June Highlights

Investors – And Voters - Are Worried

In the US, presidential elections are often popularity contests, with the winner helping their party gain seats in Congress. This time, the two most likely contenders, Hillary Clinton and Donald Trump, both have negative net approval ratings. They are the most disliked nominees in the last 10 elections, and no candidate has ever secured the White House with such low scores. This makes policy choices harder to predict, increasing investor uncertainty.

Emerging markets have problems too. Brazilian assets rallied in expectation that the impeachment of President Dilma Rousseff would lead to her replacement by a more market-friendly alternative. Still, the nation has many obstacles to overcome to reduce its fiscal deficit and pull the country out of recession. In China, political transition in 2017 may lead to uncertainty about the course of economic policy.

Political events will continue driving uncertainty and volatility for the foreseeable future. The UK referendum on its continued membership in the European Union (EU), now less than a month away, could impact assets in Europe. In the US, both the Democratic and Republican parties are poised to choose polarizing candidates as their presidential nominees. Adding to the mix, political vacuums in Spain and Brazil could unsettle European and emerging markets respectively. And moving into next year, changes in the composition of China's politburo could affect the pace of economic reform.

The Economy

Global economic growth is still in the doldrums, but at least it's staying positive, driven by the ongoing economic expansion in the US and the gradual growth improvement in Europe. It wasn't very long ago that China was the driver of global growth. Today China is struggling just to remain above stall speed. The weakness in the global manufacturing sector seems to have found a bottom, at least for now. And major headwinds to US growth in 2015 and early 2016 – specifically, the strength of the US dollar, low energy prices, and high corporate credit spreads – are fading.

European economic data are pointing toward a mild recovery in growth trends. Even emerging markets are showing signs of stabilization in economic data. Fears of a sharp devaluation of the Chinese yuan and a potential economic "hard landing" have given way to mild optimism, as new data is released. We look for China's growth to stay sluggish, but it will probably stay above stall speed of 6% or so. Meanwhile, most central banks are committed to maintaining supportive monetary policies.

Equities

Global stock prices have recovered most of their losses from earlier in the year. US and emerging market stocks have even turned positive year-to-date. We have a small overweight in US equities. US corporate earnings are expected to return to a positive growth rate for the remainder of this year. Earnings results for the first quarter are negative, but have on average exceeded analysts' sharply reduced expectations. We are seeing a stabilization in emerging market economic data, and some relief from falling commodity prices. While corporate earnings are still weak, investor sentiment toward EM assets has clearly turned positive lately.

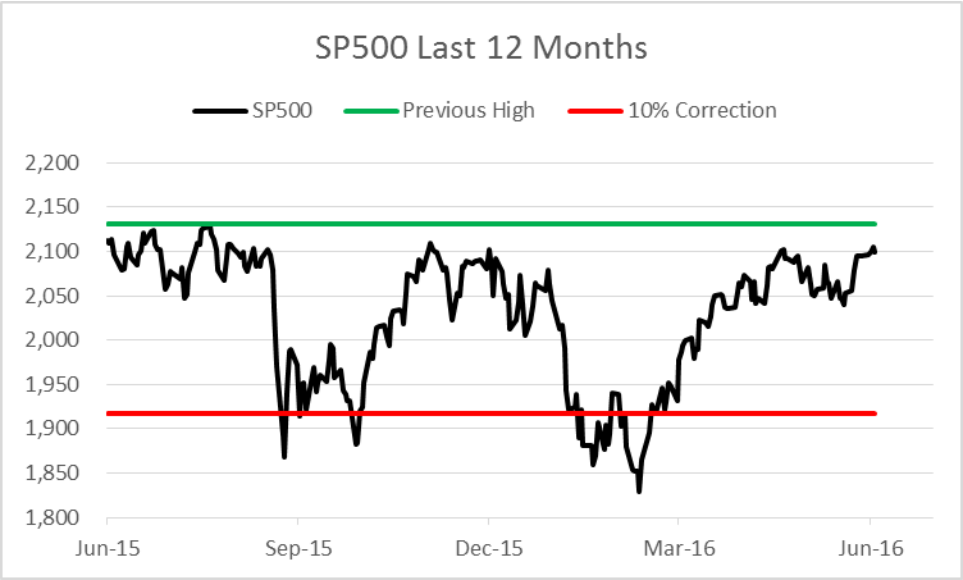
Fixed income

We maintain our preference for US investment grade corporate bonds over their European or EM counterparts. Their higher yield should help them outperform government bonds. We are neutral on US high yield bonds as prices have risen to slightly expensive levels. We expect to see more defaults in the junk bond market over the next 12 months. We have also become less enthusiastic about municipal bonds, but we are not ready to lighten up on our allocations just yet.

Stock market outlook

Chart 1 shows the track of the S&P 500 for the last 12 months. The green line is set at the previously recorded high water mark of 2,130, set in May of last year. The red line is set 10% below the green line, which represents the arbitrary but widely accepted parameter for a market correction.

Chart 1. S&P 500 with Correction Parameters



Two things to note here. First, there are two "W" formations on this chart as the market dipped below the red line – in August 2015, and again in February 2016. I'm not a big believer in the usefulness of chart patterns, but I will point out that the first "W" was successfully tested with a "higher low" while the second one was not. The second one shows a "lower low" on the right side of the "W". I point this out because chartists view this as a sign of weakness on the part of technical traders, including algorithm-based trading systems that now play a dominant role in overall trading activity.

The second note is the repeated failure of bullish traders to push through the old highs. This correction is now the 13th longest in duration since 1950. My interpretation of this factoid is that it shows a lack of confidence on the part of market bulls. Maybe the combination of high valuations and punk earnings growth is causing them to question whether this is a good time to try to be a hero.

Chart 2. S&P 500 with Zone of Death Parameters

Chart 2 shows the track of the year-over-year percent change in the S&P for the last year. The green line represents the price level that is 10% above where the market was trading one year ago. The red line represents a 10% decline from year-ago prices. The Zone of Death is the area between these two lines. The significance of the ZOD chart is that historically, once the market enters, it has a difficult time escaping. This is just what we're seeing now.

Additionally, once the market dips below the red line, the probability of continued weakness and a bear market increases markedly. Put another way, the ZOD exerts a type of gravitational pull that can be hard to overcome.

Chart 3. Market Momentum

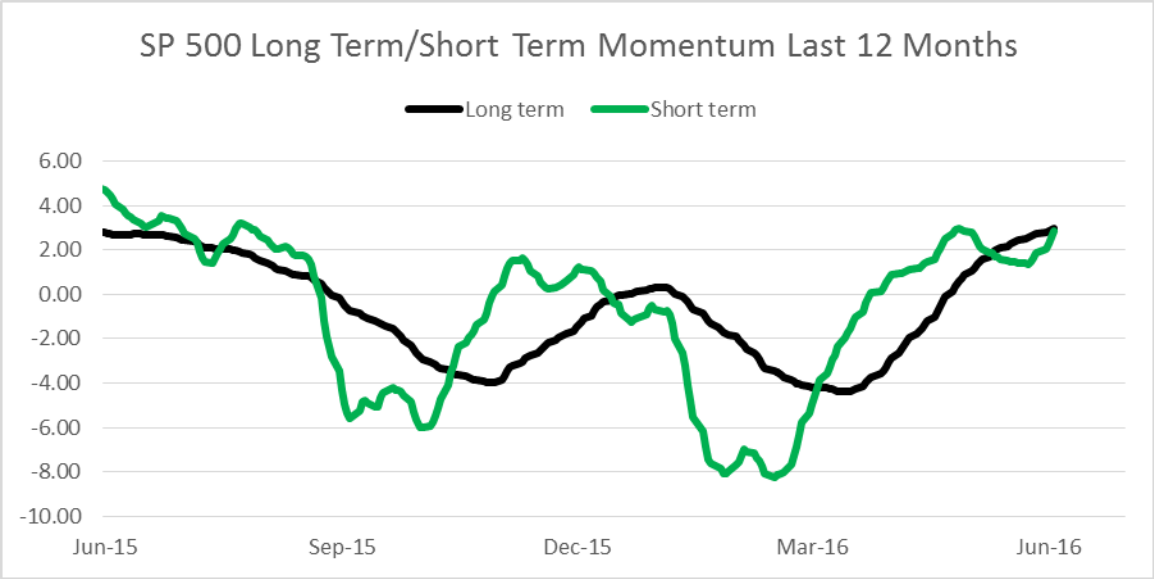


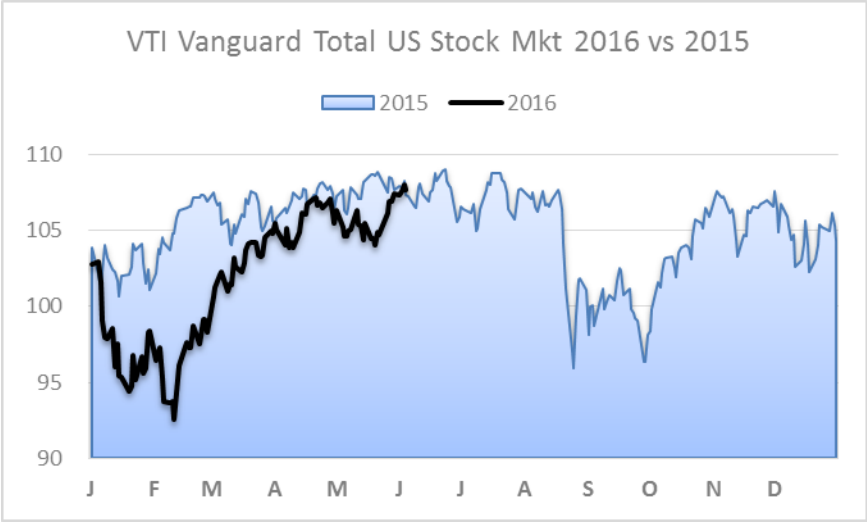
Chart 3 shows momentum as represented by the relationship between the short term and long term moving averages. The black line (long term momentum) is the 50 day minus the 200 day moving averages. The green line (short term) is the 10 day minus the 250 day moving averages.

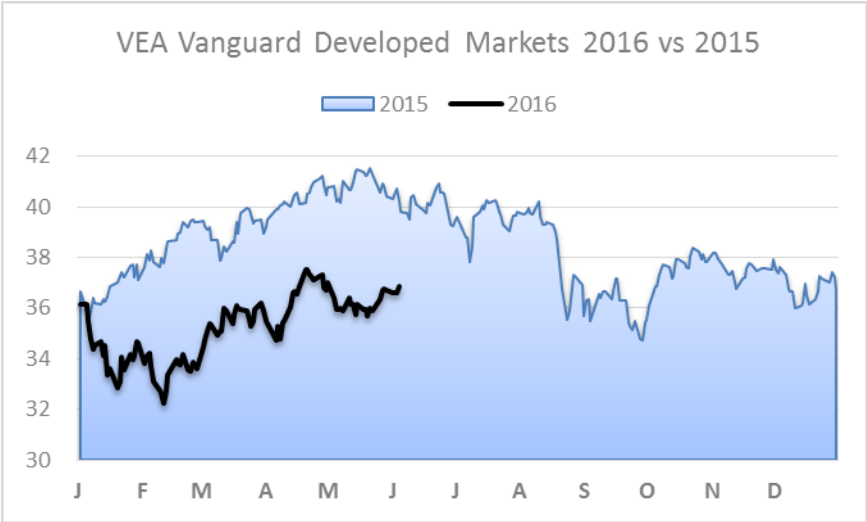
Both lines are above zero, meaning that price momentum is positive. But we've been here before and failed to hold above zero. The rally that began in the fall of 2015 looked good at first, but eventually failed. Now we have another rally that has taken both lines into positive territory, but I remain skeptical about the durability of the move.

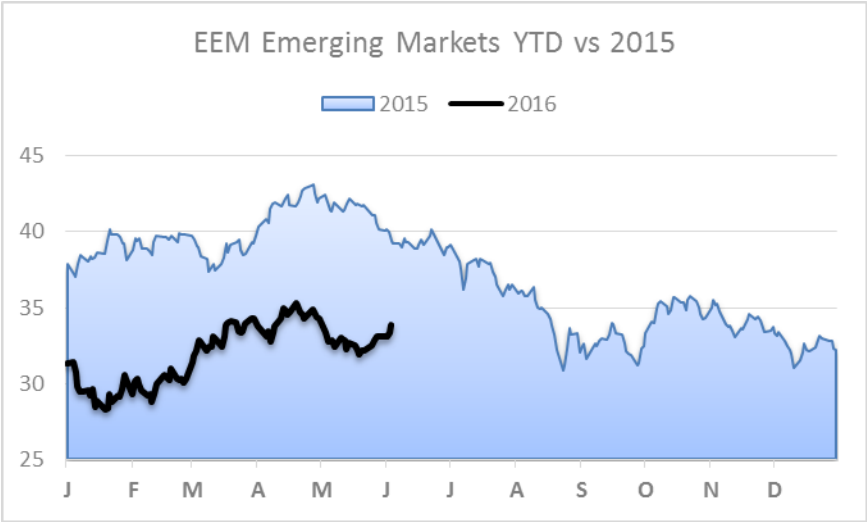
Asset Class and Sector Outlook

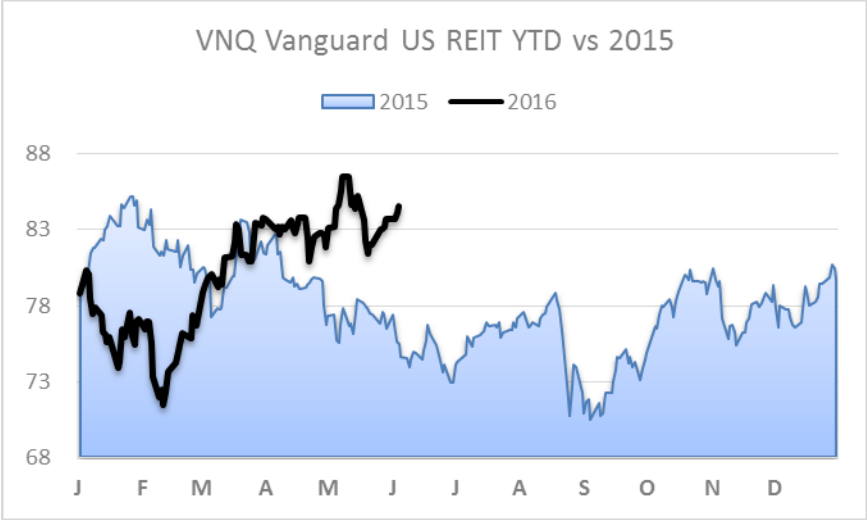
Select Asset Class ETF Charts

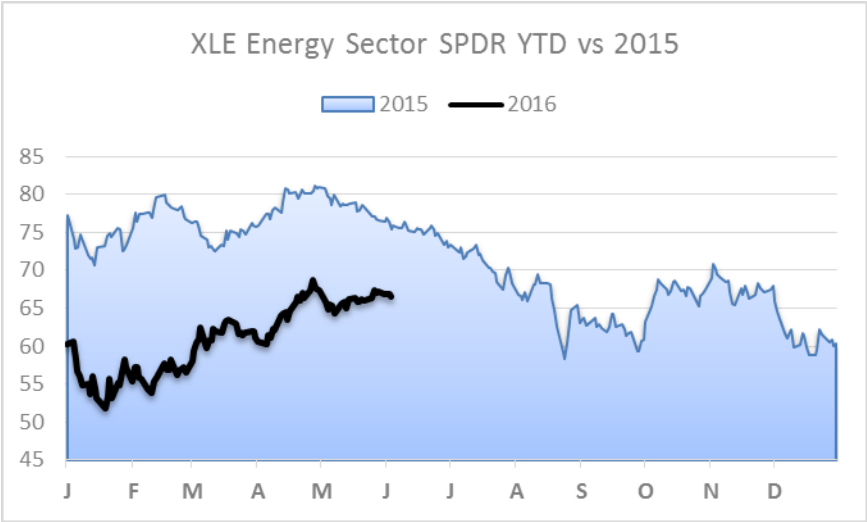
The following charts represent a series of asset classes we are tracking. They cover a cross-section of the stock, bond, and commodity markets. Each chart shows a blue background representing last year's prices, along with a black line showing this year's prices. I won't comment on each chart, as that would probably put most readers to sleep. You're welcome to browse through them at your own pace, stopping at anything that catches your attention.






EEM Emerging Markets YTD vs 2015
2015
2016
45
40
35
30
25
J F M A M J J A S O N D


VNQ Vanguard US REIT YTD vs 2015
2015
2016
88
83
78
73
68
J F M A M J J A S O N D


XLE Energy Sector SPDR YTD vs 2015
2015
2016
85
80
75
70
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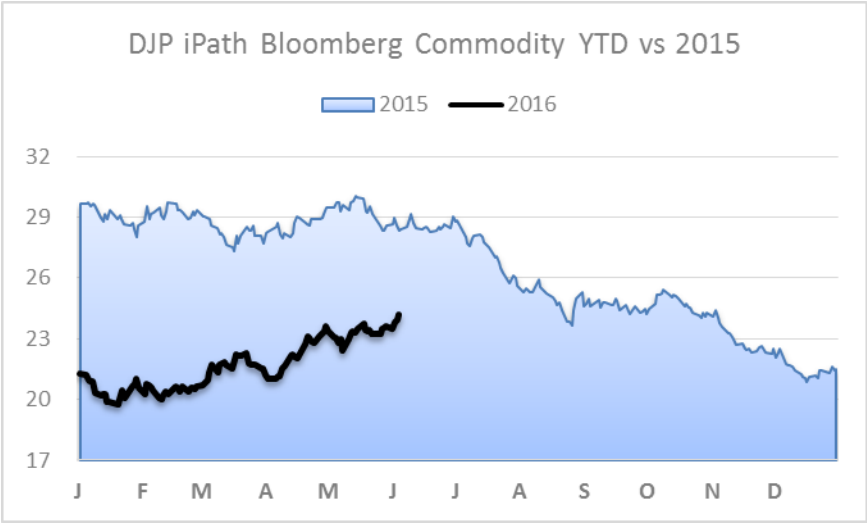
J F M A M J J A S O N D


DJP iPath Bloomberg Commodity YTD vs 2015
2015
2016
32
29
26
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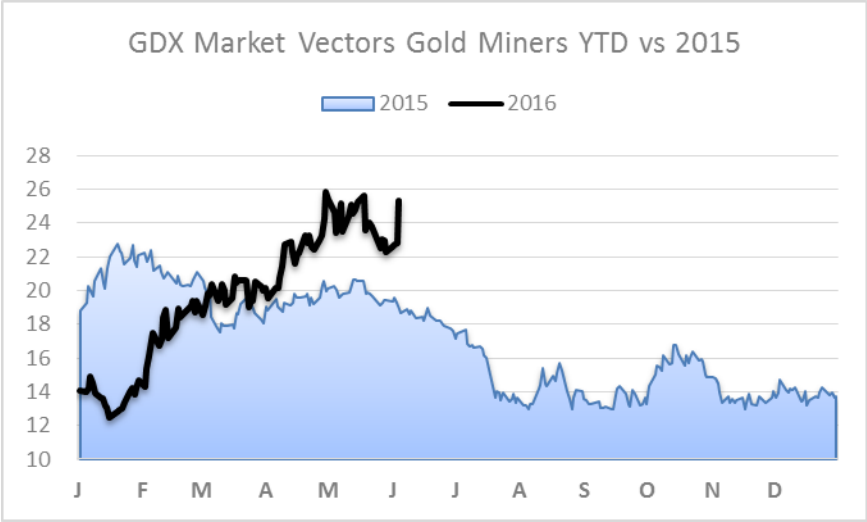
20
17
J F M A M J J A S O N D


GDX Market Vectors Gold Miners YTD vs 2015
2015
2016
28
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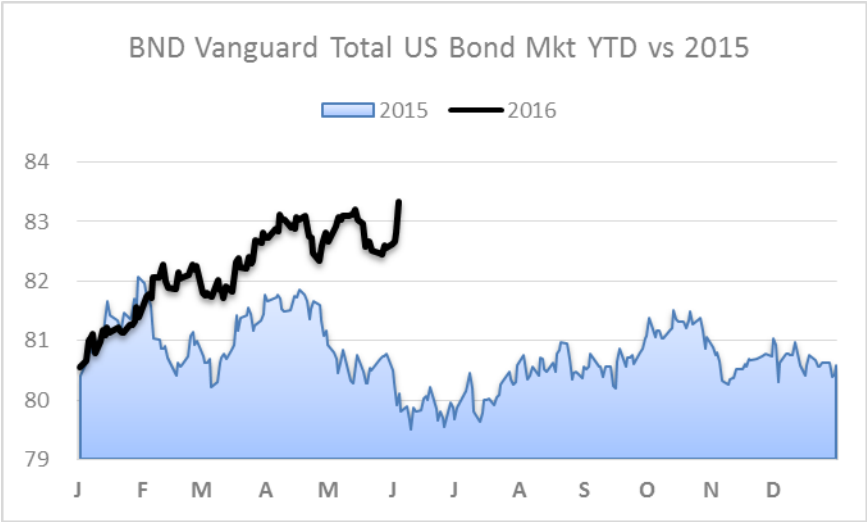
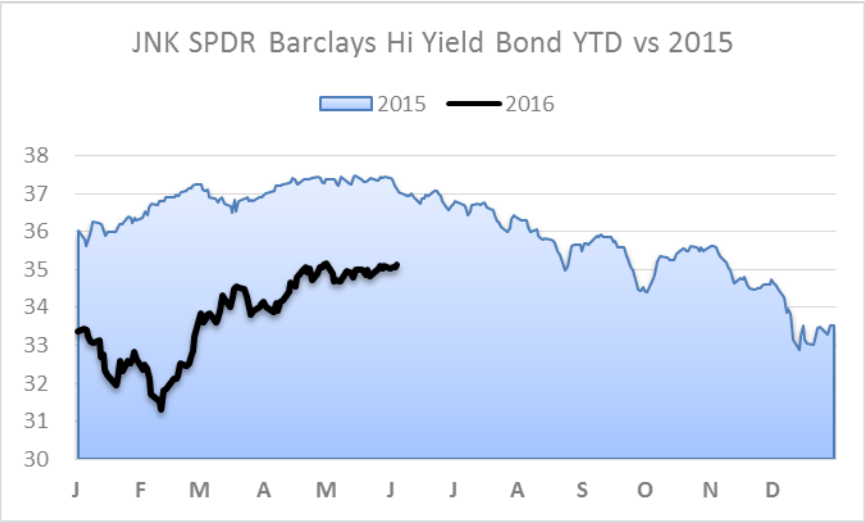
J F M A M J J A S O N D


BND Vanguard Total US Bond Mkt YTD vs 2015
2015
2016
84
83
82
81
80
79
J F M A M J J A S O N D


JNK SPDR Barclays Hi Yield Bond YTD vs 2015
2015
2016
38
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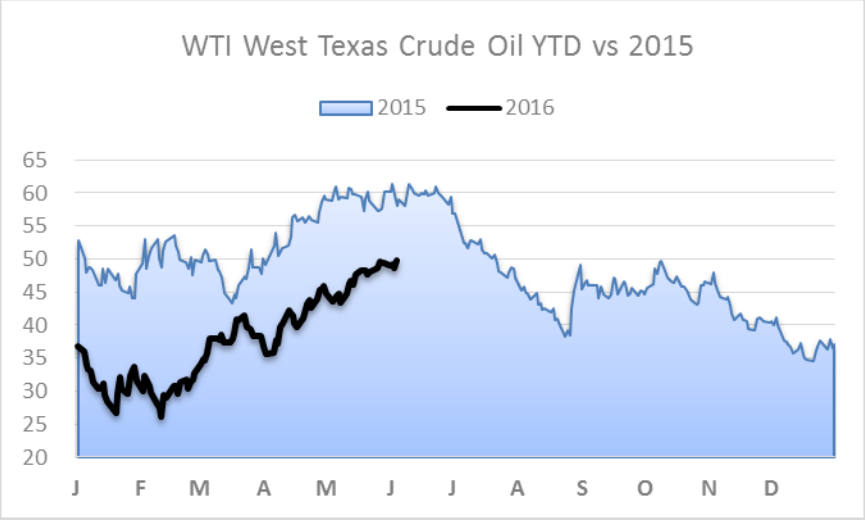
WTI West Texas Crude Oil YTD vs 2015
2015
2016
65
60
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Picks & Pans

ZI 10 Best ETFs: The 10 most undervalued asset class ETFs

Symbol	Name	1 Year
YMLP	VanEck Vectors High Income MLP ETF	-49.21%
FCG	First Trust ISE-Revere Natural Gas Index Fund	-49.17%
TAN	Guggenheim Solar ETF	-43.88%
PSCE	PowerShares S&P SmallCap Energy Portfolio ETF	-37.99%
DXJF	WisdomTree Japan Hedged Financials Fund	-34.67%
SEA	Guggenheim Shipping ETF	-28.99%
PBE	PowerShares Dynamic Biotechnology & Genome Portfolio ETF	-28.76%
REMX	VanEck Vectors Rare Earth/Strategic Metals ETF	-28.33%
XES	SPDR S&P Oil & Gas Equipment & Services ETF	-26.39%
XBI	SPDR S&P Biotech ETF	-26.32%

ZI 10 Best Stocks: The 10 most undervalued stocks

Company	Ticker	Current Price	Avg Daily Volume	P/E using 12 mo Est	Price/ Book	Earnings Est Revisions	Debt/ Equity	Technical Grade	Funda-mental Grade
Alleghany Corp	Y	$538.13	48,901	18.18	1.07	7.3	0.18	B	A
Childrens Place	PLCE	$72.64	867,625	17.24	2.62	4.1	0.00	B	A
Daqo New Energy	DQ	$24.78	63,162	5.54	1.02	33.3	0.45	A	D
Deutsche Pst Ag	DPSGY	$30.30	53,542	13.45	2.93	3.8	0.41	B	C
Enersys Inc	ENS	$67.02	233,492	15.27	2.86	4.0	0.60	B	C
Huron Conslt Gp	HURN	$60.20	126,485	18.10	2.16	0.4	0.58	B	C
Monarch Casino	MCRI	$21.85	56,474	17.62	1.80	4.2	0.00	B	A
Sanmina Corp	SANM	$28.08	690,679	12.00	1.38	3.8	0.29	B	A
Tutor Perini Cp	TPC	$23.21	390,124	11.07	0.79	-	0.50	A	D
Utd Natural Fds	UNFI	$43.18	813,328	17.22	1.46	5.6	0.29	A	B

ZI 10 Best Shorts: The 10 most overvalued stocks

Company	Ticker	Current Price	Avg Daily Volume	Debt/ Equity	P/E using 12 mo Est	% Chg Earnings Est This Year	% Chg Earnings Est Next Year	Technical Grade	Funda-mental Grade
Clean Harbors	CLH	$54.30	330,345	1.46	52.37	(27.46)	(9.37)	D	F
Covanta Holding	CVA	$16.79	934,199	4.56	131.95	(54.81)	(5.94)	C	F
Incyte Corp	INCY	$82.90	1,106,911	2.76	165.39	(114.74)	(2.51)	C	D
Lions Gate Etmt	LGF	$22.43	2,576,591	1.53	52.78	(71.29)	(55.88)	D	F
Live Nation Ent	LYV	$24.65	1,025,337	1.42	713.26	(162.14)	(42.19)	C	C
Lumos Networks	LMOS	$11.74	130,933	3.47	132.21	(118.75)	(10.00)	C	C
Salesforce.Com	CRM	$83.35	4,406,559	0.23	224.77	(25.38)	(9.71)	C	C
Taser Intl Inc	TASR	$23.52	859,013	-	74.26	(1.03)	(4.60)	C	D
Vertex Pharm	VRTX	$94.59	1,509,111	0.17	70.73	(68.48)	(42.28)	F	F
Viasat Inc	VSAT	$74.27	381,503	0.84	447.15	(66.14)	(106.61)	D	F

Our Forecast for the U.S. Economy

Moderate expansion - Probability: 60%
We expect the US to grow at a sub-par 1.7% rate over the next 12 months. Aside from a stumble in May, the labor market is healthy and improving, with solid job growth and even some early signs of faster wage growth. There is some evidence of an uptick in consumer spending. Housing starts and home prices should remain healthy, contributing modestly to overall economic growth. Rebounding oil prices will help to alleviate some of the problems in the high yield bond market. This will improve the outlook for growth, particularly in the manufacturing sector.

Strong expansion - Probability: 15%
In this scenario, US real GDP growth takes off, hitting 2.5% or more, propelled by an aggressively friendly monetary policy, strong household spending, and lower risks from overseas economies. This causes the Fed to raise policy rates faster than markets anticipate. Stock markets sell off initially, but recover when growth becomes evident.

Growth recession - Probability: 15%
In this scenario, US growth stumbles. The 0.5% GDP reading for the first quarter gets repeated in the second and third quarters. Earnings continue to disappoint. Consumers save rather than spend the windfall from lower gasoline prices, while businesses drag their feet with hiring workers and spending on expansion plans. The Fed stays on hold throughout 2016.

Outright recession - Probability: 10%
Our indicators, both leading and coincident, point to continued growth in the U.S. This month we increased the probability of recession from 5% to 10%, due in large part to the fact that Trump is now the Republican nominee. We view the possibility of a Trump presidency as a sharp negative for the economy. The other negative would be a major terrorist attack.

Commodities

Based on recent price action, it appears that the long bear market in commodities has finally come to an end. Is this just another head fake? Will the rebound in prices turn out to be just a dead-cat bounce? We've been down this road many times before, and skepticism abounds. But one thing is clear – those who piled into the crowded short trade late in the game are now licking their wounds. We estimate that about half of the short position has been covered, leaving more room for further price gains.

Crude oil

Brent crude has risen to a five-month high. Much of the move is the result of short covering in a crowded trade. Add to the mix some pockets of production outages and improving market sentiment, and you get a recipe for a classic oversold rally. But the fundamentals have not improved enough to justify the move. The oil supply glut remains, and inventories should continue to build. Supply cuts will eventually start to balance out the oversupply, but we don't expect to see that before the second half of this year.

Precious metals

Gold has been range-bound between 1210 and 1260 for the past few months. Gross speculative long positions are at their highest levels in five years, and around half of last year's institutional short positions have been covered. ETF buying of gold and gold miners has also been increasing. Our guess is that the move higher in gold has been largely due to two factors. First, there is a clear uptick in inflation expectations in the capital markets. And second, the dramatic rise in the dollar has sputtered lately. Both of these trends can reverse on a dime. As a result, we remain skeptical about the continuation of the gold rally.

Agriculture

The recent uptick in grain prices is another matter. It has the potential to be more sticky than the run-up in gold. The macro forces at work are bigger and more durable than inflation expectations or the latest zigs and zags in the dollar. Climate change, water shortages, population growth, urban sprawl – all represent seemingly unstoppable macro trends that will contribute to the scarcity and demand for the raw materials of our global food supply. Accordingly, two of the core holdings in our model portfolios are the PowerShares DB Agriculture ETF (DBA), and PowerShares Water Resources ETF (PHO).

Key Recession Indicators

As we stated earlier, our indicators show that the risk of the US economy sliding into recession this year is low – less than 5%. We base this assertion on a combination of factors that have proven accurate in calling every turn in the business cycle since 1957, with no false signals. Unlike other econometric models, ours is not proprietary. It's open to anyone who asks to see it. The input data is readily available and can be found on the internet with a few clicks of the mouse. If you would like to replicate our model, send a request to info@zeninvestor.org with the subject line "recession model."

Recession Watch

Indicator	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May
R-Score	593	579	543	573	565	544	500	395	390	423	380	395
Employment	2.5	2.4	2.3	2.2	2.3	2.3	2.3	2.2	2.2	2.3	2.3	2.2
Ind Production	0.9	1.3	1.1	0.4	0.5	-1.1	-2.3	-1.3	-1.8	-2.0	-1.8	-1.7
Market Trend	5.3	9.0	-1.6	-2.6	4.3	0.6	-0.7	-4.0	-8.2	-0.4	-1.0	-0.7
Market Stress	28.4	25.0	22.3	18.4	16.8	14.4	10	11.3	2.7	8.7	6.5	6.9
Junk Spread	4.7	5.1	5.7	5.9	6.2	6.1	6.9	7.6	8.2	7.0	6.6	6.1

Red numbers indicate warning, based on these parameters:

R-Score	< 200	This indicator combines the treasury yield curve, inflation, and unemployment.
Employment	< 1%	Year-on-year changes in private non-farm employment.
Ind Production	< 1%	Year-on-year changes in industrial production.
Market Trend	< -5%	Year-on-year changes in the S&P 500 index.
Market Stress	< 0	Combination of stock market price change and the unemployment rate change.
Junk Spread	> 8%	Difference between Junk bond yield and Treasury bond yield

Our Forecast of Asset Prices

12 Month Forecast of Asset Prices

Asset Class	Benchmark	Current Value	% chg May	12 Month Forecast
Stocks				
U.S.	S&P 500	2097	1.5%	2150
Non-U.S. Developed	VEA	36.6	-0.4%	38.5
Emerging Markets	VWO	33.8	-3.4%	37
Bonds				
U.S. Govt	10yr T-Bond	1.8%	0.9%	2.6%
U.S. Corporate	Spread	125	2.8%	125 bp
U.S. High Yield	Spread	597	3.3%	525 bp
EM Sovereign	Spread	385	0.7%	380 bp
Other				
Gold	Spot	1272	-1.8%	1250
Oil	Brent	49	1.4%	55
Agriculture	Grains	190	10.7%	205

as of 5/31/16 *Source: Bloomberg; Atlanta Fed; UBS*

Tactical Asset Allocation

Our current view is that negative interest rates available in some markets demonstrate the willingness of central banks to do “whatever it takes” to support global economic growth. We think that this topsy-turvy policy will continue to provide support for risky assets like stocks, and that it will probably continue for longer than most investors imagine.

We are keeping our slightly overweight position in US equities. We expect US profits to improve after the current earnings season, as the oil price recovery, dollar weakness, and ongoing strength in employment begin to manifest as rising corporate earnings.

We also keep our overweight allocation to US investment grade corporate bonds. Low interest rates will continue to drive a demand for yield wherever it can be found, and the low probability of a US recession make this a risk worth taking for diversified investors.

Asset Allocation

Stocks	50%	
Bonds	25%	
Alternatives	15%	
Cash	10%	100%
Stocks		
US	28%	
Foreign Developed	11%	
Foreign Emerging	11%	50%
Bonds		
US	15%	
Foreign Developed	5%	
Foreign Emerging	5%	25%
Alternatives		
Commodities	5%	
Hedge Funds	5%	
Managed Futures	5%	15%
Cash	10%	10%

as of 5/31/16

The above allocation is for tax-deferred accounts with an investment horizon of 20 or more years. For details about our models covering taxable accounts, or accounts with shorter time frames, send a request to us at info@zeninvestor.org with the subject line “asset allocations.”