. How much is that you ask? **In 2016, it was \$92.7 Billion which was slightly lower than the previous record of \$97.7 Billion in 2015 which was up from \$96.9 Billion in 2014.** So, in the years ahead, as the Fed reduces their balance sheet, the income to the Treasury will also fall. I digress. Now, nearly a decade after the start of the financial crisis, the Fed has announced its plan for shrinking the size of its balance sheet. [From BI:](#)

*"The basic idea is that the **Fed will stop reinvesting the principal of securities when they mature.** Put another way, when a 10-year Treasury on the Fed's books comes due, the money it gets back from that investment **will not be used to go out and buy another Treasury.** The slowing of reinvestment will be phased in over time. To start, the Fed will invest money back into the market only if it gets back more than \$6 billion in principal returned a month. **From there, the 'cap' will increase by \$6 billion every three months over the course of a year until it hits \$30 billion a month.** The Fed said it would ultimately have a balance sheet 'appreciably below that seen in recent years but larger than before the financial crisis' in part because the Fed expects banks to maintain higher demand for reserves supplied by the central bank. **But that is a pretty broad endpoint given that the Fed held roughly \$800 billion in assets before the financial crisis and \$4.5 trillion now.**"*

The fact the Fed will not be SELLING Treasuries to reduce the balance sheet is why interest rates did not move up appreciably following the announcement. **However, for those that believe this is a "bulletproof" market, this announcement means a great deal.** As I have shown you previously, the Fed's timing of the reinvestment of proceeds back into the market has acted as a "Stealth QE" to support asset prices against an economic or geopolitical shock.



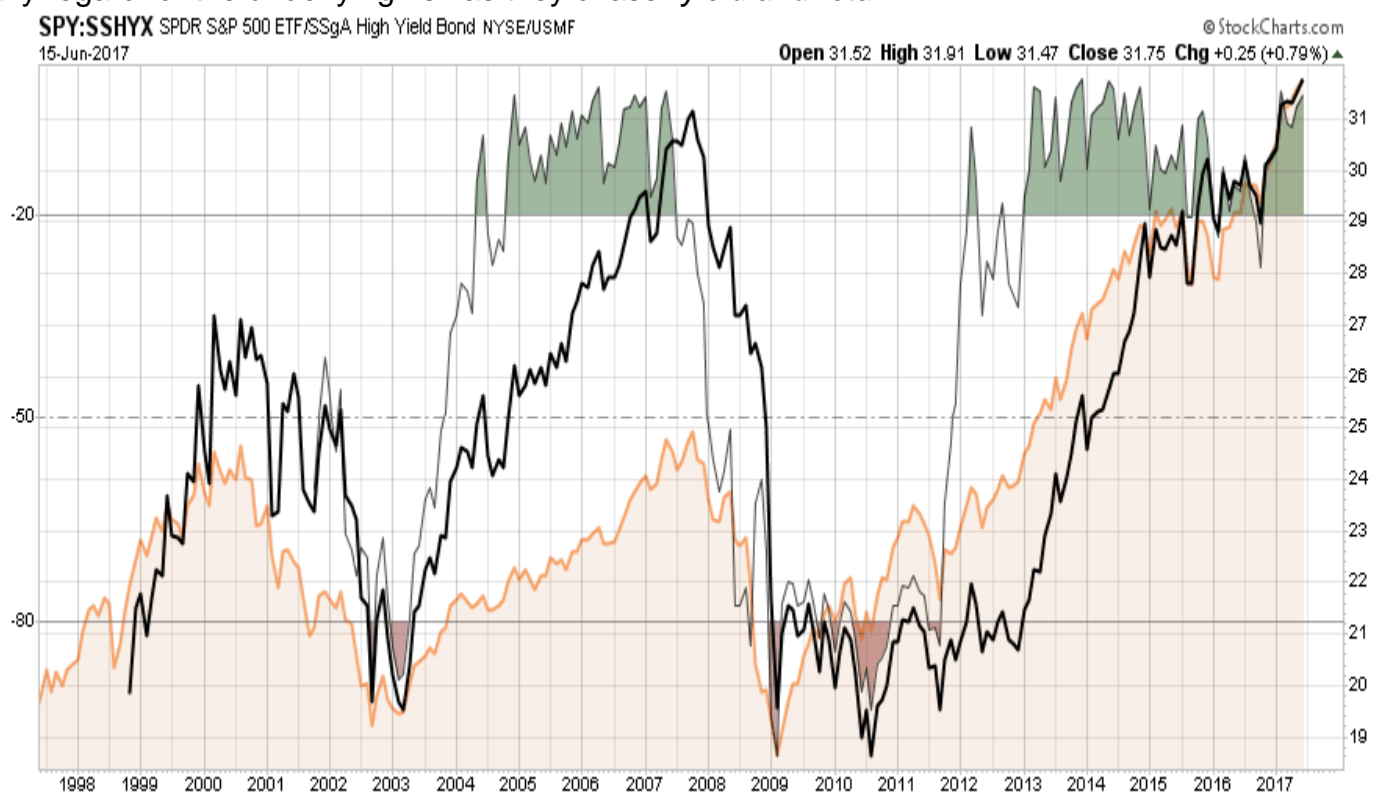
That activity has also acted to suppress volatility in the markets by providing the "Fed Put" to keep investors betting on the "long side."



[Axel Merk summed up](#) well what happens when these things run in reverse:

*"I have little doubt that a substantial driver of low volatility may be central banks. **Low interest rates and quantitative easing (QE) compress risk premia; in plain English, this means not only that junk bonds trade at a lower premium over Treasuries, but that perceived risk is reduced in all markets, including equities, causing volatility to be lower.** When central bankers 'do whatever it takes,' it is no surprise that investors chase yield **without being concerned about negative consequences.** But when central bankers 'taper' their purchases, odds are that **volatility comes back as taper tantrums have shown.**"*

He is right, there is very little concern about the risk being taken on by investors currently without any regard for the underlying risk as they chase "yield and return."



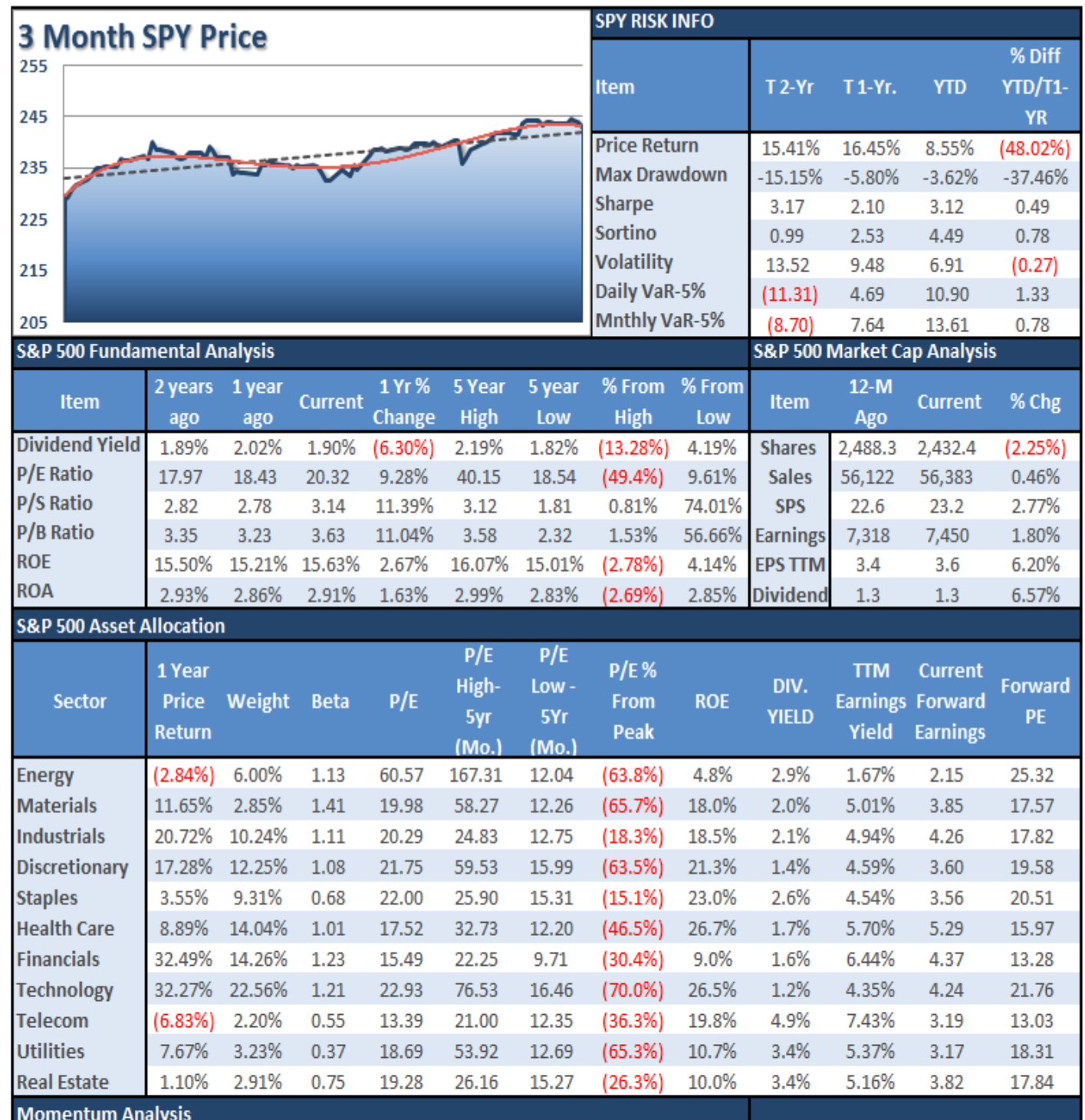
The forgotten piece of this "*fairytale*" is that **RISK = How much you LOSE when you are wrong. Currently, the risk/reward ratio is currently heavily skewed against investors in both the short, intermediate and long-term outlook.** Happy Father's Day. See you next week.

Market & Sector Analysis

Data Analysis Of The Market & Sectors For Traders

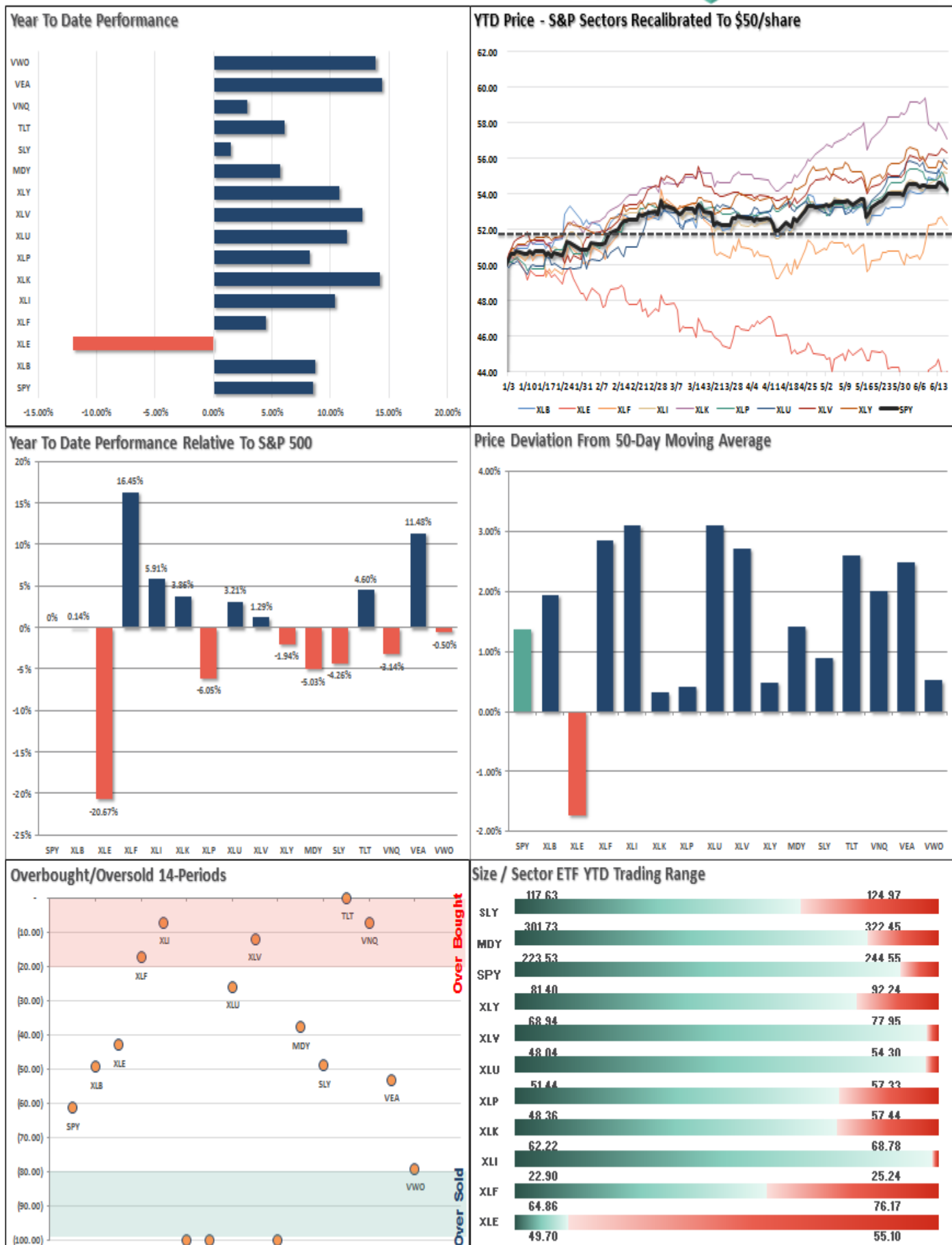
S&P 500 Tear Sheet

The "*Tear Sheet*" below is a "*reference sheet*" provide some historical context to markets, sectors, etc. and looking for deviations from historical extremes. If you have any suggestions or additions you would like to see, [send me an email](#).



Performance Analysis

New! Thank you for all the comments on the performance analysis below. Due to many of the emails I got, I have swapped out the sector weight graph for a year-to-date performance range analysis. Keep the comments coming. ([Email Me](#))



ETF Model Relative Performance Analysis

RELATIVE PERFORMANCE		Ticker	ETF NAME	Current Price	Model Position Price Changes Relative to Index					SHORT WMA	LONG WMA	% DEV - Short M/A	% DEV - Long M/A	Buy / Sell Signal
					1 Week	4 Week	12 Weeks	24 Weeks	52 Weeks					
BENCHMARK		IVV	ISHARS-SP500	245.18	0.10	2.22	4.16	8.97	17.50	239.95	232.25	2.18%	5.57%	BUY
TACTICAL	SECTORS	XLB	SPDR-MATLS SELS	54.02	(1.21)	0.80	0.41	(0.28)	(3.05)	52.81	51.40	2.28%	5.10%	BUY
		XLE	SPDR-EGY SELS	66.30	(0.28)	(4.83)	(7.46)	(20.95)	(18.38)	67.96	71.04	-2.45%	-6.67%	SELL
		XLF	SPDR-FINL SELS	24.29	(0.10)	1.81	(0.97)	(4.50)	(10.07)	23.63	23.29	2.81%	4.28%	BUY
		XLI	SPDR-INDU SELS	68.68	1.04	1.59	2.27	1.41	5.73	66.22	64.19	3.71%	7.00%	BUY
		XLK	SPDR-TECH SELS	55.25	(1.47)	(2.20)	0.40	5.27	10.84	54.62	51.51	1.16%	7.27%	BUY
		XLP	SPDR-CONS STPL	55.95	(1.37)	(1.13)	(1.87)	(0.77)	(12.86)	55.49	53.71	0.83%	4.17%	BUY
		XLU	SPDR-UTIL SELS	54.11	0.72	1.68	0.12	2.43	(10.46)	52.26	50.08	3.54%	8.06%	BUY
		XLV	SPDR-HLTH CR	77.69	0.12	1.33	0.42	3.72	(6.61)	75.36	72.57	3.10%	7.06%	BUY
		XLY	SPDR-CONS DISCR	90.15	(0.34)	(1.21)	(0.01)	1.78	(1.82)	89.11	85.58	1.17%	5.34%	BUY
	SIZE	MGK	VANGD-MG CAP GR	100.69	(0.14)	(0.29)	1.79	6.62	3.81	98.08	92.84	2.66%	8.46%	BUY
		IJR	ISHARS-SP SC600	70.07	(1.46)	0.90	(0.60)	(7.07)	4.05	68.95	68.03	1.63%	3.00%	BUY
CORE	Equal Weight Market	RSP	GUGG-SP5 EQ ETF	92.88	(0.10)	(0.12)	(0.74)	(1.77)	(0.95)	91.29	88.93	1.74%	4.44%	BUY
	Dividend	VIG	VANGD-DIV APPRC	93.85	0.01	1.12	0.10	1.20	(3.09)	91.29	88.33	2.80%	6.25%	BUY
	Real Estate	VNQ	VIPERS-REIT	84.94	1.42	1.13	(0.42)	(6.05)	(18.32)	83.03	82.44	2.30%	3.04%	BUY
	International	IDV	ISHARS-INTL SD	33.45	0.81	(0.98)	3.36	4.19	(0.87)	32.20	30.82	3.89%	8.54%	BUY
		VWO	VANGD-FTSE EM	40.75	(0.63)	(2.07)	(2.82)	4.92	2.95	40.43	38.49	0.79%	5.87%	BUY
FI	Intermediate Duration	TLT	ISHARS-20+YTB	126.35	1.47	(0.08)	0.37	(2.91)	(24.33)	122.59	121.71	3.07%	3.81%	BUY
	International	BNDX	VANGD-TTL INT B	54.73	(0.10)	(1.74)	(2.84)	(8.16)	(18.12)	54.40	54.29	0.61%	0.80%	BUY
	High Yield	HYG	ISHARS-IBX HYCB	88.15	(0.29)	(2.25)	(2.64)	(7.13)	(11.46)	87.84	87.11	0.35%	1.20%	BUY
	Cash	BSV	VANGD-SHT TRM B	79.96										

Sector Analysis

During last week's pullback, we **added modestly to our broader-based "core" holdings for the second time over the last couple of months.** to participate with the breakout. Stops have been moved up and remain very tight. **While I remain very cautious on the overall market, the trend remains bullishly biased which keeps portfolios allocated on the long side for the time being.** However, I will not be surprised by a reversal and failure of the breakout leading to us getting stopped out of positions. **On a bullish note, participation improved** as the previously lagging Small and Mid-cap stocks picked up the slack from a faltering Nasdaq. The improvement suggests some short-term *"support"* to the market as rotation keeps the overall trend intact.

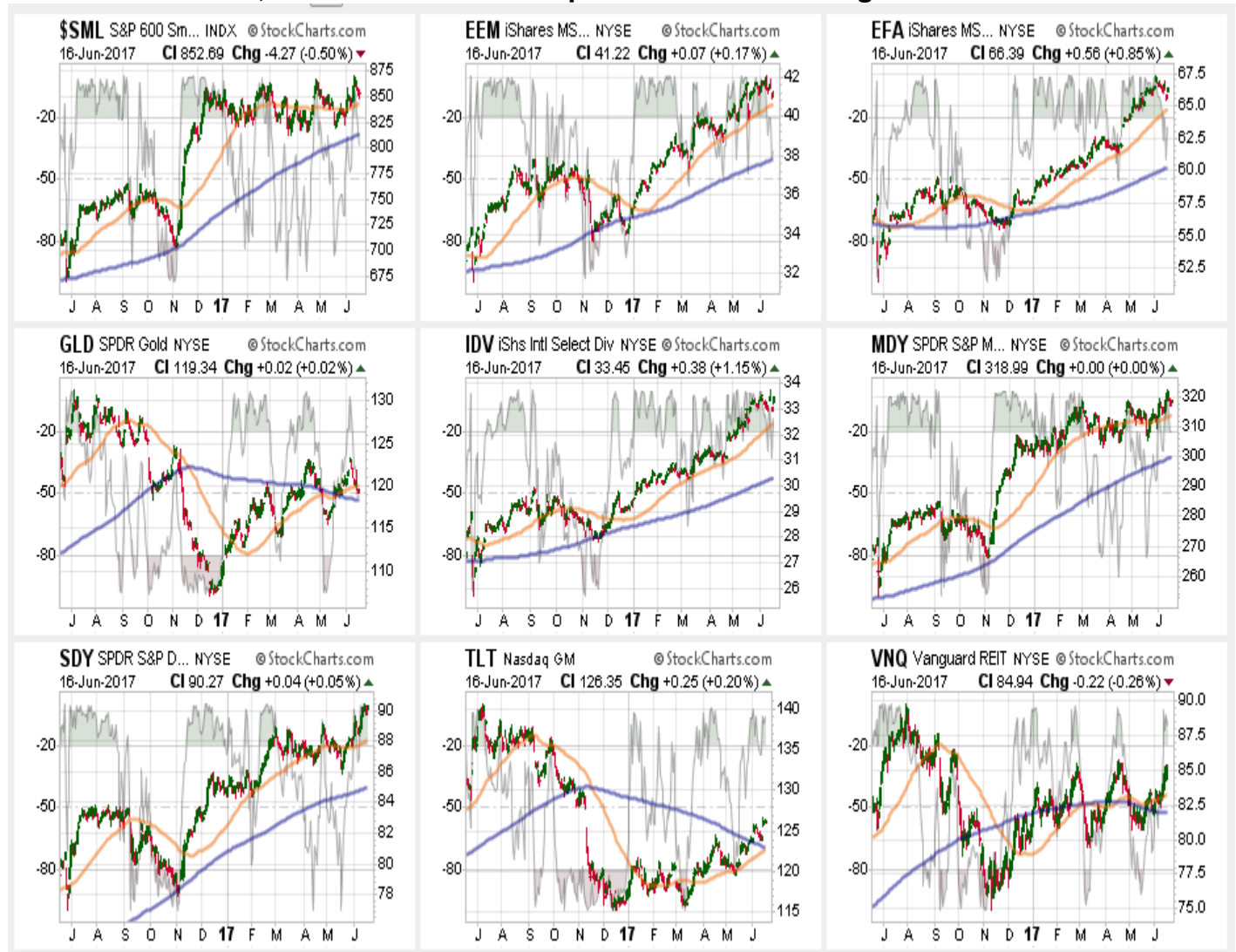
Sector Review



While Technology and Discretionary continued their recent weakness, both sectors are now testing their respective 50-dma's. Currently, both sectors ARE NOT oversold as of yet suggesting there may be some more consolidation and stagnation over the next week. **The correction does set up a potential trading opportunity provided support holds.** We will monitor closely this next week. **Financials, Health Care, Materials, and Industrials** maintained their lead this past week catching the money flows as investors rotated out of Tech and Discretionary. **All of these sectors are now VERY overbought so some profit-taking and rebalancing is advised.** As noted last week:

"Financials popped above their 50-dma average on a bill passed in Congress which will repeal Dodd-Frank and unleash the 'holy hell' of Wall Street back onto Main Street. However, it's good for the bank's profit margins, so financial's rose. The bill is unlikely to pass in the Senate due to the 'Audit The Fed' language contained in the bill. Therefore, I would 'fade' the financial rally for now."

Energy - Oil prices dropped below support at \$45 on Friday and is now set up to test the lower range of \$40/bbl in the weeks ahead. The supply of oil remains a problem with rig-counts rising and economic weakness setting in. **With a major sector sell signal, and the cross of the 50-dma below the 200-dma, we remain out of the space for the time being.**



Small and Mid-Cap stocks regained their respective 50-dma's which removes their warning signs. Both sectors also improved on a relative basis by outperforming the broad market last week, but stumbled a bit this week. **Maintain exposure for now, but do so cautiously with stops at support.** **Emerging Markets and International Stocks** as I noted last week:

"There is a good bit of risk built into international stocks currently. We took profits a few weeks ago, but the recent extension suggests another round of rebalancing is likely wise. Take profits and rebalance sector weights but continue to hold these sectors but stop levels should be moved up to the 50-dma."

That was very prudent advice as both markets stumbled this past week. A pull back to support will provide an opportunity to rebalance holdings in the short-term.

Gold - The rally in Gold over the last couple of weeks once again failed at critical resistance at 1300/oz keeping us out of our long-term positions. **Short-term trading positions were stopped out last week on the drop below \$1260/oz for now.** With Gold back below the 50-dma, caution remains advised with hard stops set on a break below \$1240/oz or the 200-dma. **S&P Dividend Stocks** regained key support levels last week after briefly breaking below their 50-dma. Last week, we recommended holding current positions which worked well as the rotation out of Technology and Discretionary found a home in dividend yielding stocks. **Continue to hold current positions but maintain stops at the recent lows.** **Bonds and REIT's** continued their advances this week breaking solidly above resistance. With the 50-dma's moving upward, **these sectors can be added to selectively if underweight.** However, this feeds back into the conundrum of the overall market, with both offensive and defensive sectors rallying, someone is going to be wrong. **We will be watching these sectors for clues as to what happens next.** The table below **shows thoughts on specific actions related to the current market environment.**

(These are not recommendations or solicitations to take any action. This is for informational purposes only related to market extremes and contrarian positioning within portfolios. Use at your own risk and peril.)

						OVERWEIGHT	BUY	HOLD	REDUCE	SELL	Notes
		Over Bought / Sold	50/200 DMA	Trend	Action						
XLY	Discretionary	Declining	Positive	Positive	Hold			X			Hold
XLK	Technology	Declining	Positive	Positive	Hold			X			Hold
XLI	Industrials	OB	Positive	Positive	Hold			X			Take Profits
XLB	Materials	OB	Positive	Positive	Hold			X			Take Profits
XLE	Energy	Neutral	Negative	Negative	Alert					X	50/200 dma Cross
XLP	Staples	OB	Positive	Positive	Hold			X			Hold
XLV	Health Care	OB	Positive	Positive	Hold			X			Take Profits
XLU	Utilities	OB	Positive	Positive	Hold			X			Take Profits
XLF	Financials	OB	Positive	Warning	Hold			X			Hold
\$SML	Small Caps	OB	Positive	Positive	Hold			X			Hold
EEM	Emerging Mkt	OB	Positive	Positive	Hold			X			Take Profits
EFA	International	OB	Positive	Positive	Hold			X			Take Profits
GLD	Gold	OB	Positive	Positive	Hold			X			No Position
IDV	Int'l Dividend	OB	Positive	Positive	Hold			X			Take Profits
MDY	Mid Cap	OB	Positive	Positive	Hold			X			Hold
SDY	SP500 Dividend	OB	Positive	Positive	Hold			X			Hold
TLT	20+ Yr. Bond	OB	Positive	Positive	Hold			X			Can Add If Underweight
VNQ	REIT's	OB	Positive	Positive	Hold			X			Can Add If Underweight

LEGEND: X = THIS WEEK => PREVIOUS DECLINING <= PREVIOUS IMPROVING

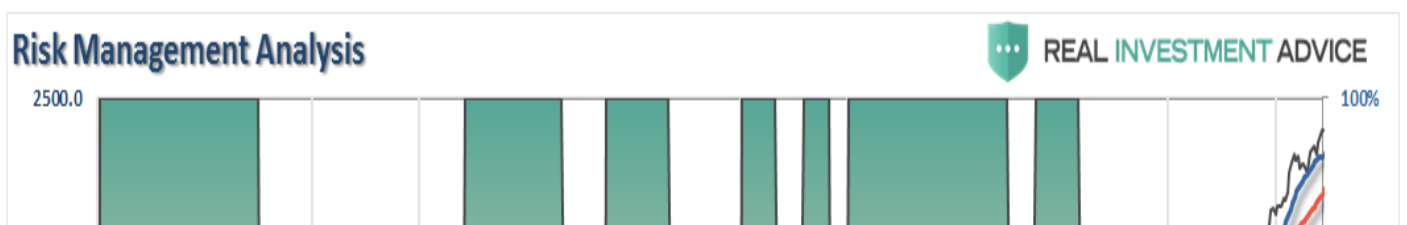
Portfolio Update: The bullish trend remains positive, which keeps us allocated on the long side of the market for now. **Last week, during the correction, we added modestly to our core holdings for a second time this year.** However, we are still maintaining slightly higher levels of cash currently, and still maintain "*hedges*" by being in areas that are traditionally "*risk off*" areas of the markets (*Bonds, REITs, etc.*) Those areas have enhanced returns this year on a total return basis. This follows along with our instructions from last week:

"If this market can maintain its bullish underpinnings on Monday, we will review portfolios for potential additions of "risk" exposure where needed. However, be mindful, that we do so with the very strict "sell" discipline in place in the event that something goes wrong."

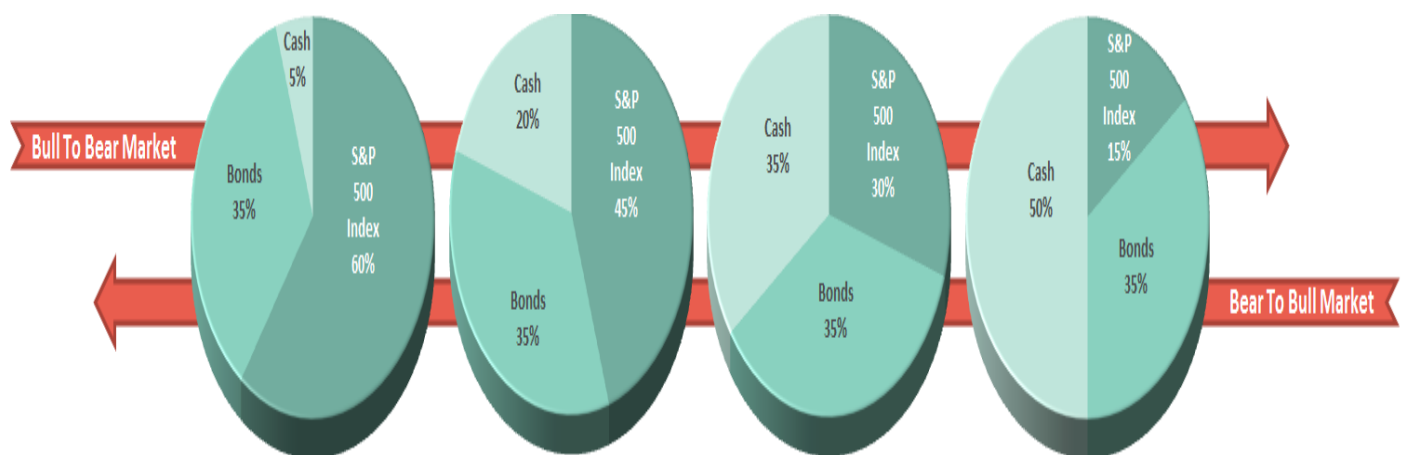
While I am not excited about the overall risk/return makeup of the market currently, as a portfolio manager **it is the discipline and strategy that drives action.** Everything else is secondary.

THE REAL 401k PLAN MANAGER

The Real 401k Plan Manager - A Conservative Strategy For Long-Term Investors



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend. Emotions keep us from taking the correct action.



Hit A Bump

As noted last weekend:

*"Given the recent volatility of the market, the lack of any movement towards legislative action, and weak internal participation, we have been **maintaining cash levels and rebalancing portfolio allocations currently.***

*Ideally, we would like to see a firming of the market environment and a reversal of the short-term 'sell signal' currently registered. **The somewhat 'mad dash' into 'everything' is worrisome particularly at a time when both 'sell signals' are flashing warning signs.***

Last week, the turmoil in the markets kept the initial warning signal and "sell" signal intact which keeps portfolios a little more heavily weighted in cash. We will watch developments closely as we head into next week to see if the recent market weakness can shore itself up.

However, if things improve next week, and the short-term signal is reversed, we will upgrade the allocation model with an expectation of a 90-day holding period outlook. **(This is due to stay in alignment with 401k trading restrictions. If we cannot get comfortable with a 90-day outlook, we will remain on hold.)**

Refrain from adding further fixed income holdings, for now, take some profits from overweight holdings, but maintain exposures.

If you need help after reading the alert; don't hesitate to [contact me](#).

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principal. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time. *(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)*

401k Choice Matching List

The list below shows sample 401k plan funds for each major category. In reality, the majority of funds all track their indices fairly closely. Therefore, if you don't see your exact fund listed, look for a fund that is similar in nature.

Common 401K Plan Holdings By Class

Cash	Stable Value	Equity	
	Money Market	Large Cap	Vanguard Total Stock Market
Fixed Income	Retirement Savings Trust		Vanguard S&P 500 Index
	Fidelity MIP Fund		Vanguard Capital Opportunities
	G-Fund		Vanguard PrimeCap
	Short Term Bond		Vanguard Growth Index
			Fidelity Magellan
	Pimco Total Return		Fidelity Large Cap Growth
	Pimco Real Return		Fidelity Blue Chip
	Pimco Investment Grade Bond		Fidelity Capital Appreciation
	Vanguard Intermediate Bond		Dodge & Cox Stock
	Vanguard Total Bond Market		Hartford Capital Appreciation
	Babson Bond Fund		American Funds AMCAP
	Lord Abbett Income		American Funds Growth Fund Of America
	Fidelity Corporate Bond		Oakmark Growth Fund
	Western Asset Mortgage Backed Bond		C-Fund (Common Assets)
	Blackrock Total Return		ALL TARGET DATE FUNDS 2020 or Later
	Blackrock Intermediate Bond		
	American Funds Bond Fund Of America	Balanced Funds	Vanguard Balanced Index
	Dodge & Cox Income Fund		Vanguard Wellington Fund
	Doubleline Total Return		Vanguard Windsor Fund
	F-Fund		Vanguard Asset Allocation
International			Fidelity Balanced Fund
	American Funds Capital World G&I		Fidelity Equity Income
	Vanguard Total International Index		Fidelity Growth & Income
	Blackrock Global Allocation Fund		American Funds Balanced
	Fidelity International Growth Fund		American Funds Income Fund
	Dodge & Cox International		ALL TARGET DATE FUNDS 2020 or Sooner
	Invesco International Core Equity		
	Goldman Sachs International Growth Opp.	Small/Mid Cap	Vanguard Mid Cap Growth
<p>The above represents a selection of some of the most common funds found in 401k plans. <u>If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.</u> All funds perform relatively similarly within their respective fund classes.</p>			Fidelity Mid Cap Growth
			Artisan Mid Cap
			Goldman Sachs Growth Opportunities
			Harbor Mid Cap Growth
			Goldman Sachs Small/Mid Cap Opp.
			Fidelity Low Price Stock Fund
			Columbia Acorn US
			Federated Kaufman Small Cap
			Invesco Small Cap