ESTATE COUNSELORS, LLC

ASSET MANAGEMENT

Monthly Market Risk Report

For the Month of March 2015

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 data below 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

In January, we implemented a calendar put spread in larger client accounts with less conservative investment objectives. This spread was implemented on the S&P 500 ETF (SPY) and consists of long December 200 puts and an equal number of short June 175 puts. The number of contracts in each account was at the time determined to provide insurance to protect each account's broad equity index holdings (large caps, mid caps, and small caps) against a market correction of approximately 10%, at which point the downside protection would be capped by the short position.

If the equity markets continue to move higher and the unrealized profit on the short June 175 puts nears the maximum potential profit with a good deal of time before their expiration, we will buy back the position and realize the gain and allow the long position to continue providing downside protection. We will also evaluate selling a longer-dated short put leg to continue spreading the hedge risk and further reducing the cost of the hedge.

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We are monitoring the profit/loss of each leg of this hedge on a daily basis. Meanwhile, domestic economic indicators continue to suggest economic growth will continue, although it should be noted that growth appears to have softened recently. U.S. equity prices, however, continue to remain somewhat inflated as indicated by several valuation measures. At the same time, uncertainty lingers in the markets as participants attempt to anticipate the timing and consequence of an interest rate hike by the Federal Reserve. As a result, we intend to leave the hedge mentioned above in place, but no new equity hedging measures are being recommended for our clients' accounts at this time.

We have, however, also hedged exposure to the interest rate risk of U.S. Treasuries (PLW) in more conservative accounts by selling those positions and writing puts 5% below the market on the 20+ Year Treasury ETF (TLT) to cover the original allocation. (The two ETFs have a 98% correlation and there is no options market for PLW.) The premium received from the short puts annualized to nearly double the yield of the underlying position, and if rates go up enough to push the underlying in the money, we will be repurchasing the position at a cheaper price than it was sold. Since this hedge was implemented, interest rates have moved slightly higher. As a result, we have avoided the depreciation in the price of PLW and at the same time have an unrealized gain on the short put position, which is currently out of the money. This position will be closed or expired before the release of next month's Market Risk Report, although we may roll the hedge further out in time.

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 March 18th, the ETI index reading was 92.9%. 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 is unchanged from the prior month, and the reading remains well above the danger zone that would indicate a high probability of a recession beginning.

   One month ago: 92.9%
   Two months ago: 95.2%

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. EMI 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 is the case with the ETI, this index is typically released mid-month based on data for the prior month. As of March 18th, the EMI index reading increased slightly to 7.9%. 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. This is the first increase in 4 months and EMI continues to indicate that the probability of a recession remains low.

One month ago: 7.8%
Two months ago: 9.8%

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 March 9th, the MMRI index reading is 6.8%. MMRI has modestly receded since the February reading, but it is still a strong reading and continues to indicate that the economy is expanding and remains above the level that would suggest a recession is imminent.

One month ago: 7.9%
Two months ago: 7.2%

4. **Chicago Fed National Activity Index (CFNAI).** The CFNAI is a weighted average of 85 existing monthly national economic indicators. It is constructed to have an average value of zero and a standard deviation of one. Since economic activity tends toward trend growth over time, a positive reading corresponds to growth above trend and a negative reading corresponds to growth below trend. Research has found that the CFNAI provides a useful gauge on current and future economic activity and inflation in the U.S. The index's three month moving average provides a more consistent picture of national economic growth and is therefore used by Estate Counselors, LLC instead of the volatile monthly numbers.

When the three month moving average moves below -0.70 following a period of economic expansion, there is an increasing likelihood that a recession has begun. Conversely, when the three month moving average is above 0.70 after a period of economic contraction, there is an increasing likelihood that a recession has ended. The three-month moving average for the month of February registered -0.08. By this measure, economic activity has been slowing in recent months and is now running below its trend line, although at this point the trend does not indicate that a recession is likely.

One month ago:	0.13
Two months ago:	0.39

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 March 24th, the BPI for the NYSE index is 62.55%. 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, stocks are considered to be oversold. The BPI moved slightly lower since last month's reading and it is still above both its 50-day and 200-day moving average. The index suggests that equities are currently trading in a fairly valued range.

One month ago:	64.90%
Two months ago:	55.44%

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 16.59, while its historical high is 44.2.

	Cape on 3/24/15	Median	Mean	High	Above Average	Neutral	Low
Cape	27.77	15.95	16.59	25.1+	22.5-25	17.5-22.4	<17.4

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

One month ago: 27.20
Two months ago: 26.77

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 3-24-15	Median	Mean	High	Above Average	Neutral	Low
Market Cap to GDP %	125.9%	68.83	75.89%	115+	90.1%-115%	50.1%-90%	<50%

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

One month ago: 126.6%
Two months ago: 121.8%

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 3/12/15	Median	Mean	High	Above Average	Neutral	Low
Tobin's Q	1.13%	0.76	0.68	0.90+	0.75-0.90	0.65-0.70	<0.65

Tobin's Q has increased since last month, and it continues to suggest that stock prices are overvalued.

One month ago:	1.11
Two months ago:	1.14

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 March 24th, the S&P 500 earnings yield is 5.04% while the yield on high yield bonds is 5.79%. This amounts to a spread of +0.75%. Stock yields have increased slightly over the past month while bond yields decreased, and the spread between stocks and high yield bonds has narrowed. By this measure, high yield bonds valuations have increased relative to stocks, however stocks remain overvalued when compared to high yield bonds.

	S&P	Bonds	Spread
One month ago:	5.01%	5.96%	+0.95%
Two months ago:	5.23%	5.99%	+0.76%

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 March 23rd, the HMM output is 93.88%. The probability that stocks will remain in a bull market has increased since last month and continues to indicate that the probability that stocks will remain in a bull market is high.

One month ago:	93.17%
Two months ago:	94.22%

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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