PARTNERVEST

Third Quarter 2017 Commentary

October 13, 2017

Dear Investor,

Just as hurricanes Harvey and Irma spiraled their way into the heart of the Gulf Coast with seismic effect on the US economy, so too did the third quarter revolve around the Federal Reserve Bank and its formative steps toward policy normalization. The most extravagant stimulus program in history, fairly regarded after the 2008 crash as a timely intervention, had evolved into a cyclone of liquidity that nearly a decade later dares its creators to diminish it. Liquidating $4.5 trillion (only for the US) in securities without rousing unintended circumstances would be difficult enough in the best of times, let alone in a rising interest rate environment that the Fed is pursuing without the help of compelling rates of inflation. Add growing political risk at home and abroad - continued dysfunction in Washington, isotope-rattling on the Korean peninsula - and one wonders if Fed Chair Janet Yellen might breathe a silent prayer of thanks given she is likely to be termed out to make room for a Trump hire.

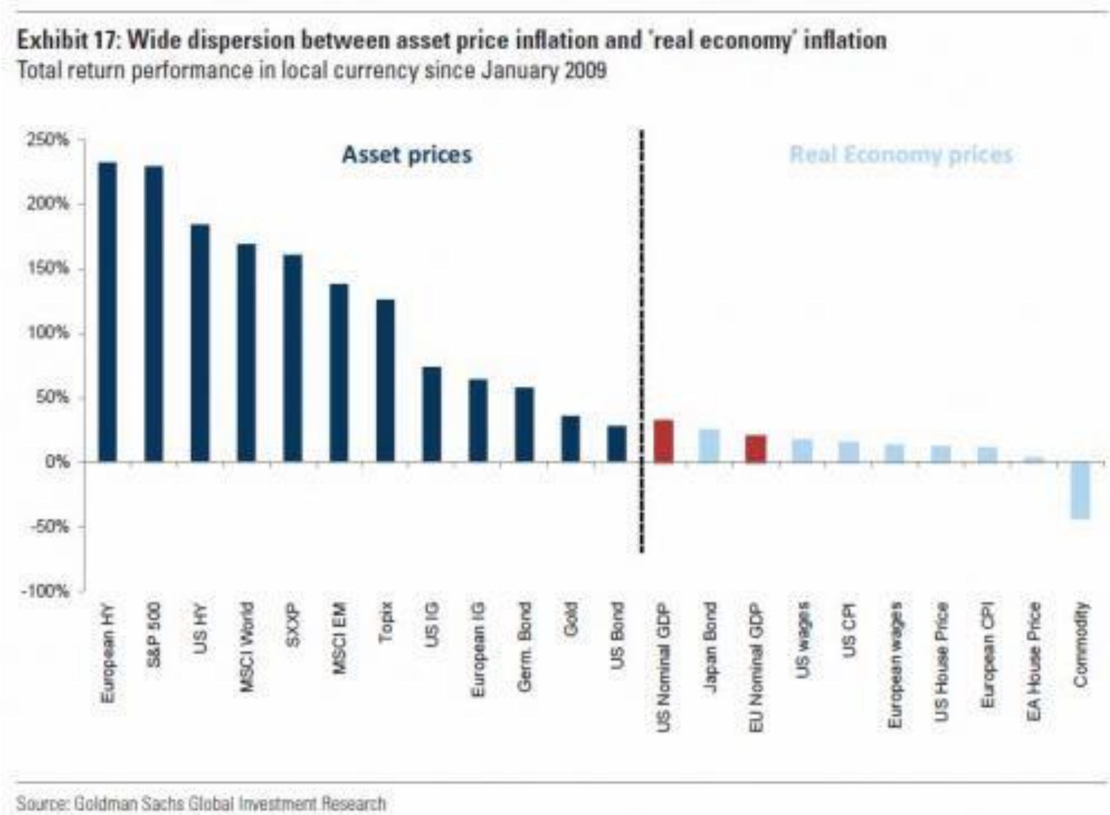
Of course, that would leave us to struggle on our own with the third quarter's natural and man-made disarray. Congress's chronic inability to fix the nation's health care system does not bode well for the prospects of tax reform, for example, and the power couple Harvey and Irma did their best to derail what we had estimated would be a good year for growth. On the other hand, stock markets ended the last three months in record high territory and many are arguing the failure of health care may be balanced with the passing of the aforementioned tax reform.

US Markets:

The Fed confirmed it would begin unwinding its $4.5 trillion debt portfolio accumulated under a crisis-era stimulus program. According to the Fed, it will liquidate $6 billion in Treasuries and $4 billion in mortgage-backed securities per month, rising every three months until the amounts reach $30 billion and $20 billion per month, respectively. Though the long-term plan has bearish implications for bond prices, the US Treasury yield curve collapsed on the announcement, dipping to levels not seen since 2007. Yields, however, recovered by the end of the month with the 10 Year Treasury yielding 2.33%.

In a webcast, DoubleLine's Jeffrey Gundlach warned investors that the run-up in share prices was largely fueled by the very stimulus program the Fed is now phasing out. He forecast turbulence for stock markets next year, noting that the percentage of S&P 500 components above their 200-day moving average was "really weak."

The Fed also signaled that it would raise interest rates for a third time this year, most likely in December, despite benchmark indicators that show inflation lingering below the Fed's target rate of 2.0%. Indeed, Robert Kaplan, The Fed's Dallas president, raised eyebrows when he declared that the US economy's real inflation rate could be as low as 0.25%. His comments were interpreted by the website ZeroHedge as a signal that the "economy's potential is lower than consensus assumes and that the Fed is finally considering the gargantuan US debt load in its interest rate."



Bank of America also piled on. Barnaby Martin, the bank's head of European Credit Strategy, concluded that global government, household and non-financial corporate debt has swelled to more than $150 trillion compared with global GDP of just above $60 trillion. As a result, Martin wrote, "both the global economy and central banks are now held hostage by both the unprecedented stock of debt injected into capital markets to offset the financial crisis and the record low interest rates associated with it." Martin concluded that some $51 trillion in fixed-income debt worldwide "is at risk if rates spike and yields move higher."

At the same time, *The Wall Street Journal* pointed out that weak trend inflation may be a secular, rather than cyclical, reality. It argued in an article that every recession since 1982, core inflation trended lower than it did in the previous economic cycle. A senior Fed official chimed in, noting that inflation has dropped 0.25-0.75% in the past decade, a deflationary trend that can only be reversed by driving the unemployment rate below its natural rate until it meets inflation targets. (That assumes, of course, that the Phillips curve and NAIRU framework is still valid.)

Despite these concerns, global stocks set new highs by the end of the quarter - to 110% of global GDP, or $84 trillion according to the Bloomberg World Stock Market Index - fueled in part by Fed hawkishness. However, the *Financial Times* reported outflows from US markets worth $7.5 billion in the week ending September 27, the largest volume of redemptions since the third week of June and the 13th in the last 15 weeks of US equities outflows. Financial-sector stocks bucked the trend however, taking in nearly $1.4 billion, the biggest sectoral inflow since the first week of July, Bloomberg reported. Junk bonds also fared well, attracting $1.36 billion in inflows, a ten-week high, while bond funds overall took in $3.2 billion.

9/30/2017	Economic and Market Review				3 Mo. Ago	1 Yr. Ago	
			1 Mo. Ago				
Overall	Indicator Name	Value	1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change
▲	S&P 500 Total Return	4,888	4,762	▲ 2.65%	▲ 4.48%	4,121	▲ 18.61%
▲	Russell 2000 Total Return Index	7,310	6,812	▲ 7.31%	▲ 5.67%	6,054	▲ 20.74%
▲	MSCI EAFE Total Return	7,801	7,561	▲ 3.18%	▲ 5.47%	6,520	▲ 19.65%
▼	MSCI Emerging Markets Total Return	2,346	2,353	▼ -0.32%	▲ 8.04%	1,909	▲ 22.91%
▲	10 Year Treasury Rate	2.33%	2.15%	▲ 8.37%	▲ 1.30%	1.60%	▲ 45.63%
▼	Barclays US Aggregate Total Return	2,038	2,045	▼ -0.34%	▲ 0.85%	2,037	▲ 0.07%
▲	AMEX Dollar Index	93.07	92.9	▲ 0.24%	▼ -2.69%	95.42	▼ -2.46%
▼	Euro to US Dollar Exchange Rate	1.18	1.19	▼ -0.92%	▲ 0.67%	1.12	▲ 5.78%
▼	US Dollar to British Pound Exchange Rate	0.75	0.77	▼ -3.49%	▼ -3.03%	0.77	▼ -2.9%
▲	US Dollar to Chinese Yuan Exchange Rate	6.65	6.59	▲ 0.93%	▼ -1.86%	6.67	▼ -0.23%
▲	US Dollar to Japanese Yen Exchange Rate	112.64	110.20	▲ 2.21%	▲ 0.21%	101.21	▲ 11.29%
▼	Gold Price in US Dollars	1,283	1,309	▼ -1.94%	▲ 1.23%	1,323	▼ -2.98%
▲	WTI Crude Oil Spot Price	51.67	45.96	▲ 12.42%	▲ 2.91%	47.7	▲ 8.28%
▼	VIX	9.51	11.22	▼ -15.24%	▼ -7.31%	13.29	▼ -28.44%

Source: yCharts

Corporate earnings also posted solid gains in the last three-month period, averaging 4.5% among S&P constituents, though this was less than half the growth rate of the previous two quarters. Bloomberg, however, citing a new report from Morgan Stanley, forecasted a return of double-digit earnings growth in the fourth quarter.

Metals fared poorly as first-half hopes for a credit-fueled price surge dissolved in the shadow of China's economic slowdown. Demand for industrial metals from copper to iron ore and zinc all plunged late in the third quarter as a result of dwindling Chinese consumption and rising inventories.

The ratings agency Moody's warned of a persistent decline in its Covenant Quality Index, which tracks the integrity of terms agreed to by bond issuers and borrowers, such as debt limits, for the sake of bondholder protection. The five-point index worsened to 4.51 last month, just one basis point off its worst-ever score of 4.52 set in August 2015. According to Bloomberg, three-quarters of the $1 trillion market for U.S. leveraged loans are now defined as "covenant-lite," meaning a company could debt-binge with impunity. According to the *WSJ*, the volume of levered loans have surged beyond 2007 levels, despite the collapse of brick-and-mortar retailers and warnings that "the market is getting frothy." However, it's important to bear in mind, with every market sector, skilled credit selection can still be beneficial for client portfolios.

Sustaining a year-long trend, the VIX, or volatility index, posted its lowest daily average in any September since the data was first collected in 1990.

Contrarians amplified their warnings of a collapse. Bank of America's Michael Hartnett, who has dismissed the current bull market as the creation of a "Liquidity Supernova" that is not long for this world, argued there is "no disconnect between stocks & bonds" owing to just $1.9 trillion of global central bank purchases of financial assets in 2017 alone. Central Bank balance sheets, Hartnett wrote in The *New York Times*, have grown by $11.2 trillion since the collapse of Lehman Brothers to $15.6 trillion today. Also in the *Times*, Robert Shiller noted the chilling similarity between current stock-market fever charts and those that prevailed prior to the 1929 crash as well as those of subsequent market bubbles. "This is not to say that a bear market is guaranteed," cautioned Shiller. "But my analysis should serve as a warning against complacency."

Meanwhile, Howard Marks, Co-Chairman of the US investment firm Oaktree Capital, warned in an interview that valuations of listed securities are "uncomfortably high" and that investors are dangerously complacent. UBS Group, the world's largest wealth manager, told clients to take profits on their stock holding as rising values make it more difficult to generate "significant" further gains. Stocks this year have climbed 15 percent globally, the group pointed out, twice its expected long-term returns.

US Economy:

Investors cheered the unveiling of a White House tax-reform plan - condemned in equal number by a non-partisan fiscal watch-dog as a sop to the rich. The dollar continued to trend lower, which Bryce Coward of Knowledge Leaders Capital attributed to such negative factors as the prospect of non-neutral tax cuts that will deepen existing budget deficits, tepid economic growth and political risk in Asia. In addition, warned Coward, the dollar has punctured the bottom of a multi-year trading range "with absolutely no technical support in the vicinity."

Citing widespread damage done by hurricanes Harvey and Irma, the Atlanta Fed lowered its third-quarter GDP forecast from 3.0% to 2.2% while its New York counterpart went farther, slashing its 2.1% third-quarter growth estimate to a mere 1.3% and its fourth quarter projection

9/30/2017	Economic and Market Review						
		Last Reported	1 Mo. Ago		3 Mo. Ago	1 Yr. Ago	
Overall	Indicator Name	Date	1 Mo. Ago	% Change	% Change	1 Yr. Ago	% Change
▼	US Core Inflation Rate	8/31/2017	1.69%	▼ -0.46%	▼ -2.83%	2.32%	▼ -27.37%
▼	ADP Change in Nonfarm Payrolls	9/30/2017	228	▼ -40.69%	▼ -29.54%	217	▼ -37.59%
▼	US Unemployment Rate	9/30/2017	4.40%	▼ -4.55%	▼ -4.55%	4.90%	▼ -14.29%
▲	US Producer Price Index: Savings Institutions	8/31/2017	95	▲ 1.27%	▲ 2.13%	92	▲ 3.57%
▲	ISM Purchasing Managers Index	9/30/2017	59	▲ 3.40%	▲ 5.19%	52	▲ 18.06%
▼	US Housing Starts	8/31/2017	1,190	▼ -0.84%	▲ 4.52%	1,164	▲ 1.37%
▲	US 30 Year Mortgage Rate	9/28/2017	3.82%	▲ 0.26%	▼ -1.29%	3.42%	▲ 11.99%
▲	US Consumer Price Index	8/31/2017	244.0	▲ 0.40%	▲ 0.49%	240.4	▲ 1.93%

Source: yCharts

from 2.6% to 1.8% for an annualized growth rate of just 1.8%. Initial jobless claims spiked by 62,000 to a total of 298,000, the highest level since April 2005.

August Retail sales fell 0.2% on a monthly basis and July's surprise gains were cut in half due to revisions, according to the U.S. government, the worst sales numbers since January 2016, as online spending tumbled 1.1%. The declines were punctuated by the failure of Toys "R" Us Inc., the largest US toys retailer, which filed for bankruptcy as a result of crushing debt and relentless competition from warehouse and online retailers. Washington also announced that Industrial Production dropped 0.9% in August, its biggest monthly drop since May 2009 and its worst year-on-year performance in six months.

Home sales posted their fifth monthly contraction in the last six months and, according to CNBC, "are not expected to improve anytime soon." The National Association of Realtors reported that pending home sales fell 2.6% in August compared to July and were flat on a year-on-year basis, testing their lowest levels since January 2016. Meanwhile, housing starts in August dipped by 0.8 from a revised July estimate but rose by 1.4% compared to August 2016. Meanwhile, 5.7% more building permits were issued in August than in July, with 1.3 million authorizations, and up 8.3% compared with year-ago figures.

September auto sales recovered from significant declines in August as consumers rushed to replace flood-damaged cars. Turnover at General Motors, Ford Motor and Toyota rose nearly 12%, 9% and 15% respectively, though Chrysler extended its losses from the previous month.

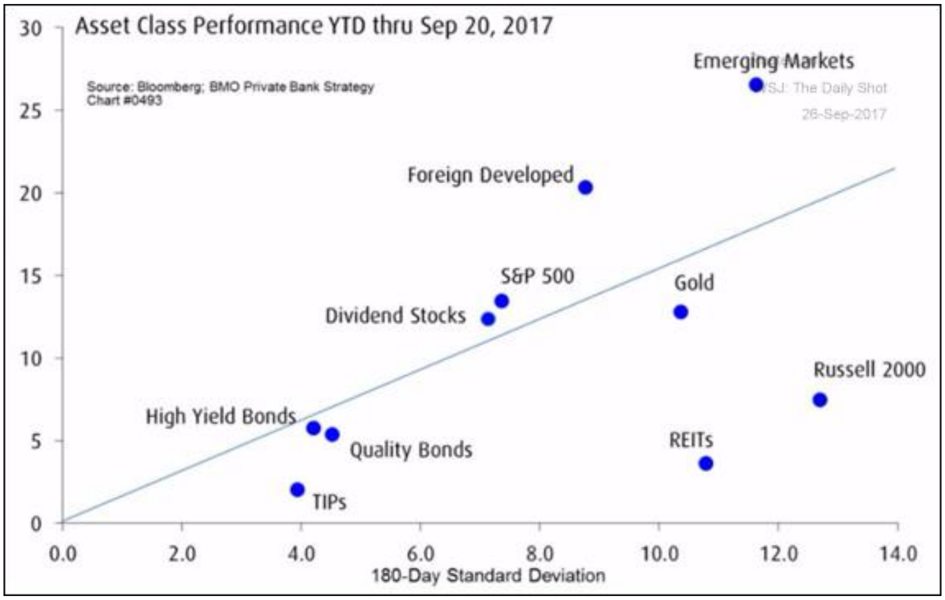
Real hourly earnings plunged 0.6% in August and housing costs continued to climb as the shelter component of the Consumer Price Index rose by 0.5% to its highest rate since 2005, according to the U.S. government. In a related move, Morgan Stanley downgraded subprime lenders Capital One and Synchrony, prompting some analysts to conclude that, despite a stable economy and near-full employment, credit card delinquencies are multiplying due to onerous financial pressures on subprime consumers, including stagnant wages, diminished consumer credit, rising rent and health care costs with the result being diminished discretionary income due expanding debt-service obligations.

On the plus side, consumer confidence remained buoyant. The Conference Board Consumer Confidence Index®, which had improved marginally in August, declined only slightly in September sustaining a multi-quarter disconnect between hard and subjective data.

International: *More Europe*

The European Central Bank said it estimates 2018 debt reinvestment would average €15 billion per month as ECB Executive Board Member Peter Praet reaffirmed bank expectations that the euro zone needs substantial stimulus to revive its 2% inflation target. This begs the question: are the Fed and the ECB working at cross purposes if the former sells $10 billion from its portfolio and the ECB buys $10 billion?

Either way, Europeans feel good about the future. The European Commission's Economic Sentiment Indicator, which measure business and consumer confidence, rose to 113.0 in September from 111.9 in August, its strongest reading since June 2007.



The Eurozone Flash Manufacturing and Services PMI readings came in better than expected in September as private-sector activity jumped to a four-month high of 56.7 from 55.7 in August. Both services and manufacturing strengthened, particularly the latter, to one of its highest levels in six years.

Investors tired of the miserly returns in junk bonds are shifting their money to high-yield, if increasingly expensive emerging-market debt, according to Bloomberg. The MSCI EM Index rose to its highest level in over five years as investors chased riskier, higher-yielding assets. The nearly 30% surge in 2017 has pushed valuations to their most expensive levels since the start of 2010, a warning sign that the sector may be overbought.

STAR™ Spectrum Portfolios: *Performance Summary*

Fixed Income:

Despite the Fed officially announcing the unwinding of their balance sheet during the quarter, returns were modestly positive for broader bond market indices. Our defensive duration posture has helped the portfolio remain steadfast in the face of uncertain markets. More specifically performance was mostly aided by our allocations to Mortgage Holdings (DPFNX) and Emerging Markets (CEMB). We anticipate more opportunities in the fixed income markets during the final quarter of the year as the Fed beings unwinding their balance sheet and potentially raises rates once again in December.

Equity:

Equities were positive during Q3 with Emerging Markets once again outperforming all other equity asset classes. Overall our equity positions were positive for the quarter and in line with the S&P 500's return of 4.49%, but slightly less than MSCI All-Country World Index which were positive at 5.34%. Our Emerging Market and US Small Cap allocations led the way for our portfolio, with US Large Cap stocks also positive. On net, our approximately 8% cash buffer and lighter allocation to Non-US Developed stocks account for the performance difference.

Alternatives:

Our alternatives allocation was strong for the quarter, Our Market Neutral holdings were the main contributors . The allocation to REITs was generally flat while Convertibles were a slight detractor.

Summary of STAR™ Spectrum Strategy Performance and Attribution

	Portfolio Weight (Equity Based & Income-Derived Models)	Q3 2017 (%)
Equity	100%	Positive (+)
Large Cap	61%	Positive (+)
Small Cap	25%	Positive (+)
Non US Developed	11%	Positive (+)
EM Market	3%	Positive (+)
Fixed Income	100%	Positive (+)
Investment Grade	73%	Positive (+)
EM Market Bond	7%	Positive (+)
Mortgage	9%	Positive (+)
US High Yield	11%	Positive (+)
Alternative	100%	Positive (+)
REITS	22%	Positive (+)
Convertibles/Preferreds	30%	Negative (-)
Multi-Asset	16%	Positive (+)
Private Equity	32%	Positive (+)
Cash*	8%	Positive (+)

*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.

Portfolio Update: *Multi-Asset Portfolios*

- There were no changes to strategy holdings during Q3 2017.
- The Investment Committee continues to scrutinize our modest holdings to international and emerging market equities as those sectors have rallied strongly through the first three quarters of the year.

- Since the inception of our allocation to XLF, performance has been lackluster compared to our expectations. However, we reviewed and reaffirmed our commitment to Banks and Financials as a thematic position, and have already been rewarded with a strong performance bounce. Year to Date through the end of Q3, XLF was up over 11%.

Sincerely,

David Young, CFA
Chief Investment Officer

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