Economic & Investment Perspectives

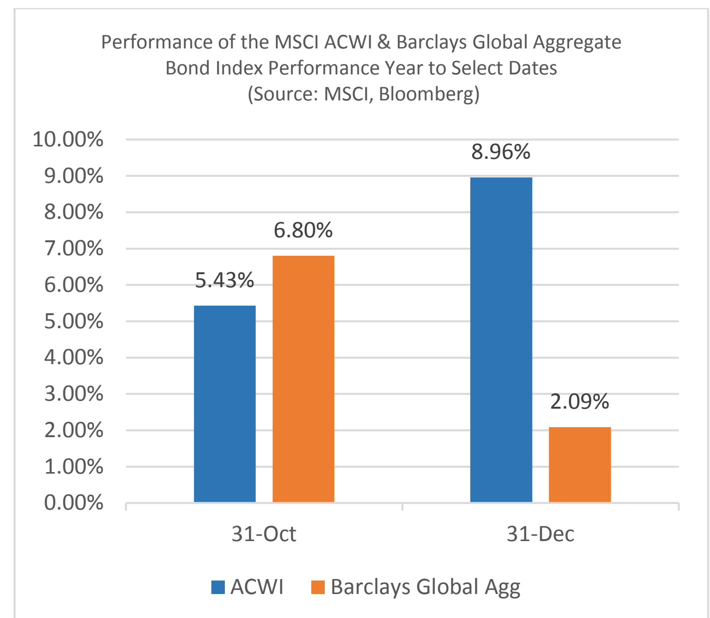
2016 Financial Markets Year in Review

Twelve months ago, the gathering storms of nationalism and populism engulfing the North Atlantic today were admittedly not a major concern of ours. In fact, while there are few detractors in terming the trends as such, associating them with clouds of concern are clearly not what many, especially the financial markets are contemplating at the moment. Not on the surface at least. If a year ago one would have asked us to supplement our relatively cautionary stance with two outcomes, first a vote in favor of Brexit by U.K. voters and second, Donald Trump winning the U.S. presidential elections. we would likely have been even more cautious in our stances. Which is exactly why the market reactions especially post U.S. elections are so remarkable to us.

At the end of 2015 we were concerned about the aging economic cycles of developed markets (which we remain so today, but more on this later) and holistically speaking favored an under-weight allocation to equities relative to fixed-income particularly in most of the developed economies[1]. In fact, we went so far as to call 2016 "the year of emerging markets" recommending an over-weight to their equities and high yield debt markets with our favorites being Asia (while we were initially neutral on China, later during the year we turned optimistic), and Latin America (specifically Brazil). We also favored select developed economies such as Japan and commodity focused Australia and Canada, while recommended being under-weight the U.S., U.K. and Germany. In general, we favored investment grade debt in the developed economies (specifically the U.S. and Europe) over high yield.

While global markets went through a very difficult start to the year on global growth concerns and subsequently reversed into the Fall, our perspectives were generally correct as late as the end of October. However, we are mindful of the fact that we defined our perspectives with a 12 month time frame in mind and is what we expect to be judged on.

Chart One



Within asset classes, global fixed income markets outperformed equities through the end of October by 137 bps (Chart One). With the U.S. presidential elections out of the way, a sharp and significant reversal occurred and by year end, global equities had outperformed fixed income by almost 690 bps, thanks in part to a large rise in interest rates on expectations for expansionary fiscal policies in the United States.

Within equities, 2016 remained "the year of emerging markets", as Latin America and Eastern Europe, Middle East and Africa (EMEA) retained their significant outperformance throughout the year (Chart Two), despite a significant pullback in Latin America post U.S. elections. Emerging market Asia's outperformance through October 31st though reversed post elections on the back of the strength of the US Dollar.

Economic & Investment Perspectives

Chart Two

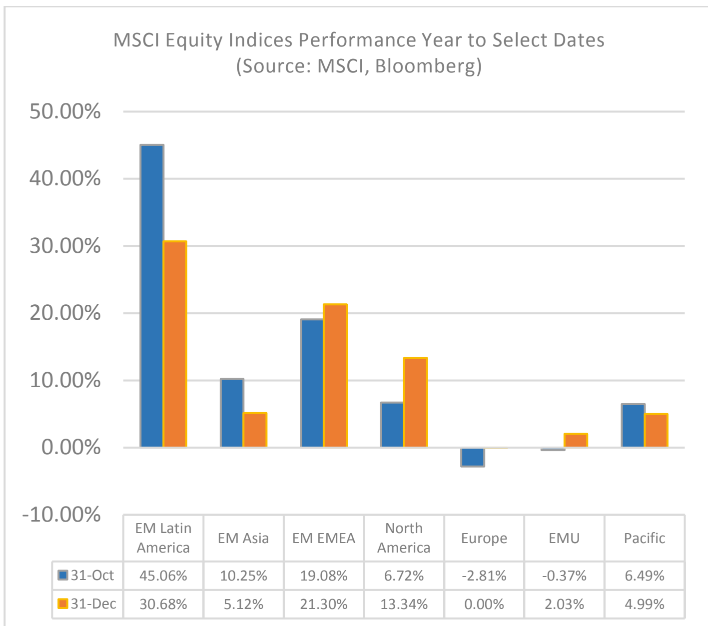
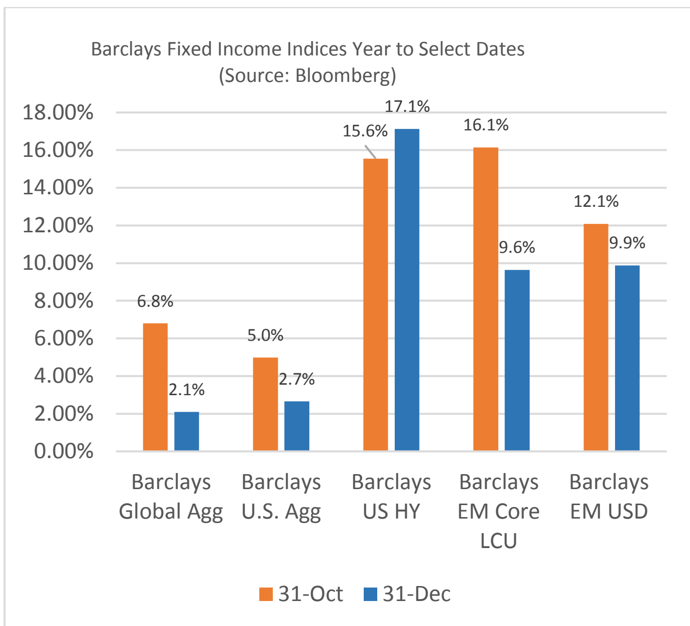


Chart Three



Within fixed income, emerging markets (both Local Currency and US Dollar issued) have been stars, and to our great surprise, high yield's performance was stellar, especially in the United States (Chart Three). While post elections the emerging markets pulled back significantly, their outperformance over developed markets remained significant (over 800 bps). Despite higher interest rates globally and specifically in the U.S., the high yield markets remained strong post elections.

Political Economy of 2017

So, will the nationalist/populist trends seemingly taking shape across the North Atlantic prove to be more hot air than anything else as some experts argue? Are the forces in favor of globalization too strong for even great orators of nationalist pride to be able to overcome? Will the pre-election promises in the U.S. of lower taxes, fiscal expansion, renegotiated trade deals, and regulatory reforms create a "nirvana" of economic growth, a renaissance in manufacturing, significantly higher wages and with it a reflationary environment? A resounding "No" from us to all of the above!

Elections have consequences. Brexit is a case in point. Despite what we believed was an unnecessary and ill-timed action pushed onto the British voters by a government anxious to seek approval for its own broader agenda, simply to affirm the status quo, things didn't turn out that way[2]. The forces of nationalism and protectionism capitalized on the anxiety of a large part of the Island over immigration, trade, and the decline of manufacturing. They succeeded in bringing to the forefront of British politics a reversal that had been in place for over forty years, namely the greater integration of the U.K. with continental Europe. A lose-lose outcome that in our opinion has now turned into an obligation for the present and all future British

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governments to complete and bring to fruition. There is no air, let alone hot-air in this reality.

Simultaneously and on this side of the Atlantic, the very same forces (American style) were busy convincing the electorate to openly express the very same anxieties over globalization at the ballot box. As it turned out, the advocates for the status-quo on globalization (ourselves included) severely under-estimated the influence of Brexit, the significance of large crowds at rallies for Bernie Sanders and Donald Trump and the impact they could have on the elections. Mr. Trump's success in the general elections is partly owed to winning a sizeable base of the electorate of the Democratic Party in geographies which for the better part of the past quarter of a century were reliable territory for the Democrats. And he did so with a powerful message of nationalism, protectionism, the promise of un-doing the status-quo and bringing back "the way things were". There is no air, let alone hot-air in this reality either.

The Brexit discussions are likely to formally begin in the Spring and will be long (multi-year), drawn out, arduous, and painful, with plenty of news headlines and photogenic handshakes in between. In the meantime, Britain will need to keep its full commitments to the E.U. (including financial ones) which voters elected to stop with Brexit while losing all influence over E.U. institutions. The E.U. leadership is not likely to make things easy and will take a tough stance on many issues including the movement of labor and citizens across borders for as long as it's necessary. There are far less incentives to complete the negotiations quickly and conclude on a sustainable relationship from the E.U.'s side. Uncertainty caused as a result of prolonged discussions will hurt the U.K. to a far greater degree. The simultaneous economic damage, weaker currency, and increased protectionist policies will only increase the pain on Britain while negotiations continue. No matter what the form of a final agreement, we believe Britain will end up on the wrong side of a wall that regardless of its height will nonetheless exist and limit opportunities for entities, industries, and economic segments too short to overcome it.

Mr. Trump will take office on January 20th, and will begin a presidency burdened with campaign promises of massive fiscal expansion, large tax cuts, the renegotiating of many trade deals, exiting from others, tariffs in certain cases, and bringing back and saving domestic jobs via what is increasingly looking like market intervening unconventional methods. Expectations, especially from a fluid electorate that can easily reverse course in the next elections are very high. Too high in our belief for delays, inactions, and reversals. However, as we have stated in our prior opinion pieces, "real" economic growth is a function of labor force growth and productivity - Period! Financial engineering of the tax system, capital relief for the banking system, trade restrictions that favor domestic production, and/or fiscal expansion via infrastructure and defense spending will simply increase government deficits and shift the burden of financing that deficit onto domestic savers' balance sheets with very little to show in terms of increased economic growth. They do not increase private sector investment, create more jobs, or improve the global competitiveness of American companies (especially unfunded tax cuts[3]).

To make matters more interesting, the ball is now back firmly on the European side of the Atlantic. With the Italian referendum and its failure to bring about much needed reform and further alignment with the rest of the E.U. over, we can now look forward to parliamentary and presidential elections in the Netherlands, France, Germany, possibly Spain and Italy during the course of the year. And while prediction markets are not giving the nationalists in France or Germany favorable odds for victories, neither were they doing so for Brexit and Donald Trump at similar points in time. The Dutch nationalist party,

Economic & Investment Perspectives

PVV is likely to be a big victor in the March elections. Depending on those results, the French polls can easily shift in favor of the Front National party and do so quickly, while improving the chances for the AfD party in Germany.

Asia by comparison will be an island of political stability in 2017. Chinese President Xi Jinping will likely see his support strengthened after the twice-a-decade leadership adjustments bring more allies into position of influence later in the year. Indian Prime Minister Modi and Japanese Prime Minister Abe's standing domestically are at historic and multi-year highs respectively. Both are coming off a successful 2016 and will be looking to capitalize on that success in 2017 emphasizing market friendly reforms. Indonesia, Malaysia and the Philippines are not too far behind with somewhat similar stories, while South Korea and Thailand remain the two spots where internal uncertainty clouds are likely to linger on for most of the year.

Any "largescale" uncertainty clouding the Asia story is likely to come from across the Pacific with the incoming U.S. administration. Threats of tariffs against China, shifts in the One-China policy of the past four decades, and potential escalation of tensions with North Korea could all act to negatively impact the Asia story for 2017. With the departure of the U.S. from the TPP (a setback to free trade and economic reforms in Asia), China's version of the agreement, the Regional Comprehensive Economic Partnership (RCEP) which includes the ASEAN economies, Korea, Japan, Australia, New Zealand and India has gained some momentum and likely to make progress during 2017.

Brazil which remains one of our favorite stories within emerging markets, will likely continue with its volatile political trend in 2017, though not likely to see another Presidential change. Michel Temer remains a very unpopular leader and is not likely to remain in office beyond the 2018 elections. In the meantime, he is likely to continue with transforming public institutions with his mix of fiscal austerity and legal reform that despite their deep un-popularity with the electorate are likely to be viewed positively by the financial markets.

Elsewhere, Argentina, Mexico, Iran, Russia, Saudi Arabia, South Africa, and Turkey are likely to have our attention in 2017, as economic and political developments both internally and externally involving those countries are likely to impact and at times significantly affect the global financial and commodity markets during the course of the year.

Financial Markets in 2017

If as we discuss above, the proposals from the incoming U.S. administration are simply financial engineering with no expected real impact on long-term economic growth, do we believe that the reflationary expectations are over-done? Will the very aged business cycle and associated bull market in equities benefit less than currently assumed by the markets? Or that the 35-year bull market in bonds is probably not over? A resounding "Yes" from us to all of the above!

The deficit expanding fiscal stimulus and tax cuts will need to be financed. Lenders will require higher spreads relative to other sovereign markets which in turn strengthens the US Dollar. The stronger Dollar will further widen the trade deficit by reducing or slowing the growth of exports relative to imports. Corporate earnings will be negatively impacted countering a large part of the benefits of tax cuts. The wider trade deficits will further pressure protectionist measures emanating from DC, impacting jobs and reducing the willingness of foreign central banks from reinvesting their Dollar earnings into U.S. Treasuries.

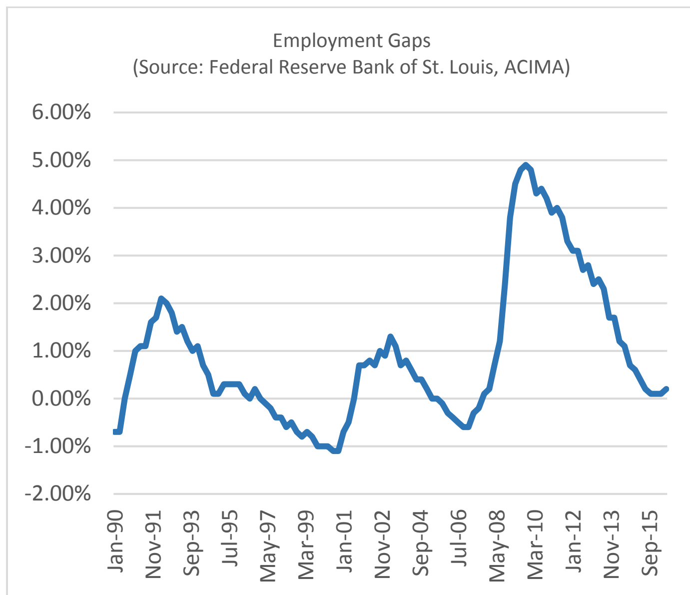
Offsetting lower marginal and statutory tax rates with equivalent eliminations of deductions will simply

Economic & Investment Perspectives

lesson the burden while leaving fiscal expansion to be financed, putting into question the very reason for the tax cuts to begin with.

The negative long-run impacts on investment and savings from widening structural deficits are well known[4], However, a positive cyclical impact on economic growth from fiscal expansionary measures when slack in the labor markets is non-existent remains questionable at best[5] (Chart Four). Any acceleration in growth will be short-lived and temporary with little if any impact on revenue growth via taxation for the government, implying greater deficit financing. But if external savers are less willing to finance the deficit, domestic savings can only do the job if the trade deficit shrank significantly, implying even more protectionism from Washington.

Chart Four



The bottom-line: unfunded fiscal expansion and tax cuts, will only be manageable if protectionism reduced the trade deficit and forced domestic savings to rise relative to investment. This kind of environment and outcome is not conducive to accelerated economic growth, in fact it would cause the exact opposite and could be the catalyst behind the next contraction and weaker equity markets. Weaker investment will eventually negatively impact employment and wages, which in turn should lower long-term interest rates and flatten the yield curve.

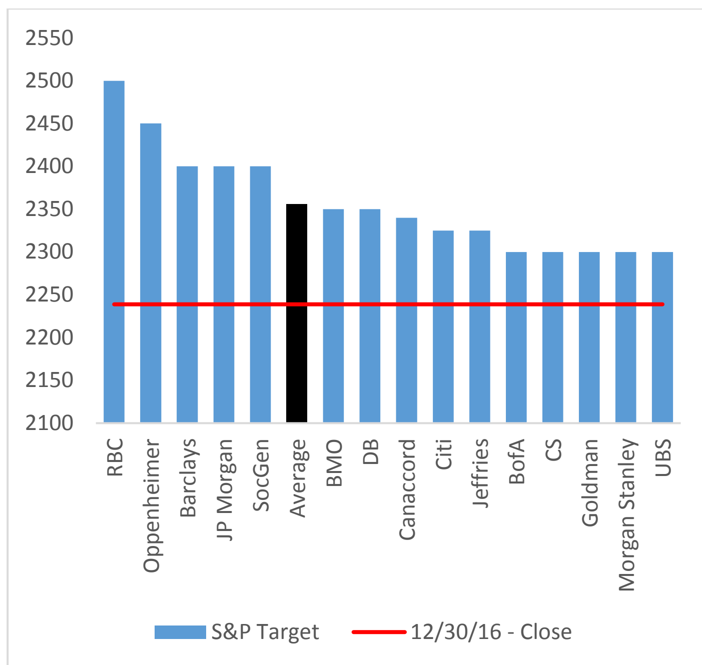
Adding to our concerns are an economic cycle in the U.S. that is now seven and a half years old, embedded earnings expectations in the markets that are more focused on the impacts of tax cuts on next year's earnings than on capital investment opportunities, and an optimism that seems to be universal. The sell side firms that we track are all and without an exception forecasting higher stock prices with total returns in the neighborhood of ~ 6.5% for the year (Chart Five). Remarkable! The legendary Merrill Lynch strategist Bob Farrells rule #9 of investing comes to mind*: "When all the experts and forecasts agree -- something else is going to happen"*[6]. Given the forward-looking nature of equity markets, such forecasts imply a sense of optimism at end of 2017 for corporate earnings during 2018 that would imply an economic expansion approaching the longest cycle of the past 70 years. Impossible? No. Improbable? Yes.

With such a setting, we remain under-weight U.S. equities and high yield debt, and over-weight investment grade debt. Our preference is to be the banker and not the investor to higher credit quality companies. We believe neutral risk-free interest rates for ten-year maturities are in the range of 2.25%-3.25% and as such are neutral on Treasuries but favor longer-term over shorter-term maturities (another contrarian perspective of ours) given the late stage of the cycle.
While we believe the U.S. Dollar has some upside especially against developed economy currencies, that upside will occur in-line with increased volatility in the FX markets. Parity against the Euro, and 1.1 USD's per British Pound are certainly in the cards. We do not rule

Economic & Investment Perspectives

out the possibility of parity against the Pound if Brexit negotiations turn sour at some point. We remain favorable towards the Brazilian Real, South African Rand, and the Russian Ruble, and depreciation potential for most Asian currencies, the Mexican Peso, and the Turkish Lira.

Chart Five



Within Europe, we believe the Southern economies are likely to see slight improvement in growth for 2017 over 2016 (Can Greece finally see real growth?), while Northern economies should see growth in line with 2016 as the weaker Euro should help with exports. We are slightly more optimistic in our growth projections for the Euro-zone as a whole than consensus, but are mindful of the aging of the cycle especially in Germany. Not so for the U.K.! We believe a contractionary environment will likely occur during the course of 2017 and into 2018, with consumer inflation pushing closer to the 3.0% year over year mark. Confidence and hiring will begin to be impacted as the markets begin to appreciate the lengthy and drawn out Brexit negotiations.

Consistent with our U.S. stance, we remain cautious towards the equity markets of developed economies in general and remain under-weight (including Europe and especially the U.K.), but take exception with Japan, Australia and Canada. We believe the continued economic rebound in Asia led by a resurgent Chinese economy will be supportive of commodity prices and demand for final goods which should help the export natured economies of all three countries.

Speaking of China, we remain optimistic and believe policymakers have succeeded in steering the country out of what to us was the cyclical downturn of 2015-2016. Yes, there remain parts of the world where conventional monetary policy tools still work! Admittedly that is an interesting statement for us to make for such an unconventional economy.

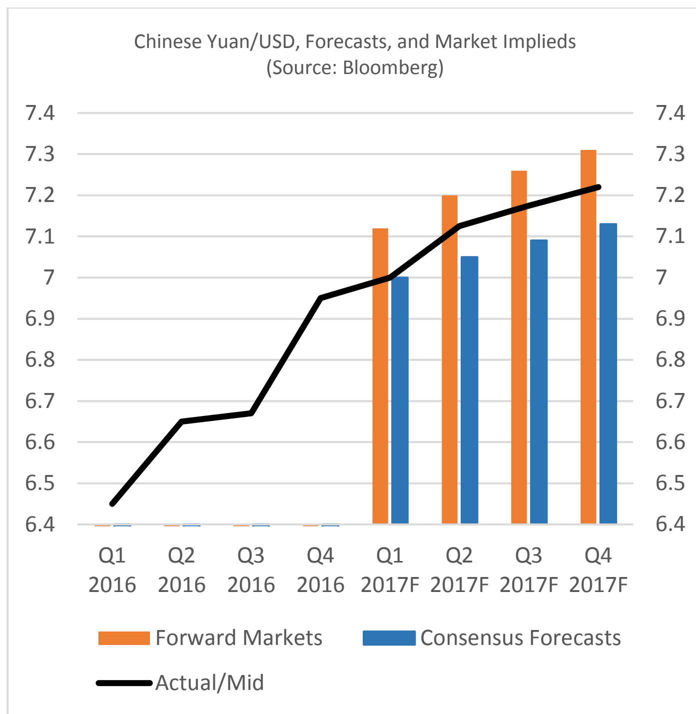
We continue to have a more unorthodox perspective on analyzing the Chinese economy and financial markets, and believe that despite the structural slowdown in growth rates (as the country transitions to a more consumer oriented economy), it's the cyclical volatility around the new trend that should define investment perspectives/themes and not absolute growth. While we are mindful of the sharp increase in credit/leverage in the system and the concerns that it is raising amongst China watchers, we would note that such concerns are not anything new. China remains a credit hungry economy, a fact that is likely to remain in place for years to come and periodic acceleration is a necessary evil as the economy transitions to consumerism.

As China continues its currency liberalization, the Yuan is expected to depreciate further in 2017 and we are predisposed to agreeing with consensus (Chart Six). We expect this depreciation to cause some consternation with the protectionist crowds in

Economic & Investment Perspectives

Washington who continue to argue the currency's undervaluation (which we vehemently disagree with) via manipulation. We are recommending an over-weight position in the equity markets of the mainland as well as Hong Kong.

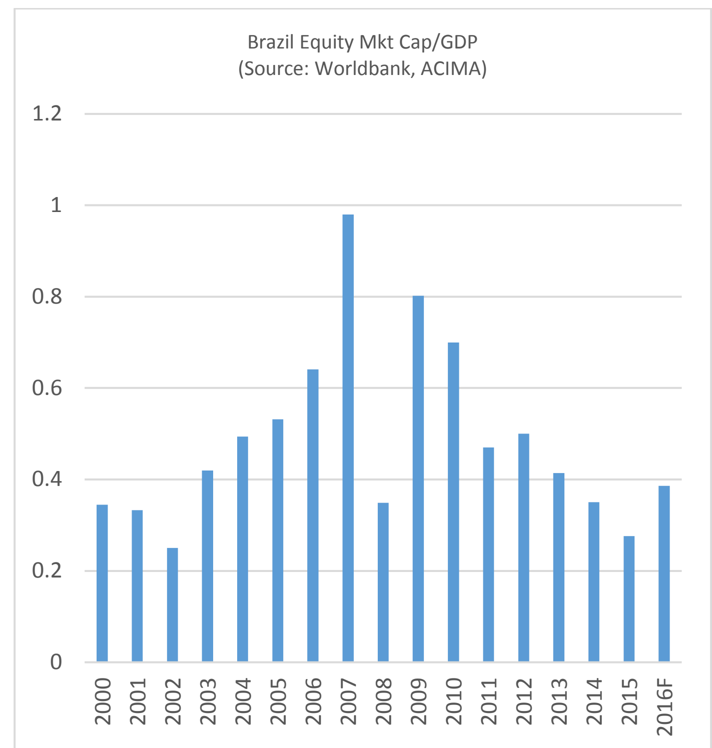
Chart Six



Taiwan and Southeast Asia will likely benefit from the China spillover as will South Korea, though with the latter we will continue to have a wait and see approach given the political uncertainties.

Latin America in general and Brazil specifically, remain a favorite equity market for us as the economy begins to exit its politically ignited and deep recession. Relative macro valuations continue to remain attractive (Chart Seven). While remaining on the side-lines we are beginning to like the story coming out of Argentina and will continue to monitor the situation as progress on the political and economic front combined with relatively cheap valuations are making for an attractive combination.

Chart Seven



In EMEA, we remain positive on Russia and South Africa as our optimism for global commodity prices should positively impact top-line growth for both countries. Inflation however, continues to remain one area of concern for us in South Africa. The wild-card for Russia is clearly how relations with the U.S. evolve during 2017 and to what degree? We are also positive on Turkey and expect the second half 2016 contraction to reverse quickly in 2017. Unemployment should peak in Q1 and begin its gradual decline. We believe growth could exceed 3% in 2017 and with valuation at their lowest levels since 2013 we recommend being over-weight. We are mindful of the geopolitical volatility

Economic & Investment Perspectives

within and including Turkey's neighbors, but believe markets have priced in that risk appropriately.

Our optimism for emerging markets equities extends into the high yield markets as it did in 2016. We recommend remaining over-weight high yield (both sovereigns and corporates) and under-weight investment grade as the economic cycles favor risk taking on the credit curve as well as the term structure. We expect double digit and high risk adjusted returns in 2017. The recent pullbacks post U.S. elections are presenting some very interesting opportunities across parts of Asia and Latin America. The wild-card remains policies of the incoming U.S. administration especially in regards to China, and Mexico, two countries that were repeatedly targeted during the campaign. Volatility in the FX markets may pose some risks for the riskier credit, Dollar denominated debt with longer maturities.

Within global sectors, we continue to recommend over-weights to energy, and materials. We favor financials, technology and consumer cyclicals in emerging markets, Canada, Australia and Japan, and staples and healthcare in other developed markets. We recommend under-weight exposures to financials, and technology in the U.S. and Europe as well.

From a style and size perspective, in general we continue to favor value over growth and larger caps over smaller caps in developed markets and vice versa in emerging markets.

With that we wish our readers a very happy, healthy, and prosperous 2017!

As always, stay tuned;

Ardavan Mobasheri
Chief Investment Officer
January 1st, 2017

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4. Huntley, Jonathan, 2014. *"The Long-Run Effects of Federal Budget Deficits on National Saving and Private Domestic Investment"*. Working Paper 2014-2 (Congressional Budget Office).

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6. http://www.businessinsider.com/bob-farrells-10-investing-rules-2009-12

Economic & Investment Perspectives

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