

Bianco Research L.L.C.

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Conference Call

December 2014

Looking Into 2015

December 18, 2014 Conference Call

(This transcript has been edited)

James A. Bianco, President, Bianco Research:

Good morning, everybody. This is Jim Bianco. Welcome to the Conference Call.

Summary/Conclusion

Before we start, on Friday, Monday, Tuesday, the Dow Jones Industrial Average was *down* 500 points. Yesterday and today, it was *up* 500 points, so I hope we're all having fun.

"Looking into 2015" – that's the topic before us right now. And I wanted not so much to do one of those year-end let's-make-a-bunch-of-predictions-that-aren't-going-to-be-right type of thing, because I'm not really into that. But I just wanted to point out more along the lines of the issues that we are facing going into 2015.

I'll start with the Fed. The Fed is a Rorschach Test. I'll be honest with you right now. I have read every permutation of what the Fed did yesterday, from they were absolutely brilliant to they were absolutely foolish, and everything in between. There's no consensus on what the Fed did yesterday.

Then, I want to go on to talk a little bit about Russia, talk a little bit about oil, talk a little bit about the U.S. Market, World markets, and then give you kind of an outlook for markets into 2015.

The Market vs The Fed's "Dots"

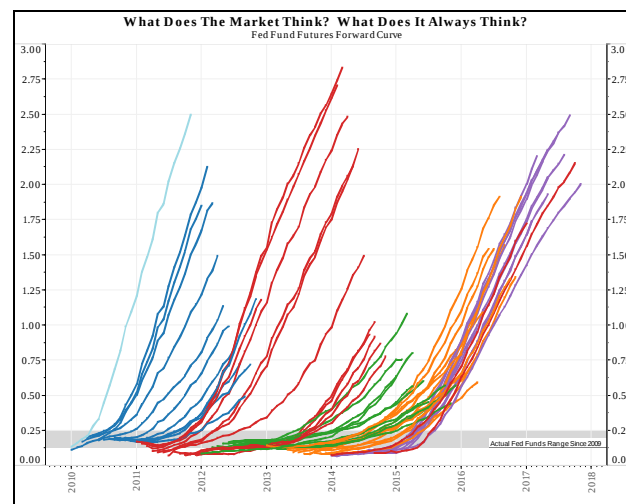
So without further ado, let me turn us to Page 2 in the handout. Let me get there real quick. And let me start with the table in the bottom-left.

	2012	2013	2014	2015	2016	2017	Long-Run	Long Run Δ
Dec-14			0.13	1.13	2.54	3.50	3.78	(0.01)
Sep-14			0.17	1.25	2.68	3.54	3.79	0.01
Jun-14			0.30	1.20	2.53		3.78	(0.09)
Mar-14			0.30	1.13	2.42		3.88	(0.01)
Dec-13		0.25	0.34	1.06	2.18		3.88	(0.04)
Sep-13		0.25	0.40	1.25	2.26		3.93	(0.09)
Jun-13		0.26	0.43	1.34			4.01	0.00
Mar-13		0.29	0.54	1.30			4.01	(0.03)
Dec-12	0.25	0.30	0.61	1.41			4.04	(0.03)
Sep-12	0.26	0.38	0.80	1.72			4.07	(0.04)
Jun-12	0.30	0.51	1.11				4.11	(0.09)
Apr-12	0.37	0.60	1.32				4.19	(0.01)
Jan-12	0.35	0.56	1.12				4.21	
Average:							4.03	(0.04)

This is the Fed Dot Chart. This is the *median* of the dots since they started this exercise in 2012, so January 2012. Remember the Dot Chart is where

the Fed tells you what they think the year-end Funds Rate is going to be for every year. Currently, they're giving you '14, '15, '16, '17, and the long-run number. So if you start on the bottom of the chart in January, you'll see those are where the Fed thought, in January of 2012, the Funds Rate would end in 2014. It would be at 1.125% or between one and 1.25%. And as that number has slowly dropped all the way down to December of '14, that is now at 0.125, or halfway between 25 basis points and zero.

For 2015, back in December of '12, they thought we would end the year at 1.75%. Now, we're down to 1.125%. And, as you could see, there's been a migration lower over the last couple of meetings or last meeting or two of the Fed, so the Fed has gotten slightly more hawkish, if you will, according to the Dot Chart, because they're lowering the year-end forecasts for where they're going to go. But make no mistake about it – the Fed is still thinking that 2015 is the year that we are going to get a hike.



If you look at the chart in the upper-left, this is the Forward Fed Fund Futures curve. It goes all the way back to 2010. These are Market expectations, and each year is a different color. You can kind of see them go across, starting with: the very light bluest is December of 2009, the blue is 2010, the red is 2011, the green is 2012, and so on and so forth. The Market always thinks the Fed is six months away from raising rates. That has been a

constant through time because that is what the Fed has told the Market. So looking out into the future and saying, "You know what? In about six months, the Fed's going to raise rates," we've been saying that off and on for a number of years right now.

Every time the Fed ends a program – when QE1 ended, we were six months away from a hike; well, that didn't happen. When QE2 ended, we were six months away from a hike; that didn't end it. When they gave an end date on Operation Twist, we were six months away from a hike; well, that didn't happen, either. And, last year, when the Unemployment Rate went under their threshold of 6.5%, we were to be six months away from a hike; that didn't happen, either. Now, that QE3 has ended, we're six months away from a hike. But, this time, we all have amnesia. We forgot that we're 0 for 7 in predicting Fed hikes after the Fed has ended a move. This time, honest to God, we're going to have that six-month period, and the Fed's is going to raise rates.

When Does The Market Expect The Fed To Hike?

December 17, 2014 Fed Fund Futures Curve

When Hikes Are Priced In?	Month	Implied Yield
	Dec-14	0.115%
	Jan-15	0.110%
	Feb-15	0.125%
	Mar-15	0.130%
	Apr-15	0.135%
	May-15	0.165%
	Jun-15	0.195%
	Jul-15	0.255%
	Aug-15	0.310%
	Sep-15	0.355%
First Rate Hike (to 0.50%)	Oct-15	0.435%
	Nov-15	0.500%
	Dec-15	0.565%
Second Rate Hike (to 0.75%)	Jan-16	0.650%
	Feb-16	0.730%
	Mar-16	0.800%
Third Rate Hike (to 1.00%)	Apr-16	0.880%
	May-16	0.975%
	Jun-16	1.045%
Dec 2015 "Dots" Forecast	Jul-16	1.130%
Fourth Rate Hike (to 1.25%)	Aug-16	1.215%
	Sep-16	1.275%
	Oct-16	1.345%
Fifth Rate Hike (to 1.50%)	Nov-16	1.425%
	Dec-16	1.485%
	Jan-17	1.560%
Sixth Rate Hike (to 1.75%)	Feb-17	1.630%
	Mar-17	1.685%
	Apr-17	1.740%
	May-17	1.800%
	Jun-17	1.845%
	Jul-17	1.895%
	Aug-17	1.935%
	Sep-17	1.980%
	Oct-17	2.020%
	Nov-17	2.060%
Dec 2016 "Dots" Forecast		2.54%

Now, admittedly, what's different about it is the Fed itself. Fifteen of the 17 members have now said that they think the Fed is going to raise rates in 2015. But the Market, even though the Market always thinks that the Fed is going to raise rates, the table

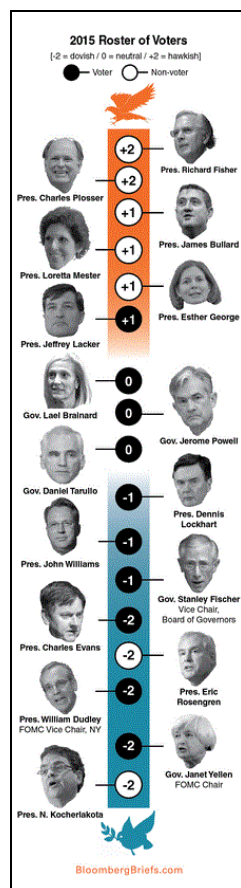
on the right, on Page Two shows the Fed Fund Futures curve, all the Fed Fund contracts, so where do they think the Funds Rate is going to be at the end of December, January, etcetera.

Next Year's Voters ... Very Dovish

October '15 – that is when the first rate hike is priced in by the Market. The second rate hike is priced in by the Market January of '16. The third rate hike is priced into the Market April of '16. And, in the blue, I've got December 2015 Dots Forecast. So the Fed thinks that, as of December of 2015, the Funds Rate will be 1.13 while the Market thinks it's July 2016. The Market thinks that, at the end of '17, we will end at 2% while the Fed thinks we're going to end at 2.54 at the end of '17. I'm looking at the bottom of the chart right now.

The point here is that the Market is a lot more dovish than the Fed. I think there are two reasons that the Market is a lot more dovish than the Fed. One, as I talked about in our *News Clips* product today, in my post-mortem about the Fed, I have now become more convinced than ever that data-dependence means the Stock Market, and that the Fed will hike rates so long as there is not a correction in stocks. If there is a correction in stocks, then the Fed will turn around and pull what I've been referring to this week as "a Bullard."

Remember on October 19th, four days off of the low, Bullard came out and said, "Hey, maybe we ought to not stop QE because the markets are falling, and we ought to give the Market more sugar," and then the Market turned around and rallied. And every Fed official said, "No, no, no. That's not the case at all." This was except for Rosengren, who essentially said, "He's right. We just need a bigger decline," so he was saying the concept was right but we were just arguing degree.



So I defined “a Bullard” as the Fed was going to lean dovish at this meeting, and they were going to do it for one reason and one reason only – the Stock Market had a bad week. And they defined “a bad week” as being that they would hold the word “considerable period” and now move to a word like “patience.” Well, the Fed did *both*. They put the word “patience” in there and told us that it meant the same thing as “considerable period,” so both words were in there.

I know that, for a lot of people, this is kind of a mind-numbing parsing of the Fed statement, but this is how they send their clues as to when they’re going to raise rates. So they sent another message yet again. “You really want us to be bullish?” Well, you could give me a bad employment number, or you can have deflation. But you know what? Give me four bad days in the Stock Market, and we’ll think about being bullish. Give me a 10% correction in the Stock Market, and we might start QE all over again.

Remember that QE1 ended. We had a 17% correction. We got QE2. That ended. We had a 20% correction. We got Operation Twist. Operation Twist had an end date of September 30th, 2012. We had a 10% correction. They refrained from the end date. So the Fed’s own history says it, and they reiterated it in a small way. In my mind, there is only one reason they kept the word “considerable time” in

that statement – because the Stock Market had a bad week. If it didn’t have a bad week, they would have dropped it for “patience” and would have said, “All systems go for a mid-year hike.” What they said was, “All systems go for a mid-year hike unless we get a 10% correction, then that’s off the table.”

I know a lot of economists are going to push back on this interpretation. Remember that, as I said in the beginning, every permutation is out there right now. There are economists that said the Fed was hawkish. They said they were dovish. They said they were brilliant. They said they were stupid. They said all of that, as well. So the first reason I think that the Market is leaning toward the hike maybe being more toward the end of the year or maybe into ‘16 is because data-dependence means the Market. If we get a correction in the Market, then I think that we are looking at the possibility of no hike in 2016.

A last thought on this and then I’ll come back to this a little bit later – if there is any doubt that what drives markets in late 2014 are changes in Fed policy, then look at what happened. When the ECB started talking about doing QE, markets rallied. Look at what happened on November 20th when the Central Bank of China unexpectedly cut rates. Our Market jumped 20 points while their stock market, in eight trading days, went up 20%; it was up 40% for the year. Look at what happened yesterday. The oil halt and the ruble turned around when the Russian Central Bank said that its \$400 billion-worth of foreign exchange reserves would be used to prop up their...

OK, I’m back in the Conference Call, so, hopefully, you guys can hear me one more time as far as where we are. So send me a note if you can hear me yet again on the Conference Call.

OK, good. You guys have got me back. OK, let me pick up where I left off. For everybody on the webcast, I apologize about that with the phone going dead. We are having phone problems on our end. There’s this start-up company called AT&T that can’t get our phone system correct. Hopefully, they will sometime in 2015.

The second thing I think about the takeaway from the Fed other than that they are leaning on the Market is, in her presser – and I detailed this as I read through the notes of the presser last night and this morning, and I detailed this in *News Clips* – Yellen was asked to define what “patience” means, and she said, “A couple of meetings.” And then, later on, they asked her, “What is the definition of ‘couple’?” and she said, “Two meetings.”

OK, she just laid it out right there. Fed-watching in 2015 is going to be really simple, *really simple*. Wait for Hilsenrath to write a story eight days before the

Fed meeting, like he did this one. They're going to drop the word "patience." When they drop the word "patience," then, two meetings later, they're going to raise rates. She just laid it out for us, that "patience" means two meetings. So that means that they're not going to raise rates at the January 29th Meeting. They're not going to raise rates in the mid-March Meeting. So those are off the table. April 30th is the next meeting. If "patience" is in the January statement, they're not going to raise rates at the March Meeting or the April Meeting, and so on and so on.

The Fed went back to calendar guidance. The calendar is now defined as two meetings. "Patience" is the word. It's all that needs to matter, is that, when January comes down, you could turn on CNBC for three seconds, and Steve Liesman, in three seconds, will say, "The word 'patience' is still there." Turn it off. All the rest of it is just white noise. We're safe 'til April. When the word "patience" is gone, then April is going to be hike.

I think Yellen has made a big mistake in that because if she thought it was hard to get rid of the term "considerable time" and had to use those double words, then wait 'til you get to the point of trying to get rid of the word "patience." And, actually, getting rid of the word "patience" – remember that these are clues as to when the Fed is going to raise rates – that is going to be the event of 2015. The minute that that word goes, we're going to price in the hike. The hikes will become afterthoughts at that point.

So the Fed has locked themselves in. I personally don't think that Yellen is very good at these pressers. I think she speaks too literally and she locks herself in, and I think she did it yet again yesterday. I think that most of Wall Street is too busy to notice, as they're getting all excited that the Stock Market is up 500 points since the Statement came out. But they will eventually notice that Yellen has locked herself in and that, in the spring, it is going to be a problem. Once you get rid of that word, it is the same thing as hiking because you've laid it out that, in two meetings, we'll have the official move, and the Market will price it in at that point.

So those are the two issues for the Fed.

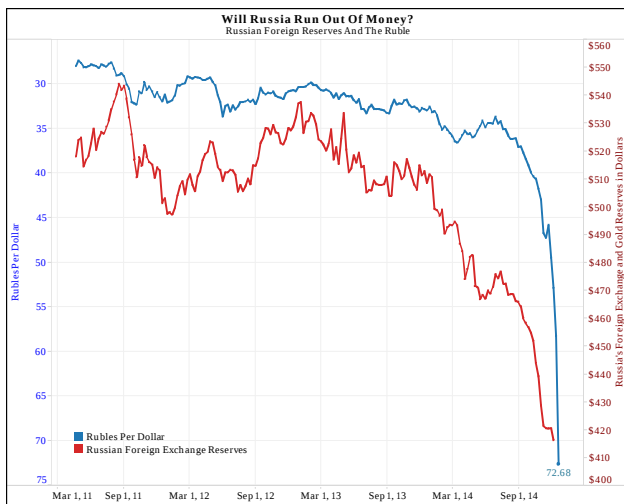
Russia

The Russian ruble – here is the chart of the Russian ruble against the dollar. It soared a couple of days ago, almost 80 against the dollar.



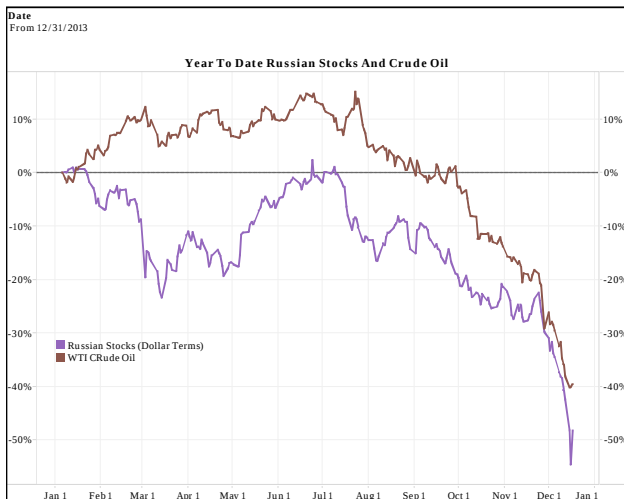
From a contrarian standpoint, I don't know if you picked it up but, on Tuesday, when the Russian ruble was soaring to 80 against the dollar, there were a lot of retail brokerage firms that allow retail investors to trade currencies, FXCM being the largest. And they all came out and said, "The ruble is too volatile. We're no longer accepting ruble trades," and the FXCM, the largest of them, said, "We're going to forcibly close you out of your trade by the end of the day if you don't do it yourself." Well, at that point, you knew the move was at least temporarily over.

When they announced that it was too volatile for them to accept trades, that meant that the volatility was peaking, and that's what it did. Again, they also came out and also threw in that they're going to backstop their banks with their foreign reserves. I think that part of the reason that the ruble was collapsing or was on its way to 80 rubles the dollar was I think they market was afraid that, with the ruble weakness, that the banking system in Russia was going to be at great stress, and that the Western banks were going to pull their lines of credit from those banks. And, in essence, I think they were but they were replaced by \$400 billion of foreign exchange reserves that Russia holds, and that is why the ruble is calming down. That does not solve the problem of the ruble.



I still think we're probably going to go revisit 80 at some point in 2015 on the ruble, if not potentially higher. Then, if you look at the chart in the upper right on Page Four, one of the reasons that I think that is going to happen is that the red line is foreign exchange reserves held by Russia. They're down from earlier this year by over \$100 billion. This is weekly data. It is only current through December 5th. We're going to get the data for the 12th this week. I suspect that, over the next several weeks, my guess is that we're going to see that red line, the amount of foreign exchange reserves, really plunge in the next several weeks, as well, as they support their banks and try and hope to slide in the ruble.

And there might be an issue as we move forward as to whether or not Russia is actually going to run out of foreign exchange reserves. That is not an issue now, nor will it be an issue immediately.



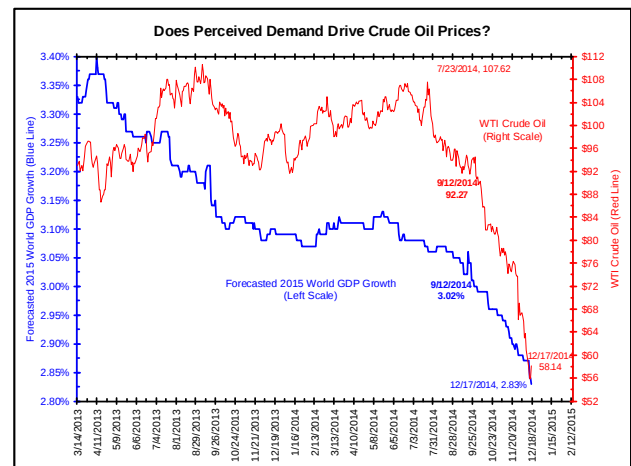
If you look at the bottom-right chart, this is an indexed level of crude oil in brown, and, in purple is the Russian Stock Market. It is all about falling oil prices that seem to be driving the Russian Market down. And as long as oil prices stay weak, I think that that is going to continue to be the problem for

Russia. So its problems are not over. They've gotten a temporary respite. They've chased everybody out of their speculative trades because it was too volatile. They're propped up their banks with foreign exchange reserves. That will work for a while, but that is not a fix. Actually, the fix is probably going to be crude oil going back to \$90 or \$95.

What Drives Crude?

To that end, if we go to Page 5 and talk about crude oil going back up, I've talked about this the last couple of Conference Calls – Page Five – what is driving crude oil prices. My sense is that, when you read analyses of crude oil, especially from economists, they're acting like, "Hey, look! This random event that nobody thought up just happened. And this random event is that crude oil prices went down, and this is a tax cut for the consumer, and it's all good." It is not a random event.

Generally speaking, the price of crude oil went down because of one of two things: either there was a supply glut or there was a fall in demand. Now, Wall Street's preferred definition is a supply glut because a supply glut is very bullish for risk markets. But if you look at the red line on this chart and you look at I've listed that the price was \$107 on July 23rd. We didn't know that there was fracking and that there was a shale boom in late July. Books had been written about this in 2010, that are gathering dust in libraries. Of course we knew! There has been no change in any of the supply numbers since summer. This is Wall Street doing what it does best – taking a square peg and pounding into the round hole of supply glut. There is a supply glut because that's bullish.



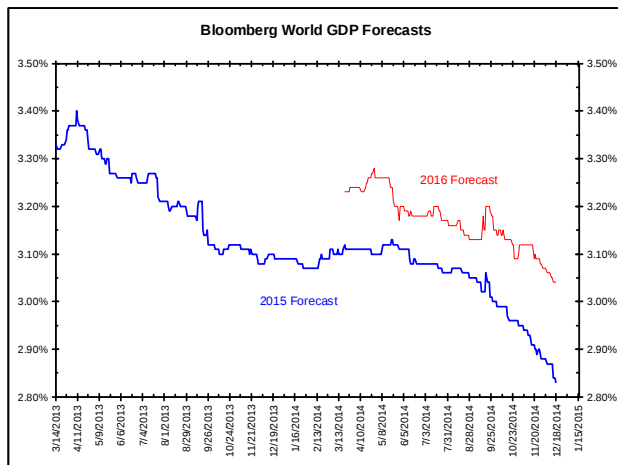
Instead, I will point out to you that, on September 12th – and that's why I highlight that – the price was \$92. And, on September 12th, the IEA, the International Energy Agency – and we highlighted this on the 12th – came out and said that there was a

remarkable fall in oil demand. And then they went on and said that, in the second and third quarters, it was like oil demand fell off a cliff.

If you look at the blue line, world growth has been sliding quite a bit since the middle of September when the price was at \$92. What this suggests -- and this is what we've been arguing strongly for the last few months -- is that the price of oil is falling because demand is sliding. Economies are slowing. They need less of the stuff, and so the price is adjusting accordingly. That is not nearly as bullish as everybody would make it out to be.

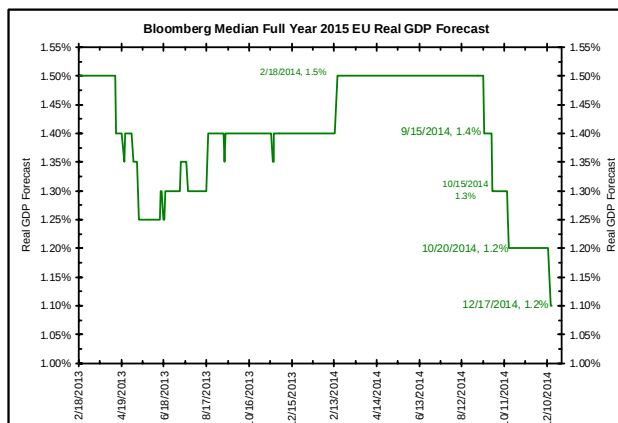
World Growth Forecasts

Let me just show you the charts on Page 6. You could see the forecast for oil for 2015 and 2016. It is basically showing that both of those estimates are coming down.

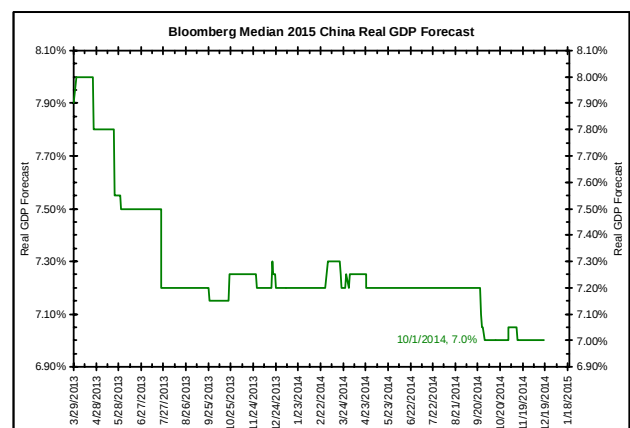
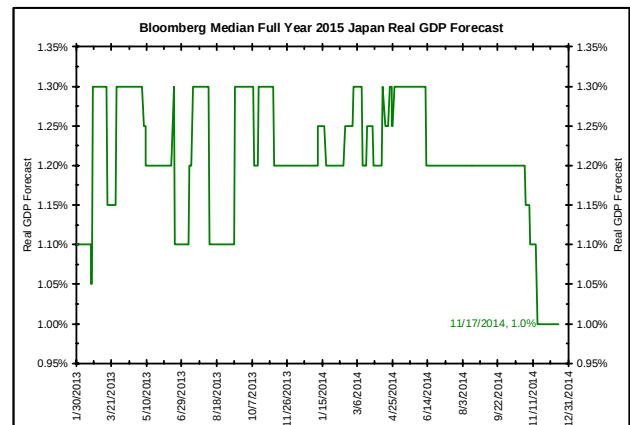


Country/Region Growth Forecasts

If we go to Page 7, then we see that we break down the major regions of the world and the major economies of the world. Europe -- the European 2015 GDP forecast is falling. It is down to 1.1% (1.2 is actually a typo on that chart. I apologize for that.) Down from 1.2%. And it's the lowest level in a couple of years, for 2015.

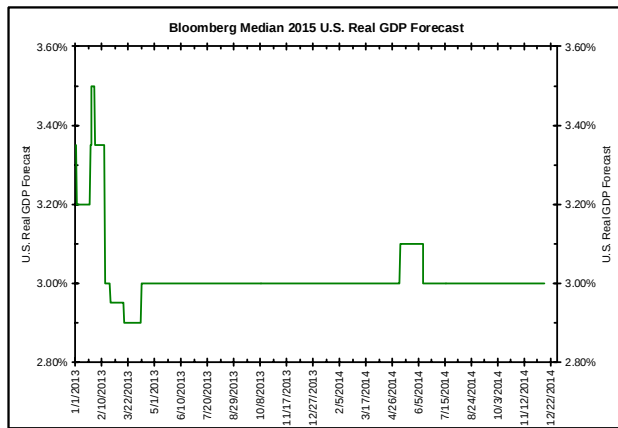


Also on Page Seven, in the lower left is Japan. Its numbers are coming down -- 1% growth for Japan.



Also on the chart, in the upper right, is China. Its growth rate for 2015 is now estimated to be 7%. You might recognize that 7% number. That is what is defined as a hard landing. Remember that developed countries in the West have recessions when growth goes below zero while, in China, they have a hard landing when growth goes below 7%. That is the forecast for 2015 -- the Chinese equivalent of a recession.

Japan, Europe, and China are seeing extraordinarily weak growth. That is why world growth is falling. That is why demand for oil is going down. There is no supply glut. There is no change in supply. That's the happy talk from Wall Street. There is a fall in demand.



Now, if you wanted to get nuanced about it, there is a bullish twist to that story, and that bullish twist to that story is the chart on the lower right. Here is estimate growth in the U.S. The economists are holding steady that they think that 2015 will be 3%. Now, we haven't had a 3% growth rate in almost 10 years. This year, it is going to be in the low twos again. For the fourth year in a row, we've been in the low twos. If we get 3%, then that would be above trend or above potential. That would be a good number. Let's see if it happens. Nevertheless, the U.S., while it isn't immune, is an outlier from the rest of the world; its growth is strong.

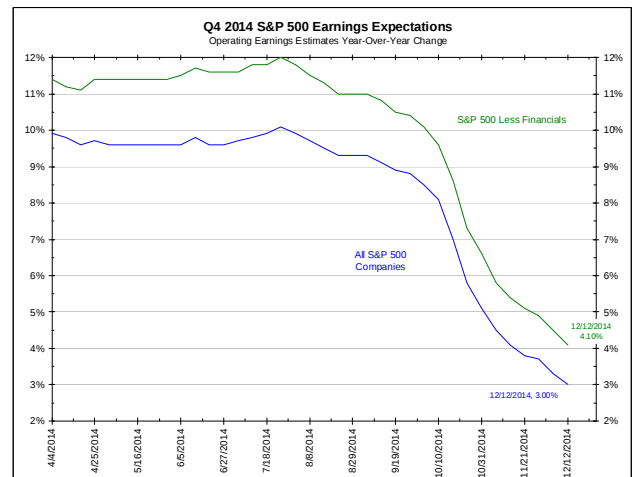
So you could say, "Yes, you're right. Oil is sliding because of a fall in demand, because of weak economic growth. However, that does not apply to the U.S." And that would be a more nuanced and correct way of saying it, as opposed to pounding in these supply numbers into finding a glut where there isn't one. I mean, the glut will exist only to the extent that demand is falling and, if production doesn't cut, then we will develop a glut because of falling demand.

Earnings And Revenues Forecasts Take A Hit

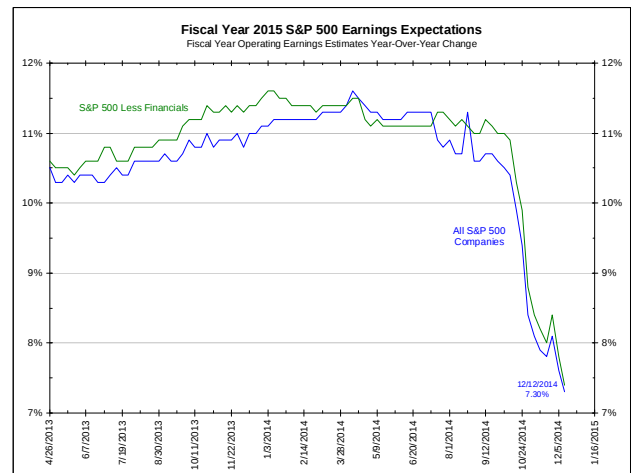
So if you go to Page 8, that then begs the question, Can you the U.S. remain, to use an old Greenspanism, "an ocean of prosperity?"

Wall Street, again, has two statistics they like to vacillate between. When world growth is strong and the dollar is weak, Wall Street rushes to the cameras and says, "45% of the revenues of S&P 500 companies come from overseas. These managers are brilliant that they're selling their products overseas. It's strong. The dollar is weak. It's all good." When the dollar is strong and your growth in the rest of the world is weak, they rush to the cameras and say, "Only 13% of the U.S. economy is trade. It's one of the lowest of the Developed World. We're more insulated through it from everybody else." Both numbers are true; it just depends on what story you're trying to promote with those numbers.

Can we remain an ocean of prosperity? First of all, let's look at these earnings numbers.



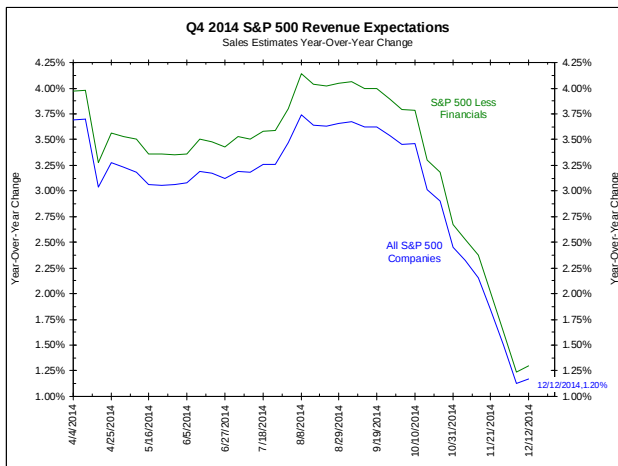
The upper-left chart on Page Eight – "Q4 Earnings Expectations." This is Bloomberg data, updated weekly. We are now down to 3%, the blue line – 3% year-over-year growth for S&P earnings for the fourth quarter, 4% if you take out the financials. This number will bounce up one or two percentage points, maybe three. This is because, remember, 75% of the companies will always outperform. But the question is how low does it go before the first week of January, before we eventually start into earnings season?



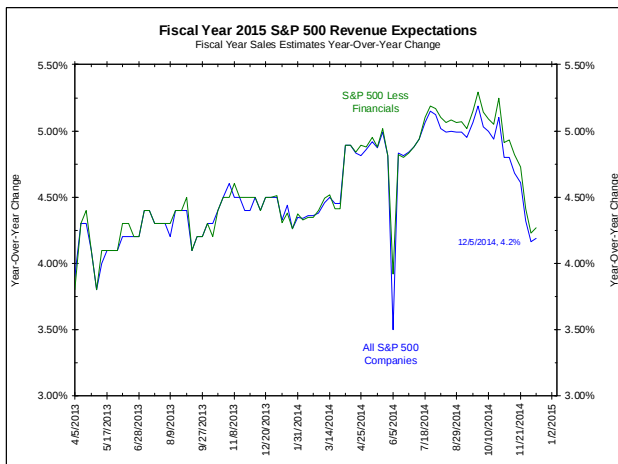
This number has come down quite a bit. Let me just show you the rest of the charts and then I'll talk about it. 2015's forecast is down to low sevens right now. This is for all of 2015.

By the way, every year since the Great Recession has ended, since 2009, if you go to December before the following year, so if you looked in December of 2013, looking into 2014, or December 2012, looking into 2013 forecast, and so on, Wall Street always thinks that we're going to have 10 or 11% earnings growth. This year, they think that we're going to have 7% earnings growth. So this is

a marked difference. Expectations of earnings growth is the lowest it has been since the Great Recession has ended.



If we look at revenue growth – and this is the upper-right chart – year-over-year changes in revenue growth are 1%, not even the inflation rate right now. Revenue growth won't necessarily bounce with earnings because, remember, only about 50% of the companies beat on the revenue line, 50/50, but it's 75 on the earnings line. So this number could stay this way through it.



Then, if you look at all of 2015, that number in June was right. I do think that it was reported as a mistake, but I have no reason to change it so we'll leave it there. But taking out that one spike down, we are at the lowest level in about a year, in the low fours for earnings.

Now, why is it that earnings and revenue are falling? I think that there are two reasons. One, Wall Street is obliterating its forecasts for the energy companies for 2015 and the fourth quarter. They're 13% S&P 500 right now on a market cap-weighted basis. Their earnings numbers are coming down by 40 or 50%. Their revenue numbers are going to come down, too, because of falling oil. Also, 45% of

revenue from the S&P 500 companies comes from overseas.

So, to that end, can the U.S. remain an ocean of prosperity? To some extent, I think the answer is yes, but I think that we're going to be disappointed with it. It is going to be another repeat of the last four or five years. We're not going to have a recession. I'm not predicting a recession. We're going to have another year of poor growth, at least measured by GDP, another substandard year of earnings.

Remember the way that earnings work on Wall Street. Stock Market up -- just announce earnings are good. Stock Market down -- announce earnings are bad. Look at the actual earnings numbers – don't get bogged down with that detail. So I do think and I have been arguing that I don't think the earnings numbers have been particularly great. I don't think that they're going to be particularly great. I do think that the world growth is going to affect it and it is definitely going to affect it on the energy side, as well. And, eventually, it is going to drag on the U.S. economy, as well.

Everyone Is Still Bearish Bonds

Let me go to Page 9, and then I'll come back to the Stock Market in another quick second.

Bearishness everywhere. I've got to hand it to economists – nothing ever changes their opinion. The latest survey came out on the 11th of December last week. Seventy-one economists were asked their opinion. Of the 71, the lowest guess was that, in June of 2015, the 10-year would be at 2.23. That was the lowest guess of them. 100% of economists yet again think that we are going to have high rates in six months.

Bearishness Always And Everywhere Results From Bloomberg's Monthly Economist Survey For The 10-Year Treasury Yield											
Survey Date	10-Year Yield	Median Forecast 6-Months (2 Qtrs) Forward		Number of Economists Surveyed	% Expecting Higher/Lower Rates		Highest Forecast	Lowest Forecast	Six Months Later		Was The Forecast Directly Correct?
		Level	Change		Higher	Lower			Actual Level	Change	
9-Dec-11	2.06%	2.35%	0.29%	66	89%	14%	3.90%	1.50%	1.65%	-0.41%	No
13-Jan-12	1.90%	2.34%	0.44%	67	99%	1%	3.35%	1.50%	1.50%	-0.40%	No
10-Feb-12	1.89%	2.29%	0.29%	88	92%	8%	3.45%	1.50%	1.68%	-0.31%	No
14-Mar-12	2.06%	2.30%	0.24%	71	86%	14%	3.45%	1.90%	1.72%	-0.34%	No
12-Apr-12	2.05%	2.50%	0.45%	70	97%	3%	3.88%	2.00%	1.67%	-0.38%	No
10-May-12	1.86%	2.40%	0.54%	64	100%	0%	3.68%	1.80%	1.88%	-0.27%	No
6-Jun-12	1.65%	2.10%	0.45%	59	97%	3%	3.88%	2.00%	1.72%	0.07%	Yes
10-Jul-12	1.50%	2.00%	0.50%	65	97%	3%	3.76%	1.30%	1.90%	0.40%	Yes
9-Aug-12	1.60%	1.81%	0.13%	72	89%	14%	3.76%	1.30%	1.99%	0.31%	Yes
13-Sep-12	1.72%	1.89%	0.13%	69	80%	20%	3.76%	1.30%	2.02%	0.30%	Yes
11-Oct-12	1.67%	1.90%	0.23%	81	89%	12%	4.03%	1.40%	1.75%	0.08%	Yes
14-Nov-12	1.59%	1.93%	0.34%	67	94%	6%	2.79%	1.30%	1.77%	0.19%	Yes
13-Dec-12	1.72%	1.90%	0.18%	78	78%	22%	3.50%	1.40%	2.14%	0.42%	Yes
10-Jan-13	1.90%	2.05%	0.15%	75	76%	24%	3.56%	1.50%	2.62%	0.72%	Yes
14-Feb-13	1.99%	2.20%	0.21%	65	80%	20%	3.56%	1.60%	2.64%	0.65%	Yes
14-Mar-13	2.02%	2.10%	0.08%	78	76%	24%	3.50%	1.75%	2.91%	0.89%	Yes
8-Apr-13	1.75%	2.00%	0.25%	66	83%	17%	5.60%	1.30%	2.68%	0.93%	Yes
9-May-13	1.77%	2.20%	0.43%	71	94%	6%	4.11%	1.50%	2.68%	0.92%	Yes
13-Jun-13	2.14%	2.33%	0.19%	78	78%	22%	3.76%	1.50%	2.88%	0.74%	Yes
11-Jul-13	2.62%	2.80%	0.18%	63	67%	33%	3.40%	2.20%	2.84%	0.22%	Yes
7-Aug-13	2.64%	2.80%	0.16%	57	75%	25%	3.93%	2.20%	2.72%	0.09%	Yes
12-Sep-13	2.91%	3.00%	0.09%	74	92%	8%	3.93%	2.20%	2.64%	-0.27%	No
10-Oct-13	2.68%	3.07%	0.39%	63	94%	6%	4.21%	2.35%	2.65%	-0.03%	No
14-Nov-13	2.69%	3.08%	0.39%	65	97%	3%	3.50%	2.35%	2.60%	-0.09%	No
12-Dec-13	2.88%	3.08%	0.20%	65	99%	11%	3.76%	2.35%	2.62%	-0.26%	No
14-Jan-14	2.84%	3.10%	0.40%	69	97%	3%	3.76%	2.45%	2.99%	-0.25%	No
13-Feb-14	2.72%	3.20%	0.48%	75	99%	5%	3.81%	2.45%	2.43%	-0.29%	No
13-Mar-14	2.64%	3.20%	0.56%	71	97%	3%	3.76%	1.95%	2.54%	-0.10%	No
10-Apr-14	2.69%	3.2%	0.69%	67	100%	0%	4.00%	2.79%	2.32%	-0.33%	No
14-May-14	2.60%	3.25%	0.65%	71	99%	1%	4.00%	2.55%	2.35%	-0.25%	No
12-Jun-14	2.62%	3.07%	0.45%	75	99%	1%	4.00%	2.55%	2.16%	-0.45%	No
10-Jul-14	2.59%	3.15%	0.56%	67	100%	0%	3.94%	2.54%	???	???	???
14-Aug-14	2.43%	3.11%	0.68%	67	100%	0%	3.63%	2.45%	???	???	???
11-Sep-14	2.54%	3.00%	0.46%	68	96%	4%	3.63%	2.39%	???	???	???
8-Oct-14	2.32%	3.10%	0.78%	73	100%	0%	3.80%	2.50%	???	???	???
13-Nov-14	2.35%	2.90%	0.55%	82	99%	1%	3.75%	2.23%	???	???	???
11-Dec-14	2.16%	2.80%	0.64%	71	100%	0%	3.66%	2.23%	???	???	???
					Average 89% 15%				Completed Forecasts		66
					More Than 50% 66				Correct Forecasts		30
					Less Than 50% 2				Percentage Correct		45%

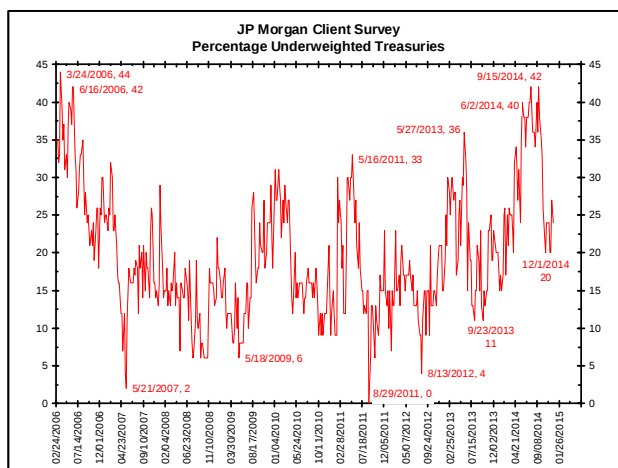
I might add that, if you go back to May, six months ago, roughly, or if you want to go back to June, they were telling us that the year-end, we would see 3.07

to 3.25 on the 10-year note right now. How is that working out? We're off by only 100 basis points. And now they're telling us that we're going to see somewhere around 2.80 on the 10-year note in June. So I think they're just going to continue to stay at 100% for a while as we move forward from here.

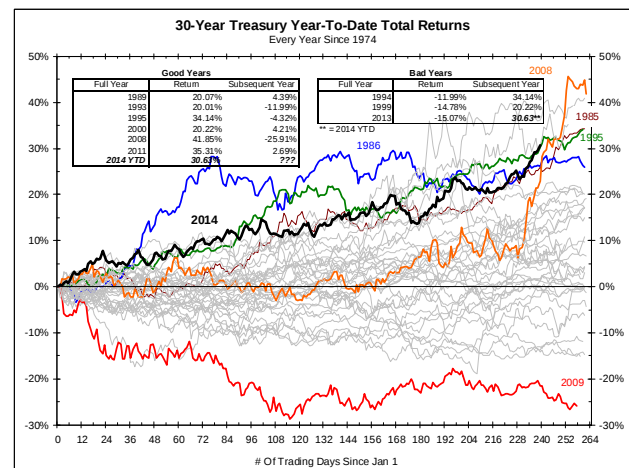
Let me take these in the order I have them.

Bad Year To Be Bond Bearish

The next chart is on Page 10, in the upper left. Economists may not have changed their opinion that they have been 100%, but since the Bond Market flash crash of October 15th, which we've talked about in the last couple of Conference Calls, the money management community has reduced risk. I don't think it is that they have turned bullish but they've reduced risk. They've gone from being 40% underweight Treasuries – that's underweight duration, not necessarily overweight credit – to around 25% underweight. So there has been some marked movement in their crowd.



But all of this is coming at exactly the wrong time. If you look at the lower-right chart on Page 10, it is showing you the black line, which is 2014. This was done at year-to-date close on Tuesday – and I know yields are up a bit – 30% gain in the 30-year Treasury. That would mark the third-best year ever. The year that the economists have been 100% bearish on bonds has been one of the best years in history to own them, so now we know what their worst call has ever been – right now – whenever they open up their mouths about this, that they've made this call wrong, as well. So we've had a 30% gain.



Now, the tables in the chart – there is mean reversion. When you have a great year, there is a bad year adjoined to it, but the bad year was 2013. In 2013, the total return of the 30-year was -15%. That was actually, believe it or not, the third-worst year ever behind '94. Or, I'm sorry, that was the worst year ever, as '94 was -11%, and '99 was -14%. And now, we're on track to have the third-best year ever.

So people have asked me about the mean reversion. Well, since we had such a great year this year, does that mean we have to go down next year? No. We went down in 2013. We're rebounding in 2014. Next year is a freebie from a mean reversion standpoint, "freebie" meaning that it can go up or down next year. There is no mean to revert to; that is what we're doing this year.

Another quick word about total returns –

The Treasury Market has positive convexity. Yields are at the lowest levels ever. So you're getting massive swings in the returns on bonds. That is why you had a -15% year last year, you have a 30% year this year. Even though we do track this all the way back to 1974, you don't really see a lot of the years from the early '80s when we had super-high interest rates.

To give you one quick example, when interest rates were 14%, the duration on the 30-year was 6.5. That's the modified duration. That means that, at 14%, a 100 basis move will move the price 6.5%. Currently under three, the duration of the 30-year is more like 20. So a 1% move right now will move bonds 20%. Or, to restate that, to get the same move that you had, that 6.5% move in the early 1980s, you needed only 25 or 30 basis point move.

Now, in fact, we've had that in the last three or four days, as well. So you would expect that all of the big total return moves are going to be right now with these very low yields and very long durations, thanks to the positive convexity. And that is why bonds are a rather intriguing investment. It has

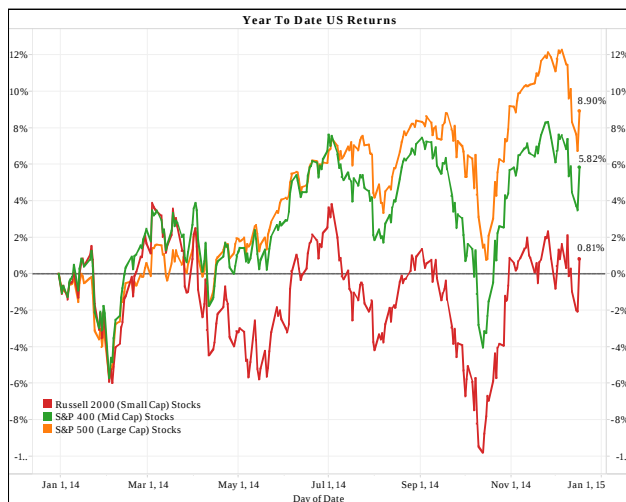
nothing to do with yield. It has everything to do with that there are 20 or 30% moves in these instruments to be made every year; it just trying to figure out which way it is going to be.

I am going to stick with, still, on this idea that we are still going to retest 1.86, the low of the flash crash on October 15th, before this is all said and done. Boy, a couple of days ago, we got down to 2.01 on the 10-year note, and it looked like we were real close to it. But I still think we are probably going to go back and retest that 1.86. My hope or my thought would be that, once we go down there, maybe I'll get some of these economists to move off this 100% bearish, and then that'll mark the end of the move. And then we can have a move higher in yield, and not everybody will be taking bows that they got it right; although, even if they do at this point, they've been so wrong that all they're doing is recouping losses, not actually making any money on it.

So I do think that, for going into '15, the economy is going to be so-so. If we get any kind of market volatility then we could see that push down rates, maybe even stall off a Fed rate hike. I still think we're going to retest 1.86 as we move forward from here.

Stock Outlook

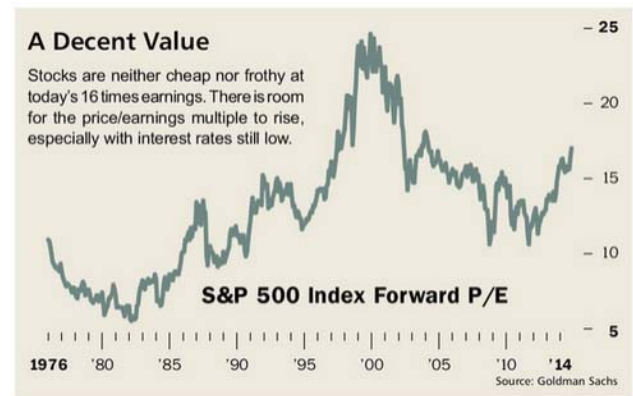
If we go to Page 11 and take a look at the Stock Market, this chart here in the upper left on Page 11 shows the year-to-date returns to the Stock Market through yesterday afternoon, so right before we published this, I put it out. The Russell 2000 in red is up less than 1%, at least through yesterday afternoon. The S&P MidCap is up 5%. And the S&P LargeCap, or the S&P 500, is up around 9%.



I had come into the year thinking that we would have something like a zero to -5% return in the Market, kind of a flattish, slightly down year. It looks like that that is going to be a little bit too pessimistic except for small-cap stocks, that they're still in the hunt, maybe, to make that forecast look right. I'm going to

stick with that same idea going into 2015, kind of another flattish kind of year as we move forward. And the reason is – I'm going to take us to the next chart –

This, I got out of Bloomberg, because I don't have the data all the way back to 1976; I've got it only back to the early '90s. Stocks are neither cheap nor frothy at today's 16-times forward earnings. There is room for price earnings multiples to rise, especially with low interest rates.



Now, there are two things about that. First of all, I drew the red line on this chart. Remember that forward PE earnings, earnings over the next 12 months, what Wall Street expects, this is Wall Street's favorite metric, and I think it is their favorite metric for, really, one major reason. It is the one that is really not as overvalued as a lot of the other ones. But there was only one other period in the last 40 years that we've seen it be higher than 16, and that was the bubble period, in the late '90s and early 2000s. That was it. So unless we're going to say that only anything above 25 is overvalued, this is pretty frothy – 16.

Now, the comment also says, "Especially with interest rates so low." Now, what that is is a veiled connection to the so-called Fed Model. If you turn the PE ratio around to an EP ratio, or an earnings yield, you look at the earnings yield and you compare it to interest rates, and that gives you the Fed model or valuation.

Now, there is one problem with the Fed model -- and this has been documented in academic work, and we had it in our *News Clips* last week and linked to some of it – and that is that it doesn't work. It is nice. I get the idea, that PEs or EPs, the earnings yield should be compared to interest rates. But if you measure it empirically, measure what has actually happened, it doesn't work. I also think it doesn't work in an era where the Fed is manipulating interest rates. And I have come to the

conclusion that I see a 16 forward PE as being rather heady right now.

Can the Market go up from here? Sure. But it's going to go into overvalued territory. That is what it would need to do. Are we going to get the earnings rise to have the Market go up? We're already starting with the lowest earnings forecast in five years right now. Of course, earnings forecasts, they will be wrong. They're always wrong. But except in recessions, earnings forecasts at the beginning of the year always turn out to be too high. Only around the turns of a recession do they turn out to be too low. So that low 7% number will probably come down. That means that, at best, if you want to hold the 16 PE, then you've got only earnings growth to have the Market go up, and that's mid-single digits.

Add to that, if you believe interest rates are going up because 100% of economists think that rates are going up, and you still think the Fed Model works, then 16 is going to have to start coming down, too. You're going to have to have a contraction in the multiple. So the only way I could see that you could say that we could have a decent year in the Market – 10% or more – is to say, "The forecasts are wrong. It is going to be a good year."

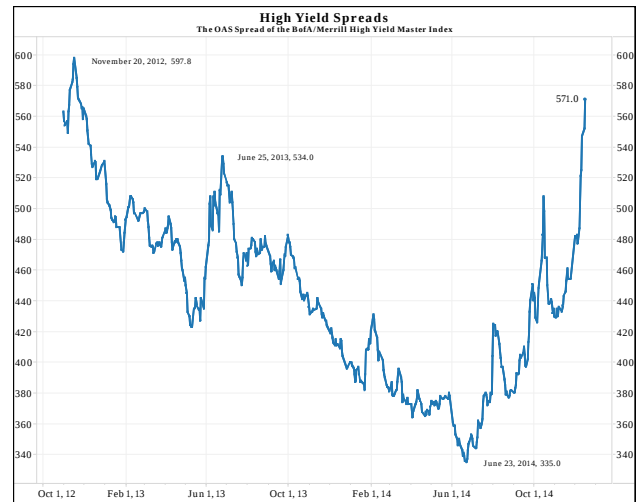
Now, you can always say that. History always says that the earnings forecasts are always too high at the beginning of the year, not too low. But this could be an outlier year, of course, that it turns out to be that way. And, of course, we've been saying that since the Great Recession has ended. We've been saying it forever, and it hasn't really worked.

Finally, for this kind of sanguine forecast – again, I'm not in the bear market. I'm not David Tice. I'm not looking for a recession. I just think it is going to be another kind of middling year, and we're going to see 1.85 on yields. We're going to see kind of putrid growth. We're going to see more struggles out of Russia. And we could possibly see a 10% correction, finally, out of stocks that would put off the Fed from raising rates in 2015.

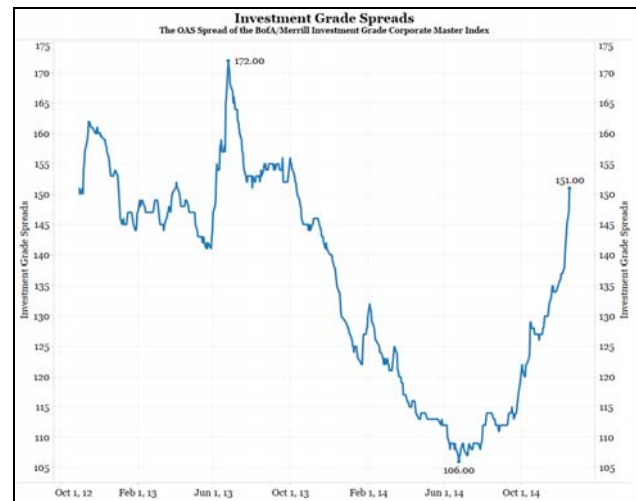
Credit Outlook

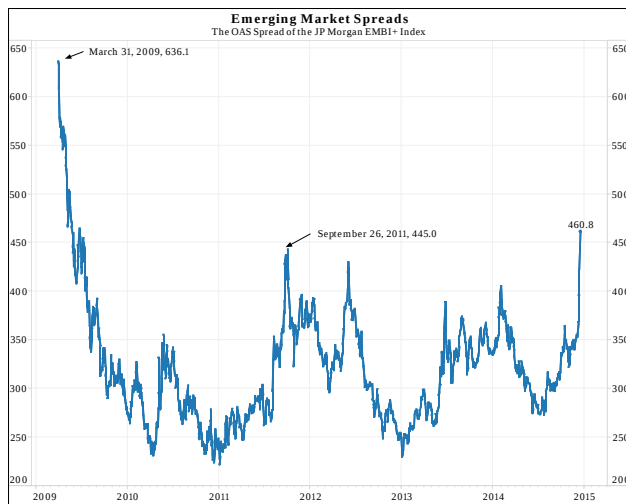
There is a big warning sign hanging out there, and that is the final chart on Page 12, which is "Credit." Let me remind everybody about 2007.

In 2007, we had this thing called subprime blowup that nobody had any idea about. Now, we have oil. Nobody had any idea that that was going to happen. When subprime blew up in 2007, one of the first markets to run into stress was the Credit Market. Now, what we're seeing is, since the peak in oil, one of the first markets to run into stress is the Credit Market.



Let me run through the charts here real quick. If you look at the upper-left chart, here is investment-grade credit. "OAS" is option-adjusted spreads. Over Treasuries, they've gone from 106 basis points to 151, a big rise. If you look at the lower-left chart, that's high-yield. It's gone from 3.35 in June and, actually, the low, the tight yield was the same day that crude oil peaked to 5.71. If you look at the chart on the right, emerging markets spreads are at the highest levels since 2010 at 460 basis points.





One technical thing – one of the things that, of course, is driving these spreads higher is that the Energy Sector is a pretty big sector, and that is getting destroyed right now, and that is taking up the whole index. But, in 2007, we had the same excuse – “Well, that’s all the homebuilders and the Housing Sector that are getting killed, that are driving those spreads higher, as well.”

Here is the bottom line – what we learned from 2007 and '08 -- and I would actually argue the same thing happened in 2002, around major turns in markets – Credit goes first. And when Credit goes, we all then retort to the same thing that we learned reflexively – the Stock Market is the leading indicator. As long as the Stock Market continues to go up, I don’t care what Credit is going to do, because the Stock Market is in the index of leading indicators, not Credit.

But I would actually argue that, in the last couple of cycles, Credit has led both on the upside and the downside. It got worse first and then it got better first. So going into 2015, Credit is the big warning sign. It is not doing well. The excuse that, “That’s all Energy. Look at the X.” We said the same thing in 2007. “Look at X Housing. It’s not as bad.” It is a problem. And if Credit is going to continue to be a problem, then this is going to continue to weigh on markets.

Conclusion

So the bottom line is that problems are still there. I don’t think that they’re debilitating at this point; I just am not very, very bullish as we move forward from here. And I do think that, if there was anything to be learned from yesterday, I think that, as we evolve forward from here, Yellen’s comment that patience means a couple, and a couple means two is going to be very problematic for her. And that is going to be very problematic for her because that means that we’re moving the word “patience” as the de facto day that they hike, because then you just wait two

meetings and they’ll actually pull it off, then, at that point.

And if you think she had a problem getting rid of “considerable time” yesterday, just wait ‘til the spring when she wants to try to get rid of the word “patience.” Like I said, the only way that this is going to work is if Hilsenrath writes his story 10 days before the Meeting, they’re going to get rid of the word “patience,” and the Stock Market doesn’t take a dive.

Remember that he wrote that 10 days ago, and the Stock Market took a dive. They’re not related, those two events, but they did happen in that sequence. He said 10 days ago that they wanted to get rid of the term “considerable period,” then the Stock Market went down, and they couldn’t do it; they were too afraid that, if they got rid of it, and the Stock Market close in the lows of the day, then either, A, it would be their fault, or, B, as I wrote yesterday, if they got rid of “considerable time” yesterday, and the markets continued to slide for another week, then they might be forced to react to them, and it would look like they were undoing what they just did. So maybe they even did it from a PR standpoint.

But I do think that defining “patience” and a calendar, meaning two meetings, is going to be their biggest problem. And I do think that, as long as world growth stays weak, then Energy is going to stay down, Credit is going to stay under stress. And 45% of revenues come from overseas, and that is now going to be an albatross around companies’ necks, not the virtue that it has always been.

Question/Answers

The first question is:

“What is the end game with OPEC, U.S. shale in Russia? It does not make sense for Saudis to target U.S., which is an amalgamation of a wildcat spirit in capital markets, fear and greed. Seems like the three players in the \$10-million-a-day-per-barrel club. Saudi and Russia are producers. The U.S. is a pro-consumer. Is it really about bringing Russia into the cartel with all its membership responsibilities?”

Now, you bring up a bunch of interesting questions. Let me answer them in the way that I think they should be answered.

I think that the reason that the oil prices collapsed is that the man fell off a cliff, as the IEA told us in the middle of September when the price was \$92, and the price immediately started to dive right after that. And all the data since the summer has shown a marked drop in demand. None of the supply data has moved. It is a demand-drop reason that we’ve had oil go down.

The Saudis didn't see this coming. No one say this coming. They didn't engineer the decline, so let's put that off to the side. This is not some deal with the White House to punish Russia and Iran or something like that. This came out of the blue, to the extent that they did not expect demand to drop that badly because they didn't expect Europe, Japan, and China to go south so badly.

Japan is already in recession. They've had two negative quarters, if you want to define it that way. China is on the verge of a hard landing. They haven't had negative growth there since the '80s, but 7% would be their equivalent of a recession, and that is what everybody is predicting. And Europe is on the precipice of one. Half of the continent is already in recession, anyway, and that is why the demand for oil is falling.

So the Saudis didn't see this coming. Now that it happened, they're not particularly upset that it happened, which is why they're not bending over or in any hurry to do anything about it. "Hey, look, this is a gift. I didn't expect the price of oil to go down 40%, but now it did, and now that I could squeeze Russia, now that I can squeeze Iran, now that I could blow up some of the shale producers, as well, I'm fine with that." So now they start talking about OPEC discord. It's not that the Saudis want to keep the price down; it's OPEC discord. So if there is any conspiracy theory there, it is, "They didn't cause it to go down, but now that it has gone down, they're not busting a gut here to try and get it to go back up by cutting production." They're not interested in it.

So I think that that is where they are. Saudis want to reassert themselves. They would love to see some of the shale producers go bust. And, at current prices, in the high 50s, they are not making money. They're going to try to ride it out, but the price is going to stay down here until we see a lot of these projects close and a lot of these companies go bankrupt. It is going to happen.

Do they want Russia in the cartel? Meh, maybe, maybe not. But, again, I don't think that Russia is necessarily their need. I think that they were afraid of what they were looking at from a supply standpoint with what shale was going to do in the next several years. And now that we've gotten this demand drop that has led to a big drop in the price, they're going to try to hold it down here and squeeze the shale producers. So they didn't cause it but they're certainly not in any hurry to make it go back up.

Eric asks:

"What does the fall in oil have to be, one of the two things? We knew world GDP stunk in July, too."

Yes, we did know the world GDP stunk in July. I'm going to throw this chart back up on the webcast for us. We did know the world GDP stunk in July. And if you go back to July, it was at around 3.1%. Now, it is around 2.83%, so it is a lot stinkier now (to stick with the words, then). So it stunk then but it's a lot worse right now, to that end.

"The end of most commodity cycles is both supply and demand stories. Demand contracts because of high prices, and supply increases because prices are high. Supply sites' surprise wasn't shale oil; it was here. It was January 1st forecast that shale growth was more than 1 million barrels to come for June."

Yeah. Actually, we've been increasing it a million barrels a year in the U.S. for four years in a row, and the forecasts are still that we're going to increase a million barrels again in 2015. But I do think that what changed on the margin, yeah, you could have said, we could have written – I mean, as early as 2011, I could have written, "Look at these big increases in supply. This is eventually going to lead to lower prices." And, for year after year after year, month after month after month, 'til late July, you could have said, "Look, the price is \$107. The story is not working." Then – BAM! – \$56.

Now, you could argue that the Market is dumb and didn't see it coming, or you could argue that something changed on the margin since the late summer, and that change in the margin is demand. Japan went into recession since late summer. China has really cut their forecasts, both private and official forecasts. And Europe has gotten so bad now that Draghi is openly pushing for QE. That has all happened since summer. And that is, I think, what has been the change on the margin. Maybe the powder keg of excess supply was always there but it wasn't working 'til we got demand. And you're right.

Finally, you mentioned about "most commodity cycles." Now, I didn't bring these charts but I've used them before in other Conference Calls and stuff. But if you look at industrial commodities – copper, iron ore – they all look like the oil price. All of them are going south at the same time. That is because demand is dropping, not because we're fracking that it is causing iron ore to collapse just like oil is collapsing. They're both going down because demand is falling from around the world.

Like I said, the bullish hint – and this is valid – is that, you're right, it's everywhere but the U.S. But then the question is, "Can the U.S. continue to survive as long as it has been that way?" And I think that the answer there is, "No."

Scott asks:

"Question on Page Seven – real U.S. GDP growth – " which is this chart here on Page Seven – "of 3%. Working backward to the growth rate of our Labor Force is now running at a half of a %; therefore, this must result in a projection of 2.5% productivity which, of late, has been woefully lagged due to the massive amounts of unproductive debt -- think household buy-backs, etcetera – weighing on productivity. So where, in your opinion, will the higher productivity come from?"

Well, to answer your question truthfully, I don't think there is going to be higher productivity, which is why I think that this forecast is going to be wrong again. If you go back and look at December of every year, what do they project for the next year? This is the fifth year in a row that it has been 3% if not higher – the fifth year in a row. And what does it always come in at, since the end of the Great Recession? The low twos. It comes in at 2.2, 2.3, 2.1 every single year. Now, for those of you who are not familiar with it, that is a big difference. That is a big difference between the two.

So, yeah, you're right about productivity. I just don't see where it is going to come from at this point. I don't see where the productivity is going to come from. What? We've invented the Internet and we've got very slick products that we could use? That's been around for 20 years now; that is not new. So I'm of the opinion that this is too high a forecast again, and that it is going to be wrong again.

Now, I know that the argument is, "But look, four of the last five quarters have been 3% or more growth." Yeah, but the problem is, inconveniently, that one-quarter in the middle was -2. That counts. If I get a B, a B, an F, a B, and a B, then I'm not a B student. It doesn't work that way. And I know that economists want to say, "Look, we're just going to ignore all of the bad quarters and look at all of the good quarters," but you cannot do it that way. And you don't know whether or not there is going to be another bad quarter coming. And the earnings forecasts are terrible as we look forward from here.

Chris asks:

"What are your thoughts on the Yield Curve slope in 2015 – flatter?"

I think long-rate bullish flattening, the long rates are going to come down. I think that short rates are going to have a hard time coming down. While I am

of the opinion that the Fed doesn't hike in 2015, that is a minority view that will not get priced in. So the front end of the curve is going to stay around the low-60s in the two-year note, maybe even a little bit higher if markets calm down a little bit. And I think the back end is going to come down, and I think that the Yield Curve is going to flatten, at least from that perspective.

It will be later in the year, if I'm right and we get enough volatility in markets that they put off the rate hike, that we could probably see a steepening. But first things first, flatter as far as the curve goes.

Next Question:

"What do you regard the net speculative long in WTI, in that it could also be driving WTI lower?"

I've looked at it. Tomorrow, we'll put out our Commitment of Traders Report. We will again detail a lot of the positions.

The speculative positions in WTI, the speculative positions in Brent, I don't think are that out of line. I don't think that this has been as much a hot-money speculative move as everybody wants to make it out to be.

I know how the world works. The price goes up. Congress holds a hearing and drags the evil speculators in, and asks them why the American Public has to pay higher gas prices. The price goes down. There are never evil speculators when the price goes down; I guess they're patriots when it goes down.

But, that said, speculative position in WTI has not been that outrageous. Really, where the speculative position was outrageous, if I could go off on a quick tangent, has been in short-term interest rates. If you go back and look at what the Eurodollar contract was looking like in late September/early October with that *humongous* short position that the speculators were carrying, because everybody knew the Fed was going to raise rates. And then they got blown up on October 15th, and they've been paring back risks, and it has been coming into line.

But short of short-term interest rates, we haven't seen anything really there. And you couldn't predict the price of WTI from this speculative position.

Thank you. Bye-bye.

END

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