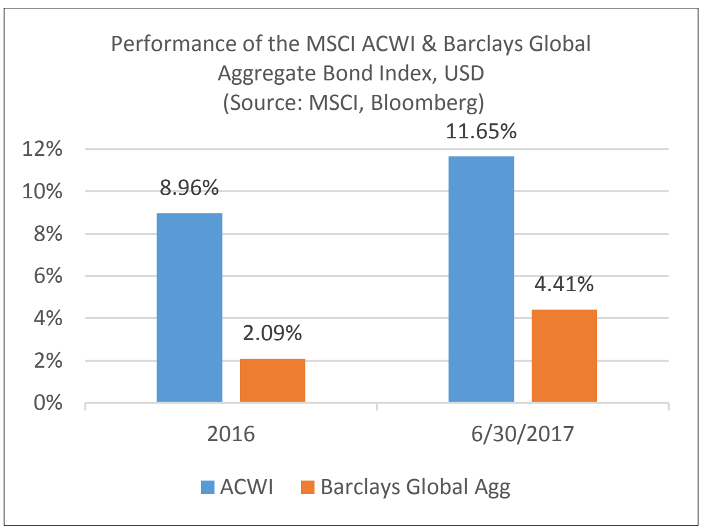
Economic & Investment Perspectives

First Half 2017: Financial Markets in Review

We started our 2017 outlook commentary by saying how remarkable we thought the financial markets reactions to the rise of populism, protectionism, and nationalism were in the wake of the 2016 elections, and particularly in the U.S.[1] So, it's curious to know, if the markets' overall 2016 performance was a surprise to us, how do we feel today after an even more remarkable first half performance of 2017 (Chart One)? For answers, let's first dissect the first half.

Chart One

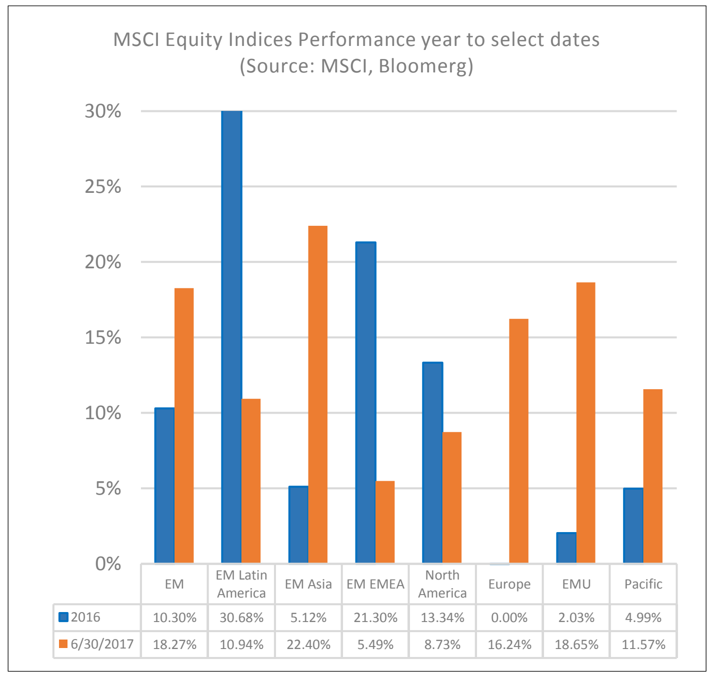


Global equities picked up 2017 right where they left off 2016, except with even more thrust. Equities not only rose by double digits, but also outperformed their fixed income peers by nearly 725 basis points.

As with 2016, emerging markets led the way for both equities (Chart Two) and fixed income (Chart Three), though the strengthening of the Euro against the US Dollar helped Euro denominated markets outperform their developed markets peers by considerable margins (more on the Dollar to follow).

Within regional equity markets, the leadership baton was passed from Latin America and Europe, the Middle East & Africa (EMEA) to Asia in emerging markets, and from North America to Europe in developed markets.

Chart Two



Within fixed income, emerging markets local currency debt outperformed all other sub sectors (in USD terms), while U.S. High Yield continued to outperform all other U.S. peers.

Speaking of the US Dollar, the currency declined 4.65% against other currencies on a trade-weighted basis (Chart Four). It declined 7.87% against Gold, and appreciated 16.36% against WTI Crude Oil.

As global asset managers, consideration of the role of home currency in total return becomes key both in terms of the ex-post analysis of contributions to returns and our ex-anti perspective on the asset allocation

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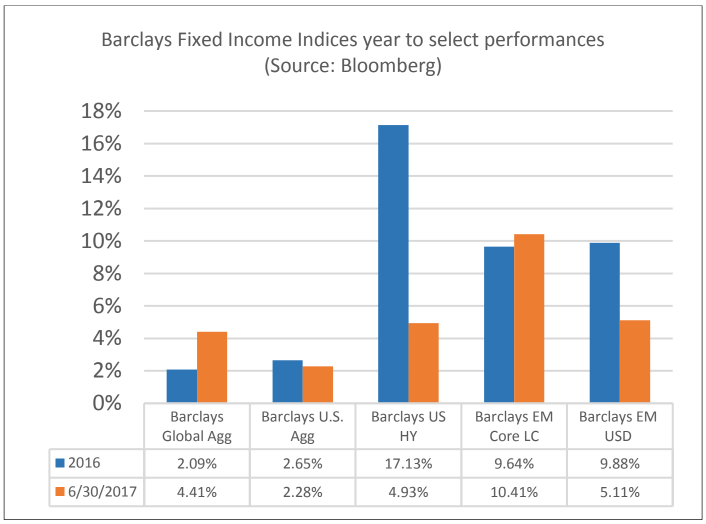
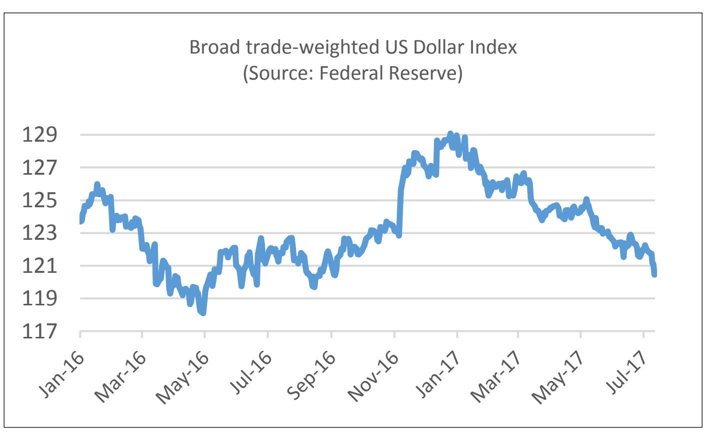
process. And while the former is primarily informational in nature, the latter is a pillar of the decision making at its core.

Chart Three



So, while for a U.S. based investor the above returns across asset classes were very strong by historical standards, a significant percentage of those returns (especially in equities) was due to the global depreciation of the purchasing power of the USD (Chart Five).

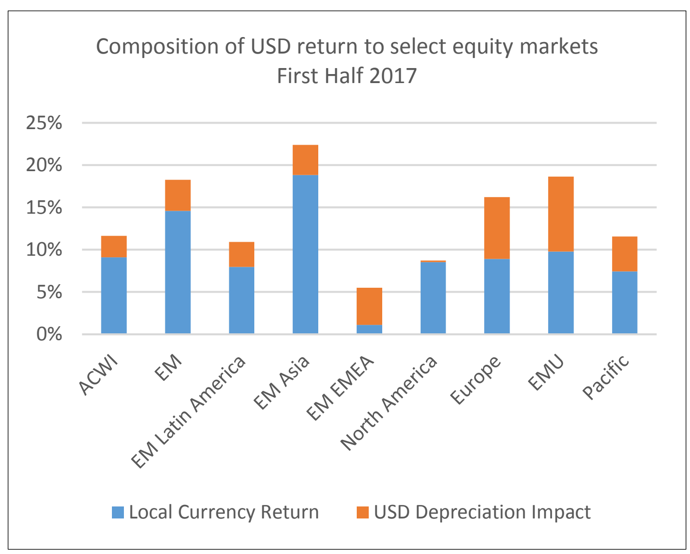
Chart Four



Moreover, while the U.S. equity market (represented by the S&P 500) was up 9.34% in US Dollar terms, on a trade-weighted basis it was only up 4.48%. Foreign revenues represent over 45% of S&P revenues. Controlling for all other factors, the depreciation of the currency should be a huge boost to sales and earnings. Yet according to Goldman Sachs, a consensus bottom-up 2017 earnings forecast for the S&P 500 has remained unchanged since the beginning of the year at $132. Either the consensus has fallen behind the curve in adjusting their forecasts, or the forecasts imply weaker than expected U.S. based earnings.

Combining unchanged earnings forecasts with an approximately 4.65% drop in USD purchasing power leaves the remaining 4.48% of total returns to an expansion of the earnings multiple of the S&P 500 for the first half (not a comforting place to be as we discuss below).

Chart Five



This expansion of multiples during the first half was not limited to the U.S. or North America. The degree of expansion was even greater in Asia and Europe. The

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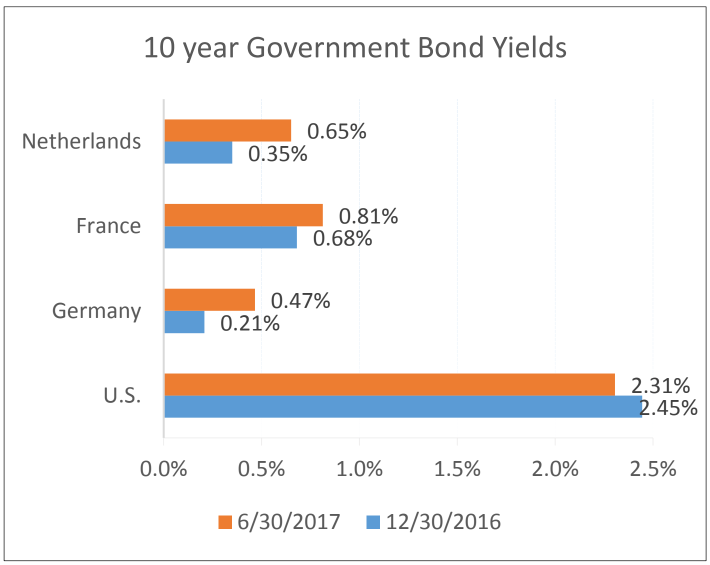
weakness of the USD has had the expected negative impact on earnings of European, Japanese, Chinese, and other emerging market exporters, and offsets from the strength of the economic cycle and domestic consumption have not been full.

The Dollar owed its depreciation to an array of factors across markets and regions: convergence of long-term interest rates in Europe (Chart Six), relative strength of expectations (Asia), and even a period of relative calm as it relates to deteriorating trade policy from the U.S. administration (Mexico).

Chart Six



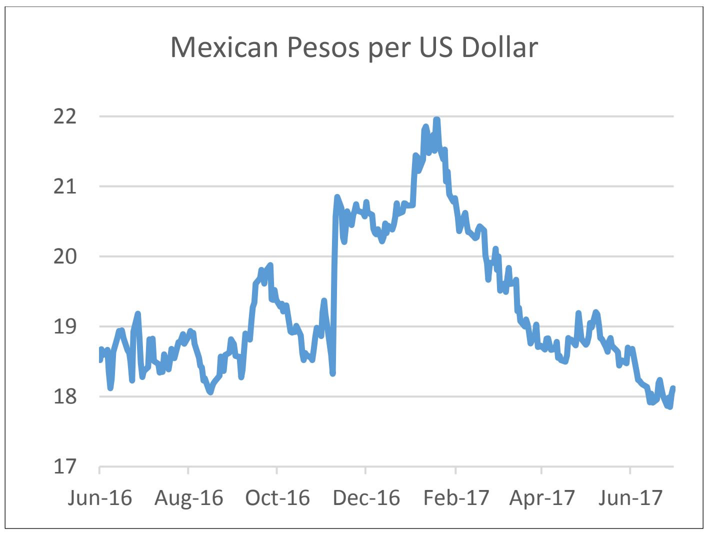
Our Perspectives for the Second Half

Three events of the first half that shape our views for the second half and beyond:

President Donald Trump's inauguration speech

The award-winning journalist Susan Page of USA Today referred to the speech as "…a populist manifesto...that was darker in tone, and blunter in language than any inaugural address in modern times…". While "modern times" is quite nebulous in its historic reach, we will be a bit more precise and call it the most populist inaugural address since FDR in the 1930's, and one which could not have been more luminous in the plans of the President, and how he intends to have his legacy shaped. The existing world order, with the United States at the helm of a socio-economic globalization movement meant to expand the reach of free trade, was about to change. Not the movement, but its leadership.

Chart Seven



As the so-called "Trump trade" fizzled out, one of the biggest beneficiaries was the Mexican Peso, which more than completed a full cycle post the November elections depreciation to regain its pre-elections values (Chart Seven).

Lack of follow-through with the pre-election promises of immediate NAFTA departure and very little post-election rhetoric are popular explanations for the strength; however, there is more to the story. If these are the primary reasons for the Peso's strength, we believe such moves to be premature for two reasons.

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First, the President's trade infrastructure team has only just recently completed its leadership tables and is still in the process of completing several major reviews of trade policies with recommendations to the President coming in the second half of 2017.

Second, the President's policy team purposely prioritized domestic policy over trade policy to begin the term: healthcare, tax cuts/reform, budget, etc., and so the quiet on the trade front is only temporary.

To date however, the administration has encountered significant legislative road blocks on all fronts and, as we noted in our May 25th commentary, is not likely to find success beyond several narrow sub-components of those priorities[2]. In such a scenario, actions within the reach of the President's desk that can provide the administration with tangible evidence of success will increasingly become popular within the corridors of the executive branch. Trade is one such area. We experienced the U.S. exit from the Trans Pacific Partnership with one stroke of a pen during the first week of Trump's presidency, while more recently we have seen actions against Canada and aggressive rhetoric against China. We believe we are only in the very early stages, and depending on the twists and turns of domestic policy, we will see protectionism trade style on the forefront sooner than later.

But if there is more to the story, as we argue, then what explains the Peso strength as a case in point and Dollar weakness in general? A careful analysis of the positions of the Trump administration on multiple fronts consistently brings us to the conclusion that the primary aim of the President and his team is shrinking the U.S. trade deficit. Repeated calls for "fair trade" no longer refer to the opening of markets or deregulation, but instead are immediately supplemented by reference to the large deficits as a problem in need of a solution[3]. In our belief, there is only one solution that can deliver such results in the short-term: the "beggar-thy-neighbor" competitive currency devaluation and protectionist barriers.

We have been here before and have seen this game played out in the past. A deliberate multi-year plan, be it coordinated or not, and be it publicly stated or implied through policy actions, can and has improved a country's trade balance. While the negative implications for wealth accumulation and investment are well documented, we will leave that discussion for another time. While we are not so enthusiastic about significant appreciation of the Peso, Won, and other emerging markets currencies (save for the BRIC's), we do believe that the Dollar in general is in the early stages of a multi-year depreciation which will likely weaken it to levels immediately following the financial crises in 2011.

The election of Emmanuel Macron to the French Presidency

One of our major concerns for 2017 was (and to a smaller extent still remains) the potential success of the political far-right in Europe and its associated nationalist protectionism after gaining momentum post the Brexit vote and U.S. elections. The failure of Italy's constitutional referendum last December only added fuel to our concerns.

And while elections in the Netherlands and France did show the most impressive results for nationalists in decades and perhaps even "modern times," in all instances none resulted in leadership being transferred to such movements. In the case of the UK elections, the conservatives were handed their second great loss in as many tries and in as many years—an indication that "buyer's remorse" may be at hand.

Though the German elections scheduled for later in the Fall are still ahead of us, we believe the result of the French election, with a very strong showing from

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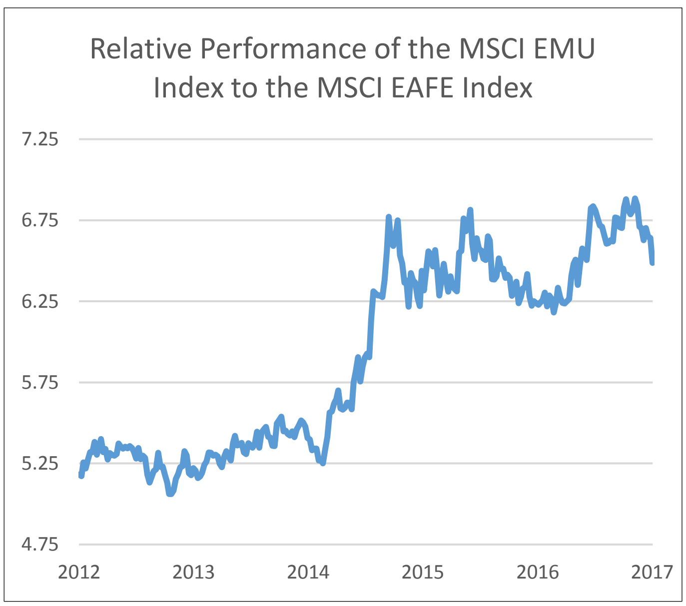
Emmanuel Macron and his movement in parliamentary elections, was the tipping point which sent a powerful signal that there is an upper bound (at least for the foreseeable future) to the ability of anti-EU movements to gather votes and ultimately influence policy.

While the story of the anti-EU nationalist movements is by no means over, barring a major upset in the upcoming German elections, we don't see any significant openings for success in the near future. In fact, we believe the pro-EU have gained enough momentum that it could make for some very difficult and volatile Brexit negotiations over the coming months and quarters. Could that create an opportunity for a previously pro-EU Theresa May and a nervous UK electorate to find maneuvering room for compromise and even a settlement that resembles "stealth" membership in lieu of a full exit? It's possible, but too early to plan for.

Chart Eight



The financial markets have not only responded with narrowing the spread of Euro denominated bonds with US Treasuries and strengthening the Euro, but also handed the leadership in equity markets outperformance within the developed markets to the EU (Chart Two). While it will not be smooth sailing going forward as seen by the recent catch-up by other developed markets (Chart Eight), we believe we have a lot further to go on this front, especially as the ECB begins to contemplate and plans for the end of QE (discussed below) over the coming year.

The Federal Reserve's announcement regarding balance sheet reductions

We have been of the belief that the economic considerations for such a move simultaneous with higher Fed Funds rates have been in place for some time now. Estimates of the output and employment gaps, our measures of the depth of employment[4], and age of the business cycle have been confirming the need for tighter monetary policy as early as the first quarter of 2015. The almost dual-minded focus on "core" inflation and the stability of financial markets has prevented the Federal Reserve from normalizing monetary policy for the better part of two years now.

We applaud this recognition; however, we remain concerned that any action towards normalization will be subject to financial market volatility and political considerations assuming Chairwomen Yellen is not reappointed next year, and the age of the economic cycle and the need to have sufficient firepower to counter the next downturn will take a back seat.

We also hesitatingly applaud the Bank of Canada's recognition of the need for monetary tightening, as well as Mario Draghi's testing of the waters (with the EU economy a step or two behind that of the U.S., we believe the ECB still has some flexibility).

Though the story for the other two giants of central banking (China and Japan) remains a world apart from that of their North Atlantic peers, the elevated size of

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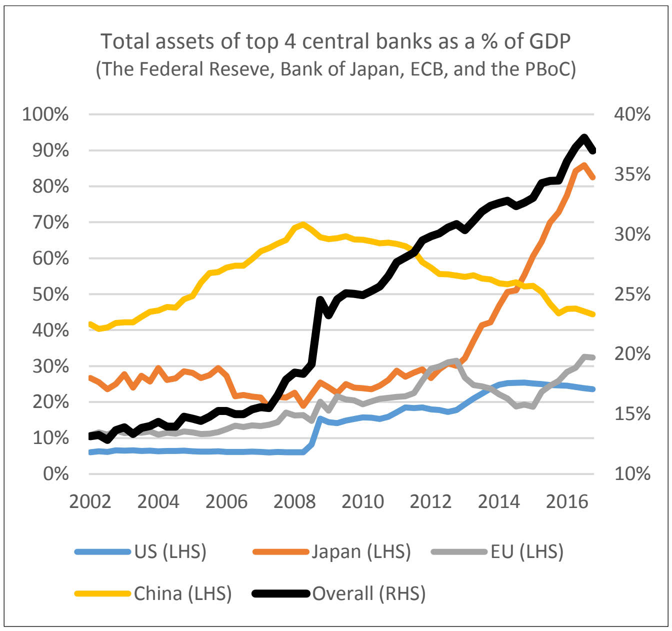
the combined balance sheets should give pause to any consideration of a relatively less risky and non-problematic unwinding operation over the coming years (Chart Nine).

Chart Nine

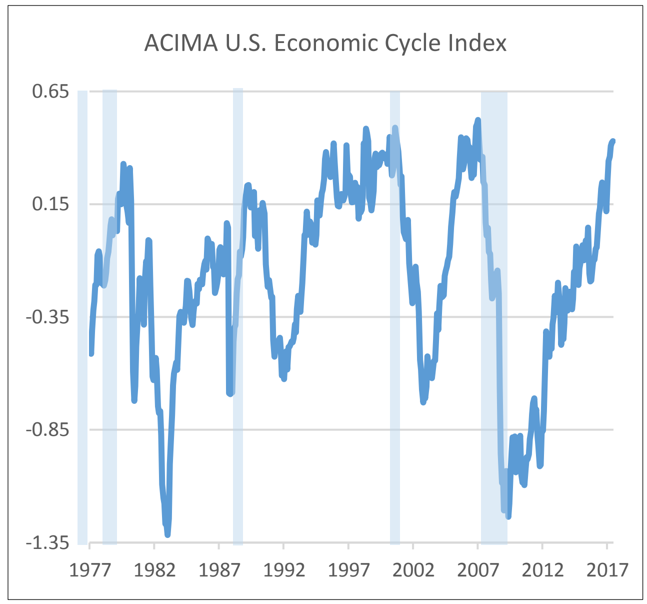


Opportunities and Concerns

The developments above, along with the un-synchronized nature of the economic cycles globally, continue to provide superior opportunities from where we stand for risky assets primarily in emerging markets, while at the same time providing interesting opportunities within fixed-income (in particular, government and investment grade debt in developed economies—a contrarian view we recognize).

While tactically speaking most equity markets globally are stretched, strategically speaking, valuations remain very attractive across select markets in Asia-Pacific (including Japan and Australia), Latin America, and Eastern Europe and Africa. The high yield corporate sector in those regions continue to offer attractive yields relative to peers in developed markets as do select higher-yielding government debt.

Chart Ten



Our primary concern for many of the developed markets of the North Atlantic (with the exception of Canada) remains the ever-expanding universe of tail perspectives that are increasingly being viewed as mainstream with a "this time is different" mentality back in vogue. We see this as the case especially in the U.S. and the United Kingdom. Our proprietary economic cycle indicator for the U.S. (itself a proxy recession probability model) is at its highest levels since 2007 (Chart Ten). The top of our list of concerns include the age of the U.S. economic cycle[5], valuations of U.S. and U.K. equities, below investment grade credit spreads across the developed economies, and Australian and Canadian home prices.

We also continue to be amazed that despite all considerations for short-term factors such as economic cycles and inflation, as well as long-term factors such as demographics, economic efficiency, and

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technology, that a significant number of our peers continue to worry about the ending of the secular bull market in interest rates across the globe and especially in the developed economies.

As always, stay tuned;

Ardavan Mobasheri
Chief Investment Officer
July 28, 2017

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Notes

1. ACIMA Private Wealth *2017 Outlook* 1/1/17 http://www.acimaprivatewealth.com/wp-content/uploads/2017/01/ACIMA-2017-Outlook-1.pdf

2. ACIMA Private Wealth *Economic & Investment Perspectives* 05/25/2017 http://www.acimaprivatewealth.com/wp-content/uploads/2017/05/ACIMA-Market-Insights-05-25-2017.pdf

3. Mobasheri, Ardavan, June 17, 2017. "*U.S. Trade balance: not broken and does not need fixing*". Richmond Times-Dispatch http://www.richmond.com/opinion/their-opinion/guest-columnists/ardavan-mobasheri-u-s-trade-balance-not-broken-and-does/article_15dcc9cb-2048-5466-8951-e6179fe4716d.html

4. ACIMA Private Wealth *Economic & Investment Perspectives* 05/11/2017 http://www.acimaprivatewealth.com/wp-content/uploads/2017/05/ACIMA-Market-Insights-05-11-2017.pdf

5. Mobasheri, Ardavan, June 27, 2017. "*A history of economic cycles going back to the 1850s suggests a recession is near*". CNBC.com http://www.cnbc.com/2017/06/27/op-ed-a-history-of-economic-cycles-suggests-a-recession-is-near.html

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