KAM COMMENTS

KRUSE ASSET MANAGEMENT, LLC

BREXIT SCHMEXIT

It was just a few weeks ago and we were all aflutter with "BREXIT" talk. There was all this uncertainly in the markets: How will it affect the EU, the US, the world trade? Pundits were on the TV shouting "it's a catastrophe!" but Kruse Asset Management was quick to point out that, just like in most media driven storms, this is a short-term emotionally charged topic that shouldn't affect our long-term planning and market outlook.

As it turned out, the market uncertainty lasted all of two days and then the S&P 500 immediately rebounded to within a few points of the pre-Brexit date (and 14.75% higher than the Feb. 11th lows when the markets were concerned about China — See chart to the right).

Now just a few weeks later the S&P 500 has hit all-time highs. Is this a fake-out or is there some merit to these levels?

While it is true that compared to historic multiples, the markets in general are slightly higher than average, they are by no means at lofty levels, and analyst estimates suggest higher future earnings, which would bring those multiples in line fairly quickly. Additionally, the stock markets are still rebounding from '09 lows and historically markets just don't stop at "fair value," but generally overshoot to the up and down side (depending on the current direction, which is current up), so it wouldn't be unprecedented that the markets continue to move higher until they reach more lofty levels.

Finally, market PE ratios being around 16.5, lower oil prices (which are unmistakably simulative to our economy) and interest rates moving up from a low starting point, all point to robust future S&P 500 performance, which could easily average double-digits over the next five years.

This in no way suggests we will not have down years, because they **will** happen. And we might have an economic recession along the way (since we haven't faced one for more than seven years); however, the long-term risk reward profile for the equity markets point to an over-allocation in KAM's models.

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Did you know?

* Current forward P/E ratio of the S&P 500 is 16.6x (25-year average is 15.9x)
* We are 84 months into current expansion (4th longest since 1900 and almost twice the average.)
* Housing starts are still not back to 20-year average levels.
* Congressional approval rating is at lowest point since 1949.

KRUSE ASSET MANAGEMENT, LLC

216 S Jefferson St., Suite 302
Chicago, IL 60661

Phone: 312-775-6000
Fax: 312-264-4557
www.KruseAssetManagement.com

Principles that Outperform!

J. Stuart Kruse, CFA
Alvin Medina

OIL PRICING

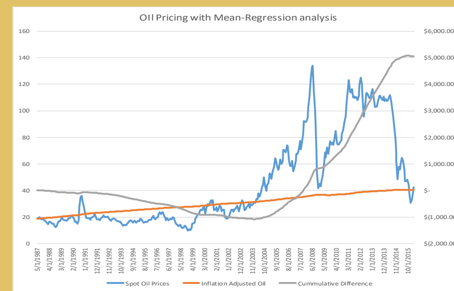
There is a theory called "regression to the mean," which loosely interpreted means that most things tend to get pulled back towards the average.

For example, if your store tends to get 100 customers a day, but for three days in a row you get closer to 150 customers, either something had changed or you're going to get days where you might only get 50 customers.

It might be easy to point to exterior forces as to why you're now getting 150 customers instead of 100 (like good weather is driving more traffic or another store closed nearby, etc.) Perhaps there is now a "new normal." However, it has been said that the most expensive words on Wall Street are, "It is different this time…," suggesting that much more often than not, it is **not *really*** different at all. Nothing has changed and you will likely be experiencing slower days too.

Most people are familiar with the "regression to the mean" concept, but somewhat less well known, but equally as powerful, is a concept that suggests the amount spent above an average, must eventually be equal to the amount spent below the average (otherwise there is not actually a mean regression happening.) This "amount" can be represented by an area on a graph.

So if we apply this to oil pricing, to help us figure out where we think oil might be long-term, we might look to see what the inflation-adjusted price of oil has been over several decades, calculate how much time we've spent above the average to help us understand how much we might spend below the average in the future.



The blue line is "spot oil" pricing, the orange is inflation adjusted oil and the grey line is the cumulative weighted average time spent above vs. below the orange line.

As can be seen by the chart, we have recently spent quite a bit of time above the orange line and if theory holds, we'll need to allow time for oil to "catch-up" below the orange line.

We're not suggesting that nothing has changed with respect to supply and demand of oil, proven reserves, technological advancements, alternative energy, etc. However, keeping in mind that it often justified why it is different this time only to find out it is not later, KAM would propose that relatively lower oil prices are here to stay for a while.

Lower oil prices have always been a long-term stimulus to the U.S. and the global economy in the past, which is one more reason we believe in the long-term risk/reward profile of equities.

— J. Stuart Kruse, CFA