

Fourth Quarter 2016 Commentary

January 17, 2017

Dear Investor,

Defined by one of the most unorthodox and unsightly elections in U.S. presidential history, Wall Street ended 2016 with corresponding excess by shredding one financial-market record after another. Anticipating an inflation brew of lower corporate taxes, deregulation and an expansive fiscal policy, investors handed the Federal Reserve the mandate to raise interest rates it had been struggling for years to articulate. The result was an abrupt end to a near decade-long run for bond prices, soaring yields and unbridled equity markets.

Unknown at this time are details into how the President-elect would implement campaign promises into nuts and bolts policy actions or new legislation. Yet to be seen, for example, is how a mix of tax cuts and proposed border-adjustment import duties will accelerate growth in America's industrial base without unduly disrupting manufacturers' existing supply and operating procedures and/or swelling the nation's existing \$20 trillion debt pile.

Nor is it yet clear what the potential global consequences of any trade wars could be if America's commercial partners – particularly China - refuse to consider renegotiating existing trading relationships. One of the President-elect's signature projects, a spending plan to revive the country's aging infrastructure, could face opposition from Congress who fears its weight on the nation's public accounts.

Indeed, it is debt - \$217 trillion worldwide, or 325 percent of global GDP - that now informs the global economy in more ways than at any time in history. It is debt that shades the prospects for Mr. Trump's bold initiatives, obliges some college graduates to defer home ownership, discourages debt-heavy companies from investing in productive enterprises and vexes Chinese leaders as to its very nature and magnitude.

About the only thing that stalks global growth as ominously as preponderant debt is mushrooming political risk, which will most certainly intensify in 2017.

Sincerely,



David Young, CFA
Chief Investment Officer

Markets and Corporations: *Out like a lion*

The S&P 500 and the Russell 2000 indices surged by 3.83% and 8.83% respectively in the fourth quarter, building on similar gains in the previous three-month period. The yield on the 10-year Treasury leapt from 1.6 percent in the third quarter to 2.45 percent by the end of December, kindling speculation of a 3.0 percent yield for the first time since December 2013. Bond prices, meanwhile, sank from a gain of 0.47 percent to -2.98 as measured by the Barclay US Aggregate Bond Index. As the average yield across the fixed-income spectrum remains depressed, the overall focus is trained on high-yield products.

The dollar strengthened and precious metals weakened while industrials like iron ore and copper rallied on the Trump victory and the prospect of accelerated growth. Emerging markets weakened and crude oil rallied after an OPEC production-cut agreement appeared to hold despite concerns that aggressive drilling by US companies may undermine it.

In what has become a grim yuletide passage for the brick-and-mortar retail industry, JC Penny, Kohl's and Macy's all reported disappointing holiday sales amid rumors that Sears may soon declare bankruptcy. As a result retail shares tumbled. Meanwhile, Amazon continued to dominate online holiday sales with a 38 percent share of online orders, followed by Best Buy's 4 percent and Target's 3 percent. The Seattle-based Amazon accounted for half of all online orders placed the Monday before Christmas Day.

Encouraged by the prospects of significantly reduced corporate taxes, investors piled into US equity markets that before the election were thought to be overheated, but with investor confidence reaching multi-year highs about future prospects markets kept climbing. Among the most aggressive purchases were share buy-backs by listed companies that may push markets even higher. According to Goldman Sachs, S&P 500 companies will spend about \$780 billion on share buybacks in 2017, a 30% rise from 2016, buoyed by corporate tax reform and the repatriation of cash held overseas.

At the same time, according to a report from Swiss Bank, pension funds that rebalance on a monthly and quarterly basis are poised to sell US shares in the value of some \$38 billion to reset previous allocation levels which may cause some downward pressure on US equities.

MARKETS		
	Q4	2016
S&P	3.83%	11.98%
Russell 2000	8.83%	20.12%
10-year Treasury yield	2.45%	1.62%
Gold	\$1150	\$1075 (6.9%)
Silver	\$15.99	\$13.89 (15%)
Oil	\$53.72	\$36.76 (46%)
Dollar Index	102.29	98.97 (3.35%)
Dollar/Yen	116.89	12.33 (-2.85%)
Dollar/Sterling	1.23	1.47 (-16%)
Dollar/Euro	1.05	1.08 (-3.17%)
Barclays US Aggregate Bond Index	-2.98%	2.66%
MSCI EAFE Index	-0.68%	-1.87%
Volatility Index	14.04	20.70 (-22%)
MSCI Emerging Market Index	-4.08%	8.58%
Sources: Morningstar, Investing.com, MSCI		

US Economy: *Debt and tax cuts*

Emboldened by the post-election market activity, the Fed announced it may raise interest rates up to three times in 2017. While that may be overstating things, we expect the Fed will move with greater confidence as the economy assumes a familiar cyclical rhythm and “leading from behind” becomes a more suitable posture than it was in the recent past. Inflationary pressure, still hovering at the 2-percent level is expected to build gradually in an economy that has managed only modest growth since the 2008 financial crisis.

Unlike financial markets, the Obama economy closed out the year like a lamb. By some analyses it has been competently nurtured since it debuted in January 2009: aggregate stock markets up by 180 percent, according to Bloomberg, corporate earnings up 112 percent, auto sales up 85 percent, consumer sentiment up 60 percent, home prices up 24 percent and real GDP up 15 percent. But the pace of job growth, at about 1.04% annually, was agonizingly slow. Moreover, the vast majority of jobs created during the Obama years were temporary positions, creations of the so-called “gig” economy which, stripped of its hipster mythology, is another way of describing unsecured employment with few if any benefits. The national debt soared during Mr. Obama's two terms - by 88 percent to \$20 trillion, or nearly 100 percent of the US GDP

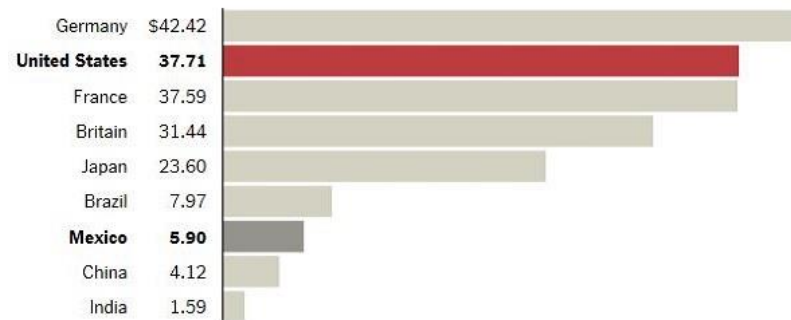
Job creation in much of the country was offset by job losses in rust belt states, continuing a decades long trend of business movements inside the country. Non-farm payrolls for December grew by 156,000, well below the 204,000 created in November and surprisingly low given the season. That lukewarm report followed a lower-than-expected 3.1 percent rise in third-quarter productivity from the previous quarter but, when assessed on a yearly basis, represented the first two-quarter decline since 1993.

The decades-long diminution in worker productivity is considered to be a root cause of the low-grade Obama recovery and it will certainly bedevil Mr. Trump's pledge to reanimate America's dwindling labor force. His plan – a stick of import tariffs and a carrot of tax cuts for manufacturers who produce in the US or repatriate jobs from abroad – would reverse a half-century of outsourcing that delivered the consumer-centric economy Americans regard as a birthright. (“I don't pay retail” is as uniquely an American manifesto as it is in many ways self-annihilating.) Nor is it certain if steep tax cuts will countervail the burden of US labor costs, which rank second only to Germany's as the world's most expensive.

The president-elect claims his plan will pay for itself with the new payrolls it will create along with the levies on foreign-made goods. It is an intriguing theory, one that would likely be challenged by the World Trade Organization and in regional trade rounds. It is also worth noting that state and municipal authorities have for decades been competing for middle-class jobs by showering manufacturers with tax holidays, land grants and other subsidies even as those jobs evaporate. Also, we are troubled by the nationalist quality of Mr. Trump's plan, which seems to be inspired by the mercantilist ideals embraced by post-war Asia before it was done in by them in the late 1990s.

... but American workers are still much more expensive than those in other countries

Average hourly manufacturing compensation, including benefits.



Sources: Bureau of Labor Statistics; Conference Board

Even Mr. Trump's highly touted spending bill cannot be taken for granted. As the *Financial Times* reported early last month, US companies have assumed debt worth \$8.4 trillion over the last decade, an increase of 75 percent and enough to give bankers pause in the face of tightening credit rates.

US ECONOMY		
	Q4	2016
Core Inflation	2.1%	2.1% (Jan16)
Non-farm Payroll Report	156k	168k (Jan16)
Unemployment	4.7%	4.9% (Jan16)
Personal Spending	0.2%	0.1% (Jan16)
Household Savings rates	N/A	5.99%(2015)
Institute for Supply Management Index	54.70	48.2 (13.5%)
Housing Starts	1090 (000's)	1160 (-6%)
Factory Orders	-2.4%	-2.4% (Jan16)
Sources: World Bank, Investing.com, TradingEconomics		

International: *China quakes, Europe wakes*

Were it not for the burlesque of the US presidential race, the biggest story of the year may well have been China. A year after the International Monetary Fund included the renminbi alongside the dollar, the yen, the euro and sterling in his basket of reserve currencies, China now shudders under the heft of gargantuan debt, currency flight, an array of asset bubbles, too-big-to-fail legacy companies and slowing growth.

Last fall S&P Global, the rating agency's research and intelligence arm, reported that rising debt levels will worsen the credit profiles of China's top 200 companies, requiring the country's banks to raise \$1.7 trillion in capital to cover a likely surge in bad loans. The *FT* chimed in, reporting that China has lost favor with emerging market investors for carrying "the world's riskiest debt load," while the IMF warned that China's credit binge has elevated its chances of default. A

government- proposed debt-to-equity swap program was dismissed by *The Wall Street Journal* as a back-door bailout for the country's heavily indebted "zombie" companies.

Circling the wagons, Premier Li Keqiang told state media that the Chinese economy was healthy and that stabilizing the property market was a government priority. Such blandishments assured no one, however, and investors raced for the exits. Capital flight in 2016, estimated at \$710 billion in the year to November has prompted Beijing to impose currency controls even as it has bled some \$403 billion in US government paper from its foreign currency reserves to defend its currency. The withdrawal represents one of the most aggressive selling of US Treasuries in history.

If things weren't bad enough for the world's second largest economy, the cost of servicing its outstanding corporate debt, valued at 120 percent of GDP, has nowhere to go but up.



With China struggling to stay afloat, Japan typically trading water and emerging markets all but swamped under a strong dollar and a bias toward higher-quality assets, we turn hopefully to Europe as the only non-US economy with the potential for lift. The augers are mixed. On the one hand it has the legacy of Brexit to work out along with political uncertainties ahead of several national elections. On the other there are positive indicators. The composite Purchasing Managers' Index for the Eurozone rose to 54.4 in December, up from November's 53.9 and aligned with its highest level since May 2011. Euro parity with the dollar can only strengthen export receipts, a fact reflected in surveys featured this month by Gavekal Capital. Confidence levels within the European Union not only beat expectations in December, they rose to levels not seen since 2007. The surveys were released just days after Reuters reported that several German economists called on the European Central Bank to raise interest rates after Eurozone inflation accelerated at a faster rate than expected in December. In addition, sales are up among Europe's top-five auto manufacturers.

Political Risk: *The Weight of History*

The highly respected and deeply established Eurasia Group released a report this month that declared 2017 would be the "most volatile" year for political risk since World War II. In addition to Chinese and Russian adventurism the report cites the threat of ongoing jihadi violence and fissures in the Eurozone that threaten mortal ruptures.

Heady stuff, we agree. But there's little in the report that makes us nostalgic for such white-knuckled Cold War crises like the ones in Berlin, Korea, Suez, Budapest, Beirut, Cuba, and Prague, to say nothing of those occasions when an unconfirmed nuclear strike turned out to be a glitch in the radar grid with only minutes to spare. (At least a half-dozen such episodes between 1961 and 1998, in case you're wondering.)

Apparently, the first casualty in political risk analysis is perspective. The geopolitical landscape is indeed perilous but it is important to understand the taproot that destabilize it. During the last half-decade or so the unipolar world has given way to the return of a multipolar one. This realignment was driven not by a lack of U.S. resolve as it was never U.S. resolve that preserved the global order, as Eurasia calls it, in the first place. (Not convinced? Ask yourself what the Hungarians and the Czechs must have thought about the "global order" in 1956 and 1968.) Despite narratives to the contrary, America's global hegemony was artifice so long as Russia and China were too busy struggling under the legacy of their own misrule to test it. Now, having stabilized their economies under ruthlessly effective rule, they are reclaiming the spheres of influence that history and geography has conferred upon them.

The return of the multipolar world has frayed the bonds that commit Washington to intervene militarily on behalf of allies worldwide. However, we believe the Pentagon and related national security agencies will sustain their imperial writ despite the president-elect's threats to unwind it. However formidable candidate Trump was on the campaign trail it remains to be seen if he can subdue the survival instincts of America's national security cadres and their complex of annual budgets equal to nearly a quarter of federal outlays. (As this report goes to press, incidentally, NATO is conducting a major new deployment along its eastern perimeter designed to protect new members Estonia, Latvia, Lithuania, and Poland from alleged Russian designs. Facts on the ground, if nothing else.)

Though rarely advertised as such, America's bedrock foreign policy is to deploy lethal force anywhere in the world in days, if not hours. On behalf of that objective Washington has invested immense financial and diplomatic resources courting allies for access to their sea lanes and air corridors. Many of these host countries share borders with Russia and China which makes them flashpoints between competing hegemonies. As we believe it is unlikely the US will concede its prerogatives in Asia and Europe, we can only conclude that some kind of conflict between Washington and its former Cold War adversaries is inevitable. Those who suggest otherwise are in contempt of history.

A more thoughtful risk analysis, released this month by the World Economic Forum, highlights the rise of anti-establishment populism in western democracies – expressed most dramatically in Britain and the US last year – as evidence of a growing backlash against “the domestic and international status quo.” Grass-roots outrage, the forum argues, may have “passed the stage where [economic growth] alone would remedy fractures in society: reforming market capitalism must also be added to the agenda.” The dividends of free trade, globalized production and consumer-empowered economies, the forum suggests, may be diminishing as new technologies appear to be destroying as many jobs as they create at the cost of weakened social cohesion and faith in representative government.

The report considers a crisis within democracy itself, fueled by rapid economic and technological change, deepening social and cultural polarization and the emergence of “post-truth” media. It also warns of the consequences of under-funded state mandates and the decline of employer-backed social-protection plans even as “technological change means stable, long-term jobs are giving way to self-employment in the ‘gig economy.’”

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