

First Quarter 2017 Commentary

April 17, 2017

Dear Investor,

What a whirlwind 1st Quarter it was! Markets continued to climb higher, continuing the post-election run-up. But as predicted the bumps in the road started to appear just as the quarter was coming to a close. We hope to give you some insights as to what happened last quarter and our expectations for the future.

As if to confirm the laws of gravity have not been repealed, markets as the quarter came to a close returned some of their post-election gains due to political as well as economic factors. Stock indices posted their sixth-straight quarterly gains only after surviving a bruising sell-off in March. Steady job growth and strong corporate earnings expectations, while certainly welcomed, were by themselves unable to galvanize a stubbornly sluggish economy. The Federal Reserve Bank of Atlanta, citing slack consumer spending, forecasted annualized growth at a mere 0.6%, the dollar weakened steadily despite a rising interest-rate environment, loan growth slowed, wages declined for two consecutive months and durable-goods orders continue to disappoint. Investors bid up treasuries and gold while crude-oil prices tumbled.

The so-called Trump Trade, defined by Reuters as bets on financial and infrastructure stocks, may have survived the current administration's missteps but its margin of error appears to be wearing thin. The failure to overcome the Republican party's opposition to a bill that would have replaced the Affordable Care Act revealed a leadership vacuum at a time when the economy craves a muscular fiscal policy. While we were encouraged to hear that the White House will this year unveil a \$1 trillion plan to revitalize the nation's infrastructure, details remain elusive. We are also awaiting progress on other fronts, particularly tax reform, which will oblige the administration to conciliate rather than confront House deficit hawks. Similarly, we are closely watching how the President will redeem his campaign promises to amend trade agreements in ways that will create new jobs without provoking a trade war. There is also the matter of financial deregulation, which could promote loan growth by reducing red tape on smaller banks.

Finally, we are parsing the Fed's often contradictory remarks regarding the direction of interest rates, though the fact that the bank's preferred inflation indicator recently topped 2% for the first time since April 2011 makes additional hikes appear inevitable.

Absent an aggressive campaign to woo recalcitrant legislators behind badly needed initiatives we fear that the Trump agenda, to say nothing of the Trump trade, may dissolve.

Markets: *Trump Trade Revisited*

The Bloomberg Dollar Spot Index fell to its lowest level since November 10th 2016 after five straight days of declines. Bank of America reported that dollar bulls have all but vanished despite rising interest rates as the U.S. currency erased nearly all of its post-election gains in favor of the euro, which strengthened despite Europe's minefield of political uncertainty. The race to the exits, which preceded by several days Trump's decision to withdraw his health-care bill from Congress, was triggered according to BloombergView by concerns that that the White House may be unable to deliver on its trio of fiscal stimuli – tax cuts, infrastructure spending and deregulation.

As it became clear that the White House has no coalition to spearhead its legislative agenda Goldman Sachs chimed in, warning that tax cuts as part of an overall reform plan will be less dramatic than previously expected and most likely delayed. Fortunately, countered ZeroHedge, such apprehension has been baked into the market as tax-intensive companies have given up much of their post-election gains, providing scope for a rebound "should Trump fail to disappoint on his next key legislative item."

Bank of America also reported that equity funds suffered net recorded outflows of \$8.9 billion in late March, the largest such liquidation in 38 weeks. Hardest hit was the banking and industrial metals sector, the biggest beneficiary of the Trump victory rally. The redemptions, Reuters reported, reflected diminishing faith in the new U.S. administration's ability to deliver the fiscal and regulatory changes needed to support higher equity prices. An estimated \$8.3 billion of that investment capital was absorbed by U.S.-based taxable bond funds, according to Lipper, and yields responded in kind.

Flattened yield curves, according to the *Wall Street Journal*, reflect market worries that tax spending and investment rates are keeping inflation in check. With some spreads evaporating to their lowest levels since the election, the *WSJ* reported, Fed officials may be close to finalizing a strategy for winding down its \$4.5 trillion portfolio of mortgage and Treasury securities, a process that could begin later this year.

On a positive note, first-quarter operating income by Standard & Poor's 500 companies is expected to climb 9.1% — the fastest pace since the fourth quarter of 2011 — with per share profits totaling \$29.51, according to FactSet Research. Such results would mark the third straight quarter of year-over-year gains after a five-quarter losing streak that ended in mid-2016. Energy stocks led the increase, propelled by a \$9 billion swing back into the black. In March, however, prices swooned in response to a supply glut due to stepped-up drilling activity in the U.S. shale oil and gas sectors. According to Bloomberg, Tudor, Pickering, Holt & Co. slashed its 2018 forecast for West Texas Intermediate by 13%, to \$65 and expects U.S. output will rise by 1.2 million barrels per day, up 50% from earlier forecasts.



Source: Bespoke

On the consumer end of the oil market, auto loan delinquencies of greater than thirty days or more reached \$23.27 billion, the highest level since 2008. The seriously delinquent fraction of these loans, defined as those at least ninety days in arrears, reached \$8.24 billion. However, the delinquency level, at only 3.8% of total outstanding auto loans, is not so formidable as to menace the overall economy – unlike student loan debt, which now hovers at \$1.31 trillion and carries an 11.2% rate of serious delinquency.

According to Bloomberg, debt issued by malls and shopping center operators is under siege by hedge funds as retailers announce the closing of thousands of store locations due to weak sales and a preponderance of online shopping. By one measure, short positions on two of the riskiest shares of Credit-Market Bonds surged to \$5.3 billion last month – an increase of 50% - as prices on the BBB- pool of CMBs have slumped from 96 cents on the dollar in late January to 87 cents last month. Both Deutsche Bank and Morgan Stanley recommended buying credit protection on the BBB- tranche last month. Nine retailers filed for bankruptcy in the first quarter alone, according to consulting firm Alix Partners, equal to last year's number and on pace to reach the highest such number since 2009, when 18 chains went under.

3/31/2017		Economic and Market Review								
Overall	Indicator Name	Last Reported Date	Frequency	1 Mo. Ago		3 Mo. Ago	1 Yr. Ago			
				1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change		
▼	US Core Inflation Rate	2/28/2017	monthly	2.27%	▼ -2.12%	▲ 5.34%	2.33%	▼ -4.62%		
▲	ADP Change in Nonfarm Payrolls	3/31/2017	monthly	245	▲ 7.54%	▲ 31.09%	232	▲ 13.74%		
▼	US Unemployment Rate	2/28/2017	monthly	4.80%	▼ -2.08%	▲ 2.17%	4.90%	▼ -4.08%		
▲	US Producer Price Index: Savings Institutions	2/28/2017	monthly	93	▲ 0.32%	▲ 0.75%	94	▼ -0.74%		
▼	ISM Purchasing Managers Index	3/31/2017	monthly	58	▼ -0.87%	▲ 4.95%	52	▲ 10.42%		
▲	US Housing Starts	2/28/2017	monthly	1,251	▲ 2.96%	▲ 12.10%	1,213	▲ 6.18%		
▼	US 30 Year Mortgage Rate	3/30/2017	weekly	4.16%	▼ -0.48%	▼ -4.17%	3.71%	▲ 11.59%		
▲	US Consumer Price Index	2/28/2017	monthly	244.2	▲ 0.12%	▲ 0.93%	237.8	▲ 2.80%		

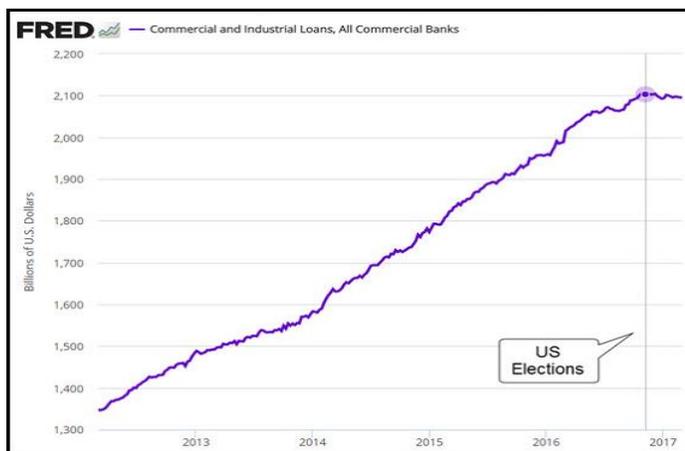
Source: yCharts

US Economy: *Marching Sideways*

Personal spending, the engine of post-industrial American growth, was muted despite surveys registering consumer confidence levels at their highest levels since the eve of the dot-com bubble over a decade ago. Indeed, data suggested that income earners were more inclined to save money rather than spend it. The Atlanta Fed reduced its estimate for first-quarter growth to an annualized 0.6% - one of several downward adjustments from the original estimate of 3.4% - after the Bureau of Economic Analysis revised its quarterly real consumer spending growth from 1.4% to 0.8%. In early March, the BEA reported that consumer spending adjusted for inflation, which generates the figures used to calculate gross domestic product, fell 0.3% after a 0.3% increase the previous month. The Commerce Department said it was the largest drop since September 2009.

Labor data offered a mixed picture. In January, the number of Americans quitting their jobs rose to a seasonally-adjusted total of 3.2 million, the highest number since February 2001, suggesting workers were confident they could find better work elsewhere. At the same time, the number of initial jobless claims surged to its highest level since May 2016 while non-farm payrolls in March grew at a desultory rate of 98,000, well below a consensus estimate of 180,000.

Corporate loan growth stagnated as borrowings and leases extended by U.S. commercial banks grew at an annual rate of 4.6% according to the Fed, down from 6.4% for all of last year, the slowest pace of debt creation since the spring of 2014. The broad-based decline, which the WSJ reported, "is at odds with the idea of a stronger economy and rising sentiment," was particularly pronounced in the Commercial and Industrial sector, which after growing at a pace of 10% in the first half of 2016 unexpectedly fell to just 4.0% as of March, the slowest rate since July 2011.



Home mortgages, however, gathered momentum in February as the pending home sales index rose by its highest level since July 2012, to 5.5% after declining 2.8% the previous month. Warm weather and rising interest rates stoked demand while lean inventories sustained relatively high prices.

It was the Congressional Budget Office, however, that had the first quarter's last word on debt and it certainly must have caught the attention of budget hawks in Congress. In its semi-regular long-term debt outlook, the CBO forecast that both government debt and deficits are expected to soar in the coming 30 years, boosting federal obligations to 150% of GDP by 2047 if the current rate of government spending continues absent meaningful entitlement reform.¹

3/31/2017 Economic and Market Review Continued....								
Overall	Indicator Name	Value	1 Mo. Ago		3 Mo. Ago		1 Yr. Ago	
			1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change	
▼	S&P 500 Total Return	4,538	4,572	▼ -0.73%	▲	6.07%	3,873	▲ 17.17%
▼	Russell 2000 Total Return Index	6,752	6,780	▼ -0.42%	▲	2.47%	5,349	▲ 26.22%
▲	MSCI EAFE Total Return	6,954	6,781	▲ 2.55%	▲	7.39%	6,196	▲ 12.25%
▲	MSCI Emerging Markets Total Return	2,041	1,979	▲ 3.10%	▲	11.49%	1,735	▲ 17.65%
▼	10 Year Treasury Rate	2.40%	2.49%	▼ -3.61%	▼	-2.04%	1.78%	▲ 34.83%
▲	Barclays US Aggregate Total Return	1,993	1,980	▲ 0.61%	▲	0.82%	1,984	▲ 0.44%
▼	AMEX Dollar Index	100.56	101.3	▼ -0.77%	▼	-1.78%	94.63	▲ 6.27%
▲	Euro to US Dollar Exchange Rate	1.07	1.06	▲ 1.19%	▼	-0.60%	1.14	▼ -6.10%
▼	US Dollar to British Pound Exchange Rate	0.80	0.82	▼ -2.30%	▼	-1.60%	0.70	▲ 14.7%
▼	US Dollar to Chinese Yuan Exchange Rate	6.88	6.90	▼ -0.18%	▼	-0.86%	6.45	▲ 6.75%
▼	US Dollar to Japanese Yen Exchange Rate	111.41	114.60	▼ -2.78%	▼	-4.60%	112.42	▼ -0.90%
▲	Gold Price in US Dollars	1,245	1,227	▲ 1.50%	▲	8.64%	1,237	▲ 0.64%
▼	WTI Crude Oil Spot Price	50.54	53.33	▼ -5.23%	▼	-4.19%	36.9	▲ 36.82%
▲	VIX	12.37	10.96	▲ 12.86%	▲	3.17%	13.95	▼ -11.33%

Source: yCharts

¹ By way of comparison, Greece's debt-to-GDP ratio is 175%.

International: *Elections jitters, Brexit, China's bloated banks*

Europe found itself pinioned between crucial national elections looming in France, a brewing confrontation over Greek debt, the stress of Brexit and a stronger currency that discomforted manufacturers. To make matters worse, Italy may be poised to follow the Brits through united Europe's door as Euro-skeptic politicians circle ex-Prime Minister Matteo Renzi's besieged ruling party. As the first quarter drew to a close, however, the Eurozone appeared to have redeemed December forecasts for respectable growth despite the uncertainty of exactly how and when Britain will extract itself from the European Union. Greece and its EU creditors agreed to new terms that allowed Athens to draw additional funds from its \$91 billion bailout program. As the Trump Trade lost its luster some investors switched into ETFs that cover European shares. accelerated in March, as an improving global economy boosted export demand in the region's biggest economies. IHS Markit said its final manufacturing PMIs for Germany, France and Italy all rose compared with the previous month. It helped push the euro-region gauge to 56.2, the highest since 2011, from 55.4 in February.

Despite this, the European Central Bank signaled it was not ready to begin liquidating its portfolio of debt accumulated since the 2008 crash, nor change its monetary policies in any meaningful way. In an interview with the WSJ, Belgian central banker Jan Smets said the ECB would not consider retiring its stimulus policy with inflation at current levels.

Speaking of debt, China's banking system is now the largest in the world, with assets worth \$33 trillion at the end of 2016, according to the *Financial Times*. That's compared with \$31 trillion for the Eurozone, \$16 trillion for the US and \$7 trillion for Japan. This is not necessarily an occasion for a Lion Dance, however. Eswar Prasad, economist at Cornell University and former China head of the International Monetary Fund, told the *FT* that the magnitude of China's banking system suggests "an economy overly dependent on bank-financed investment, beset by inefficient resource allocation, and subject to enormous credit risks."

STAR™ Spectrum Portfolios: *Performance Summary*

Fixed Income:

Despite the Fed hiking rates in the first quarter, returns for Core Fixed Income were modestly positive as were the broader bond market indices. Our defensive duration posture (1.87 years) benefited the portfolios while longer, intermediate duration holdings were hindered as interest rates rose with the Fed's second increase in four months. More specifically performance was mostly aided by our allocations to Emerging Market Bonds (CEMB) and High Yield (PHB). We anticipate more opportunities in the fixed income markets during the next three quarters as the Fed continues to take action.

Equity:

Equities were strong during Q1 with the MSCI Emerging Markets Total Return index significantly outperforming the other asset classes having returned over 11%. Overall our equity positions were positive for the quarter, yet underperformed both the S&P 500 and MSCI All-Country World Index (broad global equity markets) which returned 6.07% and 6.80%, respectively. Our Emerging Market

and Non-US Developed allocations led the way for our portfolio, with US stocks also positive, but trailing the broad equity indices.

Alternatives:

Our alternatives allocation was strong for the quarter. The main contributors included Private Equity/BDCs along with Frontier Markets. The allocation to REITs and Multi-Asset strategies were in the flat to slightly positive range, but not as strong as other sectors.

Summary of STAR Spectrum Strategy Performance and Attribution

	Portfolio Weight (Equity Based & Income-Derived Models)	Q1 2017 (%)
Equity	100%	Positive (+)
Large Cap	63%	Positive (+)
Small Cap	23%	Positive (+)
Non US Developed	11%	Positive (+)
EM Market	3%	Positive (+)
Fixed Income	100%	Positive (+)
Investment Grade	77%	Positive (+)
EM Market Bond	7%	Positive (+)
Mortgage	8%	Positive (+)
US High Yield	8%	Positive (+)
Alternative	100%	Positive (+)
REITS	25%	Positive (+)
Convertibles/Preferreds	36%	Positive (+)
Multi-Asset	19%	Positive (+)
Private Equity	20%	Positive (+)
Cash (1)	8%	Positive (+)

(1) Cash holdings added modestly to absolute results and kept pace with the broad fixed income markets – Cash was held as part of a set of defensive strategies.

STAR™ Spectrum Program Models: *Portfolio Changes*

Equity Based & Income-Derived Models

Models Impacted: Diversified Equity, Growth, Moderate, Conservative, Core Fixed Income

- 1) Reallocated approximately 4% of our cash reserves, we had 4% in Vanguard Short-Term Corporate Bond (**VCSH**) and 8% in PIMCO Enhanced Short Maturity Active ETF (**MINT**), we sold **VCSH**,
- 2) Increased allocation to Business Development Corporations by adding 2% to the current Aries Corp. (**ARCC**)
- 3) Increased allocation to Small Cap Equity by adding 2% to the current Affinity Small Capp Fund Class I (**AISQX**).
- 4) Swap large cap dividend premium US Equity, held via Vanguard High Dividend Yield ETF (**VYM**) into US Financials, SPDR Select Sector Fund - Financial (**XLFI**)

5) Where the strategy does not hold VYM, we will sell SPDR S&P Dividend ETF (**SDY**)

6) For accounts with limited Small Cap exposure, increase allocation to High Yield via PowerShares High Yield Corporate Bond (**PHB**)

Thematically the Business Development Companies and Small Cap Equity are a play on U.S. Growth and U.S. Financials is a play on growth and higher interest rates that we believe will strongly benefit U.S. financials sector.

Option Based Models

Models Impacted: VEGA and VEGA Enhanced

- 1) Reallocate 10% U.S. Large Cap, SPDR S&P 500 (**SPY**), into 6% Small Cap via iShares Russell 2000 (**IWM**) and 4% into US Financials, SPDR Select Sector Fund - Financial (**XLF**)
- 2) Rebalance out U.S. Large Cap, SPDR S&P 500 (**SPY**) so that total U.S. Equity (including Small Cap and Financials) is approximately 60% of model and put proceeds into Developed Non-U.S., iShares MSCI EAFE (**EFA**) and Emerging Markets, iShares MSCI Emerging Markets (**EEM**)

While not every model received Portfolio Changes during the 1st Quarter 2017, every model and position was reviewed for appropriateness of the allocations give the risk profile and market outlook. Since most of the changes were specific to Equity allocations, models with higher Equity allocations had more significant changes, whereas Fixed Income allocations remained mainly unchanged at this time. The only model with higher Equity exposure that did not receive portfolio changes was VEGA Core Plus and that was because the allocations to IWM and XLF were made inside of the VEGA ETF making unnecessary to trade in the model directly.

Post-portfolio changes from 1st Quarter 2017 several models continue to hold approximately 8% cash from de-risking trades that occurred during 2016. As 2017 unfolds there are 5 indicators that will determine additional re-risking done to the models:

- What is the Fed doing?
- What steps are being to over haul the tax code?
- Has there been movement with the United States and their trade partners with respect to policy?
- What developments have there been on progress toward more infrastructure spending?
- What regulatory reforms may be enacted and what would be their outcomes?

As these questions are answered, there will be better clarity into what Tactical Shifts may be on the horizon. We continue to appreciate your confidence and support in our strategies and we look forward to continuing our dialogue about the markets, models and economy in the future.

Sincerely,



David Young, CFA
Chief Investment Officer

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