Economic & Investment Perspectives

2018: The year of preserving your income, wealth, and sanity!

While a lot can be said for the markets in 2017 – and a lot has already been said – what crosses our minds the most, however, (and rarely heard these days), is the great Yogi Berra's quote "It's Deja Vu All Over Again."

We have been and remain cautious on the aging economic cycles in much of the developed and closely associated emerging market economies, cautious of fiscal policies, particularly those coming out of Washington and London, concerned about central bank complacency, and particularly anxious about valuations in equity and credit markets of the North Atlantic[1].

And while we have seen bright spots within the emerging markets universe and select fixed income markets, general over-valuation across the majority of asset classes and markets that we follow reminds us of the peaks of the two most recent cycles, and the weird science we were inundated with in rationalizing those lofty appraisals.

Will the financial engineering of the US tax system somehow bring about an expansion of productivity growth and labor force participation that historically required a different approach? Is it possible for protectionism and populism to bring about an increase in real wages across the North Atlantic? Can departure from the world's largest economic union (i.e. Brexit) and one of the most innovative trading zones (i.e. TPP) and their associated costs really bring about the economic nirvana promised by 21st century nationalists? Can a revitalization of centuries-old methods of financial exchange (i.e. bartering), with new platforms and eccentric names such as Bitcoin, Ether, and Ripple, replace the mighty Dollar, the Euro, Yen, or Yuan?

> "Given the risks, we are firmly in a period where the costs of potential further gains far outweigh the long-term benefit of remaining defensive and preserving existing gains."

Can the buzz and euphoria surrounding the above, coupled with the associated revaluation of financial assets and balance sheet risks (to levels not seen in many decades), bring about a promised "era of permanent prosperity" with new rules and standards that their promotors would so strongly have us believe, or is Yogi Berra's quote alive and well?

For speculators, the costs of being wise when everyone is foolish are too high. But for investors, any short run gains from being part of a foolish crowd are dwarfed in the long run by the inevitable costs of being over exposed to overvalued assets. Given the risks, we are firmly in a period where the costs of potential further gains far outweigh the long-term benefit of remaining defensive and preserving existing gains.

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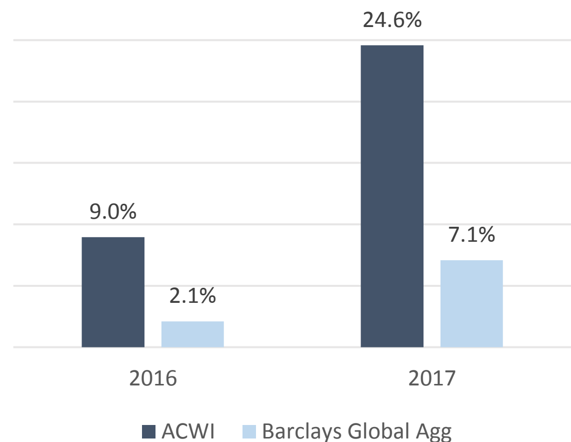
[1] ACIMA Private Wealth 2017 Outlook 1/1/17

2017: Year in Review

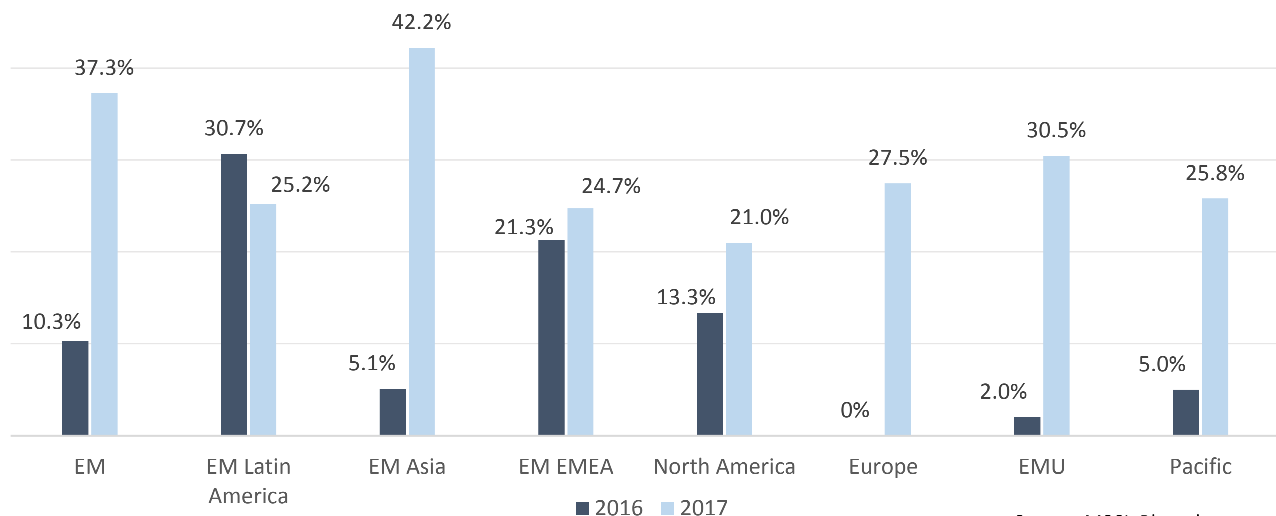
Global equities (as measured by the MSCI All Country World Index) finished 2017 with their best single year performance since 2009 (see Chart 1), rising a total of 24.6%. The performance also happened to be the fourth best since 1995, and the best late cycle rally since the 31.0% rise in 1999.



The MSCI ACWI finished December up for the fourteenth consecutive month, seventeen out of the past eighteen months, and twenty out of the past twenty-two months – all unprecedented over the twenty-three-year history of the index.

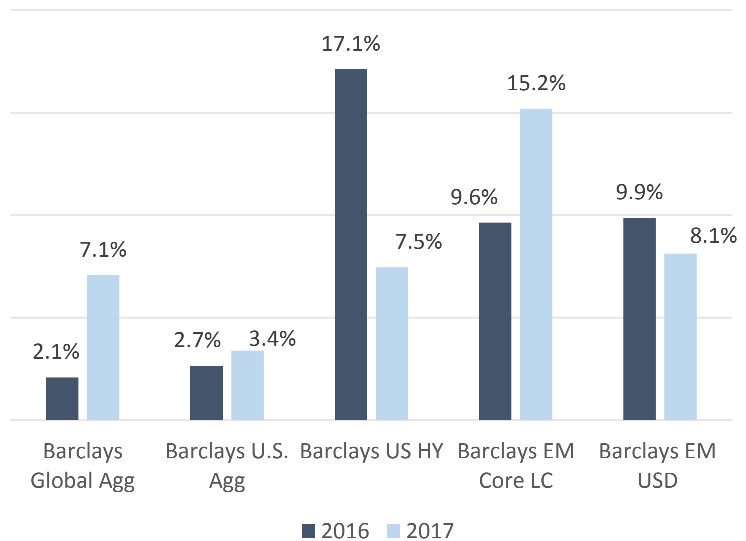
The appetite for risk taking was clearly on exhibition as the ACWI outperformed the Barclays Global Aggregate Bond Index by a significant margin of 17.5%, completely overshadowing the fact that the fixed income index itself was up a very strong and unusual 7.1%, its best performance in exactly ten years.

Within equities, leadership in the second half of 2017 remained consistent with that of the first half: emerging markets and non-USD markets. Emerging markets in general outperformed select regional developed markets by margins of 700 to over 1600 basis points (see Chart 2). Within emerging markets there was rotation in leadership from Latin America to Asia, while Eastern Europe, the Middle East, and Africa (EMEA) continued to perform strongly with back-to-back years of total returns over 20%. The non-USD story was particularly evident across the Atlantic in Continental Europe, where European



Monetary Union (EMU) equities rose 30.5% in USD terms while rising only 11.6% in Euros. From a US equities perspective, while the MSCI USA Index returned 19.5% in USD terms, it returned only 5.0% in Euro terms. More on the USD story in our 2018 themes.

Across the fixed income universe, local currency emerging markets bonds benefited from the weaker USD and topped the performance charts with 15.2% total returns (see Chart 3). The story of emerging markets went beyond just the currency effect, as even USD debt performed valiantly, returning 8.1% for the year. The US Aggregate Index returned less than half of the Global Aggregate return of 7.1%. Within the US, despite the beating during the second half, the high yield market performed admirably with a 7.5% return, though not nearly as well as last year's double-digit return.



Commodities returned 5.8% (GSCI Commodity Index), after a relatively healthy 11.4% during 2016. However, the USD effect was in full force, as the index returned -7.2% in Euro terms, -1.5% in Canadian Dollar terms, and 2.1% in Japanese Yen terms. Within the sector, US Crude rallied nearly $7/bbl to close the year above $60/bbl for the first time since the summer of 2015. Gold rallied $150/oz and closed the year above $1,300/oz. US Copper prices had a strong year closing at $3.30/lb, its highest levels since 2014. We have and continue to believe that there is relative value in global commodities, as we will discuss in our 2018 themes.

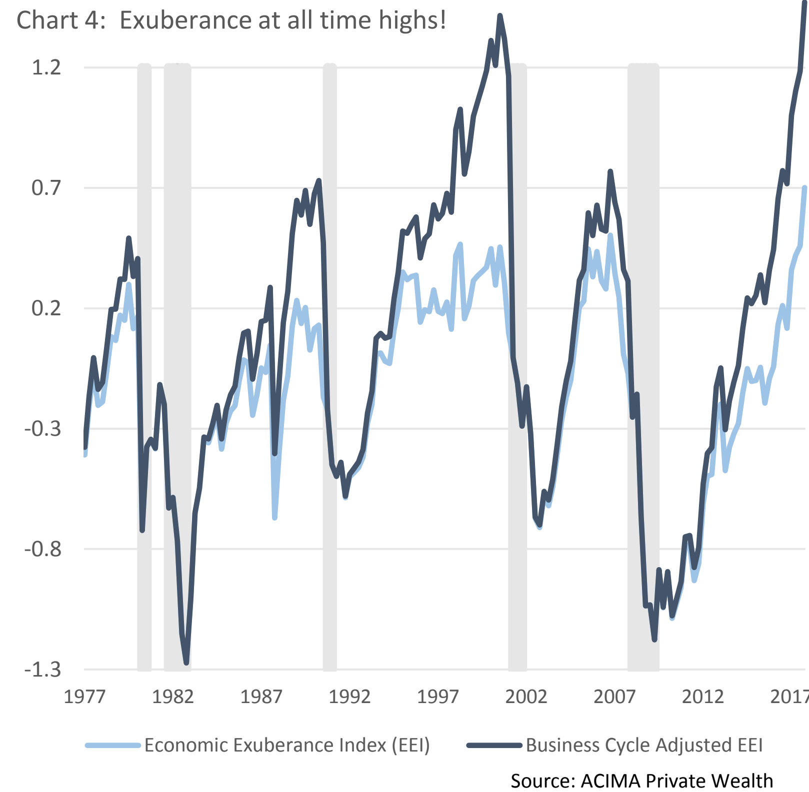
Five Themes for 2018:

Exuberance

If it feels like exuberance, sounds like exuberance, and looks like exuberance… then it's exuberance.

We are hard-pressed to find a sell side outlook for 2018 that somewhere in its many pages does not refer to the age of the business cycle and the bull market in US equities, stretched valuations that in most instances are in the extreme, and consumer and business confidence levels that match prior cyclical peaks. However, as typically is the case, most of these references are in the offing with the usual bull market arguments about their ineffectiveness this time around.

Earlier in 2017, we introduced the ACIMA Economic Exuberance Index (EEI) in an attempt to quantify "euphoria" by utilizing a series of business/consumer surveys and financial market data that historically had exhibited peaks and troughs coincidental with what we considered to have been "euphoria" after the fact[2]. Our goal was to create an indicator that allows us to see the road in the midst of the fog of bull market excitement and the proverbial "but this time is different," which we often hear late in every economic cycle.



As seen in Chart 4, whether it is the pure EEI index or the economic cycle augmented index, as of the end of Q4, both are at all-time highs by healthy margins.

The implications of such exuberance are quite clear. Shortly after prior peaks were reached (at even lower EEI levels), economic recessions have ensued, giving us strong confidence that the most recent Bloomberg consensus and Blue-Chip consensus of recession probabilities of 15% and 18% for 2018 are too low, as is the Blue-Chip consensus probability of nearly 30% for 2019.

An alternative index developed by Goldman Sachs, the Bear Market Risk Indicator, recently crossed into territory that implies a 27% probability of a bear market (defined as a market decline of 20% or greater) in the next 12 months, and a 44% probability within the next 24 months.

To paraphrase a quote from the late '90s by the legendary investor Warren Buffett: if what we are observing in the equity markets of the United States heading into 2018 is not exuberance, then we're not sure what exuberance is any longer.

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[2] Mobasheri, Ardavan, October 10, 2017. "Exuberance near a 40-year high, but no telling how long it will last" CNBC.com

Fiscal Policy

Haphazardly put together policy prescriptions—meant for a different time, different place, and a different problem—do not create economic growth.

To the credit of the President and the GOP leadership in Congress (and much to our surprise), a campaign pledge to lower taxes within the first year of the Trump administration was achieved right in time for the holidays.

However, to the detriment of the federal budget, a policy prescription was passed that neither solves the primary issues facing the U.S. economy today nor impacts economic growth in the longer run.

Given the stated number one goal of passing something quickly and in the first year, what was achievable was going to be small and limited, which is essentially what was ultimately sent to the President's desk. It was only a year ago when the initial goals were to lower corporate tax rates to 15%, introduce a Border Adjusted Tax (BAT), and lower the highest marginal tax rates for individuals to 25% amongst a larger set of "reforms." What was ultimately delivered was a lower statutory corporate tax rate that, once all is said and done, benefits a limited number of industries (retail, utilities, telecom services, smaller banks, and healthcare) with a purely domestic focus, which with the exception of the Pharmaceutical industry, are not necessarily globally competitive, and are not productivity enhancing.

On the individual side, while Democrats and Republicans will debate ad nauseum who the primary beneficiaries are ultimately going to be, what was signed was essentially a token drop in marginal tax rates, and at best the net economic impact will be a very marginal short-term increase in spending on consumer goods (many of which will be imported from overseas), before they expire in the future.

While the success of the tax cuts of 1981, and the tax reforms of 1986 have been debated and discussed for decades and are beyond the scope of our outlook, understanding the premise for them is extremely important in trying to understand the weakness of the Tax Cuts and Jobs Act (TCJA) of 2017.

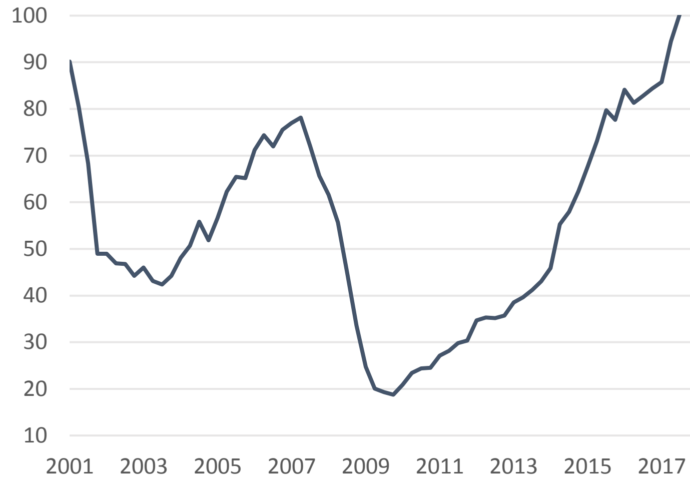
> "Our growth forecasts take into account a significant amount of uncertainty with respect to the longevity of the TCJA in its present form, as well as likely responses from other countries in countering the lower statutory rate of corporate taxation."

The United States economy of the late 1970s and early 1980s was one that despite rapid jobs creation and high utilization rates of resources had an infrastructure not built for the evolving deregulatory environment and the associated uncertainty in factors of production that were a byproduct[3]. As a result, confidence and corporate profits were low, and the economy failed to create enough jobs to absorb the millions of baby boomers and women who were entering the labor force. Inflation and unemployment rates were high (stagflation), interest rates were prohibitively costly, and a tax system not indexed to inflation was overly burdensome. While the degree

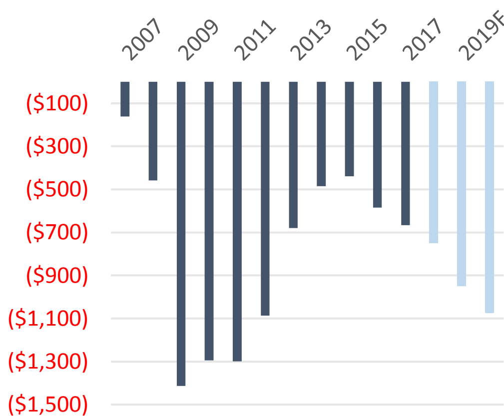
[3] Mobasheri, Ardavan, January 11, 2018. "Trump's growth plan depends on a healthy dose of international trade." CNBC.com

of tax cuts was heavily debated, there was general consensus around the idea that tax reform was the policy prescription of choice to increase corporate profits and inspire confidence to expand and hire in an economy that was still largely closed.

Unlike the 70s and 80s, the US economy of the second decade of the twenty first century is one that is facing low inflation and unemployment, high corporate profits, excess industrial capacity, and a tax system that has one of the lowest rates in the world relative to economic output. The private sector of the U.S. is not facing a shortage of jobs—it is facing a shortage of skill sets. In fact, as our own ACIMA Employment Power Index indicates, the U.S. is experiencing the best job seeking environment in 17 years (see Chart 5). It is not facing a shortage of credit, capital, or profits; it is facing a shortage of productivity-enhancing technological change. While a marginal increase in after-tax profits or incomes will encourage some increase in spending, the impact will be minor and unsustainable.



Our growth forecasts take into account a significant amount of uncertainty with respect to the longevity of the TCJA in its present form, as well as likely responses from other countries in countering the lower statutory rate of corporate taxation. As various experts and stakeholders at state, local, and federal levels digest and understand the legislation, the negative unintended consequences will be unmasked, which by themselves enhance uncertainty. At the same time, as governments in other countries understand the legislation, we are likely to see counter-proposals appear in order to defend and protect investments made by U.S. entities in those countries.



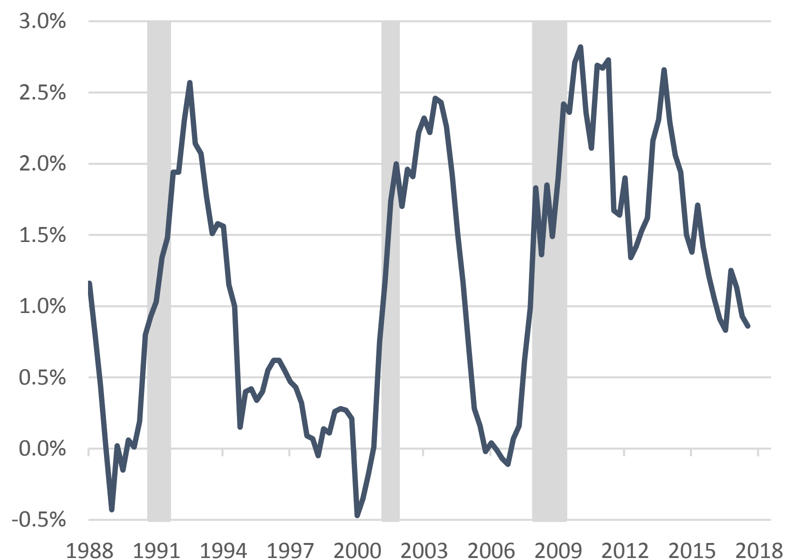
Our preliminary analysis of the TCJA concludes a short-term jump in business investment in capital equipment and a marginal rise in consumer spending, which will likely fade by the end of 2018. Simultaneously, the rise in the deficit to $750B by YE 2018, and bordering on $1.1 Trillion by mid-2020 (a likely recession by that date will increase the deficit further – see Chart 6), will crowd out a significant amount of lending to the private sector, constraining employment growth and investment. Our preliminary recession-neutral

forecast calls for growth in the first half of the year to average 2.8%, and roughly 2.1% in the second half, followed by 1.85% in the first half of 2019. While a recession in the first half of the year is unlikely, the risks materially rise as we head into the second half of the year and 2019.

Yield Curve

When it comes to the economy, trust the bond market and not the stock market.

Stocks forecast earnings, but bonds forecast the economy. One of the interesting elements of this cycle (though not really surprising at all), is how Wall Street pundits and strategists have embraced the "lack of volatility" in the equity markets as a sign of further economic confidence and growth. The irony of course is that in prior cycles the "existence of volatility" was widely considered as simple noise and not a sign of economic uncertainty ahead. The eminent economist and the first American to win the Nobel prize in Economics, Robert Samuelsson, coined the phrase "the stock market has predicted nine of the past five recessions."



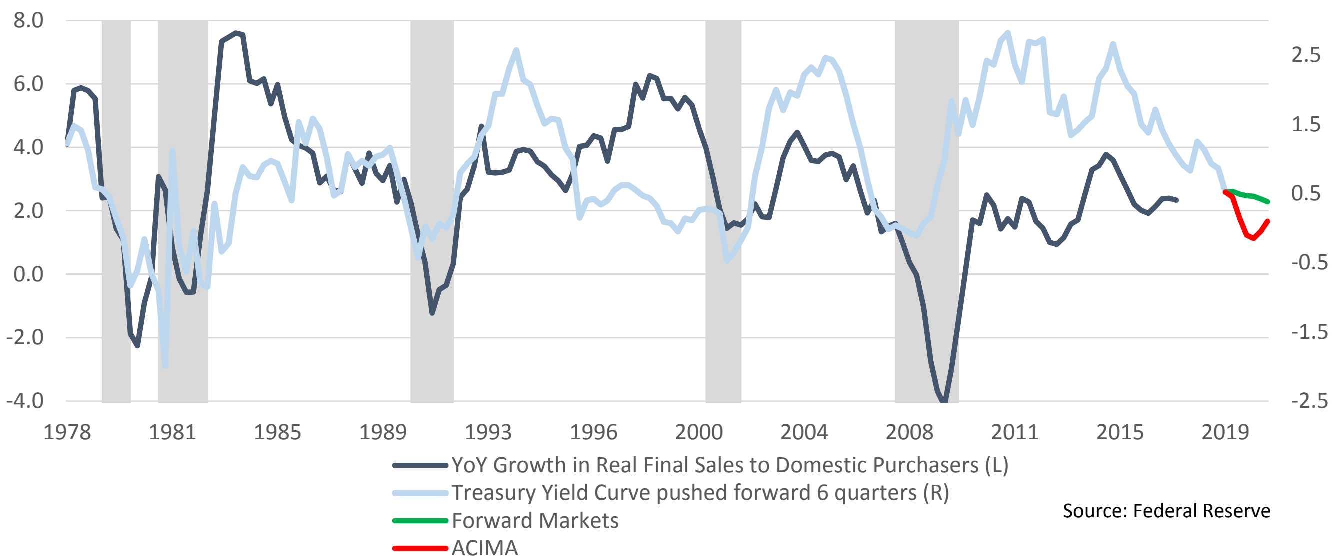
The equity markets indeed have historically been more volatile than the economy, rising and falling by faster rates than the economy in general with many false signals, as Prof. Samuelsson stated. However, false signals are not necessarily limited to the downside. In fact, they are not. Periods of low or dropping volatility late in economic cycles have often been associated with periods of "exuberance," low future returns, and underperformance of equities, and not just in the U.S.

Moreover, the drop in volatility and higher equity prices in the U.S. during 2017 have been associated with the outperformance of multinational equities. While this is not discussed often, it should not be surprising. A large part of the reason for the 3.0% plus growth in both Q2 and Q3 GDP was due to improvements in the trade balance and inventory building, not in the strength of domestic final sales.

Real Final Sales to Domestic Purchasers, the component of GDP derived purely from domestic finished goods sales, has historically been the best way of assessing the strength of aggregate demand within the domestic economy. Excluding inventory buildup from the picture allows analysts to understand how strong demand is in real time without the noise of business speculation for demand in the future which inventory buildups and drawdowns typically expose GDP too. If we are to see any positive impacts from

tax legislation, domestic spending (private and public), and improved consumer confidence, then we should see it improve the growth rate of this series.

Without significant weakness in this series, the economy is unlikely to experience a recession. And while equity markets may be too volatile for the economy, the bond market in general and the yield curve in specific have done an admirable job of predicting future weakness in GDP. In fact, all prior recessionary weaknesses in Real Final Sales to Domestic Purchasers have been predicted by an inverted yield curve as represented by the difference in yields between the ten-year and two-year Treasuries.



The forecasting power of the yield curve lies primarily in its forward assessment depicted through flattening and inversion well in advance of economic contractions. How far in advance? Our various studies over the years have shown a lag of as much as six quarters (see Chart 8). The flattening by nearly 70 bps in the yield curve during 2017, and whether it is the forward market projections or our own projections for the coming six quarters, foretell a significant slowdown in domestic aggregate demand over the coming 18 months and well within the historic levels of prior recessions.

Valuation

Valuation has always mattered. This time is no different.

The yield curve is not only a great predictor of economic recession/slowdowns, appropriately enough it is also a good forward-looking predictor of equity market valuations especially late in the economic cycle.

The rationale is clear: yield curves flatten and invert due to tighter monetary policies pursued by central banks via higher short-term interest rates usually mid to late in the economic cycle. Higher short-term interest rates impact corporate and consumer behavior via the opportunity cost of inaction. Meaning if

borrowing costs are higher or anticipated to be higher, then economic activity such as consumption and investment will be delayed and/or at times temporarily pushed forward. In either case, an outsized drop (below trend) in consumption and/or investment occurs beyond the immediate short-term which in many instances causes a recession. The anticipation of that weaker economic activity and future lower short-term interest rates lowers term premiums (the compensation investors expect to receive by holding longer maturity Treasury securities) on longer dated government securities causing yields to drop and eventually fall below the short-term interest rates, inverting the yield curve.

Equity markets, at some point after the beginning of the flattening of the yield curve, begin to anticipate weaker future earnings (or at least a weaker growth rate) which begin to put pressure on earnings multiples. The key question of course is how long after the beginning of the flattening the "at some point" is. Our estimate based on the relationship between S&P 500 trailing twelve months P/E and the year-over-year change in the Treasury yield curve (as measured by the difference between the 10-year and 1-year Treasury securities) is roughly four quarters (see Chart 9). Trailing multiples are now at their highest levels since shortly before the Asian financial crises of '98. Similarly, forward multiples are now at their highest levels since the last two years of the technology bubble.

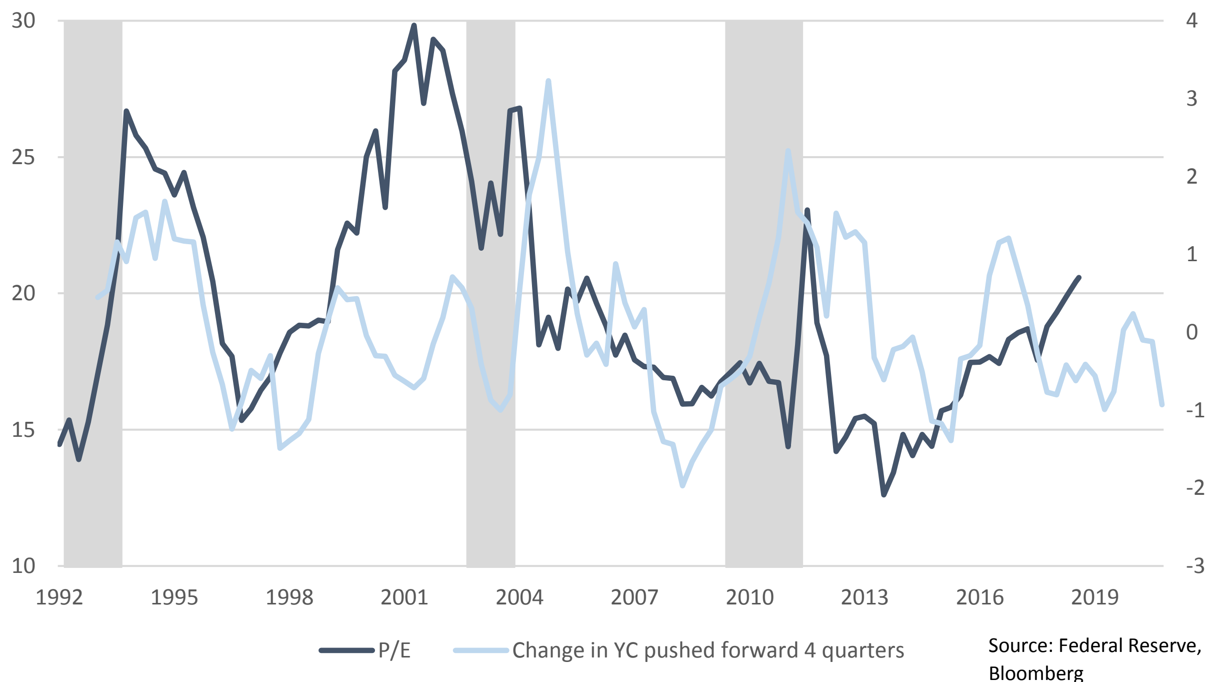


Chart 10: S&P 500 valuation summary

Valuation Metrics	Aggregate index		Median stock	
	Current	Historical %	Current	Historical %
P/E to growth (PEG)	1.3	81%	1.9	100%
EV / Sales	2.3	96%	2.9	100%
EV / EBITDA	11.7	88%	11.9	98%
Price / Book	3.3	87%	3.4	99%
Forward P/E	18.1	89%	18.3	97%
Free cash flow yield	4.3	51%	4.2	57%
Cyclically adjusted P/E*	26.5	88%	NA	NA
Median		88%		98%

** Based on operating earnings*

Source: Goldman Sachs

And when it comes to percentiles, a recent Goldman Sachs report shows that the median stock in the S&P 500 is trading either at all-time highs (100th percentile) or in the 98th percentile or higher on Forward P/E, Enterprise Value to EBITDA ratio, Enterprise Value to Sales ratio, and P/E to growth ratio (see Chart 10).

Whether the curve continues to flatten slightly based on consensus forecasts or inverts (as we may well see), a period of multiple contraction is ahead of us in the US equity markets.

Trade

Trade pacts will come under threat and some even head towards extinction.

Populism was on the move in the developed economies in 2016 and 2017, and we believe there are risks for a spillover into emerging markets that are negatively impacted by the protectionism that populists implement (or at least fight to implement) in the developed economies.

Brexit negotiations face some very difficult hurdles in the coming twelve months, while across the Atlantic, the Trump administration continues to attack existing trade pacts by setting roadblocks that could potentially derail these existing pacts and demanding alterations that are not reasonable.

Brexit

While British and EU negotiators have brought to some conclusion the financial and geographic arrangements of the divorce deal, the more difficult future relationship remains very much open, and the clock is ticking quite fast towards the departure date of 11pm on Friday March 29, 2019. The elections of 2017 have weakened the hands of Prime Minister May and her negotiators, and have put her in the difficult position of remaining tough on her stances (an interesting one given that she was opposed to Brexit prior to the referendum). And unlike some popular perceptions, the opposition Labor Party is not in any better position if it somehow was able to come to power prior to March 2019.

While another general election is not on the plate anytime soon, we believe there is a better than 50-50 chance that Prime Minister May will depart at some point in 2018, perhaps sooner than later as opposition to her within the conservatives toughens and deep differences bring about an unworkable environment for her to sustain leadership and negotiate with the EU at the same time.

Ultimately, we believe the EU will not choose to go for the proverbial kill. Given its strengthening economy relative to that of the UK, and its perceived success in preventing another departure story from

evolving, a deal can be offered where UK services would be given some of the benefits of the single market (enough to entice the UK to accept a deal), while standing tough on almost all other matters including the degree of regulatory freedom the UK is seeking.

In the meantime, the UK economy will continue to suffer and pay the costs of Brexit via reduced confidence, increased regulations, higher inflation, and a weaker Pound. While we have raised our growth outlook for 2018, we believe that growth will cap at no more than 1.2% for 2018, well below consensus.

NAFTA

The sixth round of NAFTA renegotiations are scheduled to start January 23rd in Canada. With local Canadian elections on schedule for the Fall, and Mexican Presidential elections set for July 1st, much needs to be accomplished during the next two rounds and the pressure will be on Canada and Mexico to resist major revisions. However, that is precisely the direction in which the U.S. seems to be pushing the negotiations.

Whether by design for a new vision of NAFTA, or an excuse to push for an arrangement that will ultimately be rejected by Mexico and Canada and lead to the breakup of the pact, the US is pushing for a deal that in effect weakens NAFTA's status globally. Stricter requirements for what can be included within a new NAFTA framework, and to what degree it can or cannot be linked with other countries, is a major point of contention. The U.S. is pushing NAFTA to be limited to what is originated and built and sold within NAFTA, knowing that if agreed to by Mexico and Canada would create a far smaller free-trade zone.

As it stands now, we believe the odds are much greater than 50-50 that the U.S. will announce its intention of leaving the deal at some point in the next twelve months. And while an intention to leave is not leaving per se, the resulting uncertainty that will hover over the markets will weaken the arrangements and reduce the odds that it survives in the longer-run.

Asia

U.S. trade tensions with China, South Korea, Indonesia, and even India will also be on the rise in 2018, especially with the first two as geopolitical tension with North Korea are increasingly linked to economics. Pushback from these countries especially China will be noisy and disruptive as selective nationalism in these countries becomes a natural byproduct of the rise of populism in the North Atlantic. While trade wars are unlikely in 2018, skirmishes of sorts targeted towards specific sectors, products, and counter-measures will be plentiful.

Three Major Implications for 2018

Risky financial assets are simply too risky.

While signals of overvaluation and exuberance are clear across equities and select credit markets of the U.S., including high yield fixed income and securitizations backed by consumer loans, the phenomena are by no means limited regionally. Select equity markets of Asia Ex Japan and Latin America to name a few are exhibiting valuations that are well ahead of themselves from a business cycle perspective, while the high yield bond markets of the Eurozone and the housing markets of Australia and Canada are exhibiting valuations in the extreme.

And of course, no outlook these days is complete without mentioning the colorful likes of Bitcoin, Ether, and Ripple amongst others. While a discussion around the concept of money, cash, and currencies is well beyond the pages of this write up, the almost overnight concentration of wealth comparable to the market capitalizations of the largest technology companies with billions in revenues, or the GDP of Saudi Arabia, the world's largest producer of petrochemicals in what are essentially the barter mechanisms of the 21st century are nothing short of head spinning.

"While signals of overvaluation and exuberance are clear across equities and select credit markets of the U.S., including high yield fixed income and securitizations backed by consumer loans, the phenomena are by no means limited regionally."

Dollar weakness.

We have been generally bearish on the USD since last Summer and believe the primary forces of that time (overseas monetary policy catch-up to the Fed, favorable relative economic growth outside of the US, and policymaking from Washington that favors a weaker USD) are firmly in place, and are now in fact supplemented by our themes discussed above.

If indeed a pickup in relative growth for the U.S. in 2018 will only be temporary in nature due to artificial fiscal stimulus versus natural growth in consumption and investment, as we (and the consensus) believe, then short of a financial crisis, the US Dollar should continue to depreciate against developed market currencies, as well as most emerging markets (with the possible exception of trade sensitive currencies such as the Mexican Peso, and Korean Won).

Commodities will shine.

A stance of the USD is never complete without a corresponding perspective on commodities, and this time is no different. A weak USD will have positive implications for global commodities priced in USDs.

Controlling for all other factors, a weak USD, will lower the price of USD based commodities in other currencies in global markets and naturally increase demand. Economic theory states that any price

adjustment should be one for one, i.e. a 10% drop in the USD should increase the price of USD based commodities by 10%, again controlling for all other factors.

We believe the commodity story of 2018 will include the positive impacts of "other factors," and most bring us to relative valuation. With risky assets on the financial side experiencing the kind of "exuberance" that is concerning to us, the alternative "real" asset side could provide a positive element of not only diversification and hedge, but an outright positive contributor on a stand-alone basis. Global equities have outperformed commodities for the better part of the last six years (see Chart 11) and are now at their highest levels since the early 2000s. A price adjustment of any kind within risky financial assets will in our opinion provide an attractive boost and outperformance for commodities.

Chart 11: Global Equity Outperformance Relative to Commodities

Source: Bloomberg

Conclusion

We are entering 2018 as cautious as we have been for a very long time from a capital preservation perspective. The economic cycles of the North Atlantic are now very aged (i.e. U.S., U.K., Germany), exuberance is rampant in financial assets, and significant spillover has occurred into many emerging markets that have pushed their valuations ahead of their younger economic cycles (requiring price adjustments for those markets to become more attractive). Late-cycle monetary policies, especially those seen in the U.S., are making shorter-duration fixed income more attractive (flattening yield curves are making longer duration assets riskier), and weaker dollar policies coming from Washington are making non-USD assets and commodities a safer haven. 2018 will indeed be the year of preserving wealth, income and sanity.

Wishing everyone a happy, healthy and prosperous year.

As always, stay tuned;

Ardavan Mobasheri
Chief Investment Officer
January 12th, 2018

			Positive	Neutral	Negative
Equities		U.S.	⚪ ⚪ ⚪	⚪	🔴 🔴 🔴
		North America (Ex-US)	⚪ 🟢 🟢	⚪	⚪ ⚪ ⚪
		Europe	⚪ ⚪ ⚪	⚪	🔴 🔴 ⚪
		Asia	⚪ 🟢 🟢	⚪	⚪ ⚪ ⚪
		Latin America	⚪ 🟢 🟢	⚪	⚪ ⚪ ⚪
		EMEA	⚪ ⚪ 🟢	⚪	⚪ ⚪ ⚪
Fixed Income	US	Government / Agency	⚪ ⚪ ⚪	🟡	⚪ ⚪ ⚪
		Investment Grade Corp	⚪ ⚪ 🟢	⚪	⚪ ⚪ ⚪
		High Yield	⚪ ⚪ ⚪	⚪	🔴 🔴 🔴
	Int'l	Government / Agency	⚪ ⚪ 🟢	⚪	⚪ ⚪ ⚪
		Investment Grade Corp	⚪ ⚪ ⚪	🟡	⚪ ⚪ ⚪
		High Yield	⚪ ⚪ ⚪	🟡	⚪ ⚪ ⚪

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