Demming Financial Services Corp.

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3rd Quarter Newsletter

Summer 2015

Special Notes…

Happy Summer!

As a friendly reminder, for your protection, it is now our policy that any requests for funds sent to us via email will be confirmed by phone.

Also, if any important changes are made to your contact information such as address, phone number or email address please be sure to let us know.

Check out our new website at www.demmingfinancial.com!

The Bears Invade Shanghai

Article Courtesy of Bob Veres

With all eyes on Greece, a bigger and potentially more disturbing market disruption is taking place—in a much larger economy. As you read this, the Chinese stock market is experiencing the kind of free-fall not seen since the 2008 drop in global markets. Some are comparing it to the 1929 crash in U.S. stocks.

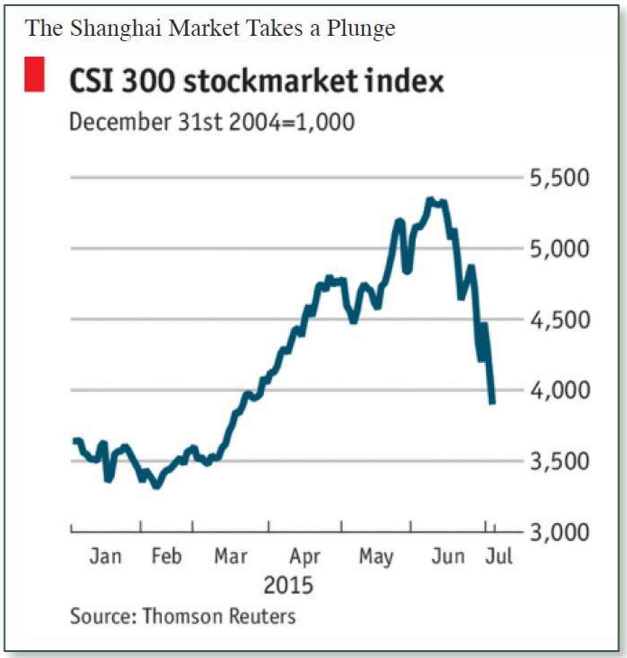
As you can see from the chart located on the following page, the fall has been fairly dramatic, even if it has not yet taken share prices on the Shanghai Composite Index below where they were previous to a perilous bull run that began in February. The fall has apparently alarmed the Chinese government, which has authorized extraordinary interventions. Among them: twenty one Chinese brokerage firms have agreed to invest the equivalent of $19 billion in stocks, in an effort to create more demand. The stock exchanges suspended initial public offerings so as not to put any more shares on the market. The Chinese central bank has cut its benchmark lending and interest rates. And the government itself, through its pension system, has now been authorized to play the market.

Perhaps the most ominous intervention, however, came when China's market regulator decided that brokers should not force people who have bought stocks on margin to engage in forced selling in order to cover their debts. Instead, the brokers were told to extend additional margin loans that would be collateralized by investors' homes. If the market continues to plunge, observers wonder, how will investors (or banks) liquidate those houses? Is it wise to spread the risk from the stock sector to real estate valuations?

Fortunately, none of this is likely to directly affect the portfolios of American investors…

The brokerage pledge to buy shares is reminiscent of 1929 Wall Street, when the great banking houses of J.P. Morgan and Guarantee Trust Company committed their resources to propping up the U.S. stock market. That experiment was not a notable success; the Dow Jones Industrial Average fell 13% the following Monday and dropped another 34% over the next three weeks. The Chinese intervention fund, led by Citic Securities Co. and Guotai Junan Securities Co., faces a similar uphill battle; the war chest represents only one-fifth of the Chinese market's daily trading volume.

So far, Chinese investors have lost $2.7 trillion of stock value—the equivalent of six times Greece's entire foreign debt. Much of the pain has been borne by individuals, who own four-fifths of China's stocks,



far more than in Western markets where institutional investors are the dominant owners. Many of these common folk borrowed money to buy their shares, contributing to a nine-fold increase in margin lending by brokerage firms over the past two years. This dramatic rise in speculative investing has echoes both in the run-up to 1929 and 2008, two periods when reckless betters (individuals in the earlier era, Wall Street in the latter) were able to borrow 90% of the money they "invested."

Moreover, the margin loans carry annual interest rates as high as 20%. Total margin debt, when you add up the brokerage firms, banks and informal loans, could amount to as much as $1 trillion. As share prices fall, investors would be left with far less in stock value than the high-interest loans they owe—making repayment problematic, potentially putting $1 trillion worth of stress on the Chinese banking system.

It gets worse. Many smaller Chinese companies have financed their expansion by taking out loans against the value of their shares. The companies have had to post additional collateral as the share value dropped down to the outstanding balance on the loan. Additional market losses could put these companies in real danger of default, adding to the stress.

Nobody knows if the free-fall will continue to feed on itself, or if the government will somehow manage to slow the descent. But highly-leveraged investing on a mass scale seldom ends well, as most of us remember from the subprime crisis when we had to reach into our pockets to make Wall Street whole again on its disastrous speculations.

Fortunately, none of this is likely to directly affect the portfolios of American investors, since foreigners account for only about 4% of the Chinese stock market. But as the crisis deepens, and especially if the defaults start to mount, companies go under and the banks stop lending into the economy, you could see commodity prices fall on weaker demand, and there could be a hit to large American companies that do a lot of business in the Asian markets. And it could be a long time before individual Chinese investors trust the stock market again.

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The Doctor On Your Wrist

Article Courtesy of Bob Veres

Chances are you think that medical costs are going to bankrupt America, and if we assume that Medicare and Medicaid costs will rise as they have for the past 20 years (despite the brief interlude these last three years), then there is reason for alarm. But ask yourself: how much of those costs are related to expensive diagnostic tests? How much are related to fixing major health problems after the fact, when they could have been prevented if we had only known where to look at what lifestyle changes to make?

What the bean counters are missing when they simply project ever-larger expenditures based on past experience is the enormous impact that wearable diagnostics are going to have on healthcare in general. You already know about Fitbit, which helps you get in shape by tracking the number of steps you take each day and week, and now also tracks heart rate, calories burned and stairs climbed. More recent innovations are the Sensoria smart sock, which diagnoses your running stride and can reliably identify a runner's rookie mistake of heel striking. If you've gone to a hospital to evaluate your endurance, well, you could have used the PerformTech heart-rate monitor, which calculates your endurance simply from five minutes on a stair-stepper.

Not getting enough sleep? Or the right kind of sleep? The Withing's Aura bed pad will diagnose the quality of your REM cycle. An app by Sleeprate will tell you when you have restless cycles. And if you're one of those people who has trouble getting into meditation, you might try the Muse headband, which contains an EEG device that measures brainwaves, and helps coach you into a state of meditative peace. It also tracks your meditative progress over time.

> *Chances are you think that medical costs are going to bankrupt America…*

Wouldn't it be nice if all of these devices were included in the same device? As you read this, ten different companies from around the world are competing for an X Prize that will be given to the first "tricorder," the device from Star Trek that was used to diagnose the damage to crew members after a rough battle with the Klingons. The winner of the Tricorder X Prize will be able to monitor your body temperature, oxygen levels and heart rate, tell if you're anemic, check your blood pressure and perform a constant EEG. It will diagnose common maladies like stroke and less common ones, like tuberculosis.

Meanwhile, if you saw the episodes of Jeopardy where a computer named Watson cleaned up the board, well, you saw the next major diagnostic engine. At this moment, Watson is busy absorbing all the medical literature, and is helping real doctors make proper diagnoses and offer remedies. IBM, the maker of Watson, expects to put the program in the Cloud, where it will be accessible to, among other things, mobile devices.

The combination of the next generation of wearable diagnostics uploading data to Watson for instant analysis will allow all of us to have our health monitored constantly in real time—by affordable devices that are as sensitive as the expensive hospital equipment that currently hits the global healthcare budget so hard. When you begin to have a problem, the wearable device will schedule a medical exam. If you start to experience the early stages of a heart attack or stroke, the ambulance will arrive at your door—before you realize you have a problem. The treatments will be much less expensive, because the problems will be caught in the very early stages.

How many billions of dollars will this save? The bean counters who draw the alarming graphs haven't even started to realize that they're living in the middle of a health care revolution. But now *you* do.

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2015 Second Quarter Report: Sound and Fury

Dear Clients,

For all the drama we've experienced in the past few months, the second quarter of the New Year has brought us slightly positive returns in many of the U.S. and global indices, and disturbing but ultimately not harmful news in Europe, China and Puerto Rico.

The Wilshire 5000--the broadest measure of U.S. stocks and bonds—was up a meager 0.06% for the second three months of 2015, posting a total return of 1.77% in the first half of the year.

The Wilshire U.S. Large Cap index gained 0.11% for the quarter, and is now up 1.38% for 2015. The widely-quoted S&P 500 index of large company stocks posted a loss of 0.01% in the second quarter, and now stands up a sliver at 0.20% after the first half of the year. However, the month of June is notable because the index declined more than 2%--the worst performance since January, and the quarterly loss snaps a nine-quarter winning streak.

The Wilshire U.S. Mid-Cap index lost 1.20% for the quarter, but is still up a comfortable 4.50% as we head into the third quarter.

Small company stocks, as measured by the Wilshire U.S. Small-Cap index, gave investors a 0.46% loss during the latest three months, but the index is up 4.03% so far in 2015. The technology-heavy Nasdaq Composite Index gained 1.37% for the quarter, and stands at a 4.70% gain for the first half of the year.

Meanwhile, in the global markets, the broad-based EAFE index of companies in developed foreign economies lost 0.37% in dollar terms in the second quarter of the year, but has posted a 3.81% gain for the year. In aggregate, European stocks lost 0.91%, although they are still up 1.91% for the year. Emerging markets stocks of less developed countries, as represented by the EAFE EM index, were down 0.24% for the quarter, but are up 1.67% for the year.

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Looking over the other investment categories, real estate investments, as measured by the Wilshire U.S. REIT index, fell 9.93% for the second quarter, wiping out modest first quarter gains and bringing the index to a 5.73% loss for the year. Commodities, as measured by the S&P GSCI index, gained 6.49% in the second quarter, but are still down 2.26% this year.

For the second consecutive quarter, investors experienced a mild roller coaster of up and down days in the U.S. and global markets, small panics and surprising rallies that ultimately cancelled each other out in what trading professionals refer to as a sideways market. For the second consecutive quarter, investors are looking over their shoulders at interest rates, waiting for the Federal Reserve Board to finally take its foot off of interest rates, for bond yields to jump higher, making bonds more competitive with stocks and triggering an outflow from the stock market that could (so the reasoning goes) cause a bear market in U.S. equities.

But of course investors have been waiting for this shoe to drop for the better part of three years, and meanwhile, interest rates have remained at historically low levels. The Bloomberg U.S. Corporate Bond Index now has an effective yield of 3.34%. 30-year Treasuries are yielding 3.13%, up from 2.90% in July 2014, and 10-year Treasuries currently yield 2.36%, down from 2.54% at this time last year. This looks remarkably low until you realize that of all the European nations, only Greece on the verge of default (with 14.56% effective yields on bonds sold on the secondary market) and Portugal (2.96% and shaky) are more generous. German 10-year bonds are paying 0.76% and Swiss bonds just 0.06%, making the (arguably) safer U.S. Treasuries look like a high-yield bargain.

At the low end, you need a microscope to see the yield on 3-month U.S. T-bills, at 0.01%. 6-month bills are only slightly more generous, at 0.11%. Your money earns almost as much when it sits under your mattress. Interestingly, 30-year municipal bonds are yielding 3.36% even though they're federally tax-exempt, which makes them extremely attractive to investors in higher tax brackets.

"CAN HE CALL YOU BACK? HE'S IN THE MIDDLE OF A SHOUTING MATCH WITH JIM CRAMER."

There is widespread speculation that the Fed will raise the Fed funds rate by 0.25% in September, which is sure to cause a mild panic among ordinary investors and quick-twitch traders, despite the fact that Federal Reserve chairperson Janet Yellen has all but tattooed on her forehead her intention to raise rates sometime this year—and finally put the nightmare of 2008 behind us. Behind that, you can expect a continuing churn in the markets caused by the uncertainty over whether Greece will leave the Eurozone and default on its debt—and wild (and almost certainly specious) speculation that maybe Spain, Portugal, Ireland, and even Italy will decide to follow suit. They won't, but the fact that some people will believe it's possible will send markets reeling for essentially no reason.

A potentially bigger problem for the U.S. investment markets is flying under the radar. The U.S. island territory of Puerto Rico, which has taken full advantage of its ability to issue municipal bonds that are federally tax-exempt in all 50 states, is dangerously close to defaulting on roughly $72 billion in bond debt—much of it held in broker-sold mutual funds that have paid higher-than-average interest rates over the past year or two. In aggregate, U.S. banks only hold about $14 billion of sovereign Greek debt, which is about 19% of what they and mutual funds own of Puerto Rican debt. This is yet another example of tempting interest rates coming at very high risk; some kind of a default is likely.

Why? Puerto Rico now owes its muni investors the equivalent of $20,000 for every man, woman and child living on the island. The debt is almost exactly equal to the entire GDP of the island territory

Another worry is China, whose Shanghai Composite Index has fallen 22% over a ten day period after a torrid 32% climb for much of the first half of the year. Analysts were visibly scratching their heads during the short, quick bull run, noting that corporate profits are actually lower than a year ago. The rally appears to have been fueled by an explosion in margin buying, which reached a record 8% of total market capitalization—a situation which often precedes a dramatic price collapse.

All of these interesting excesses and potential catastrophes are unlikely to affect the average person's diversified portfolio; only broker-sold funds are high investors in Puerto Rico, and some of them are now being sued. The Greek situation will lead to uncertainty and volatility, but not to long-term declines in the value of U.S. or even European stocks generally. China's market fall will be temporary, and seems only to be giving back speculative gains—which is probably a good thing for the underlying fundamentals.

Meanwhile, the jobs picture in the U.S. seems to be improving by the day, oil prices are still low, and America is in a path to energy independence, which would have seemed unthinkable just a few years ago. Yes, the U.S. stock markets are long overdue for a 10% correction, but if you know when that will happen—or even what year—then you have a better handle on the future than most senior economists.

It bears repeating: investors lose far more money in opportunity costs by trying to avoid future market downturns while the markets are still going up, than by holding their ground during actual downturns in anticipation of a recovery. In every case so far, including world wars, the threat of nuclear war, Presidential assassinations and terrorist attacks on U.S. soil, the U.S. market has eventually made up the ground it lost in every bear market we've experienced.

The scary news today is, in the long run, nothing more than white noise, a lot of sound and fury signifying nothing important to the long, slow process of companies and their employees building value with their daily work activities. People who listen to the alarmists tend to lose out on solid returns. You listen to the alarmists, or believe that your portfolio is at risk because of this or that scary headline, at your peril.

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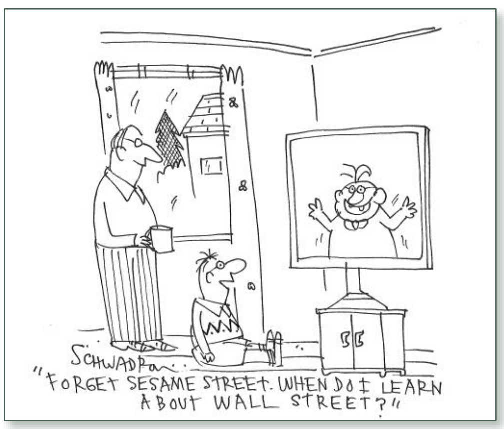

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Happy summer from all of us at Demming Financial Services Corp!