April 1, 2015

RE: Important Market Update

Dear Client,

All good things must come to an end, even if just temporarily. The stock market has climbed admirably since March of 2009 and is now at all-time high valuations according to a number of ratios in the attached charts. Calling tops is dangerous as the market has always come back and eventually made new highs, yet there are certainly good times to take profits and become less vulnerable to stock market pullbacks.

In general, we have had six great years on Wall Street with a tripling of the S&P 500 while Main Street (average private business) felt like they were still in a recession. Wall Street had the advantages of cheap and available debt, share buy-backs and accretive M&A activity; Main Street did not. However, those tricks are almost played out and now Wall Street is faced with the future prospects of higher wages, stronger Dollar, increased capital spending and higher interest rates. This will cause weak first quarter earnings and lower prospects for the year. High P/E ratios are warranted with low interest rates, but as the charts attached show, extremely high valuations do not last long – either earnings accelerate like in 1992 or prices decline like in 2000 or 2007. Either way, P/E ratios come off their highs. This is likely to happen even as Main Street is finally getting back to normal and as the US economy continues to grow.

I am writing to let you know that we are closely monitoring a number of market forecasting indicators that are flashing warning signs (Dow Theory, margin debt ratios, profit deterioration, MACD, etc.). Should the S&P 500 Index breakdown below the 1992 level before reaching new highs, we will be taking profits on stock market positions and holding extra cash to help protect your portfolio. If not, we will stay fully invested.

If you have any questions, please call Leslie or Mark at (949) 363-8686.

All the best,

Mark Van Mourick

Chart 2: Median price/earnings multiple for U.S. stocks*
*Based on all NYSE stocks with positive earnings for the last fiscal year calculated in June of each year since 1951 through 2014

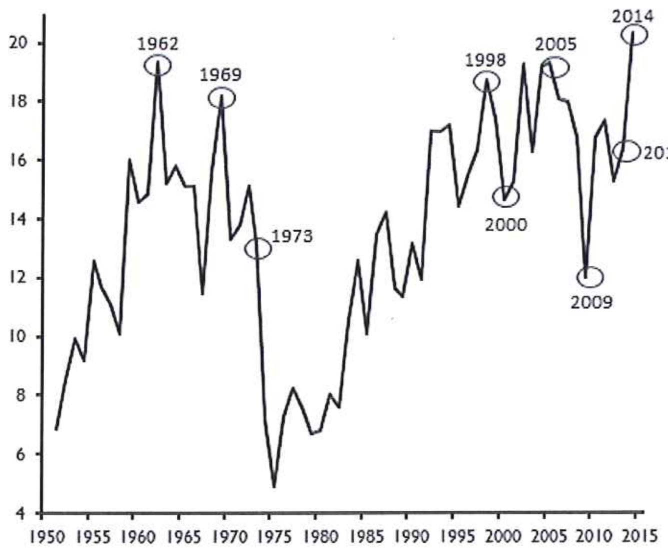


Chart 3: Median price/cash flow multiple for U.S. stocks*
*Based on all NYSE stocks with positive cash flow for the last fiscal year calculated in June of each year since 1951 through 2014

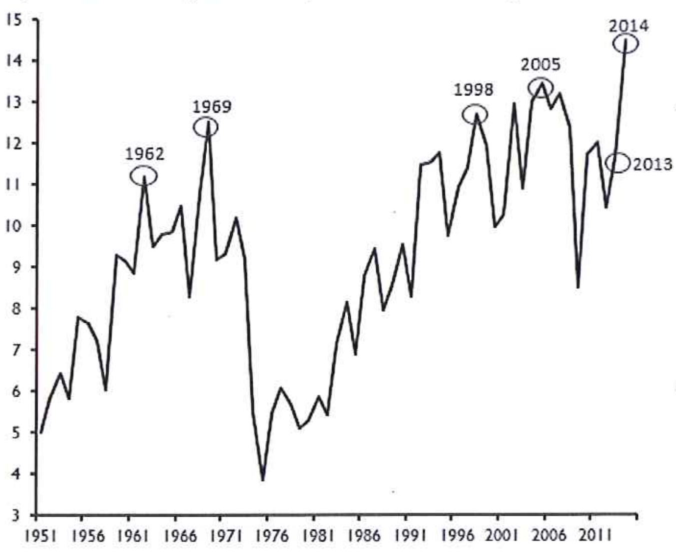
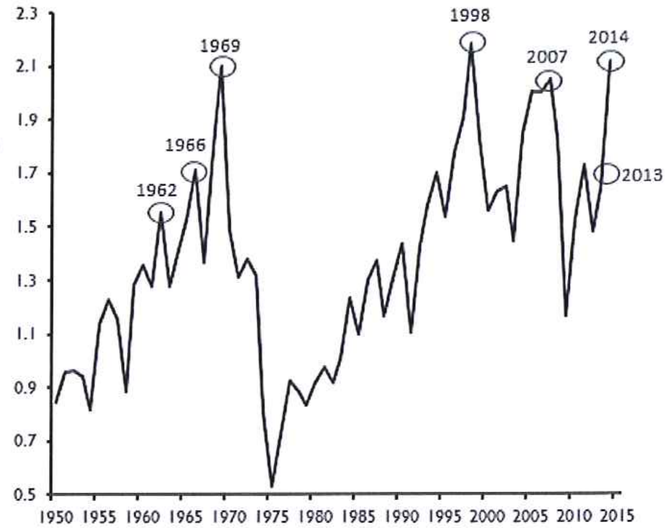


Chart 4: Median price to book multiple for U.S. stocks*
*Based on all NYSE stocks with positive book equity for the last fiscal year calculated in June of each year since 1951 through 2014

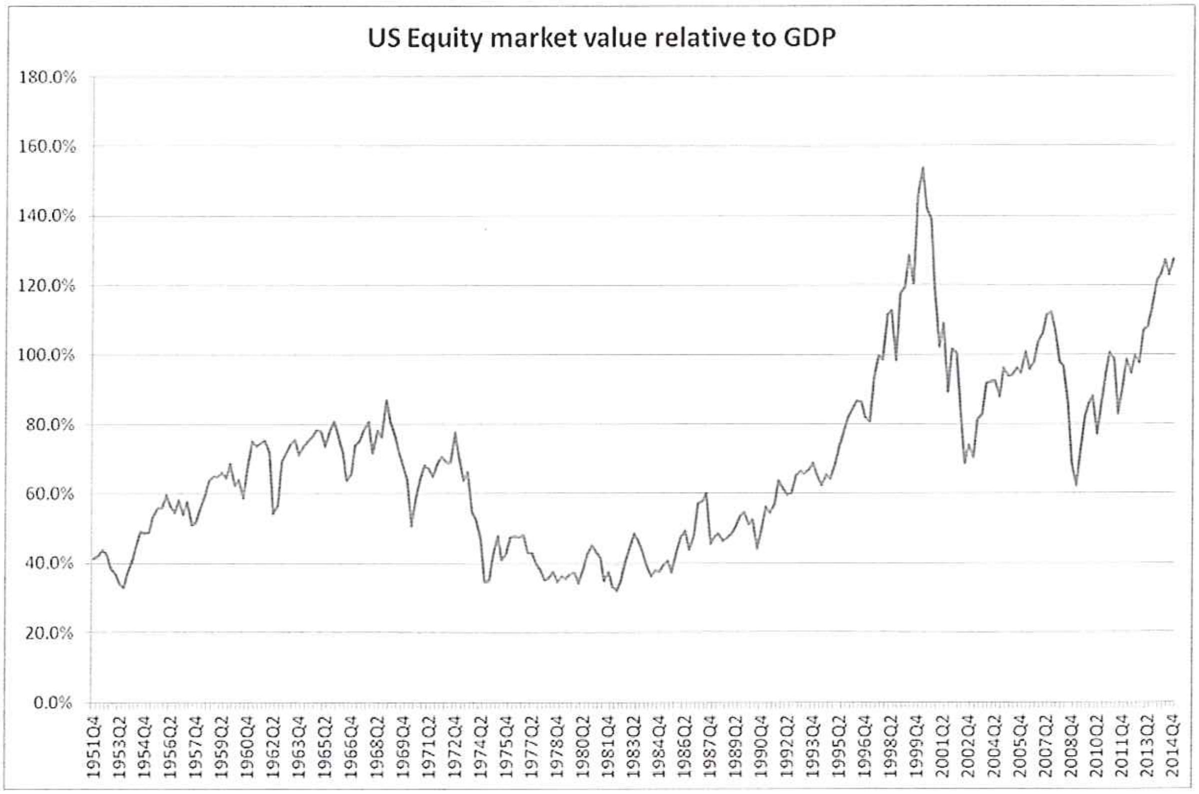


A concentrated versus a widespread valuation extreme?

Historically, the stock market has exhibited both widespread and concentrated valuation extremes. These are highlighted by comparing Charts 1 and 2.

Today, even though the market-cap weighted S&P 500 P/E multiple is only slightly above average, the median stock trades at a record high P/E (Chart 2) implying the contemporary valuation extreme is broad-based. This is similar to the valuation profiles in both 1962 and 1969. In 1962, the S&P 500 P/E multiple was only about 16 times but the median stock's P/E, similar to today, was about 20 times! Likewise, in 1969, the median stock sold for about 18 times earnings even though the S&P 500 P/E multiple was only about average at 15 times. In both of these previous episodes, like today, most stocks were aggressively priced even though the headline S&P 500 valuation was not excessive.

The stock market has also exemplified some highly concentrated valuation extremes. In both 1973 (Nifty Fifty era) and again in 2000 (dot-com top), the headline S&P 500 P/E multiple was widely recognized as very high even though median stock valuations remained reasonable. For example, in early 2000, while the overall S&P 500 P/E was near 30 (Chart 1) the median P/E (Chart 2) was less than 15.



As can be seen, aside from just a couple of quarters at the turn of the millennium (current comparison would place us somewhere in 2Q 1999), markets have not been this expensive since this particular data set started in 1951. Other analysts splicing together this data with historic pre war data can illustrate that the current market is the second most overvalued ever. The conclusion from this current level of valuation is that there is a bear market out there somewhere (unless the Fed has abolished market cycles). The simple question is will the next bear market start in the next few weeks/months or perhaps 2016. Nobody knows, but the fundamental situation as highlighted by the views from the BIS and Ray Dalio is both unsustainable and increasingly fragile.

We would add that a US equity bear market would most likely coincide with a global bear market with very few left unscathed. This is why we spend so much time analysing the US. Perhaps QE in some countries will make the bear market for them look a bit different, but we fully expect the upcoming bear market to be global in nature.

From where we sit, the risk of an US economic growth shock continues to rise. Bloomberg has consensus expectations looking for 1Q growth of 2.4% and rising to basically 3% for the rest of the year. The Atlanta Fed GDPNow model we looked at last week is tracking 1Q growth of just 0.3% after this week's updates. A recent BIS report claims that annual capex in the oil and gas

Chart 1: U.S. Initial jobless claims
Four-week moving average

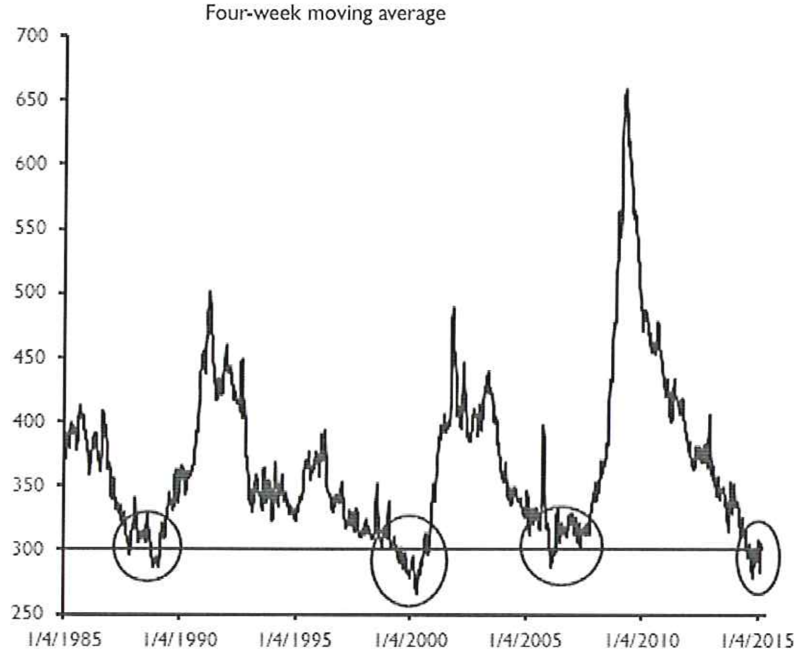


Chart 2: S&P 500 Composite Stock Price Index
Shown on a natural log scale