

AEQUITAS INVESTMENT ADVISORS

INVESTMENT REPORT – FOURTH QUARTER 2016

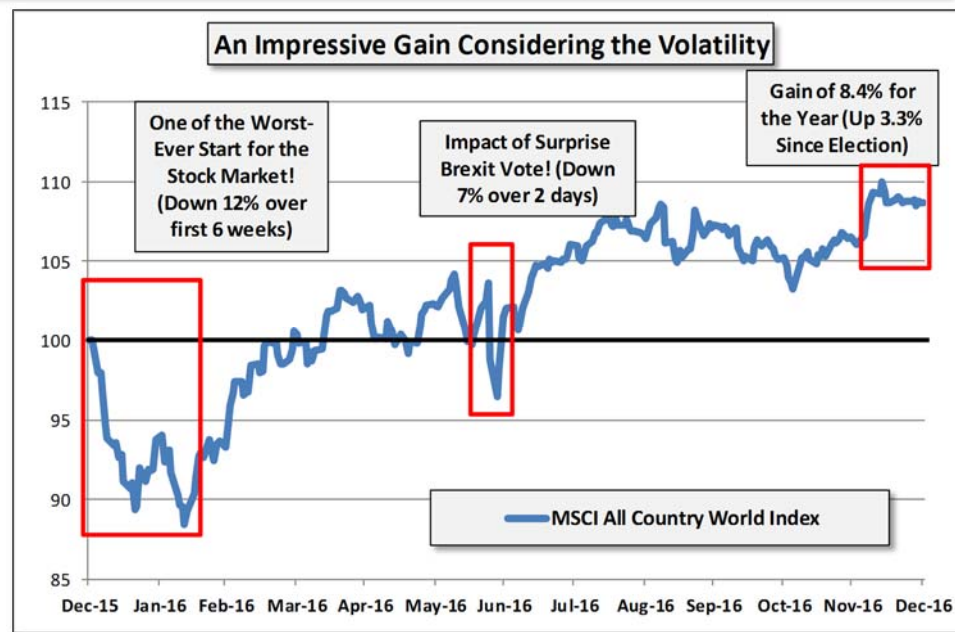
To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Navigating Our Way Through Uncharted Waters

Dear Client,

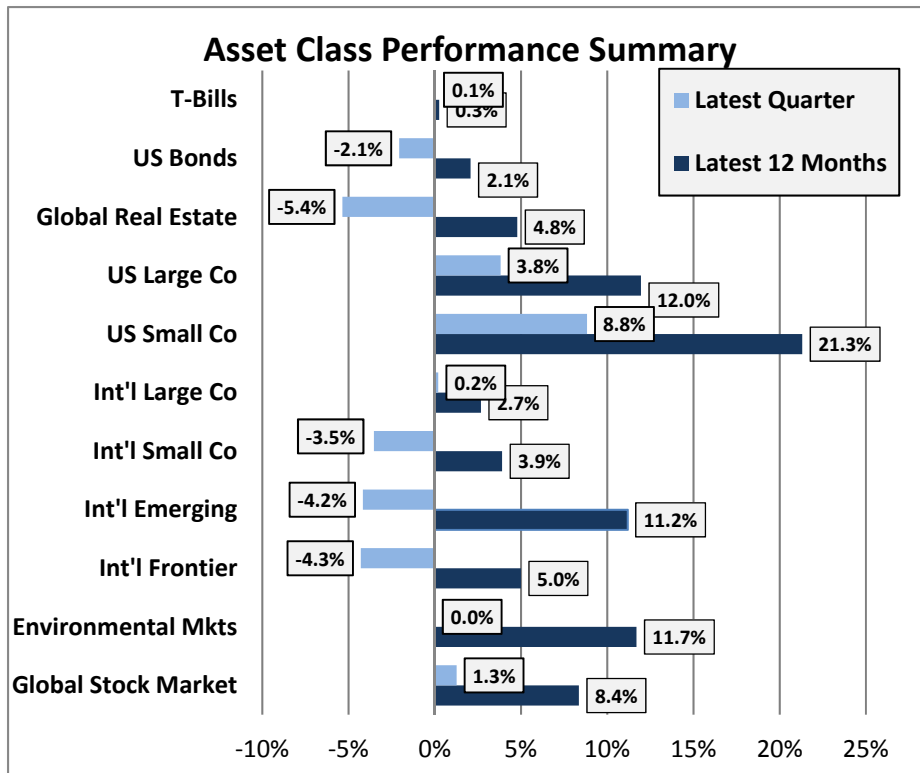
What a roller coaster year 2016 was for investors, politics, and our nerves! It all began with one of the worst starts for the stock market in history; by mid-February, stocks around the globe were down more than 12% as fears about an economic slowdown in China and plunging oil prices wreaked havoc on investor psychology. From that low point, sentiment improved as China's economy appeared to stabilize and oil prices surged by close to 40% from January's low of \$36 to more than \$50 per barrel by early May. In June, of course, investors were blindsided by the surprise Brexit vote which sent stocks downward by 7% over the two days following the referendum. Stocks recovered quickly, however, once it was realized negotiations to leave the Eurozone and the ultimate outcome would take years to unfold. The British Pound, however, fell by more than 10% against the US Dollar immediately following the vote and has since dropped another 8% (the Euro has followed a similar course). Ironically, weaker currencies in the UK and Eurozone have stimulated growth as their exports are now about 20% "cheaper" than they were before the Brexit vote (a great time to travel abroad or buy some French wine if you're so inclined). The stock market moved virtually sideways from July until early November, although there were signs global economic growth was accelerating. With the polls indicating a Clinton victory, the stock market surged by 2% the day before the election as investors appeared to be welcoming preservation of the "status quo". On election night, however, as it became clear the pollsters had gotten it all wrong (once again) and the results were pointing to a Trump victory, investors went into panic mode with pre-market stock futures plunging by more than 5%. The next day, however, sentiment turned bullish as investors began focusing on Trump's pro-growth economic platform of lower individual and corporate tax rates, increased infrastructure spending and fewer business regulations. Since the election and through the end of the year, the MSCI USA Stock Index gained 4.2% and the MSCI All Country World Index gained 3.3%. While the positive sentiment has carried into the new year, most pundits are expecting a volatile ride for the markets in 2017 given the



uncertainty created by a whirlwind of government policy changes as well as the unpredictability of the President-Elect himself. We'll explore the economic team Trump has assembled later in the report, but first, let's review the impressive performance numbers for the year that was.

Asset Class Performance Review

For the quarter, returns among the major asset classes were mixed with the biggest gain coming from US Small Co's (+8.8%) and the biggest loss coming from Global Real Estate (-5.4%). The MSCI All Country World Index gained 1.3%. On the positive side behind US Small Co's were US Large Co's (+3.8%) and T-Bills (+0.1%). Environmental Markets stocks were flat for the quarter. On the negative side were US Bonds (-2.1%), Int'l Small Co's (-3.5%), Emerging Markets (-4.2%), Frontier Markets (-4.3%) and Global Real Estate (-5.4%). All of the losing asset classes, to one degree or another, were negatively impacted by the anticipation and realization of higher interest rates. Bond prices are inversely affected by rising interest rates which is one reason we've been recommending short-term bond maturities (we expect rates to continue along a gradual path higher toward "normalization"). Real Estate securities also suffered from rising rates as investors moved away from income-oriented investments toward higher



risk asset classes, such as US Small Co's and value stocks. The losses in the international asset classes were mostly due to the strong US Dollar which gained close to 9% against a basket of foreign currencies during the quarter. For example, in their local currencies, Int'l Small Company stocks gained 5.5% for the quarter, but lost 3.5% when adjusted for the US exchange rate (a 9% differential). While a strengthening US Dollar has a negative impact on foreign stock prices in the short-term, one of the benefits of a strong dollar is that we can buy more shares of foreign stock mutual funds at the time of portfolio rebalancing. Some pundits feel the US Dollar is currently overvalued; however, with the US entering a period of rising interest rates and possibly faster growth compared to most other economies, the Dollar may still have legs to run on. (Note: the strong Dollar has created an earnings headwind for US Large Companies which depend upon selling their products overseas. This is one reason companies which are less dependent upon exports, such as US Small Co's, might outperform.)

For the year of 2016, all the major asset classes posted positive returns (for a change!). The top performers US Small Co's (+21.3%), US Large Co's (+12.0%), Environmental Markets (+11.7%) and Int'l Emerging Markets (+11.2%). Frontier Markets were next (+5.0%), followed by Global Real Estate

(+4.8%), Int'l Small Co's (+3.9%), Int'l Large Co's (+2.7%) and US Bonds (+2.1%). In last place were US T-Bills (+0.3%). The MSCI All Country World Index gained 8.4% for the year which was better than many predicted at the beginning of 2016.

Trump's Economic Team (of Billionaires)

While many are deeply concerned about the policies and the direction of the Trump administration, our focus is on the proposed economic policies which will have a direct impact on the investment markets and our financial well-being. Listed below are the primary economic advisors the President-Elect has either nominated or appointed:

Steven Mnuchin (Secretary of Treasury): A graduate of Yale University, Mnuchin worked at Goldman Sachs for 17 years, then worked for George Soros Fund Management before starting his own hedge fund. He is also a movie producer (e.g., *Sully*, *The Accountant* and *Batman v Superman*). Critics point to his company's aggressive foreclosure practices following the purchase of a failed bank during the financial crisis. On the positive side, according to a *New York Times Business Day* viewpoint article, "...unlike many people whom Mr. Trump has put on his team, he is neither an ideologue nor a populist. He is also well qualified for the job, bipartisan and relatively reserved." Mnuchin's overall objective is to achieve sustainable economic growth of 3-4% which he believes can be largely accomplished by reforming the tax system, including reductions in tax rates on corporations and individuals. Infrastructure spending is another priority which Mnuchin feels can be partially paid for by a one-time 10% tax on repatriating overseas corporate cash. Reducing government regulation is another of his top priorities.

Wilbur Ross (Secretary of Commerce): A graduate of Yale and Harvard (MBA), Ross spent his career turning around troubled and bankrupt businesses. He said his number one priority would be to evaluate existing trade agreements beginning with NAFTA. Ross has done business with China in the past, but after joining Trump's campaign he adopted a tougher position on China. He originally supported the twelve-country Trans Pacific Partnership (TPP), but has recently stated a preference for bi-lateral trade agreements, i.e., separate negotiations with individual countries rather than regional trade agreements.

National Economic Council: The Council is charged with coordinating domestic and international economic policy matters and providing counsel

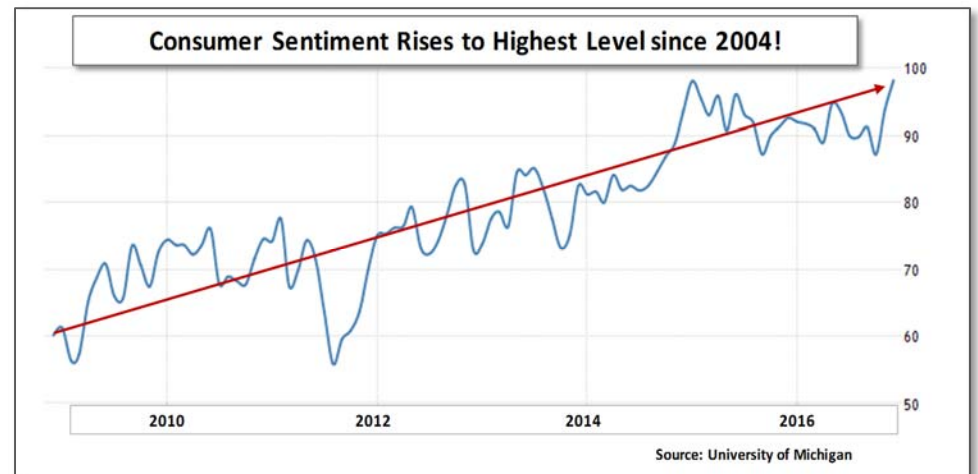
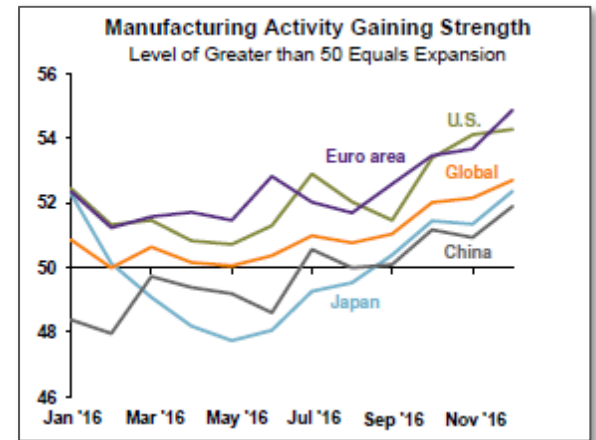
to the President. The Council has played a meaningful role in the past beginning with its formation in 1993 under President Clinton. The President-Elect appointed tough-minded Gary Cohn, President and COO of Goldman Sachs, as its Director. Other appointees read like a “Who’s Who List” of establishment business leaders, including Jamie Dimon of JP Morgan, Mary Barra, CEO of General Motors, Ginni Rometty, CEO of IBM, and Bob Iger, CEO of Walt Disney.

Peter Navarro (White House National Trade Council): A graduate of Tufts and Harvard (MPA), Navarro is a Professor of Economics at University of California, Irvine, and the author of several books on China’s unfair trade practices (*Death by China* and *Crouching Tiger*). He volunteered for the Peace Corps after college and ran unsuccessfully as a Democrat for Congress and mayor of San Diego. Navarro has become an “intellectual mentor” to Donald Trump and has helped shape much of the campaign messaging on trade and even foreign policy. His main thesis is that China has “stolen” millions of manufacturing jobs from the US over the years (with the cooperation of US corporations, of course) and by getting tough on China with the threat of tariffs, most of the manufacturing jobs will come back (hence, Trump’s appeal to the Rust Belt voters). Navarro’s critics argue that his intellectual arguments largely ignore the impact of automation and his solutions are simplistic and potentially problematic. For example, Navarro argues that once China realizes there is a strong leader in the White House who is willing to impose stiff tariffs, “...China ceases its unfair trade practices, America’s massive trade deficit with China comes peacefully and prosperously back into balance, and both the US and Chinese economies benefit from free trade.” Unfortunately, very few economists agree with this “best case scenario” which understates the damaging impact of a potential trade war with China, including reduced US exports to China (our third largest export market) and higher prices for US consumers.

To summarize, and putting aside philosophical differences, Steven Mnuchin and Wilbur Ross are highly successful business leaders who appear well qualified to assume their respective posts. However, with no government experience and with ambitious objectives, they will face a steep learning curve. We’re concerned, however, about Peter Navarro’s influence on the Trump economic team for reasons mentioned above. Perhaps a stabilizing factor will be the influence of the National Economic Council which is comprised of establishment business leaders who have inherent interests in maintaining economic growth and avoiding damaging trade wars.

Some Positive Economic News!

The President-Elect will be taking office at a time when the US and global economies by many measures are gaining strength. The most recent survey of global manufacturers indicated the strongest level of activity in more than a year. As seen in the chart at right, all major economies and regions are displaying higher levels of economic expansion (a reading of greater than 50 indicates expansion). Further, Consumer Sentiment has reached its highest level since 2004 (see chart below) and has come a long way from the depths of the financial crisis in 2009. Unemployment is at its lowest level in more than eight years (a rate of 4.7% compared to 10% in 2009); and wage growth is finally picking up steam with the average pay check growing faster than at any time since 2009. With higher wages, low energy costs and favorable borrowing rates, the financial health of the US consumer is relatively strong. For example, the year of 2016 was a record year for US autos with sales of 17.5 million units compared to just 11 million in 2009. Business leaders appear more confident, as well, with the US Small Business Confidence level rising to a 12-year high last month following the election (hopefully, this will lead to increased business activity, more hiring and capital investment). With the prospect of lower personal and corporate taxes, as well as infrastructure spending and a more business-friendly regulatory



environment, many economists expect growth to pick up even further in 2017 which would be positive for the jobs market (hopefully expanding into the Rust Belt), corporate earnings and the stock market.

Portfolio Considerations for 2017

We've made some adjustments to our recommended model portfolio which will be integrated into client portfolios in upcoming reviews. Below are some of the changes and/or reminders of our strategy:

- Adding inflation-protection to the bond section of the portfolio. With rising wage pressures, recovering commodity prices and higher interest rates, we feel the addition of Short-Term Inflation Protected Securities (i.e., TIP's) will offer some protection against higher future inflation.
- We are maintaining our short-duration in the bond portfolio to defend against rising interest rates now and be in a better position to take advantage of higher rates in the future.
- Given longer-term concerns about the negative fallout of Brexit, we are reducing our model portfolio's weight to stocks in Europe and the UK. The reduction will primarily flow to US Large Value stocks and, to a lesser extent, stocks in the Emerging and Frontier Markets where valuations appear the most attractive for the long-term.

Given the likelihood of a volatile 2017, but with a realistic expectation of higher stock prices, we believe it's more important than ever to have both a good defense and a good offense in our portfolio structures; portfolios which provide a safe-haven during downturns as well as the opportunity to participate in the long-term growth potential of globally diversified stocks. A good defense is created by allocating a sufficient portion of the portfolio to safe-haven assets, such as high quality short-term bonds. For clients who are retired, or near retirement, we normally recommend an allocation to bonds equivalent to 7 to 10-years' worth of future spending requirements (typically an allocation of 40% to 60% in bonds). Once the safe-haven reserve is established, we can then feel more confident investing in stocks which offer the potential of substantially higher returns beyond the 7 to 10-year period. By creating a good defense and offense, we can avoid market timing mistakes and allow sufficient time for our long-term investment objectives to be met.



Closing Thoughts

We've limited our assessment of the new administration to its economic proposals and the team selected to achieve its objectives. Of course, there are a host of other policy proposals which may also have a significant economic impact, including changes to environmental regulation, immigration policies and health care. In addition, geopolitical developments will likely create additional uncertainty and market volatility given a more assertive role in foreign affairs under the new administration. Perhaps the greatest wild card, however, is the President Elect's penchant for creating controversy by way of 140 character tweets.

In closing, we are clearly entering uncharted waters with a great deal of uncertainty on the horizon. On the one hand, there is the possibility of faster economic growth and greater prosperity. Pro-growth policies have the potential to create better jobs for those who were left behind during the recovery over the past eight years (that would certainly be a positive development!). On the other hand, there is the potential for negative surprises and shocks to the system. We will soon have a new administration with little government experience and many proposed policies which are controversial and largely untested. We believe the best course for investors is to maintain a globally balanced portfolio structure which includes adequate defense and sufficient offense to enable us to reach our financial destinations.

Let us end with a quote from R. Buckminster Fuller, author, designer and inventor, "And never forget, no matter how overwhelming life's challenges and problems seem to be, that one person can make a difference in the world. In fact, it is always because of one person that all the changes that matter in the world come about."