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BALANCE IN A CHANGING WORLD
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SECOND QUARTER 2017 ADVISORY INVESTMENT REPORT

"Uncomfortably Numb"[1]

World equity markets continued their upward trend in the second quarter, amid continued evidence of steady global economic growth. In last quarter's report, we observed "... (Another) big shift was that overseas markets dramatically outperformed the US. President Trump seemed to back away from his earlier protectionist rhetoric, the US dollar (USD) softened, and as recently noted by The Economist, "Today, almost ten years after the most severe financial crisis since the Depression, a broad-based economic upswing is at last under way... In America, Europe, Asia and the emerging markets, for the first time since a brief rebound in 2010, all the burners are firing at once."[2] If this proves to be a lasting event, then overseas markets, after dramatically underperforming the US markets for many years, are arguably truly undervalued – at least relative to the US. There is still plenty of risk in these sectors, but it appears to be more political risk such as the uncertainty surrounding the upcoming French elections or the 5-year Communist party leadership shuffle that occurs this year in China. This past quarter, we increased our international exposure and, for the first time in several years, began investing again in the Emerging Markets."[3]

So far, so good. After a choppy beginning, in mid-May the markets resumed their uptrend, paced by Emerging Markets which gained 6.27% during the period.[4] The synchronized global recovery noted above has in fact continued apace and we feel this is one of the major drivers supporting the stock market rally. Certainly, the market has not been driven by political calm and cohesion! In talking with clients, the level of concern seems to be rising by the week. The sentiment was aptly captured by one (typically optimistic) client who – when questioned about the sources of his concern – paused for a moment and then replied "I guess I just see potential calamity around every corner". Nor is it difficult to list any number of such concerns, from political events in the US and Europe, geopolitical threats from North Korea, the Middle East or Russia, and so on.

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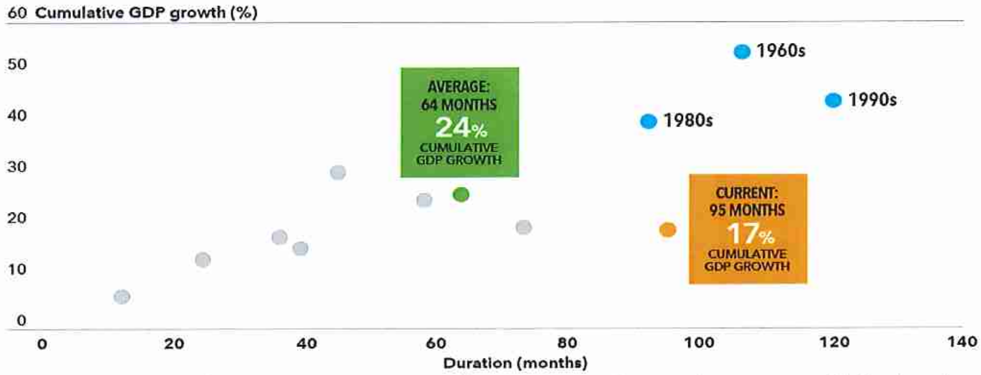
The question of how much further this cycle has to run is a good one, and highlights two key issues. According to Capital Group and shown below, we are some 95 months into the expansion, making this the third longest recovery on record, and more than two years longer than the post-war average. However, cumulative GDP growth over this period has only been 17%. This is significantly below its historical average of 24%.[8] Many observers, including this report, has focused on the anemic economic growth rates and posited that growth was being subdued by the massive accumulation of debt. This may well be valid, or perhaps 17% growth is just the "new normal". In any case, the bottom line is that ironically, it's hard to find an area of the economy that's truly overextended and over levered.

The Current Growth Cycle Is Longer Than Average, But The Growth Rate Has Been Lower Than Average



Sources: National Bureau of Economic Research, U.S. Bureau of Economic Analysis. Expansion duration uses monthly data through 5/31/17, as reported by NBER. Cumulative GDP Growth uses quarterly data through 3/31/17.

To be sure, pockets of excess can be found in the auto sector, or in student debt. But it's hard to argue that there's excess comparable to the housing and subprime mortgage sector prior to the 2008 financial crisis, or comparable to technology stock valuations prior to the NASDAQ bubble in 1999/2000. This supports the case that the current economic cycle can run for much longer than expected. The debt cycle is another story. According to the NY Times, "In the first quarter of 2017, consumer debt rose to $12.73 trillion, exceeding its peak in the third quarter of 2008".[9] Note though, that the composition of the debt has changed significantly. Mortgage debt still remains below the peak levels of 2008 prior to the housing colapse. All of the new growth was driven by student loans and auto loans (also discussed in last quarter's report). This is depicted in the below chart from ZeroHedge.[10]

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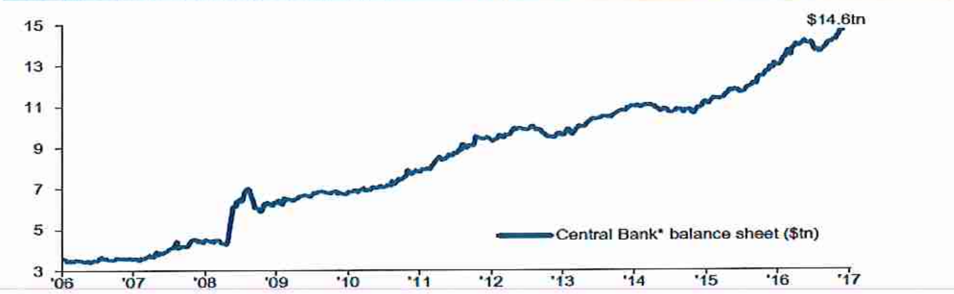
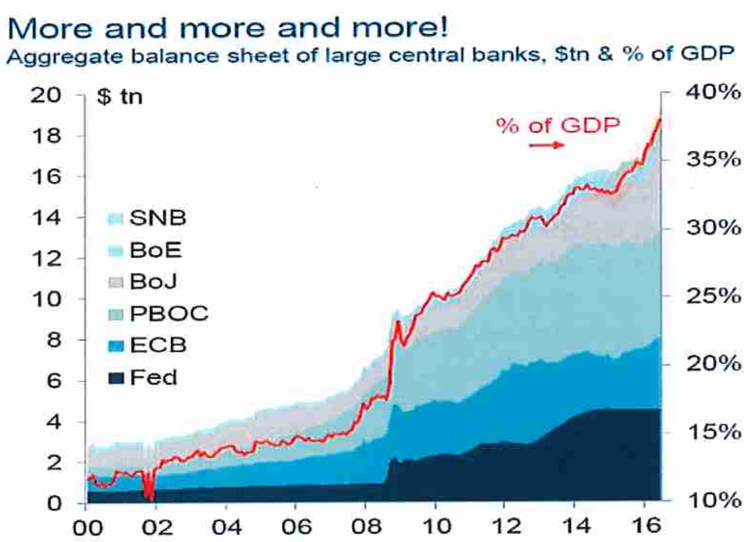
Gross Domestic Product. The import of all this was nicely conveyed in recent tweets from bond manager Jeffrey Gundlach; "*Sure, the volatilities are different, but real GDP for the past decade is identical to that of the 1930's: 1.33% annualized. Think about it!*[13] And, "*Of course, this time US added around $10 Trillion of additional debt to achieve the 1.33% rate of real GNP growth. Around 1/2 a year's GDP!!*[14]

As astounding as this is, when you place it into the context that every major central bank in the world has done the same thing, the astonishment begins to defy comprehension – partly because we've never been here before and there is little historical equivalent for reference, and partly because the absolute numbers are just so large. The charts below from ZeroHedge put this into some context[15];

Chart 1: Central banks have bought $1tn in assets YTD



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg; * ECB + Fed + BoJ + BoE + SNB



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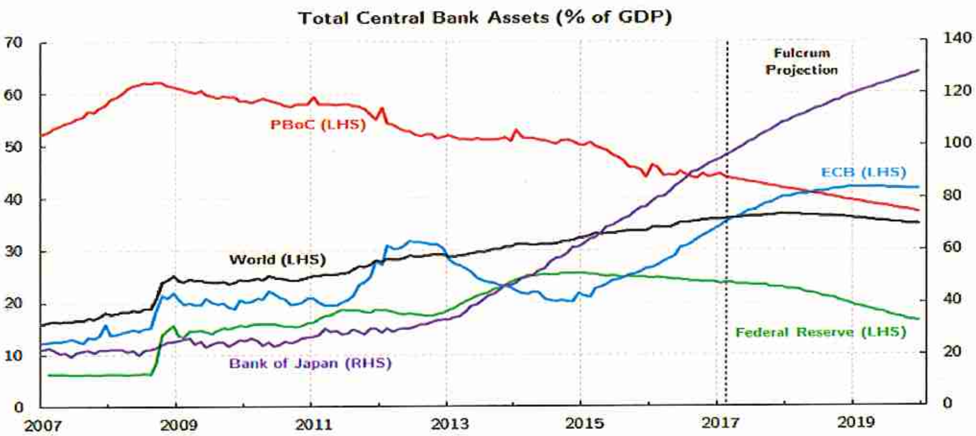
It should be noted that, according to Bloomberg, at the peak of the Quantitative Easing (QE), the Fed was buying $85 billion of securities each month.[18] Thus, it's clear that the Fed intends to tread as lightly as possible in their balance sheet reductions. A good outline of where we are now and where we might be heading was provided in a recent FT article;



Sources: Haver Analytics and Fulcrum Asset Management

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A few key takeaways here are that:

* Somewhere around the first half of 2018, central bank balance sheets will shrink
* The rate of the growth of their balance sheets is already diminishing
* All of the future heavy lifting will be done by the BoJ and the ECB while the Fed and the PBOC begin their reductions.

It remains an open question as to how this will all play out. One observer, JPMorgan CEO Jamie Dimon, struck a cautious tone. As reported by Wolf Richter, at a recent finance conference in Paris, Dimon stated "'We've never had QE like this before, and we've never had unwinding like this before…Obviously that should say something to you about the risk that might mean, because we've never lived with it before.'"[20]

Dimon was less concerned with the actual interest rate increases the Fed was initiating, and we've long argued that "normalizing" interest rates was long overdue. However, Dimon worries that "'when selling securities in the market place starts,' that's when it gets serious…'When that happens of size or substance, it could be a little more disruptive

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[19] http://blogs.ft.com/gavyndavies/2017/03/26/the-end-of-global-qe-is-fast-approaching/
[20] http://wolfstreet.com/2017/07/12/unwinding-qe-will-be-more-disruptive-than-people-think-jp-morgan-ceo-dimon/

Quarterly Market Review Second Quarter 2017[24]

U.S. STOCKS

	2Q 2017	*Year-to-Date*
Dow Jones Industrial Average	3.95%	9.35%
S&P 500 Index	3.09	9.34
Nasdaq Composite Index	3.87	14.07
S&P MidCap 400 Index	1.97	5.99
Russell 2000 Index	2.46	4.99

INTERNATIONAL INDEXES

MSCI Index	*2Q 2017*	*Year-to-Date*
EAFE (Europe, Australasia, Far East)	6.37%	14.23%
All Country World ex-U.S.A.	5.99	14.45
EM (Emerging Markets)	6.38	18.6

GLOBAL BONDS

Index	**Q2 2017**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond Index	1.48%	2.27%
J.P. Morgan Global High Yield Index	2.07	5.00
Bloomberg Barclays Municipal Bond Index	1.96	3.57
Bloomberg Barclays Global Aggregate Ex-U.S. Dollar Bond Index	3.55	6.12
J.P. Morgan Emerging Markets Bond Index Global Diversified	2.24	6.19

[24] https://www3.troweprice.com/usis/personal-investing/planning-and-research/t-rowe-price-insights/markets/quarterly-market-review.html

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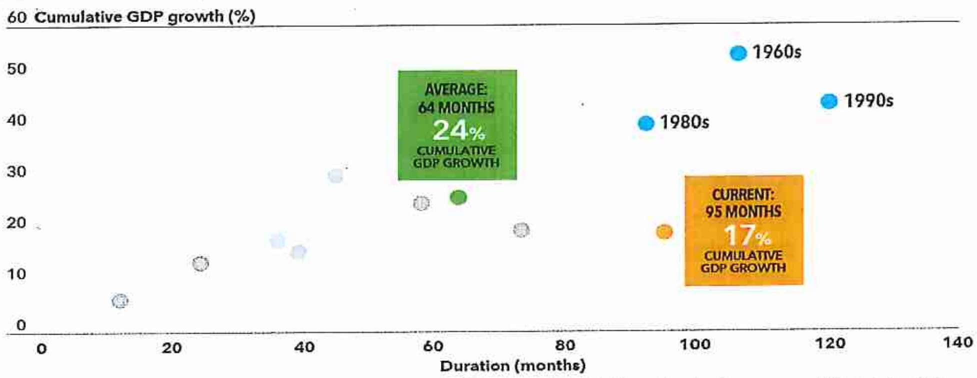

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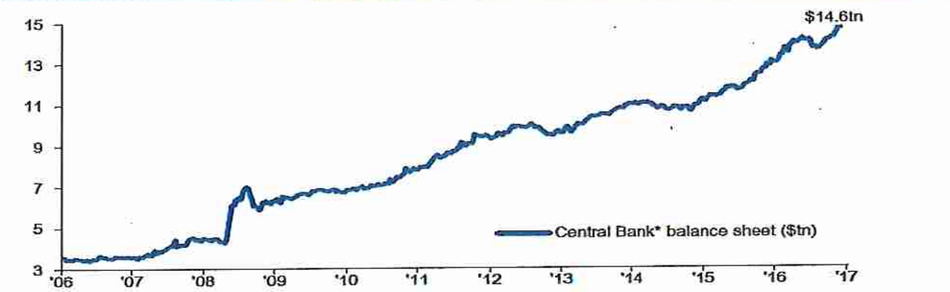

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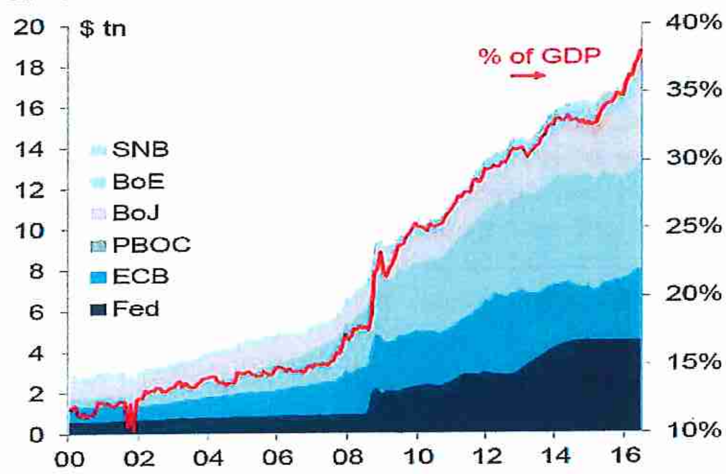
More and more and more!
Aggregate balance sheet of large central banks, $tn & % of GDP



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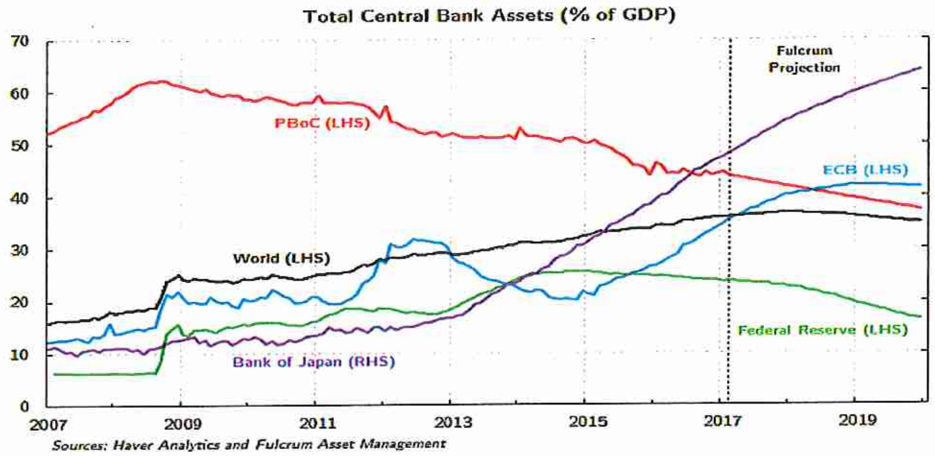

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