ESTATE COUNSELORS, LLC

ASSET MANAGEMENT

Monthly Market Risk Report

For the Month of November 2014

Contact Us

- Our Website: www.estatecounselors.com
- Our E-mail: firm@estatecounselors.com
- Our Phone Number: (262) 238-6996
- Our Address: 414 N. Main Street Thiensville, WI 53092

Estate Counselors, LLC monitors a number of forward looking economic indicators in an effort to identify when the risks of a market bubble or adverse economic conditions are increasing. If those indicators suggest there is an unusually high risk that a market bubble has formed or that a recession is on the horizon, then we may recommend to our clients that they consider investing in option contracts that are intended to increase in value should either a bubble pop or a recession take hold.

The following is a list of indexes tracked by Estate Counselors, LLC and their current forecast. Based on the foregoing it appears that:

Economic Risk is **LOW**

Market Risk is **ELEVATED**

Hidden Markov Model (HMM) indicates that the equity markets are currently in a **BULL MARKET** trend

At this time we continue to believe that the equity markets may be somewhat overvalued. However, economic indicators continue to suggest the economy is growing and the risk of a recession remains low. Additionally, lower gasoline prices and an improving jobs market have lifted consumer confidence going into the holiday season. As a result, we are not recommending any new hedging measures in our client accounts.

A. ECONOMIC INDICATORS

1. **Capital Spectator's U.S. Economic Trend Index (ETI).** ETI is a diffusion index that measures the percentage of 14 leading and coincident indicators that are trending positive for economic growth. More specifically, a diffusion index represents the percentage of the variables that are positive. Accordingly, if all of the indexes included in ETI were positive, the value of the ETI index would be 1.0 or 100%. If 7 of the 14 variables were positive, the value of the ETI index would be 0.50 or 50%.

This index is typically released mid-month based on data for the prior month. As of November 20th, the ETI index reading was 100.0%. Higher readings equate with more indicators signaling that the economy is expanding; lower readings imply a weaker economy, with levels below 50% signaling a high probability that a recession has started. ETI again edged up from the prior month and the current reading remains well above the danger zone that would indicate a high probability of a recession beginning.

One month ago: 97.6%
Two months ago: 92.7%

2. **Capital Spectator's U.S. Economic Momentum Index (EMI**). EMI is the monthly median percentage change for the 14 indicators that comprise the ETI. ETI is based on the median rather than the average (i.e., the mean) of these indexes because the mean is subject to outlier numbers, which can mislead us as to the true average. The median, by contrast, is immune to extremes because it reflects the middle point for a batch of numbers.

As in the case with the ETI, this index is typically released mid-month based on data for the prior month. As of November 20th, the EMI index reading decreased from the previous month to 11.4%. Near zero and below zero readings are indicative of recessions, usually with a slight lead time relative to the start dates, as determined by the National Bureau of Economic Research. Therefore, by this measure, the probability of a recession remains low.

One month ago: 10.3%
Two months ago: 11.3%

3. **Capital Spectator's Macro-Markets Risk Index (MMRI).** MMRI measures the daily median change of U.S. stock, bond, and oil prices. Because this information is available in real time, with continuous updates, prices have an edge over conventional economic statistics, which are published with a lag of a month or more. In addition, unlike published indexes, the market data on which MMRI is based is not adjusted. Accordingly MMRI is intended for use as a supplement for developing perspective on the current month's economic profile until a complete data set is published.

If MMRI falls under 0%, that would suggest that recession risk is elevated. By contrast, readings above 0% imply that the markets are anticipating/forecasting economic growth. As of November 10th, the MMRI index reading is 8.2%. MMRI has rebounded slightly from the October reading and indicates that the economy is expanding and is above the level that would suggest a recession is imminent.

One month ago: 7.9%
Two months ago: 13.2%

B. MARKET VALUATION INDICATORS

1. **Bullish Percent Index (BPI).** BPI is a popular market breadth indicator that is calculated by dividing the number of stocks in a given group (an exchange, an industry, etc.) that are currently trading with Point and Figure buy signals, by the total number of stocks in that group. For example, if 2,100 stocks signal buy and 700 signal sell, the value of the NYSE Bullish Percent Index is 75.

As of November 21st, the BPI for the NYSE index is 59.89%. When the percentage of bullish stocks within a particular index is 70% or higher, the index is considered to be overvalued. When the index is below 30, it is considered to be oversold. The BPI rebounded considerably since October and it is now above its 200 day moving average but below its 50 day moving average. The index come down considerably since the summer months and it suggests that equities are currently fairly valued.

One month ago: 44.61%
Two months ago: 64.63%

2. **CAPE Ratio.** CAPE is a modified form of the PE ratio of the S&P 500 as determined by Robert Schiller. CAPE is simply the S&P 500 index's current price divided by the 10 year average of trailing earnings, adjusted for inflation. A high CAPE reading may be evidence that stock prices are inflated. The long term average of this ratio is 16.6, while its historical high is 44.2.

	Cape on 11/20/14	Median	Mean	High	Above Average	Neutral	Low
Cape	26.50	20.52	16.60	25.1+	22.5-25	17.5-22.4	<17.4

The CAPE ratio suggests that stock prices remain inflated, as they have been for the past several months.

One month ago: 25.80
Two months ago: 26.40

3. **Total Market Cap of the U.S. Stock Market to GDP.** This statistic is an indicator of whether the stock market is fairly valued. It compares how much money is invested in the market relative to GDP, which is closely tied to corporate profits. A high reading would be an indication that equity prices are inflated.

	Market Cap to GDP on 11-20-14	Median	Mean	High	Above Average	Neutral	Low
Market Cap to GDP %	126.5%	68.83	75.89%	115+	90.1%-115%	50.1%-90%	<50%

The Total Market Cap to GDP ratio has increased since last month, and this measure continues to suggest that U.S. stocks are significantly overvalued. The ratio is registering at a 2014 high. It should be noted, however, that this metric compares current market conditions to historical GDP, which is itself a lagging indicator.

One month ago: 121.6%
Two months ago: 124.2%

4. **Tobin's Q.** This statistic is calculated by dividing Total Market Value (as represented by the Wilshire 5000) by the Total Asset Value. A low Q (between 0 and 1) means the cost of the assets of companies included in the Wilshire 5000 is greater than the combined value of their stock. In that event the stock market is undervalued. Conversely, a high Q (greater than 1) implies that the stock price of all Wilshire 5000 companies exceeds the replacement cost of the assets of those companies. A Tobin's Q that significantly exceeds its historic average of 0.68% is a potential indicator of an equity market bubble.

	Tobins Q on	Median	Mean	High	Above Average	Neutral	Low
Tobin's Q	1.12%	0.76	0.68	0.90+	0.75-0.90	0.65-0.70	<0.65

Tobin's Q is has receded slightly since last month, but still suggests that stock prices remain elevated.

One month ago:	1.15%
Two months ago:	1.15%

5. **S&P Earnings Yield.** This statistic is the inverse of the S&P 500's P/E ratio (trailing 12 month earnings divided by index price). It can be used to compare equity valuations with the yield on bonds. If the S&P earning's yield is higher than the yield on high yield bonds, then that is an indication that stocks represent a better value than their closest fixed-income equivalent.

As of November 21st, the S&P 500 yield is 4.99% while the yield on high yield bonds is 5.83%. This amounts to a spread of +0.84%. Therefore by this measure, stocks continue to appear over-valued relative to high-yield bonds.

	S&P	Bonds	Spread
One month ago:	5.23%	5.89%	+0.66%
Two months ago:	5.05%	5.76%	+0.71%

C. Hidden Markov Model (HMM)

A Hidden Markov Model is an econometric tool for representing probability distributions over sequences of observations. It measures the probability of a bull or bear market. It uses trailing S&P 500 1 year returns (calculated monthly) and the previous month's probability of a bull market as inputs and then generates the current probability of a bull or bear market as an output. HMM outputs above 75% indicate a high probability of a current bull market. If the HMM output is below 25%, it is an indicator of a high probability of a bear market. As of November 20th, the HMM output is 94.46%. By this measure, there is a high probability that stocks will remain in a bull market.

One month ago:	93.7%
Two months ago:	95.2%

END NOTES

- The latest ETI reading can be found at http://www.capitalspectator.com/.
- The latest EMI reading can also be found at http://www.capitalspectator.com/.
- The latest MMRI reading can also be found at http://www.capitalspectator.com/.
- A reading of the bullish percent index for the NYSE can be found at http://stockcharts.com/h-sc/ui using the symbol $BPNYA.
- The most recent CAPE reading can be found at http://ycharts.com/indicators/pe10.
- A current reading of total market cap to GDP can be found at http://www.gurufocus.com/stock-market-valuations.php.
- Tobins Q can be found at http://www.advisorperspectives.com/dshort/updates/Q-Ratio-and-Market-Valuation.php.
- The current S&P earnings yield can be found at http://www.multpl.com/s-p-500-earnings-yield.

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