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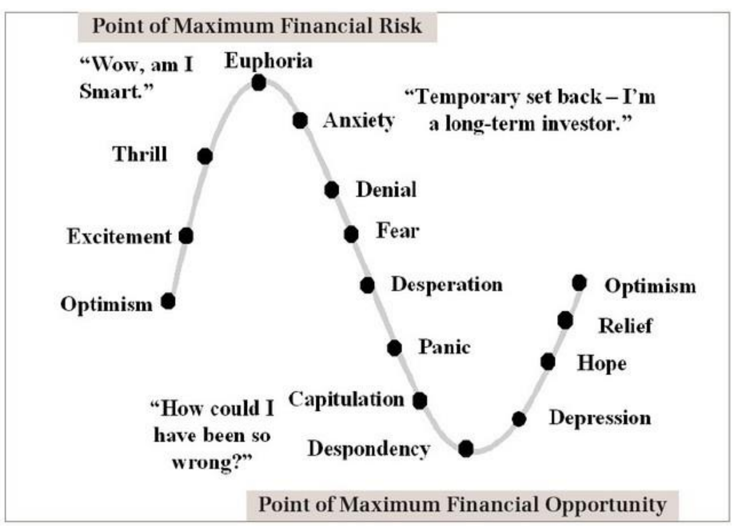
It has been said that, while you cannot predict what the markets are going to do, you oftentimes can predict what investors are going to do and, from our perspective, that is just the other side of the same coin. Indeed, this premise of investor predictability has developed into alternative investment approaches that can provide very useful insight to supplement the more traditional fundamental analysis of company and economic data. These include both "behavioral finance" and technical analysis.

Behavioral finance is a relatively new field that combines behavioral and cognitive theory with conventional economics and finance to help explain how and why investors often rationalize irrational investment decisions. On a more macro basis, it helps to explain the foibles and anomalies in the "efficient market hypothesis" (the premise that markets are so efficient at discounting information into prices that it is virtually impossible for active portfolio management to outperform the markets themselves over the longer term).

From our perspective, this science has its greatest utility when you combine together the behavior of the tens of millions of investors across the globe that are influenced by these principles, and consider it in light of what is known about human nature, as it gets to the heart of the "delusion of crowds" phenomena that we discussed in last month's writing.

While we acknowledge that some of this discussion will seem a bit "wonky" at first, we believe that some of these applications can shed valuable light on to much of what is going on today in the world's capital markets.



The same can be said of technical analysis, which for centuries has used mathematical models to measure variables like sentiment, valuation, momentum, and trend, in combination with the study of human nature, to help anticipate future market direction and characteristics.

Perhaps the best known example of this intersection of psychology and capital market cycles was described by renowned investor Sir John Templeton, who noted that "Bull markets begin in despair, grow on pessimism, mature on optimism and die in euphoria."

This quote makes more sense once you recognize that a "bull market" is nothing more than the process of "bears" being converted into "bulls". The more bears that are out there to be converted, the greater the upside potential of the markets, because each such conversion brings more money into the markets which pushes prices progressively higher (the simple laws of supply and demand). When the market runs out of bears to convert, it runs out of its supply of new money. Starved of this critical fuel, markets ultimately collapse under their own weight. "Bear markets" are the exact opposite.

In both bull and bear market cycles, prices reach their lows when news is at its worst and peak when the news is as good as it is going to get. Between the two extremes, markets vacillate up and down depending on whether current fundamental data is turning out to be better than or worse than was expected.

We just witnessed a perfect example of this phenomenon, in how markets reacted to the Greece-centered crisis in Europe. When Prime Minister Tsipras called for a referendum under the premise that it would strengthen Greece's hand versus its lenders, it was unexpected bad news for investors and created a significant number of bears, which caused a sharp decline in European shares. However, as it became increasingly evident that Greece's strategy backfired on them, more and more bears progressively became bulls, and the market rebounded sharply.

From our perspective, while the outcome of Greece's negotiations will probably create a most unfortunate humanitarian crisis in Greece, as the country was forced to take a deal that was much worse than what they had turned down previously, it was a near-ideal outcome from an investor's perspective as, in our opinion, it greatly enhanced the stability of the European financial system. To explain, while we believe that Greece will still ultimately need to withdraw from the Eurozone, we believe that the remaining countries in the currency union are now inured to the risk of a future Greek withdrawal.

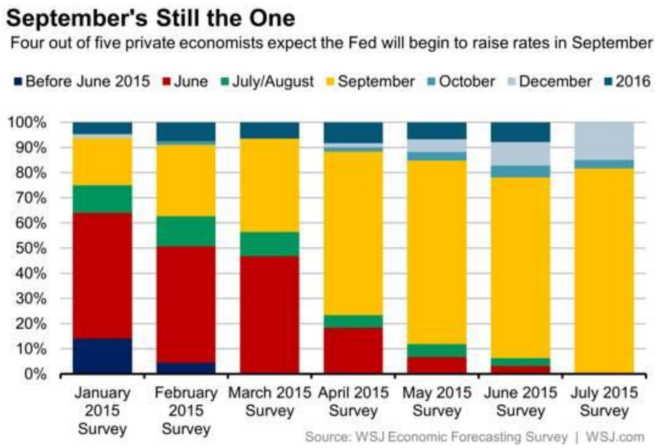
"Investors buy the rumor and sell the fact (and vice-versa)".

-Unknown

In essence, the rest of the Eurozone members looked over the edge of the cliff, and realized that there was really not that much to fear after all. Moreover, we believe that the outcome greatly reduced contagion risk (the risk that other indebted European countries (like Italy, Spain and Portugal) would opt to leave the Eurozone currency union, as no country is going to willingly follow in Greece's steps, once it becomes evident just how badly Greece will suffer for its fiscal irresponsibility and hubris.

However, by the time that this very investor-friendly resolution was confirmed as fact, it had already been well anticipated and fully reflected into market prices. All of the bears that could be converted to bulls were already converted and, without additional flows into the markets, equities peaked on the day when news was as good as it could get. European markets have meandered lower ever since.

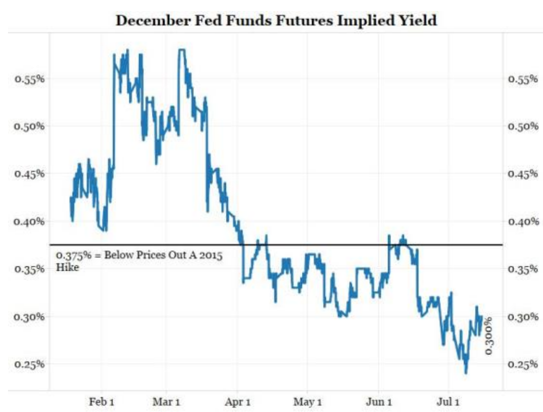
It is very rare for a majority of investors to reach the same decision at the same time. Instead, market prices generally adjust gradually over time, as bulls get converted to bears and vice-versa. This allows for an incremental adjustment in prices, which greatly reduces short-term market volatility.



This is part of the dilemma currently faced by the Federal Reserve, which feels a real need to start "normalizing" monetary policy (raising interest rates and reducing credit and money supply), due to their concerns that current policies have the potential to create additional financial bubbles, which could lead to a new financial crisis.

At the same time, the Fed has created almost $4 trillion of new money with the goal of elevating the prices of real estate and financial assets, in order to stimulate the economy through a "wealth effect", and the last thing that they want to do is raise interest rates before the markets have sufficiently priced it in, which could create a "negative wealth effect" by causing these same real estate and financial asset prices to reverse course and head lower.

This is why the Fed has been so clear in their guidance and commentary. They want the markets to price in the first interest rate hike before it takes place, so as to avoid any violent market reaction that might at least partially offset almost seven years of extraordinary and unprecedented monetary policy.



Most recently, in her July 15th testimony in front of Congress, Fed Chairwoman Yellen said that "The economy can not only tolerate but demands higher rates". She went on to say that they would likely raise rates in 2015, "when it [the Fed] has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term". Next came the statement after the July 28/July 29 meeting of the Federal Reserve which stated that, "The labor market continued to improve, with solid job gains and declining unemployment".

This level of clarity is remarkable coming from an institution that has historically prided itself on being opaque. They just want the markets to get the message so that investors can start adjusting both asset prices and expectations accordingly.

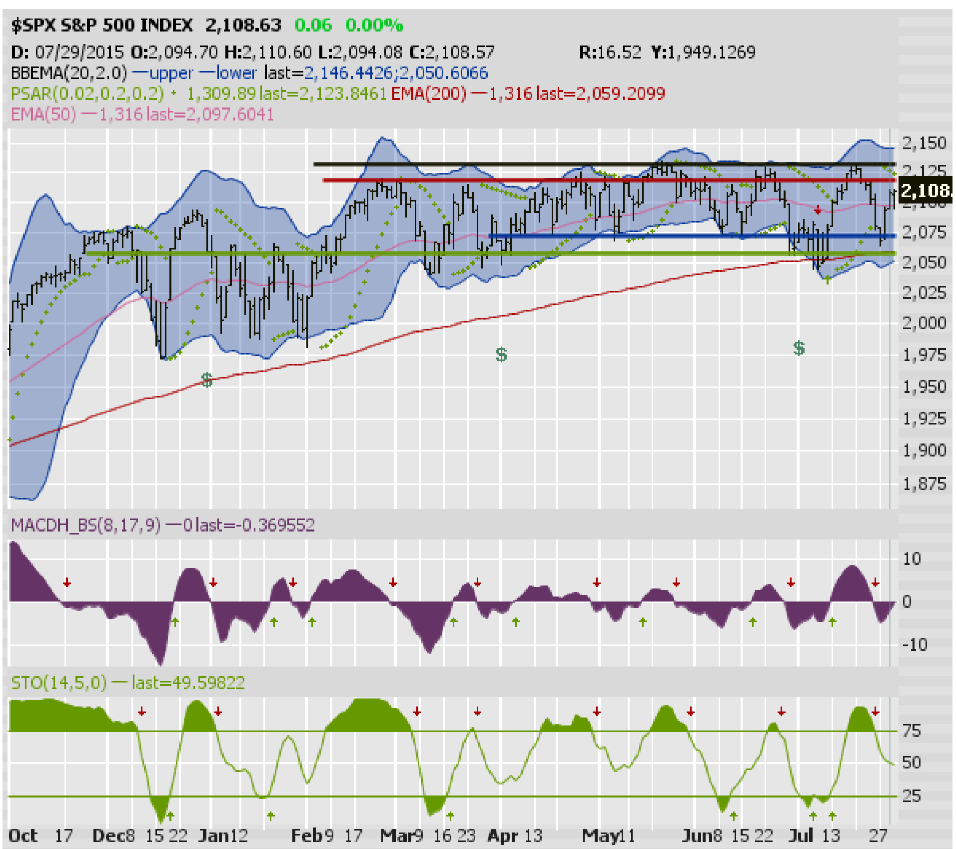
Most Wall Street economists (over 80% of whom believe that the first rate hike will take place in September) seem to be getting the Fed's message. However, the portfolio strategists and managers who actually make the portfolio-related decisions seem to think that the Federal Reserve is just bluffing, and that the first rate increase will not take place until at least 2016. This is reflected in the Fed Funds futures contract for December, which is not pricing in any rate increase in 2015.

This is the Fed's dilemma. They feel a need to raise interest rates, but almost need the market's permission to do so, and the markets currently seem totally unwilling to do the Fed's bidding (although all that investors are really doing is just delaying the inevitable).

We have talked about how human nature and psychology impact markets and market analysis. So does memory. Indeed, in many regards, market memory is every bit as important as is sentiment and psychology. To explain, investors (and people in general) have a very strong tendency to repeat behavior that has been pleasurable or rewarding in the past, and avoid behavior that has been unpleasant or harmful in the past.

As a result, it is very common for a market to have areas of support and resistance. An area of support is normally a price level which has both marked the end of numerous previous declines and the starting point for numerous previous rallies.

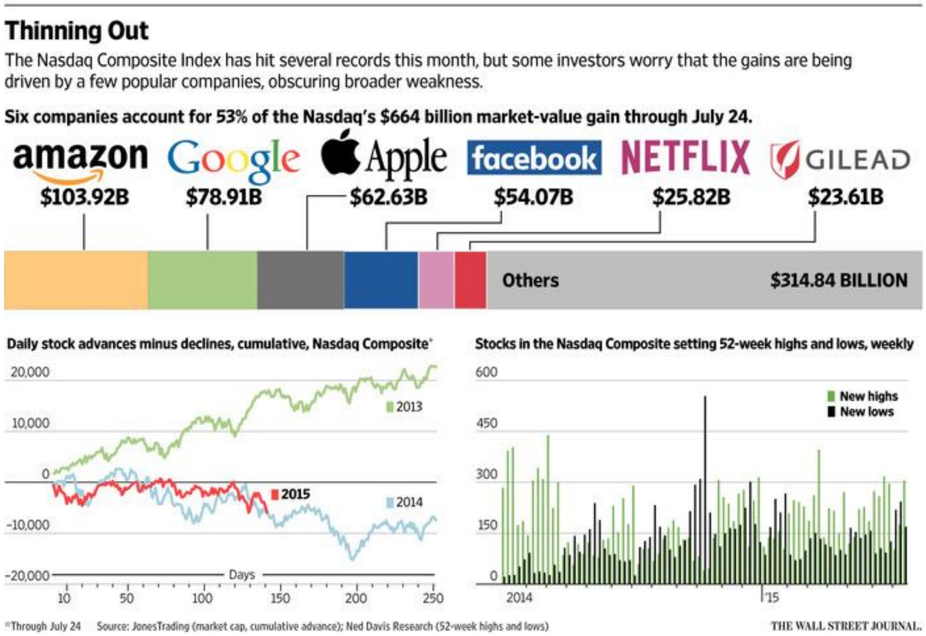
As such, it is not unusual for cash to sit on the sideline until those lows are retested, at which point money pours into the market, ending the decline and launching the next leg higher. The exact opposite is true of areas of resistance (a.k.a. over-head supply). When there are price levels that the market cannot get through, and which have proven to both cap numerous previous advances and mark the starting point for numerous past declines, investors will purposefully sell at those old highs. This often catalyzes the next decline. Markets (or securities) cannot break above these resistance levels until such time as buying power is more than sufficient to absorb all of that pent up selling pressure.



You can see this illustrated perfectly in the chart of the Standard & Poor's 500 Index. Support (under-lying demand) is found between the blue and green horizontal lines and resistance (over-head supply) exists between the black and red horizontal lines. This "tug-of-war" between supply and resistance has been ongoing since February and has created one of the longest and tightest trading ranges in modern market history. This trading range will continue until either the bulls or bears become sufficiently dominant to overwhelm either the overhead supply or the underlying demand.

While such a trading range might suggest a state of bull/bear equilibrium, it actually masks a worrisome phenomenon in the equity markets that is usually found only in the later stages of bull markets. To explain, a characteristic of most "healthy" and sustainable bull markets is that you get broad participation (i.e. the majority of stocks are participating to the upside).

In contrast, aging bull markets tend to have increasingly narrow market leadership. For example, at the peak of the technology bubble in March of 2000, the top six stocks in the Standard & Poor's 500 Index had accounted for all of the index's gain that year. At that same time, six technology companies had accounted for 55% of the S&P's huge gains made over the twelve-month period leading up to the peak.



This year, market breadth is the poorest in more than fifteen years, with two sectors (healthcare and retail) accounting for more than 100% of this year's modest gains. Moreover, only six companies (Amazon, Google, Apple, Facebook, Netflix, and Gilead Sciences) have accounted more than half of the value added to the NASDAQ Composite Index this year, and Amazon, Google, Apple, Facebook, Gilead and Walt Disney account for more than 100% of this year's gains in the S&P 500.

Indeed, despite being the top-performing domestic equity index this year, the NASDAQ actually has a negative "advance-decline line" (more stocks are down than are up). This phenomenon is normally associated with the later stages of bull markets. This is particularly noteworthy when you consider that the U.S. markets have not experienced a 10% or greater decline (a "correction") in almost 1,400 days (the third longest period in the history of the domestic equity markets). To put this into some perspective, according to Bloomberg, since 1927, equity markets have experienced, on average, a correction of at least 10% every eight months (approximately 244 days).

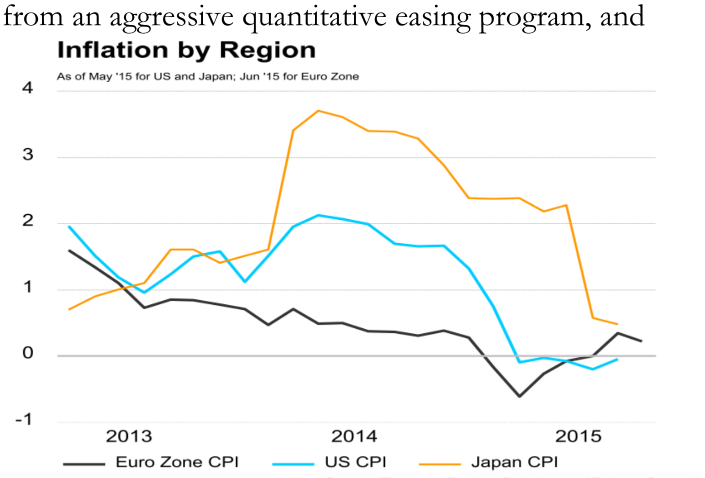
Despite this worrisome condition, these are not normal times, and the ongoing role of the central banks may allow the U.S. bull market to continue to defy the averages and last much longer than most expect. Indeed, we expect for domestic equities to remain as one of the better-performing asset classes over the intermediate term. However, we do believe that we are very over-due for a correction of 10% or so, and that the catalyst for such a decline may be the first tightening move by the Federal Reserve (particularly if the markets continue to ignore the Fed's guidance). Importantly, we would expect for such an event to be "healthy" for the markets, and would likely extend the life of this bull market.

In regard to the other major markets, we will reiterate our caution regarding the bond markets, which we have addressed at great length in recent writings. Our perspective was just reinforced by former Federal Reserve Chairman Alan Greenspan, who said in a 7/29/15 interview on CNBC that, "What we have now is tantamount to a bond bubble."

Emerging markets (both debt and equity) are another likely casualty of higher U.S. interest rates, as higher rates should increase the value of the dollar and depress commodity prices (both of which are very harmful to most emerging market economies). On top of that, three of the four biggest emerging market economies (China, Russia, and Brazil) are each in the midst of their own severe financial challenges.

In contrast, European equity markets (the EMU) remain quite intriguing. The European Central Bank is engaged in an aggressive quantitative easing program, average year-over-year earnings growth is an impressive 15%, 55% of European companies are exceeding earnings expectations, and Europe has an undervalued currency, which provides it with a significant competitive advantage in the export markets.

Japanese markets are also benefiting from an aggressive quantitative easing program, and Japanese pension plans, which average equity allocations of less than 25%, are moving significant sums into the Japanese equity markets. Even the government itself is actively buying Japanese shares, in the hope that they can help replicate the results that the Federal Reserve achieved in the United States through its quantitative easing programs.



We are seeing hopeful signs of recovery through much of Europe, Japan, and the U.S., which should ultimately be sustainable enough to allow all of the major central banks (starting with the U.S. Federal Reserve and the Bank of England) to start to normalize global monetary policy, which would allow prices to once again be set by free markets rather than central banks. However, in the meantime, with global central banks already owning over $22 trillion of financial assets (the size of the entire U.S. economy is only $17.7 trillion), it is still the central banks that hold all of the cards…something to consider with the Fed apparently on the verge of raising interest rates for the first time in almost a decade.