

Third Quarter 2016 Commentary

October 19, 2016

Dear Investor,

Since the beginning of the year I have written to you about Mr. Toad's Wild Ride and the sage words of Tweety Bird. This quarter as we near Election Day, I turn to the famous philosopher Linus Van Pelt for words of wisdom, "There are three things that I've learned never to discuss with people: religion, politics and the Great Pumpkin."

While I am not here to discuss politics, it has been at the forefront of everyone's mind recently. This election season has been an idiosyncratic one, to say the least. Whatever the outcome of the election, it will have a lasting impact on both our Economic and Fiscal policies going forward.

During the Third Quarter the Wild Ride seemed to smooth a bit, but we remain ready for any additional bumps ahead. Election years can add uncertainty to the market, and markets do not like uncertainty.

Both at home and abroad we are facing uncharted territory. Which is why it remains imperative to stay vigilant in the management of the portfolios. Below you will find my team's thoughts and analysis of the current market conditions and what we might expect going forward.

While you take to the polls next month, know that whatever happens with the election, we are here to steer the car safely through whatever the market throws our way.

Sincerely,



David Young, CFA
Chief Investment Officer

Market Commentary

- The International Monetary Fund (IMF) slashed its forecast for US GDP growth this year, from 2.2% to 1.6%, and trimmed estimates for next year's growth by 0.3 percentage points to 2.2% GDP.
- We forecast US 3Q annualized GDP growth at to below, the Federal Reserve's projection of 1.8% and 2.0% in 2016 and 2017, respectively.

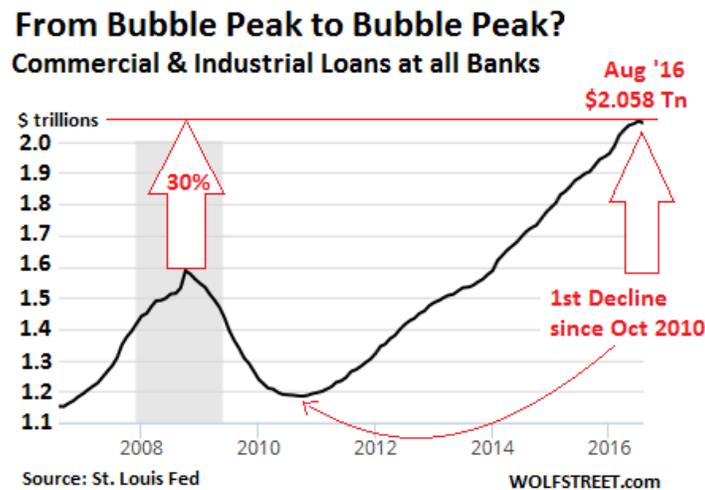


Graph Source: ZeroHedge
S&P 500 vs. Expected GDP Growth during 2016

- Nonfarm payrolls rose by 156,000 in September, down from a gain of 167,000 in August and the third consecutive slowdown in monthly job growth. The unemployment rate rose a tenth of a percentage point to 5.0% as more Americans rejoined the labor force.
- The British pound suffered a snap decline of more than 6 percent against the US dollar early on Friday October 7 before recovering most of its losses, a market event that was attributed as much to a computer glitch as it was to mounting concerns over the UK's exit from the EU.
- We can no longer rule out the prospect of a global recession given mounting concerns over Brexit fallout, the solvency of some European banks, negative interest rates, China's asset devaluations rising debt levels and a murky credit environment.
- The S&P 500 Index finished the quarter up 3.86, an advance of 0.02 for September.
- The yield on the benchmark 10-year U.S. Treasury bond continued to rise on a monthly basis, ending September at 1.60%.
- Driven largely by demand for commodities, the MSCI Emerging Market Index ended September at 1701.69, an increase of 5.8%.
- Annual inflation rates for G20 economies fell for a second straight month in August, dropping to 2.1% from July's 2.2% rate, the lowest rise in consumer prices since October 2009, despite the QE campaign mounted by central banks.

Economic

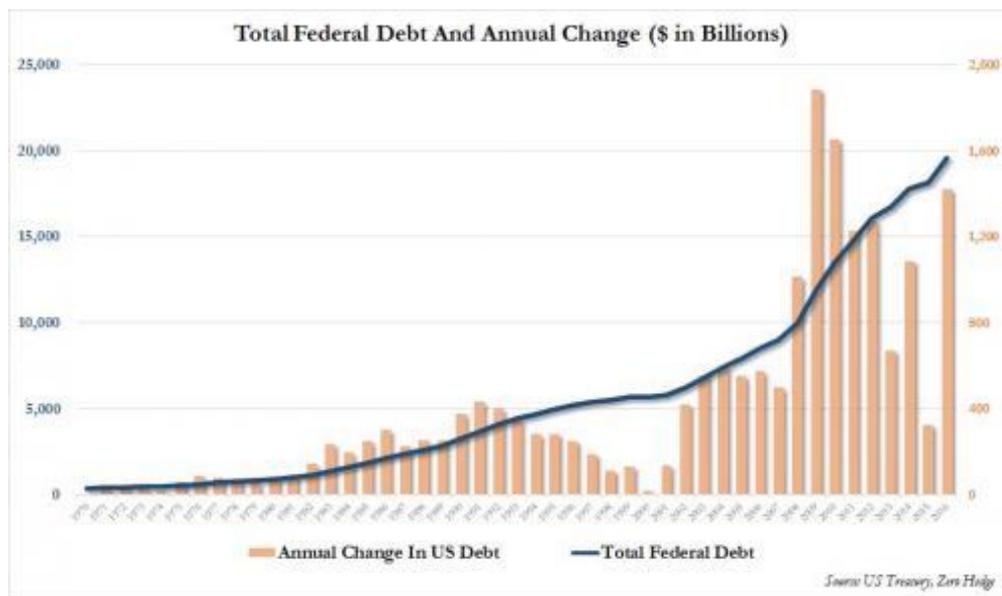
- The NY Federal Reserve in October cut its estimate for 3Q GDP growth to an annualized rate of 2.2%, down from the previous 2.8%, citing lackluster manufacturing and retail sales and housing and construction data. The 4Q16 estimate was also reduced to just 1.2%.
- The number of C+I loans generated in the U.S. during the 3Q slowed unexpectedly, a potential drag on the U.S. economy generally and the financial sector in particular.



- Personal expenditure rose 2.6% in August on a YOY basis while savings held steady during the same period at 5.7%.
- Bloomberg noted that consumer spending, while growing, may be too weak to sustain its role as the engine of overall growth.
- Factory activity expanded in September as the Institute for Supply Management's index increased to a better-than-expected 51.5, up from 49.4 in August.
- The ISM non-manufacturing index jumped to 57.1 from the prior month's 51.4 and expectations of 53.0 indicating some potential re-acceleration in activity levels as the fourth quarter was starting.
- Oil prices, which ended September trading in the sub-\$50-a-barrel range, continue to struggle under the weight of excess supply and relatively weak demand. Both the International Energy Agency and US Energy Information Agency issued reports in September that forecast depressed prices for the foreseeable future.
- Gold and silver prices ended September on the low end of a three-month trading range after bullish US factory-order data sent the US dollar index up nearly 0.20 percent re-igniting interest rate increase fears.
- U.S. Construction spending fell 0.7% in August despite analysts' projections for a 0.2% increase and housing starts fell beyond expectations, by 5.8%, following two straight months of strong performances in both categories. However, a rebound in permits for single-family dwellings signaled continued hopes for strong demand for new housing.
- Business inventories in July remained unchanged from the June MoM increase of 0.2% despite market expectations of an 0.01% increase. Inventories continue to be high for

current sales trends and are expected to pressure future economic activity as they should be reduced to appropriate levels.

- Retail sales retreated in August by 0.3% on a monthly basis but rose by nearly 2% compared to year-ago figures - still the weakest YoY rise since sales plunged in the spring.
- The U.S. cost of living in August advanced by 1.1%, up from the previous month's 0.8%. Meanwhile, Core CPI, which excludes volatile energy and food prices and is regarded by the Fed as a key inflation indicator, rose 1.7 compared with July's 1.6%. This Core CPI increase stoked expectations of a looming interest rate increase.
- FedEx, which by the nature of its business offers valuable insight regarding economic activity, forecast in its earnings release that the US economy will grow by 1.6% for calendar 2016, 10 bps below its estimate 90 days earlier, and 2.3% in 2017. It estimated global GDP would expand at 2.2% - down 20 bps - and 2.7% percent during the same periods.
- The U.S. federal debt level grew by \$151.5 billion in August, on course to reach \$1.36 trillion for the fiscal year that ended September 30, its third-biggest annual increase on record.



Fixed Income

- Sustained low interest rates and surging shareholder rewards have fanned corporate debt to record high levels, according to a recent Standard & Poor's report, as the median debt-to-EBITDA ratio has reached its highest ratio in a decade.
- Bloomberg reported that the total face value of negative-yielding corporate and sovereign debt in the Bloomberg Barclays Global Aggregate Index of investment-grade bonds jumped to \$11.6 trillion as of September 30, up 6.1% from a month earlier.
- The Barclays U.S. Aggregate Bond Index returned 0.46% in the third quarter.

- Traditional holders of US government debt like China and Japan have reduced their holdings of U.S. Treasuries for three consecutive quarters, the most sustained pullback on record, according to recent Federal Reserve data. The decline has accelerated in the past three months, coinciding with the recent backup in U.S. bond yields.
- U.S. Treasury bonds as of September 30 had yields of 0.77%, 1.60%, and 2.32% for the 2, 10, and 30-year bonds, respectively. These yields increased from 0.58%, 1.46% and 2.28% at the end of the June quarter as market participants focused more on the possible Federal Reserve actions. The S&P 500 dividend yield was estimated at 2.06% as of 9/30/16 vs. 2.13% at 6/30/16 and 2.19% at 9/30/2015.
- U.S. bond spreads tightened in the quarter driven by continued customer yield demand and the increase in Treasury yields. The “B” bond spread ended the quarter at 502 basis points vs. 538 at June 30th. The “BB” rated bond ended at a spread of 323 basis points vs. 338 at the start of the quarter. The 20 year median for both sectors is 524 bps and 342 bps, respectively, meaning current spreads are not far from historical levels.

Equity

- Share prices finished strong for the second consecutive quarter as the S&P 500 finished the three-month period ending September up 3.86% and the Russell 2000 gained 8.83%.
- Stock buyback announcements by U.S. companies sank to \$115.0 billion in the third quarter, the lowest level in nine quarters, according to TrimTabs Investment Research increasing concerns about support for equity prices as buybacks have been an important source of demand for several years.
- According to a Cantor Fitzgerald study, only 68% of companies have reported EPS above mean EPS estimates, below the 1-year average of 70% and in line with the 5-year average of 68%. The study concludes that these companies are barely beating already depressed EPS expectations.
- Bloomberg reported that S&P 500 Index companies would have to increase profits by 13 percent in order to redeem next year's consensus analyst forecasts, which hasn't happened in the last four years. Otherwise valuation multiples – already at their highest levels since the financial crises – could climb to 20 times annual income.
- A lack of breadth could be the S&P 500's Achilles's Heal, according to Bloomberg, which last month reported a plunge in 52-week highs among its constituents, a condition that has preceded past corrections.

International & Emerging Markets

- The World Trade Organization announced global trade volumes are set to grow by just 1.7% this year - the first time in 15 years that international commerce has grown more slowly than the global economy.

- The World Bank cut its estimate for Japanese GDP growth for the year to 0.5%, down a full 100 basis points from its previous forecast, while leaving unchanged its 6.7% growth projections for China.
- Citing the negative impact of the Brexit, the International Monetary Fund (IMF) recently forecast Eurozone growth will slow to 1.6% this year and 1.4% in 2017, compared with last year's 1.7% expansion.
- All but 20 percent of developed markets are effectively overbought, according to Gavekal Capital. It cites indices in the U.S. and Canada as among the "extreme" overbought positions.
- Eurozone business activity this month expanded at its weakest rate since the start of 2015 as Markit's Composite Flash Purchasing Managers' Index fell below expectations to 52.6 from August's 52.9. Personal spending climbed 0.4%, building on a similar monthly increase in the previous month although Eurozone retail sales again reported a decline of 0.1% in the August period.
- Despite historic gains against the British pound amid Brexit concerns, the dollar continues to trade in a tight range against its main trading partners owing to Fed reluctance to raise interest rates.
- The Chinese yuan formally joined the U.S. dollar, the euro, the Japanese yen, and the British pound as a global reserve currency on October 1 as the IMF included it in a "basket" of currencies it manages to address economic crisis.

PERFORMANCE SUMMARY

Portfolio Performance Commentary

- In this quarter, we saw good performance in most Equity and Fixed Income products, although the return was concentrated in the first half with a virtually flat performance in the second half. This is a testament to the high level of volatility in the market, and the uncertainties in the economic outlook.
- Several sectors that underperformed earlier this year, experienced a reversion to the mean, and showed strong performance relative to the general market. These sectors include US Small Cap Stocks and Non-US Developed Markets. REITs, which outperformed the general market earlier this year, pulled back with a slight negative return for the quarter.
- In the Fixed Income market segment, High Yield and Emerging Market Bonds continued strong performance, driven by investors hunt for yield and their resulting price increases. The valuation in these sectors are consequently becoming of some concern.
- Mortgages continued to provide a steady return, albeit at a lower level, but also resulting in a lesser concern for over-valuation.
- Full valuation levels in the equity market also generate some concern, and will limit further upside to the market, unless we see a dramatic improvement in economic growth, which is not anticipated.
- We increased the cash equivalent positions as applicable in portfolios by another 4% to 12% total, after the strong performance in July. We reduced Real Estate and High Dividend

yielding positions, which have subsequently underperformed. Overall the market stalled, and the cash position did not provide any drag on the quarterly performance.

- For Alpha and VEGA portfolios, while we did not explicitly raise the cash position, we did rebalance the portfolios in conjunction with 4% cash increase for other portfolios. Specifically, we reduced positions that had done well during the year, adding approximately 1% to the cash position.

Market Outlook

- We are concerned that the similar troubles engulfing Germany's Deutsche Bank and Italy's Banco Monte de Paschi di Siena may also snag other European banks in response to the weak EU economy and the turmoil triggered by Britain's split from Europe.
- We are also sensitive to the prospect of a major correction in "expensive US equities." We believe odds are good that companies on the S&P 500 will again report earnings declines as they have done for 5 of the last 6 quarters.
- We expect energy prices to continue to trade above \$40 per barrel as this month's OPEC meeting failed to reach concrete agreements leading to immediate meaningful production cuts.
- We believe the Fed needs to increase its policy rate by 25 to 50 basis points in the next few quarters to begin the process of wringing excess liquidity from financial markets...
- But we now doubt the Fed will move in time to forestall a disorderly result.

Q4 Investment Strategy:

- Maintain a defensive position relative to interest rates, as we expect rates to normalize from their low and zero levels, as and when the global economy improves.
- Equity markets, in particular the US stock market, are approaching full valuation which warrants caution.
- For the time being, remain neutral on US equity strategic weightings, and maintain lower allocations of non-US equity.
- Emphasize high quality yield enhancing corporate credit / MBS / ABS fixed income allocations.
- Consider reducing High Yield and Emerging Markets debt allocations due to concerns over the valuation in these sectors.
- Remain vigilant as asset markets reach for new highs, which means retain the cash cushion we have established, and look for opportunities to raise more cash.

- At the same time and conversely we will look for openings to deploy the cash reserve, if / when the market experiences a pullback.
- For our option based hedged strategies, we continue to stay U.S. centric with limited exposures to Foreign Developed and Emerging Markets. As volatility increases we expect to capture higher premiums from the sale of covered calls.

Economic

- Global equity prices and pound sterling recovered from the panic selling that greeted the news Britain's EU departure in June. (See Partnervest Brexit Market Commentary June 29, 2016) However, we fear the coming Brexit (UK expects to commence negotiations in March 2017) may imperil European banks thanks to their heavy reliance on the London financial markets to sustain existing assets and to generate new ones.
- Despite a tepid recovery in commodities prices and cheap valuations we continue to underweight the energy sector.

Fixed Income & Equity

- A proliferation of negative-yielding debt in Europe and Japan threatens to undermine the US Federal Reserve actions to "normalize" U.S. Treasury rates as the hunt for yield becomes a race to the bottom – a trend foreshadowed by the heavy accumulation of yield-seeking long future positions on US sovereign debt.
- We expect continued high volatility to prevail at least until the end of this year and in turn we have increased our exposure to short-term, high-quality debt in sectors with strong cash positions.
- We continue to assign myriad global risks - from terrorist violence to divergent monetary policies – as potentially decisive factors in our outlook.

International & Emerging Markets

- The political and economic challenges facing the global economy outside the US continue to be vast and forbidding.
- We believe the Chinese economy is in the early stage of an epic, long-delayed re-focusing toward internal activity that may well elude the grasp of the leadership. Deflation, diminished growth and political instability remain distinct possibilities.
- The Euro bloc and Japan have been pushing on negative interest rates with little to show for it. Europe is grappling with a refugee crisis, the not-unrelated scourge of terrorist violence and now the departure of one of its most important markets, Britain while Japan struggles with very weak demographics and extremely high national debt levels.
- We anticipate increasing weakness in emerging markets as economies and companies adapt to China's "new normal" of slower less commodity intensive growth.

- Globally Corporations and Government Agencies are issuing bonds faster than they have in nearly a decade thanks to historically cheap borrowing costs, according to Dealogic. So far this year investors have bought \$4.88 trillion of debt, slightly below the \$4.91 trillion raised in 2007 (the record year) during the same period.
- Pantheon Macroeconomics warned last month that spikes in narrow money supply in post-Brexit Britain, together with similar activity in Japan, Switzerland and Germany suggests cash-hoarding rather than dynamism. "On the contrary," it concluded, "the pick-up in the desire of households and firms to hold money, as opposed to other assets, is a worrying signal."
- The IMF slashed its forecast for UK growth next year to 1.3%, down 0.9 points from April - after warning that the decision to leave the EU has damaged the British economy's short-term prospects and hobbled the global recovery. A report from the European Commission forecast 1.1% for Britain in 2017 and would not rule out a contraction.
- Anticipating a return of inflation, reports the FT, some investors are revving up for the next Bull Run in commodity markets. According to Barclays, commodities-related investment flows as of August reached \$54 billion, an all-time high for the first eight months of the year.
- Prime Minister Shinzo Abe is planning to cut his inflation forecasts to 1.4% for the year, well below its 2% target, according to Reuters, a move that could lift the prospects for additional stimulus efforts by the Bank of Japan.

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